Putting your house in order

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Paul Mason considers the effect of the implementation of IR35 in the private sector

Key Points

What is the issue?

Implementation of IR35 for the private sector has been delayed until April 2020.

What does it mean to me?

It provides a 12-month reprieve for medium and large businesses even if it provides an effective exemption for the smallest 1.5 million businesses which might engage temporary resources on an off-payroll basis

What can I take away?

There is now certainty over timing, but not necessarily the effects of the change.

IR35 in the Private Sector: 15 months for everyone to put their house in order.

‘Off-payroll working in the private sector’: the Sword of Damocles, which has been hanging over the heads of contractors, agencies and end clients, ever since April 2017, when HMRC introduced changes to off payroll working in the public sector. The issue was never ‘if’ the changes would be incorporated into the private sector; the debate raged about ‘when’.

There will have been a collective sigh of relief within the recruitment chain that implementation has been delayed until April 2020: contractors were preparing for their post-tax earnings to be slashed; agencies and end clients wondering how to enforce the legislation. But it merely provides a 12-month reprieve for medium and large businesses even if it provides an effective exemption for the smallest 1.5 million businesses which might engage temporary resources on an off-payroll basis. And almost two months after the Chancellor’s Autumn Budget Statement, engagers, agencies and contractors should be planning for April 2020 for a variety of reasons, partly because we know what the legislation will look like if it is a replica of the public sector changes, but also because the private sector regime will create completely different scenarios for all parties based purely on the business structure of the end client engager.

Since April 2000, the Intermediaries legislation had made the individual trading through his/her own Personal Service Company (PSC) the IR35 decision-maker, but HMRC has identified that there is a compliance problem – in the May 2018 consultation, HMRC argued that only 10% of all contractors who should be treating their engagements as caught were doing so. HMRC believes that number should be

closer to a third of all engagements. This prompted the Government to act in an attempt to put its own house in order and transfer the IR35 decision-making responsibility from the PSC to the public sector body engager.

The new public sector legislation found at ITEPA 2003, Part 2 Chapter 10 also introduced the concept of the ‘fee-payer’ – the entity which pays the PSC. An engagement directly between PSC and public sector body would make that body liable for any incorrect status decisions. But where there are agencies in the chain, the agency immediately above the PSC in the contractual chain becomes the fee-payer and therefore responsible for the tax liability of an incorrect status decision. Whilst there are provisos within the legislation for the public body to take reasonable care in arriving at its decision, and that it must provide information about its rationale within a 31 day time period if requested to do so by the agency it engages, it essentially created a situation where the public sector body took the decision for which another party would be liable if that decision was wrong.

An agency is unlikely to quibble with a ‘caught by IR35’ decision, which results in the PSC being paid net of tax and NICs. Yet, agencies wishing to avoid any liability would certainly be more likely to challenge the decision to pay gross. Essentially, agencies have become fee-payer and quasi decision-maker because they can decide to pay the PSC net; effectively overturning the engager’s decision. This situation would not change in the private sector after April 2020 onwards.

The blanket ‘caught’ decisions of many public sector bodies will have meant that there were few decisions for agencies to contest and we feel sure contributed to HMRC being able to claim in the Budget Brief issued on 29 October, that the changes had raised £500 million for the Exchequer.

Yet, the real sting in the tail for those operating through PSCs in the public sector was the removal of the 5% allowable deduction from the PSC’s income for general expenses incurred in the running of the PSC’s business. Contractors soon realised that if all engagements were going to be treated as caught, then all of the income would be accounted for as either tax/NICs or net pay; i.e. nothing to set running costs against.

As a result, many contractors closed their companies and became umbrella employees or left for the private sector. Although strenuously denied in the Consultation, there is sufficient anecdotal evidence to suggest that contractors

leaving the public sector had a negative effect on many public sector projects.

Consequently, many commentators argued that if the public sector rules were brought into the private sector, the cost to business in terms of administration and increased temporary resource costs coinciding with anticipated negative impacts of Brexit would have a debilitating effect on the economy.

It seems the Government has listened to the concerns of the Consultation respondents and delayed implementation until April 2020. The Summary of Responses issued on Budget Day noted that ‘in recognition of the need for organisations to set up systems to comply with the reform and review existing contracts’.

It continued that ‘for services provided to small businesses, the responsibility for determining employment status and paying the appropriate tax and NICs will remain with PSCs. Small businesses will not need to consider the employment status or deduct employment taxes from the fees of people they engage in this way.’

The government intends to use similar criteria to define small businesses as is found in the Companies Act 2006. The use of the word ‘similar’ is noted and we await further clarification on this point. However, the Companies Act 2006 defines a small business as one which can satisfy two of the following during the year:

1. Turnover of not more than £10.2 million
2. Balance sheet total of not more than £5.2 million
3. Has not more than 50 employees (but would one need to include temporary employees/contractors in this number?)

The section concludes: ‘As a result, over 95% of businesses will not need to apply the reform’ and the decision and payment will remain with the PSCs.

The Consultation response acknowledges an awareness of concerns that businesses might use blanket decisions for the employment status of groups of workers in similar roles without recourse, should those decisions be incorrect. ‘The government intends to further explore options for the consequences of businesses failing to use reasonable care in making their decisions’.

This statement is interesting for two reasons: firstly, the Government has yet to equate blanket decisions within the public sector as being a failure to take

reasonable care in making status decisions. But more importantly, HMRC appear to be offering a commitment to publish further guidance to help understanding, and also set out ‘what people should do when they do not agree with the business’ decision on their employment status’.

Will the government enforce this through legislation to provide a statutory right of appeal to PSCs? If so, this seems to be counter-productive, as HMRC will be forced to determine IR35 when it acknowledges that enquiry and enforcement activity focused on individual PSCs is both costly and drawn out and that compliance activity alone cannot solve the problem. Therefore, why would HMRC want to offer a statutory right to appeal?

HMRC also addressed criticism of its Check of Employment Status for Tax (CEST) Tool. The Summary of Responses noted that: ‘HMRC is looking at where the CEST tool, along with wider guidance might be improved’ and acknowledges the requirement from respondents that the tool must say more about mutuality of obligation (but doesn’t commit to doing so).

Can the CEST tool be ‘improved’? And what might the new guidance look like? Although any effort made to align the CEST tool more closely with case law would be welcomed.

Returning to the Budget Brief, contractors may be comforted that the reform will not be retrospective: ‘HMRC will focus its efforts on ensuring businesses comply with the reform rather than focus on historic cases’. Moreover, ‘HMRC will not carry out targeted campaigns into previous years when individuals start paying employment taxes under IR35 for the first time following the reform and businesses’ decisions about whether their workers are within the rules will not automatically trigger an enquiry into earlier years.’

The Brief concluded that there would be ‘further consultation on the detailed operation of the reform to be published in the coming months’, which would ‘inform the Draft Finance Bill legislation expected to be published in Summer 2019’.

So, we have certainty over timing, but not necessarily the effects of the change.

How will medium and large businesses make their decisions? Will they take a view that there is a balance to be struck between reviewing hundreds of engagements each year and/or simply determining that those below a particular level are caught?

And will the Government really challenge such an approach when there is a tax advantage to the exchequer for not doing so?

Agencies will take centre stage: fee-payers and also decision-makers. Caught between end clients wanting them to produce solutions to retain the best contractors and the pressure from PSCs desperate for engagements to be deemed ‘not caught’, offering processes that demonstrate due diligence – possibly backed by insurance – will become attractive propositions to end clients who want no interruption to their supply of temporary resource, nor the repercussions of incorrect status decisions.

And PSCs? The private sector changes offer two contrasting scenarios. When working for medium and large engagers, they could be at the mercy of decisions taken above them. But won’t those decision-makers look more favourably if the PSC can evidence the engagement is not caught based on an independent assessment?

And won’t such an assessment be even more relevant for an engagement with the 95% of businesses which the Government state will be unaffected by the change? If a PSC wants to have a fighting chance to argue an engagement is not caught, then what better way to do so than a contract review? Even if HMRC can successfully challenge that decision, the PSC has undertaken sensible due diligence and at the very worst should avoid a penalty if deemed caught by IR35.

Yes, all parties have just over 15 months to get their house in order, but there is still one nagging doubt about the changes. HMRC has been very clear that it is only fair that two individuals working in the same way pay broadly the same income tax and NICs, even if one of them works through a company.

However, the ‘exemption’ for the 1.5 million smallest companies doesn’t seem to meet that objective and seems to create to a two-tier system which is inherently unfair and has the potential for continued non-compliance. It makes me wonder if HMRC can allow this exemption to continue in the long term.