Off-payroll/IR35 rules

Tax voice | Employment Tax

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Nicola Pitcher looks at developments in the off-payroll working rules over the last year following the deferral of their implementation in the private sector until 6 April 2021

Last year's edition of Employment Taxes Voice covered the pending changes to the IR35 rules in detail. At that time, we had just heard that due to the pandemic, the implementation of the new regime would be deferred to April 2021. The purpose of this article is not to re-examine the legislation in detail, but to look at developments over the last year.

The deferral announced last March re-ignited calls for the changes to be scrapped and even now, with 6 April 2021 a matter of weeks away there are still rumblings of discontent and speculation that changes could be announced in Budget 2021. However, any further deferral or cancellation seems highly unlikely. The legislation is in place and although businesses have been grappling with the consequences of the pandemic and Brexit, they have benefitted from an extra year to prepare for the new IR35 regime. Further, at a time when the Chancellor is considering tax rises to off-set pandemic spending, it seems inconceivable that the government would further delay a measure which is designed to enforce compliance with anti-avoidance legislation and to increase tax and NIC revenues.

A brief overview of the new rules

The legislation is included in Finance Act 2020 at Schedule 1. It extends the regime (in Chapter 10 ITEPA 2003) which has applied to public sector organisations engaging workers via intermediaries since April 2017, to all engagers other than those defined as "small" under the definition set out in Section 382 of the Companies Act 2006 (new section 60A ITEPA 2003), or who do not have a UK connection in a tax year.

Under the new rules, end users within Chapter 10 will determine whether IR35 applies to an engagement with an off-payroll worker engaged via an intermediary. Often the intermediary will be a personal service company ("PSC") but could be a partnership or another individual. There may also be other intermediaries in the supply chain, such as an agency, but the end user will still be responsible for assessing whether the engagement is "inside" or "outside" IR35. If an engagement is inside IR35, the "fee-payer" will be responsible for deducting and accounting for any PAYE and NIC due. The fee-payer will generally be the entity paying the PSC, but this can shift where there is non-compliance with the rules within the supply chain. The end-engager is required to notify the individual worker and the next entity down the supply chain (e.g., an agency) of the IR35 status of each engagement and the reasons for it. The end-engager is also required to put in place a "client-led disagreement process" to deal with disputes arising from the status determinations that it makes.

Where a private sector end user qualifies as small, the rules in Chapter 8 ITEPA 2003 apply such that responsibility for assessing the IR35 status of an engagement remains with the worker's intermediary.

For most of last summer and into the autumn the focus of many businesses was quite clearly on managing their response to the pandemic. However, over more recent months we have seen an increasing focus on preparing for the new IR35 regime and it would be comforting to think that most businesses will be reasonably well prepared. So, what has happened over the last year?

Section 61O

The Finance Act 2020 received Royal Assent on 22 July 2020. One clause that has drawn particular attention is the amendment to section 61O of Chapter 10, which sets out (from 6 April 2021) the conditions of liability to be met when the intermediary is a company. Prior to this amendment Section 61O(1)(b)(i) of Chapter 10 states that an intermediary that is a company meets the conditions for Chapter 10 if the worker has a "material interest" in the company. Material interest is defined in section 51(4) ITEPA 2003, which is broadly taken to be more than 5% of ordinary share capital or a right to receive more than 5% of the distributions from the company.

HMRC were concerned about potential avoidance arrangements whereby an individual holds a less than material interest in the intermediary, but still receives a payment or benefit for the services provided which is not taxed as employment income. The amendment to section 61O was designed to counter this potential avoidance arrangement. However, HMRC have acknowledged that the clause, as currently drafted, does not quite work as intended as it broadens the conditions of an intermediary to include all workers providing their services to a client through a company, even where the payment has already been taxed as employment income with PAYE and NIC operated. For example, it could extend to payments via an umbrella company, agency or even a supplier seconding an employee.

HMRC are proposing an amendment to this section in Finance Bill 2021 to correct the anomaly such that it will not apply where a payment for services by a worker who holds less than a material interest in the intermediary has been treated wholly as employment income. HMRC have also proposed introducing a Targeted Anti-Avoidance Rule into section 61O to deter potential abuse. We have yet to see the detailed drafting and guidance.

Avoidance schemes

As the commentary on section 61O above highlights, HMRC are very aware that unscrupulous intermediaries operating in the temporary labour market are developing new or extending existing avoidance schemes with a view to circumventing the new regime. This is nothing new – every tightening of legislation by HMRC in the temporary recruitment sector has tended to fuel inventive solutions, particularly at the lower paid end of the labour market where the pressure on margins is high.

As end users risk assess the workers that they engage via PSCs, it is inevitable that they will conclude that some roles or groups of workers are best suited to an employed arrangement. This could be a permanent role, a fixed term contract or employment via an intermediary such as an umbrella. There will be an obvious trade-off between the additional costs of employment versus an adjustment to workers' pay which can provide leverage to intermediaries marketing solutions which appear to help bridge that gap.

HMRC have been guiding end users towards effective labour supply due diligence for some years and their guidance was updated in December 2020 (Advice on applying supply chain due diligence principles to assure your labour supply chains - GOV.UK (www.gov.uk)). One avoidance model that has become more prevalent in the marketplace in the lead up to the new IR35 regime is the "mini-umbrella" model. This model involves engaging workers via a series of small companies and is designed to inappropriately claim the Employment Allowance and to profit from the VAT Flat Rate Scheme. HMRC are very aware of mini-umbrellas and in November 2020 they wrote to end users, agencies and contractors warning them not to use the model. They also say in their communication that their Fraud Investigation Service is using civil and criminal powers to challenge those involved in mini umbrella schemes and that they have made a number of arrests.

Client led status disagreement process

One criticism of the public sector IR35 rules that were introduced in April 2017 was that there was no right of appeal against a Status Determination Statement ("SDS") issued by an end client. To remedy this, from 6 April 2021 end users are required to have in place a "client led status disagreement process." Last year's edition of

Employment Taxes Voice covered this process in detail. Broadly, the end client must have a status disagreement process in place to deal with disputes of SDSs by workers and deemed employers (in most cases this will be the fee-payer). The worker or their deemed employer can make representations to the client that an SDS is incorrect at any time during the engagement and prior to the final payment that is made in relation to the engagement. The end client is not obliged to respond to representations made outside of this timeframe.

Within 45 days of receiving the representations, the client must provide to the worker or deemed employer either:

- a statement that the representations have been considered, it has been concluded that the status determination statement is correct and the reasons for the conclusions reached; or
- a new status determination statement with a different determination and the dates from which the new status determination applies and the previous determination is withdrawn.

Failure to meet these obligations will result in the client being deemed to be the fee-payer.

Whilst the legislation requires the process to be in place and no doubt HMRC will ask end client to provide details when undertaking a review or "interaction", how frequently will the process be invoked? In practice, if the SDS concludes that the engagement is "outside" IR35 it is unlikely that the worker will want that decision overturned. The fee-payer may potentially be nervous as it is their responsibility to operate PAYE and NIC if required, but in practice they are more likely to protect themselves with contractual indemnities and insurance and indeed many fee-payers market their "services" on the basis that they shoulder the PAYE and NIC risk.

The disagreement process is more likely to be invoked where the SDS concludes that the engagement is "inside" IR35.   However, in practice we are seeing a tendency for end clients to adopt policies such that where a temporary contract role is likely to be akin to employment, it will not engage the contractor via a PSC – instead, it will insist on engaging the contractor on an employed basis such that the requirement for an SDS simply does not arise. Indeed, some organisations, particularly in the financial sector have taken an extremely conservative approach and will not engage with contractors via PSCs at all.

HMRC compliance strategy

In February 2021, HMRC published their Off payroll compliance strategy (HMRC issue briefing: supporting organisations to comply with changes to the off-payroll working rules (IR35) - GOV.UK (www.gov.uk)).

This confirms the approach to penalties announced in February 2020 – i.e. they will adopt a 'light touch' approach for the first 12 months of the legislation coming into effect unless there is evidence of deliberate non-compliance.

HMRC say that they will support businesses who are genuinely trying to comply and will provide advice and support to help them get things right and correct mistakes where these arise. They will use a specialist team who will use a risk-based approach to compliance activity – targeting those areas where they most expect organisations not to apply the rules correctly.

In certain circumstances HMRC may also seek to publish details of deliberate defaulters – an approach that has been used in relation to National Minimum Wage compliance.

Calculating liabilities in the event of compliance failures

Another area of concern that has prompted discussions with HMRC is how they propose to address the calculation of PAYE and NIC liabilities where tax has already been paid on income in the hands of the worker and/or their PSC. In a direct employment status compliance settlement (i.e., where the individual has a direct engagement with their client such that IR35 is not in point), Regulation 72F of the Income Tax (Pay As You Earn) Regulations (SI 2003/2682) allows HMRC to take account of the income tax self-assessed by the individual and to reduce the calculated settlement accordingly. There are similar provisions for NIC.

The circumstances are quite different where the worker is engaged via a PSC and where the PAYE and NIC liabilities are the responsibility of the deemed employer. The PSC may have paid corporation tax on the income and the individual may have paid income tax on income drawn from the PSC in the form of salary, or more often dividends. Regulation 72F does not provide for any set-off in these circumstances. Neither are there any specific provisions in Chapter 10 that allow for a set-off of taxes paid by the individual or the PSC against the PAYE and NIC payable by the deemed employer. Whilst professionals have called for legislative changes to facilitate such a set-off, HMRC are of the view that any adjustments to ensure that tax is not paid twice on the same income should be made via the tax returns of the PSC and the individual worker. HMRC's rationale is that they would have insufficient information on the income of the PSC and the worker and that the process of seeking this information would be administratively burdensome for all concerned. However, HMRC seem to be able to operate Regulation 72F pragmatically to obtain the information needed. Further, where a settlement in relation to direct employment involves a large number of employees, Regulation 72E allows HMRC to sample a selection of employees and extrapolate the amount of tax paid via their self-assessments to calculate the total off-set. There should therefore be scope for HMRC to be a bit more flexible in relation to Chapter 10 and tax professionals are pressing for a re-think of approach.

As with Brexit no doubt there will be a few teething problems with the new regime after 5 April 2021. As with Brexit, businesses have had some time to prepare! Of course, there will be a settling in period, but let us hope that this is not too disruptive.