The unprecedented confusions in the IR35 rules

Employment Tax | Large Corporate

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The IR35 rules have always been complex but the back and forth changes in recent months are unprecedented. We take a look at where we are now – and a brief explanation of how we got here.

Key Points

What is the issue?

Then Chancellor Kwasi Kwarteng's announcement in the 'mini budget' on 23 September that the off-payroll working reforms were to be scrapped from April 2023 took most of us by surprise. They were followed almost immediately by Jeremy Hunt's reversal to the April 2021 position.

What does it mean for me?

This article attempts to clarify the position as it stands at the time of writing, as well as explaining how we got here and where we could yet go regarding this complex and controversial legislation.

What can I take away?

Taking the time to accurately assess engagements and consider an appropriate approach to the rules holistically may end up more than paying for itself.

The rules relating to off-payroll working and IR35 have long been a contentious issue for self-employed (or not) contractors and, more recently, organisations utilising their services. This is truer than ever in recent months, following the farce of the ‘mini budget’ and some misleading information in the public domain.

In this article, I attempt to clarify the position as it stands at the time of writing – as well as explaining the hokey cokey legislative dance behind how we got here and where we could yet go regarding this complex and controversial legislation.

2000: Intermediaries legislation

The intermediaries legislation was first mentioned in a 1999 Inland Revenue press release named ‘IR35’ – which was how it was known colloquially when it became law in 2000. It was introduced to combat the growing issue of contractors (particularly in IT) working through their own limited company in order to prevent an employment relationship with an organisation using their services, even if they were ostensibly working in an identical manner to their employed peers.

In addition to the genuine flexibility and apparently reduced employment rights, there was a motivation for employers to be complicit in such arrangements due to the NIC savings. A personal service company (PSC) avoided PAYE withholding and Class 1 NIC for both the contractor and the engager. The contractor could structure their affairs in a more tax and NIC efficient manner by taking a small salary (up to the NIC primary threshold) and dividends, as well as potentially claiming relief on commuting costs and other expenses to which an employee would not be entitled (this was stopped more recently). Some would even pay a small salary to an otherwise non-earning spouse in order to utilise their tax-free personal allowance.

The original IR35 legislation required contractors operating through a PSC to self-assess their deemed employment status by reference to a hypothetical contract existing between the contractor and the engaging entity. They were required to ignore the existence of the PSC and look through the contractual arrangements to determine the substance of the arrangement and whether the relationship between the contractor and engager was akin to employment.

As the tests for what constitutes an employment relationship are based upon a myriad of case law, this was a highly complex and subjective test, despite HMRC’s supporting guidance and later its online tool to check status (which had severe limitations, including the ease by which it could be manipulated).

The more artificial arrangements would no longer be effective under the new legislation. Those contractors genuinely operating as a business for commercial reasons and the flexibility of working as a self-employed consultant were technically unaffected. However, honest and compliant contractors were being tarred by the same brush so unsurprisingly IR35 proved unpopular with almost all contractors. Ignorance of the new rules or more deliberate non-compliance led to numerous challenges from HMRC, which took up a lot of resource for limited success.

During this era, the standard advice to organisations engaging with contractors was that there was no tax risk to them as long as there was a genuine B2B relationship with a (UK) PSC. However, organisations had to be wary of additional future legislation which could potentially interact with some arrangements, including the 2007 managed service companies (MSC) legislation and the 2014 ‘offshore intermediaries’ legislation, which strengthened the host-employer rules.

Later, the much maligned 2019 loan charge was a particular challenge for contractors using some umbrella company arrangements. A detailed discussion of these other legislative regimes and their interaction with IR35 is

beyond the scope of this article and would not make light reading.

2017: Public sector responsibilities

April 2017 saw the introduction of new legislation building upon the existing provisions in Income Tax (Earnings and Pensions) Act (ITEPA) 2003 Part 2 Chapter 8. The new ITEPA 2003 Chapter 10 legislation was known as the off-payroll working rules but the term ‘IR35’ continued to be used. It only applied to the public sector, primarily changed who was responsible for assessing the deemed employment relationship. Where the engager was a public sector body, that ‘end client’ was obliged to assess status and inform the contractor of the result. If the engagement was deemed to be an employment (‘inside IR35’) then the end client (or the entity paying the fee to the contractor and their PSC) was required to operate PAYE on related payments to the contractor or their PSC.

Failing to assess IR35 status accurately, or to operate PAYE correctly where necessary, would result in the end client being responsible for any under-withheld PAYE and NIC. However, instead of undertaking balanced and accurate assessments, public sector bodies took a more prudent approach to compliance. Numerous contractors were deemed to be inside IR35 when they should perhaps have been outside if accurately assessed. Worse, many organisations deemed all of their contractors as inside IR35, regardless of the facts, or simply put in place a ban on working with PSCs outside of PAYE.

This wasn’t helped by the revamped HMRC tool now known as Check Employment Status for Tax (CEST), which appeared to give over-prudent results, did not give an answer on borderline cases when certainty was most needed, and failed to take into account the concept of (the potential lack of) mutuality of obligation (MoO). Additionally, results from the short questionnaire were easily modified by simply changing the answers. Contractors completing CEST would often obtain a different result than an end client. The statutory right of appeal for contractors was perhaps another reason that many organisations completely blocked PSC engagements.

The expanded legislation was widely seen by many as a stepping stone to roll out of the reforms to the private sector.

2020: Plans to expand to the private sector

It was announced that in April 2020 the off-payroll working reforms would be expanded to the private sector. To combat concerns about the compliance burden, the rules would only apply to medium and larger businesses. This led to more complexity regarding defining a small business and the transition from small to ‘not small’ and vice versa.

The updated legislation also introduced some changes to Chapter 10 which would impact the public sector as well. The legislative right for a contractor to appeal was tweaked and some ambiguous transfer of liability provisions were introduced, as well as the need to exercise ‘reasonable care’ on assessment.

Similar results emerged in the private sector as had previously been seen in the public sector: rationalisation of contractors and blanket bans. There was also a growth in the use of umbrella company arrangements, often opaque or even unknown to the end client. HMRC issued increasing warnings about non-compliant arrangements and guidance for end clients to undertake appropriate supply chain due diligence to avoid liabilities for non-compliance being passed up the supply chain.

Many businesses appeared to struggle with the issue of even identifying what contractors they used. The common business practice was highlighted of limiting headcount by using a contractor as a pseudo-permanent member of a department, thereby raising the question of whether they should be treated as an employee. Other ambiguous scenarios included the use of outsourced services or 'Statement of Work' contractors. At what point is an outsourced service actually a supply of labour and personal service needing to be assessed for IR35? Is it when the same individuals spend significant time delivering the service, or when they are named, perhaps vetted or requested by name by the end client?

Another key challenge was understanding how far to go regarding supply chain due diligence. Was it sufficient to take an agency's word that there were no PSCs further down the chain or that PAYE was being operated? Businesses were baffled due to the uncertainties in the rules and the insufficient published guidance, although this has been expanded since.

When the Covid-19 pandemic arrived, the expansion of the rules to the private sector was delayed by one year. This was universally welcomed and gave businesses more time to prepare, albeit it is doubtful whether many used the time to do so with other priorities taking their focus. The legislation took effect from April 2021. HMRC did offer a 'light touch' approach to compliance during the first year.

September 2022: The Liz Truss curveball

More recent events have caught most of us by surprise. Even with Liz Truss saying that she wanted to review IR35, I don't think many were expecting the curveball announced by the then Chancellor Kwasi Kwarteng, who announced in the 'mini budget' on 23 September that the off?payroll working reforms were to be scrapped from April 2023.

Most businesses appeared to welcome the news, although some were likely irritated by the now irrelevance of all the hard work they had put in to be compliant. HMRC was perhaps somewhat confused and silent on the issue. Many questioned the opportunity for contractors to evade tax, as well as the impact on the Criminal Finances Act 2017 and the corporate criminal offence of failing to prevent the facilitation of tax evasion.

Many contractors took to social media to herald the death of IR35. This was a potentially misleading statement, however, as it was only the 2017 and 2021 changes – i.e. Chapter 10 – that were to be repealed. As we understood at the time, the original Chapter 8 rules would still apply from April 2023, meaning that contractors would again have the obligation to assess their own IR35 status. This would mean that the risk moved back to contractors and threw up a number of questions, including how HMRC would regard an arrangement suddenly flipped from being seen as inside IR35 to outside IR35. Regardless, the conjecture was short lived and we didn't have long to consider these questions.

October 2022: The next swift U-Turn

By 17 October, Jeremy Hunt was Chancellor and announced the reversal of much of the mini budget announcements of his predecessor. This included the repeal of the IR35 changes and hence we were back to the April 2021 position. At the time of writing, the expanded IR35 rules continue to place the onus on end client engagers in the public sector and also in medium and large private sector businesses to assess the IR35 status of the PSC contractors in their supply chain.

So what does this mean?

It’s possible that there could be another reversal, but the political damage of constant flip-flopping on policy, combined with the fact that such a move would be expected to increase the budget deficit even further, probably makes that unlikely in the immediate future. For now, the April 2021 legislation continues to apply. The main thing for organisations and contractors is to keep calm and carry on.

However, there could be some tweaks around the edges of the legislation and supporting guidance. Business might welcome more certainty regarding the widely drafted transfer of liability provisions, how this applies to outsourced or contracted-out services, and more complex supply chains. We continue to have a regime which requires end users to assess status, often without full visibility of all of the facts applying to a contractor and their PSC. They may be forced to make assumptions or rely on potentially misrepresented facts by the contractor or agency. And CEST continues to have serious flaws and provide false assurance.

One argument often made about IR35 is that it is only necessary because the UK tax regime differentiates between the employed and self-employed. Another challenge is the sheer complexity and ambiguity of status case law. A statutory employment test or an alignment of the tax treatment for employed and self-employed has been rules out but is perhaps something that a future government might revisit. In my view, this is an area which needs to be properly reviewed and simplified.

Regarding HMRC’s approach going forwards, we will have to wait and see how it enforces IR35 compliance but any organisation taking a laissez-faire approach would be well advised to rethink and ensure that they take the rules seriously.

Be aware that some agencies don’t fully understand the rules or are deliberately vague about the use of PSCs further down the supply chain. For anyone entering into agency and Statement of Work contracts, the importance of supply chain due diligence cannot be underestimated. Contracts are often unfortunately drafted, which can lead to the engagement being directly between the individual and the engager, instead of a B2B contract with the PSC or agency. I would also urge any organisation with a policy that prohibits the use of PSCs to consider whether this is the right approach. This could actually *increase* the risk of non-compliance by driving PSC use underground. A ban on PSCs could also lead to the mistaken belief that appropriate governance and controls in this area are not required.

Any public or private sector organisation must consider how to assess arrangements in scope of the off-payroll working legislation, whether knowingly entered into or due to indirect PSCs in the supply chain. Using HMRC’s CEST is likely better than doing nothing and constitutes a valid Status Determination Statement (SDS) but you should also consider its limitations. There are also commercial status assessment tools in the market which could be a good option but need to be well researched and understood.

Specialist external professional advice can be an option, both in terms of assessing individual arrangements and regarding the suitability of existing policies, processes and governance. Whatever the chosen route, taking the time to accurately assess engagements and consider an appropriate approach to the rules holistically may end up more than paying for itself. Regardless of what the future may hold, one thing is certain: IR35 remains a great example of the complexity and ambiguity in the UK tax system, the challenges for businesses in complying, and the challenges for HMRC in enforcing compliance.