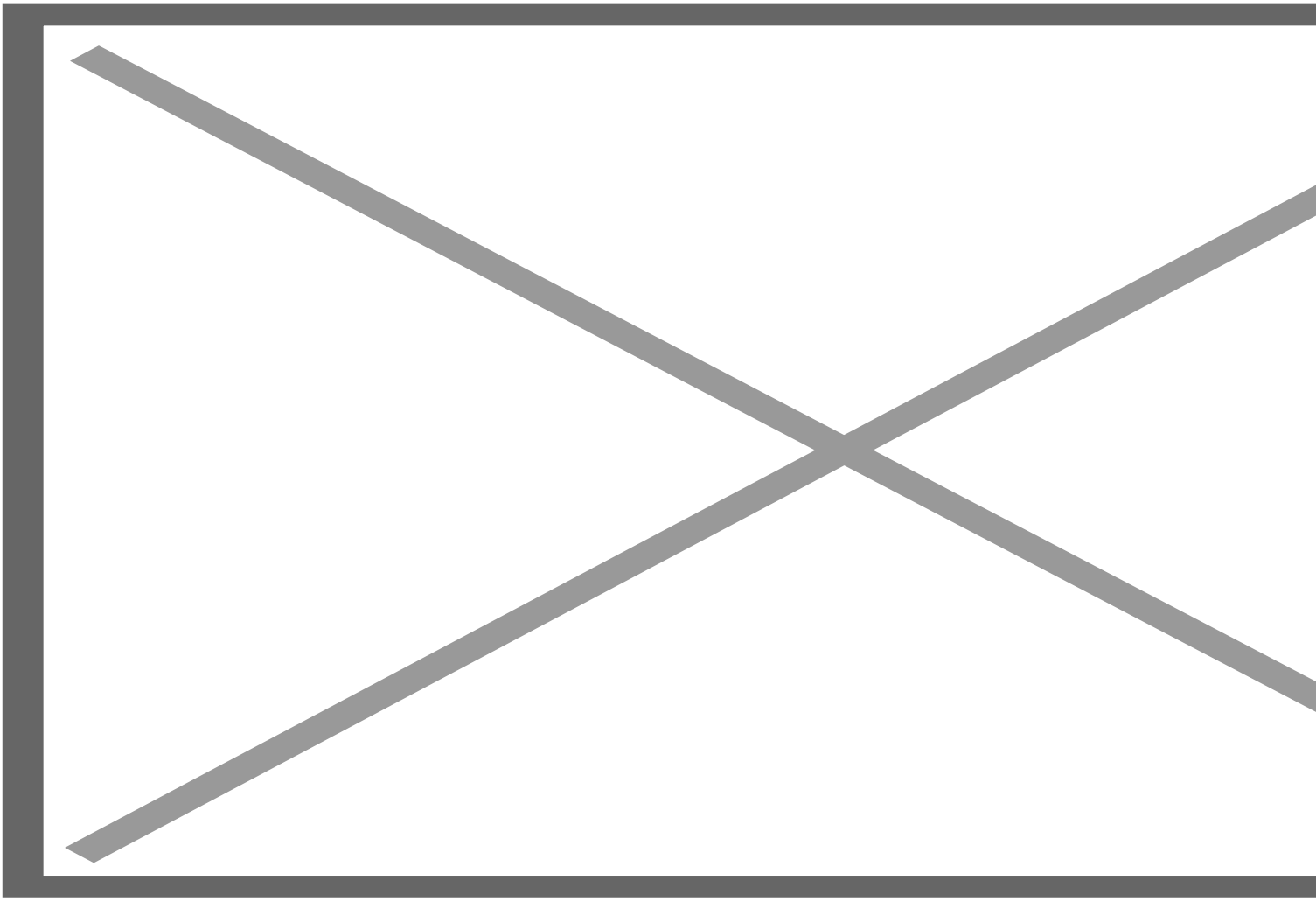
A dress rehearsal

Employment Tax



01 May 2020

Nicholas Yassukovich examines the impact of the last minute delay to private sector off-payrolling legislation

Key Points

What is the issue?

On 17 March, the government announced the deferral by a year of the private sector off-payrolling legislation that was due to come into force on 6 April, which was in just 19 days' time.

What does it mean for me?

This article focuses on the core policy issues at the heart of the rules, the tensions between those issues and how both large businesses and tax advisers have reacted.

What can I take away?

Whilst HMRC will consider the end result of off payrolling, when it happens, as a success, this will come from over compliance, and an imbalance in rights and obligations among the key stakeholders that the market will probably need to resolve.

Tuesday 17 March was a rare moment in tax. The words ‘Fiscus Interruptus’ came to mind when the government announced the deferral by a year of the private sector off-payrolling legislation that was due to come into force on 6 April, which was in just 19 days’ time. Those involved in planning for this legislation must now treat the last six months as a dress rehearsal and look forward to a new launch date in April 2021. Many, but not all, contractors will be pleased with another year of managing their own taxes.

There are still many technical issues outstanding with the legislation and accompanying guidance. However, this article focuses on the core policy issues at the heart of the rules, the tensions between those issues and how both large businesses and tax advisers have reacted. It does so by looking at a specific part of the contractor population – broad based office workers – who often work alongside employees at their clients’ offices in back office functions such as IT. It does not cover specialist roles, such as those in the medical and media sectors, or the special IR35 issues associated with consultancies and managed service providers.

Background

The off-payrolling legislation changes the application of the existing ‘IR35’ legislation, where an individual providing services to a client via a qualifying intermediary – typically, a personal service company (PSC) – must decide whether they should pay tax as an employee or as a self-employed individual. This is a decision which impacts their net income, and the off-payrolling rules make the client responsible in place of the worker for what was seen by many as an emotive decision. The rules also make the client or their agent responsible for operating the PAYE and National Insurance payments that might be due if the client concludes the individual is an employee for tax purposes.

To many, this would appear to be a practical change, not least because it aligns the responsibility for determining employment status with all other forms of contractual arrangement between clients and workers. However, the underlying challenges with IR35 around the differences in employment status for tax and for employment law makes this issue far from straightforward in practice.

Key factors in the market reaction

It became quickly apparent that this was not a tax issue. Rather, it was a workforce issue and an issue that presented businesses with competing risks around tax, finance and operations.

These risks stem from three key challenges:

1. The extreme subjectivity of the case law on employment status places every contractor somewhere on a spectrum between self-employment and employment (the spectrum devised by EY involves a 200 point scale). Tension was always going to arise between the tax risk profile of large organisations and that of contractors, where two competing positions could both be acceptable within their respective attitudes to risk.

2. The contractor ecosystem involves frequently complex supply chains, often with a number of agencies or intermediaries between the client and the worker. These chains create a disconnect between the worker and the client, with the worker sometimes unable to discuss contractual terms with the client and the client potentially having no relationship with the organisation paying the PSC.
   In response to these two risks, HMRC developed complex law to manage the issue. Most notably this involved the status determination statement (SDS), which the client had to ensure was passed down the chain to the fee payer, and the SDS appeals obligations.

3. The 30 year growth of the contractor market, and its approach to tax risk, allowed a broad compact among workers, their clients and society to develop. This is a compact with which most people were comfortable, and which is best defined by the formula:

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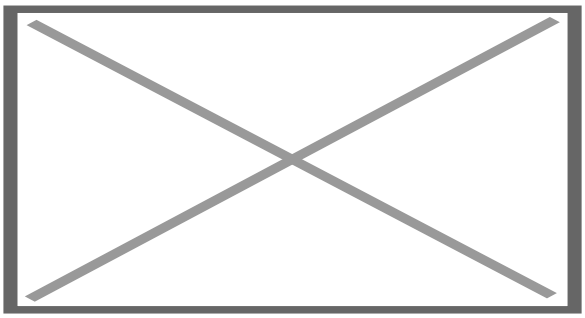

The off-payrolling rules broke this compact by ignoring a profound difference in appetite for tax risk between the parties, effectively allowing the client to impose their approach to risk on the worker without granting the worker any additional rights in return.

These three challenges led directly to competing risks that have driven organisations' approaches to off-payrolling, particularly in the banking sector where I personally specialise.

1. Few employers have taken any form of employment tax risk since the demise of tax efficient remuneration schemes in the early 2000s. Appetite for risk was very low, and many organisations were reluctant to pay any contractor on a gross basis under the new rules. Many banks were also cautious about the operational tax risk that the SDS system presented.

2. Any decision to avoid employment tax risk generated immediate additional costs of between 13% and 15% as off-payrolling moves the NI liability to the fee payer from the PSC.

3. Decisions to pass the additional cost on to contractors via amended day rates increased the reduction in income the contractor faced if they had continued to assess themselves as outside IR35. 'Inside IR35' decisions also generated fear that their tax affairs prior to April 2020 would come under HMRC scrutiny.

Clients were initially concerned about a repeat of the contractor turnover that this tension between the risks created in the public sector in 2017, an anxiety later tempered by a realisation that during 2017 contractors had somewhere to go to maintain their tax position, namely the private sector.

How did organisations react to these competing risks?

Organisations across different markets reacted very differently in terms of attitude to tax risk, which was driven by factors such as availability of talent, size and sector. It took some firms significant time to put a plan in place due to issues around responsibility within the organisation; whether it be the tax, HR or procurement functions. The larger organisations found it easier to form multi-function working parties to assess the impact of the new rules and provide information to key executives impacted by the changes and assess scenarios for resolution. In many cases, responsibility was then vested in project teams based in procurement/HR, with tax often becoming just a provider of technical expertise in key technical decisions.

Many firms quickly decided to move some long-term contractors into employment positions. However, delays in broader decision making occurred for a number of reasons, including a lack of information on how many contractors they had, and which used PSCs. A key issue was also a desire not to be an outlier in terms of policy decisions. This was particularly acute around the decision on whether to pass the cost of employer NI down to the contractor via reduction of day rate, and anecdotally, many organisations preferred the option of reducing day rates early on but were unsure when to confirm this position.

In the banking sector, the position taken was probably the most conservative, given its heightened approach to compliance. Tax risk trumped all, overriding any concerns about the operational risks. This approach was driven in part by a distortion in the supply and demand of contractors. Some of the larger banks had become overly reliant on contractor labour as way of managing their employee headcount and they took the proposed change as an opportunity to rethink this reliance on contractors with new or accelerated reductions in contractor numbers and shifts of work to consultancies. This allowed them to impose contractual arrangements on their remaining contractors that bypassed the off-payrolling rules entirely and ensured everyone was subject to PAYE as either an agency worker or an umbrella company employee. Moreover, they often did so without much regard to the question of whether an individual contractor was or was not inside IR35.

Other sectors and geographies adopted less conservative positions. Whilst still believing that broad-based back office contractors were more likely than not to be within IR35, some organisations accepted a greater exposure to tax risk and additional costs depending on the scarcity of the talent pool from which they were seeking to recruit contractors. Techniques used to manage the operational risks of disaffected contractor populations included:

1. case by case assessments of contractor status (an expensive and time-consuming process);

2. the use of third-party software in conjunction with CEST to demonstrate a willingness to take independent advice and in recognition of a number of CEST's limitations; and

3. countenancing other forms of contractual arrangement, such as Statements of Work or even LLPs.

4. Expanded use of agencies/MSPs to manage broader risks better.

What did this mean for advisors?

The unique nature of this tax issue, and how best to advise on it, illustrated again the changing nature of the tax profession and the skills required. We are increasingly focused away from delivering technical advice or

compliance and more on developing and maintaining tax risk control frameworks that impact on third parties such as the customers of our clients. Off-payrolling was a good example of this and a number of lessons worth learning in this regard include the following:

1. Consult widely and go to market with multidisciplinary teams. Identify the end game you want to achieve in terms of the contractual arrangements that would be supported and plan backwards. ‘Plan Right to Left’ was a phrase I learnt from my corporate tax colleagues.

2. Develop a point of view but flex it as thinking evolves. You need to do more than just articulate the issue and help work out a solution. You need to demonstrate a holistic understanding of how the issue manifests and what the solution is, then introduce the plan of action at the most opportune time.

3. Embrace simplicity: when an issue can be resolved by simplification, don’t try to over complicate matters. The tax profession thrives on complexity, but advisers should not be afraid to embrace simplicity when it is needed.

4. Understand and use the basics of programme management: problem statements, design principles and agile working. This may seem like management consultant speak to tax technicians, but it can help speed up the process of finding a solution.

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Where next?

Since 17 March, the market has been deciding how to change their IR35 compliance rules in light of the deferral. For those who had chosen to ban PSCs, there is an interesting dilemma as to whether to allow them again for a further year. This requires balancing a number of competing issues such as project cost, fairness and compliance risk, including the impact of the Corporate Criminal Offence regime. By now, many organisations will be looking forward to re-running the events of the past few months at the beginning of next year. Organisations may or may not decide to choose a different approach for April 2021, but we can expect that many more contractors will move onto PAYE arrangements at that time and the tension associated with the broken contractor compact above will increase.

However, to date, this particular tension has not been a factor in the wider and separate debates about employment rights in the gig economy and the differing NI rates between the employed and self-employed. It is possible that resolution of these two issues may now finally progress, given the extraordinary policy changes that COVID-19 has triggered. We can hope that we will see a better way to categorise workers, a better balance between rights and obligations for each category and, ideally, a better way to manage the difference between employment for tax purposes and legal employment.

However, if they are not resolved by public policy, then organisations that use contractors and oblige them to pay employee levels of taxation may have to address the tension in the contractor compact themselves.