IR35 – The fringes of employment

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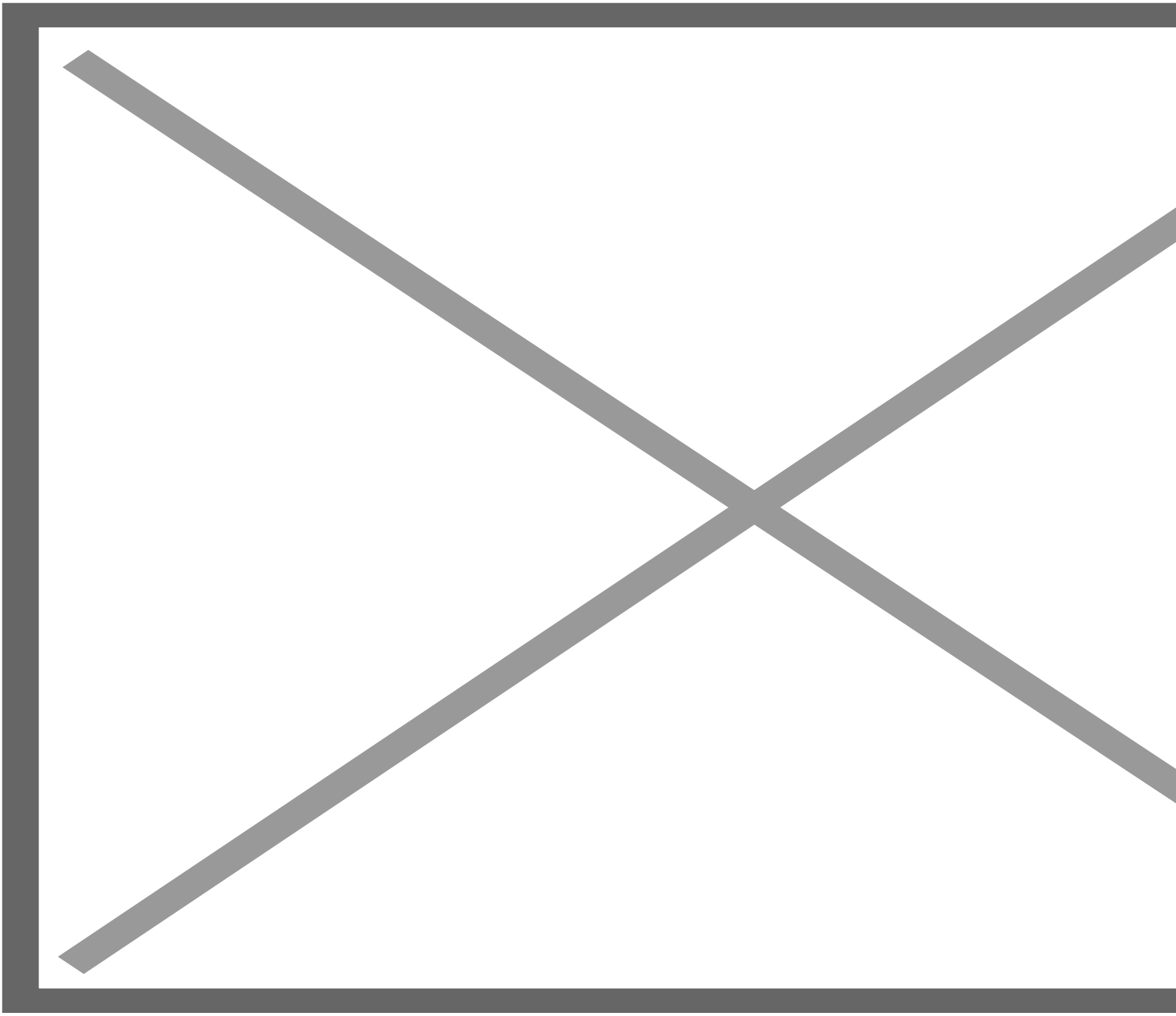

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Lesley Fidler provides us with an update on recent developments

In Issue 2 of Employment Taxes Voice (March 2017), I outlined some of the attempts to reduce employment taxes and national insurance contributions that have now been blocked by legislation. My focus was on those methods which relied on restructuring the conventional employer-employee relationship.

The counter-attack

HMRC's activity continues. 2018 has already seen the issue of Spotlight 32 relating to schemes to avoid PAYE and Class 1 NICs by Managed Service Companies. This was HMRC's response to its recent success in an appeal by a several managed service companies (*Christianuyi Ltd and others v HMRC [2018]* UKUT 10 (TCC)) against the decision that they were involved with a MSC Provider. The effect being that the intended savings in tax and NICs were lost. The decision in *Christa Ackroyd Media Ltd v HMRC [2018]* UKFTT 0069 (TC) has been published 'looking through' a well-known local television presenter's service company to decide that she should suffer essentially the same tax and NICs costs as a direct employee.

The blocking legislation has created a legislative maze that needs to be navigated by the compliant temporary worker and any engager of his services. But this does not mean that the need for contractors has disappeared. Far from it! Contractors remain an integral part of the UK business world in both the public and private sectors. (Note that in this article I shall use the term 'contractor' to refer to any individual who provides services of some kind in order to be paid but who does not choose, or is not offered the option of, permanent employment. The Construction Industry Scheme use of 'contractor' is not relevant here.)

Commercial reality

To those used to working as an employee, it may seem odd that any business would choose to engage a worker via an agency or chain of agencies, suffering the cost of the agencies' commission and the considerably higher daily rates that a contractor can command compared with an employee. There are many factors that drive engagers to use contractors instead of employees: the immediate cost is only part of the picture. It is often the perception of risk or the need to operate flexibly in uncertain times that drives the decision. The factors include:

- The requirement for short-term, specialist skills. For example, a business decides to revamp the online shopping area of its website to allow customers to build up and then use a loyalty bonus supported by customer emails and texts that will be General Data Protection Regulation) GDPR compliant. There is no suitable off-the-shelf product and so it needs a small team of specialist IT contractors to design, build, test and implement the software in a matter of weeks, although the exact time needed is not known at the outset. Once the software is up and running, day-to-day maintenance can be carried out by the business's own IT resource and the contractors will no longer be needed.
- The agency has already carried out pre-employment checks (for example possession of a current licence/permit/safety certificate/right to work in the UK as well as taken up references) and has the contractor on its books. Hence the lead time at the start of the engagement is far less that it would be for the employer to advertise, screen and select a candidate (assuming there are any applicants at all) and then carry out the necessary checks in order to take on an employee. It also avoids the business needing to devote time and effort to this activity.
- A good agency will be able to advise on the exact skills required since the work will often be outside the engager's core activities and, if necessary, subcontract to another agency specialising in a niche area.
- At the end of the engagement, with some limitations, contractors' services can be dispensed with at short notice. In the case of employees, justifying a redundancy programme and the risk of financial penalties and reputational damage if the employer is found to have not operated a fair process fairly requires the employer to expend resource, time and money.
- Similarly, poor performance by a contractor can be managed by asking the agency for a replacement, whereas to dismiss an employee on grounds of capability requires the employer to apply time and attention to the issue before this can be done and there is the attendant exposure to a complaint by the former employee.

- Contractors (again, with some safeguards) are not entitled to the full range of employee benefits such as employer pension contributions, paid holiday and training. They don't need a manager to devote attention to their objectives and development plans, appraisals, salary reviews and career development.

The chosen approach

As was expected when my previous article was published, on 6 April 2017 a deduction at source rule was introduced for public sector contractors. Broadly, this requires the user of the contractor's services to consider the nature of the engagement and, regardless of the legal structure used, for the payer to deduct income tax and account for NICs if (a) the worker is not an employee, but (b) the work-related (rather than remuneration-related) features of an employment are present. This rule does not make the worker an employee and it does not provide the contractor with any of the employment law protection that employment brings.

The definition of 'public sector' has been cast widely since it includes almost all bodies that are subject to Freedom of Information requests.

This new rule shifts responsibility for considering the nature of the engagement. Under the IR35 rules (which still apply outside the public sector) it is up to each individual contractor who works through a limited company to decide whether or not the relationship with the end user of the services is so akin to employment as to require the operation of PAYE and payment of Class 1 NICs or settlement of equivalent amounts with HMRC via a deemed employment payment. Now, for work delivered to a public sector engager, it is the responsibility of the public sector end-user of the services that determines whether income tax should be deducted at source. Because the end-user and each agency are all 'on the hook' for that income tax, it is not surprising that that determinations appear to have been made on a prudent basis.

The new rules can be found in *Chapter 10 of Part 2 Income Tax (Earnings and Pensions) Act 2003 (sections 61K – 61X)* with the national insurance provisions tucked away in *The Social Security Contributions (Miscellaneous Amendments No. 2) Regulations 2017 (SI 2017/373)*. They mean that when tax returns for 2017-18 are being prepared, there will be a new group of contractors who have worked through their own limited companies as employees (and directors and shareholders) of those companies but whose company receipts have been received net of an income tax deduction. Section 141A ITEPA ensures that the amount on which the deduction at source was calculated 'is not required to be brought into account in calculating the profits of the trade'. This also ensures that the contractor does not need to consider making an IR35 deemed employment payment. The income will nevertheless need to be shown on the self assessment return and it remains to be seen whether there will be specific provision made for this. Members of the IR35 Forum (a group of stakeholders including the CIOT who meet regularly with HM Revenue and Customs to improve the way in which IR35 is administrated) have asked HMRC for further guidance on the accounting treatment of such payments and HMRC has agreed to take this forward, but at the time of writing no response had yet been received.

The next step

With the Government estimate that non-compliance with IR35 will cost the Exchequer £1.2bn by 2022/23, it is clear that change is likely. Two concurrent approaches are expected. A short-term 'fix' that seems likely to involve the public sector rules being extended in some form to the private sector and a longer-term review of employment status generally.

On 7 February, HMRC published four consultations all of which are led by the Department for Business, Energy and Industrial Strategy (BEIS) and which stem from the Taylor Review of Modern Working Practices which was published in July 2017. None suggests that the deduction at source rule is to be rolled-out to all sectors

imminently. Hence there is still time for HMRC to address the challenges to the current version of its Check Employment Status for Tax (CEST) online tool which it provides to assist end-users in deciding whether income tax should be deducted. The challenges include:

- a body of case law cannot be encapsulated in an online decision-tree
- the ‘mutuality of obligation’ test is not addressed effectively
- public sector engagements have fewer variations in their structuring than those in other fields
- end users are ignoring the tool and making blanket decisions that deduction is required in order to protect themselves.

One of the four consultations is on employment status and is led by BEIS jointly with HM Treasury and HMRC. Consequently both employment law and tax issues are considered in the context of maintaining the existing categories of self-employed, worker and employee. (For tax and NICs purposes the first two categories are currently treated as one). It is also acknowledged that there are additional impacts on social benefits that will also need to be addressed. Mark Groom considers the issues in greater detail in his article 'Good Tax – the tax cost'.

There will no doubt be plenty written about the issues raised in this consultation and the conclusions that Government draws from the responses in due course. For now, it is clear that contractors, their engagers and anyone else involved in today’s flexible labour market need to keep a lookout for changes that will impact on their rights or incomes or both.