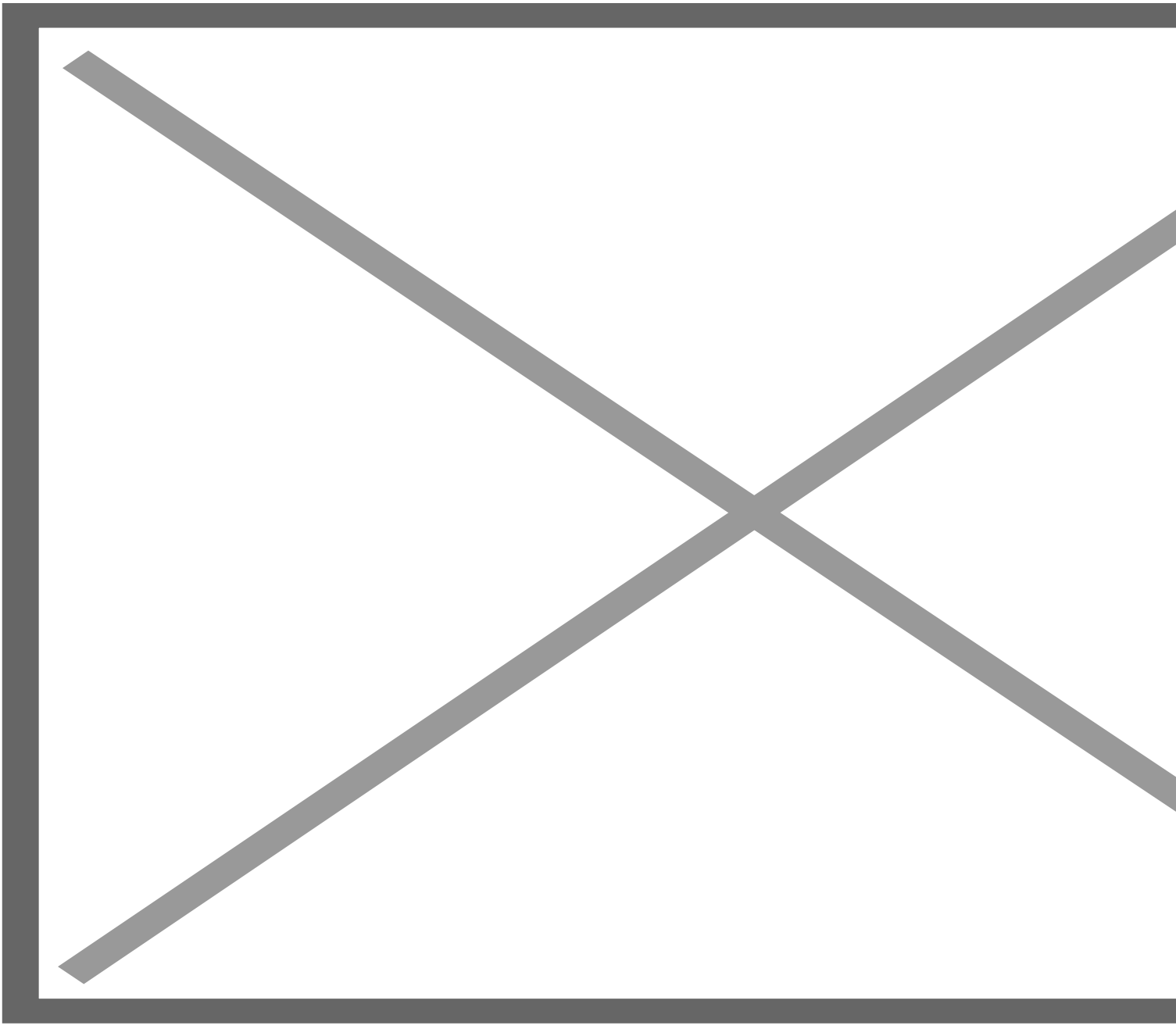
Patrolling the waters

Employment Tax



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Marion Hodgkiss and *Michael Steed* consider the challenges of giving advice relating to IR35 in the public sector

Key Points

What is the issue?

Finance Act 2017 introduces a new Chapter 10 of Part 2 of ITEPA 2003 and the effect of this is that we now have an extremely blunt tool to attempt to solve the off-payroll working issue in the public sector, which will not work in a significant number of cases.

What does it mean to me?

As advisers, we will have to patrol these waters explaining to our clients that the new rules are extremely inflexible.

What can I take away?

This is very likely to be a dress rehearsal for the private sector.

IR35 – an imperfect history

IR35 was first introduced in FA2000 as a way of making sure that contractors in one man one woman companies would self-police their exposure to income tax and NICs through their own Personal Service Companies (PSCs).

Not surprisingly, contractors almost universally deduce that they are not caught by the rules (which would require a 'deemed payment' subject to IT and NICs under S54, ITEPA 2003) and invoice clients as normal, receive their invoices paid gross as normal and take minimum salaries and large dividend payments as normal.

There has been an ongoing cat and mouse game between the contractor sector and HMRC, with various attempts by HMRC to address the issue and to pull more contractors into IR35, for example the business entity tests – a points system that was introduced in 2012 and withdrawn in 2015.

Contractors have long purchased 'IR35 proof' contracts with substitution clauses, which they claim solve the issue. On this point, we have always felt that the standard tests for whether IR35 applies or not, have been deficient in one major respect. None of the tests have focussed on the length of the contract, so an obvious simplification may be to declare that contracts say over 3 months would be caught, with an anti-avoidance rule to say that if they returned within say 12 months they would automatically be caught by the deemed payment rules. This would separate the proper 'hired guns' from pseudo-employees.

So what's new?

From April 2017, when a worker supplies his or her services to a public body through an 'intermediary' (here we will concentrate on the classic PSC – see new section 61M, ITEPA 2003), then the decision whether or not to apply a deemed employment treatment to the worker's remuneration no longer resides with the PSC; it now moves to the end client - the public body. Public bodies are those which are subject to Freedom of Information requests (new ITEPA 2003 s 61L) including any companies owned by these bodies.

It is expected that the public body will use the new Employment Status Service (ESS) which is effectively 'son of ESI' (The Employment Status Indicator). The ESS is an on-line questionnaire which will assist the public body in its decision. The use of the ESS is not mandatory.

The outcome is binary – either the off-payroll working rules do not apply (in which case business as usual for the contractor) or the rules do apply. If the public body does determine that the rules apply, then that decision is passed down the food-chain to the 'fee-payer' (which is normally an agency) that sits just above the PSC. This allows for multiple agencies to sit in the supply chain.

So let's imagine a simple supply chain – the end client (say the NHS), an agency and the PSC. By the way, if the PSC contracts directly with the public body, then the public body is both the end client and fee-payer.

If the client determines that the new rules do apply, then the agency is required to deduct IT and Class 1 primary NICs from the payments to the PSC, so the PSC effectively receives a net payment on behalf of the worker (as the worker's employment earnings – see new S61N, ITEPA 2003). The agency is also required to account for Class 1 secondary NICs to HMRC, thus reducing its profit margin. We understand from our various clients that in practice agencies are not only deducting the primary Class 1 NICs, but they are also deducting the secondary Class 1 NICs (and incidentally, Apprenticeship Levy payments, covered further on page 16) as well, to preserve their profit margins.

It is optional for the agency or public sector body to take account of the worker's expenses when calculating the tax due. This puts these workers in the same position as other employees, whose employers can choose whether or not to reimburse the expenses they incur (see new ITEPA 2003 s 61Q(1) – step 3).

Any VAT charged by the PSC to the agency is outside the scope of these changes, so it will be paid as normal on the PSC's invoice, thus throwing up some interesting Box 1/Box 6 relationships on the PSCs VAT returns (new ITEPA 2003 s S61Q(1) – step 1,)!

It is also worth noting that these new rules supersede the CIS rules. Where the new rules apply, the CIS does not.

The worker has to account for the payment and the tax deducted, on his or her personal tax return as employment earnings (new ITEPA 2003 s 61N). So at first sight, it appears that the worker is an employee of the agency (and this feels like the FA 2014 rules for agency workers), but the worker receives no other benefit from the agency – all statutory payments, such as sick pay and holiday pay, will have to be claimed from the worker's own PSC. At the end of the year or the end of the contract, the agency will issue a P60 or P45 as appropriate in the worker's name (payslips are not required).

But hold on a minute, how different is this from normal IR35 in the private sector? If a contractor self-polices and concludes that IR35 applies, then the payment from the client will have to be split between the employer's Class 1 secondary NICs and the deemed payment. There are two key differences, however, in that under the new public sector rules the 5% allowance in ITEPA 2003 s 54 is not available. And it is, the end client who effectively ends up funding the secondary NICs.
Some workers are outside the scope of the rules – this includes workers who are supplied by fully compliant Umbrellas and retail businesses providing ophthalmic and pharmaceutical services for the NHS. There are special rules for workers who are non-resident in the UK (new ITEPA 2003 s 51R).

No appeal!

It is worth emphasising that there is NO appeal process in this new legislation, however, the HMRC guidance provides that: 'If a worker thinks they have been taxed incorrectly, they can submit a repayment claim to HMRC. HMRC will then determine if they are due a repayment of Income Tax or NICs and repay as appropriate'.

This would seem to be a mis-categorisation process and we would reasonably expect that many contractors who are subject to blanket decisions from public bodies will use this faux-appeal.

Surely double taxation?

There's an immediate problem with all this. If the PSC receives a net payment on behalf of the worker, then that net payment becomes the turnover for CT purposes in the PSC's hands. To prevent the double taxation issue, new ITEPA 2003 s 61W legislates for relief and allowances of some deductions.

In essence it allows for the PSC to either retain the net sum paid to it by the fee-payer, or pay out up to the net sum without any further tax and NIC deductions. Payments to the worker should be done through a standard payroll and marking the payments as non-taxable.

The guidance for agents also makes it clear that HMRC is not bothered what you call the payment – it can be classified as salary or dividends – they don't care because they have got the tax! It does not appear possible to reclaim tax on the basis that the PSC has made dividend payments to the worker and that the dividend nil rate band and dividend tax rates should apply. The deeming of the payment as employment income trumps this idea (new ITEPA 2003 s 61N).

It also allows for some deductions that would have been deductible for employees, such as pension payments or claims for capital allowances (see new ITEPA 2003s 61W(2)). Presumably too, the normal rules on individual income tax relief, such as EIS and SEIS relief, will apply as normal.

But this does not solve the PSC issue. The PSC will have its own deductions – say car lease payments, accountancy fees and pension payments and these would appear to be lost from the point of view of tax relief.

And the conclusion is…?

First, that public authorities are making blanket decisions about workers' status, because this is easier than trying to negotiate on a case by case basis. As we have noted above, the only recourse is for the worker to take the issue up with HMRC.

Second, that many public bodies are saying that the only choices are: full employment, suffer deductions from agencies under the new rules, employment through a fully compliant Umbrella, or out.

Third, that many PSCs will effectively become redundant for contractors in the public sector. HMRC has estimated that these will affect around 30,000 PSC, but this estimate feels low; in any event, if the rules migrate into the private sector, the effect will be immeasurably greater.

Anecdotally we have heard that some loss of contractors in the public sector include IT specialists from HMRC who were working on Making Tax Digital. If that were true, that would be a delicious irony!