Off-payroll working – preparing for the changes in April 2020

Tax voice



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Rob Woodward looks at the potential impact of the changes to off-payroll working and the impact on agencies

The proposed changes to off-payroll working (commonly known as IR35) from April 2020 for contactors operating in the private sector via limited companies (typically) will have a significant impact on both the contractors and the organisations that engage them. A significant proportion of the contractors are sourced via agencies and this article considers the impact on such supply chains in light of experiences

from the previous changes to IR35 in the public sector that occurred in April 2017.

Background

Prior to 6 April 2017, where a contractor was not directly engaged as an employee but instead through a limited company in which they possess at least 5% of the share capital/dividend rights (known colloquially as a Personal Service Company, PSC), the contractor (and by implication the PSC) was required to determine whether or not that working relationship was, in reality, one of employment. In other words, contactors had to ask themselves, “If I had been hired directly (rather than via the PSC), would I have had an employment relationship with the client?” If the outcome was a “yes”, then there was a deemed employment by the end client and the PSC was required to treat the payments received in respect of services provided as employment income with PAYE and Class 1 NIC operated accordingly.

These rules applied whether the PSC engaged directly with the end client or the supply chain included an agency. Regardless of the complexity or length of the supply chain, all parties were clear in the knowledge that the tax compliance risk resided with the contractor and the PSC.

The first shift in the PAYE and NIC risk began on 6 April 2014 with the introduction of the Offshore Intermediaries legislation. Under this legislation, where the contractor is subject to supervision, direction or control by the end client, the contractor’s PSC is a non-UK company and the final link in the supply chain to the end client is via a UK agency, the UK agency is then liable to operate PAYE and NIC in the event that those obligations are not already being met elsewhere in the supply chain. This legislation sought to address a perceived weakness by HMRC in the ability to apply the host employer provisions where a PAYE liability existed (including circumstances where IR35 applied). The Offshore Intermediaries legislation does not replace IR35 and instead needs to be taken into account alongside any consideration as to whether IR35 applies. Even where the agency is not liable for PAYE and NIC, since 6 April 2015, quarterly reporting of contractors supplied by the agency on a non-employed basis (including those via PSCs) has been required under the Employment Intermediaries reporting regime,

On 6 April 2017, the most significant change to date took place in respect of IR35 contractors providing services to an end client that was a public sector entity. “Public sector” in this context means any public body organisation as defined under

The Freedom of Information Act. In these situations, the public sector end client is required to determine if a deemed employment exists for any individual who personally supplies their services via a PSC. If the public sector body concluded the relationship was a deemed employment, unless the contractor was supplied via an agency, that public sector body would be required to make the payments in respect of the services provided via the payroll with PAYE and Class 1 NIC operated accordingly.

Agency impact

Where an agency is involved (and in a significant proportion of cases contractors supply their services to the public sector via PSCs), if the public sector body concludes that a deemed employment arises, the agency would be required to operate PAYE and NIC. For agencies, this change resulted in a reassessment of the relationship with both the end client and contractors: a number of practical impacts of this change had to be considered.

Beyond changes to processes to capture situations where a contractor is classified as a deemed employee (adaptations which inevitably resulted in increased costs), the agency is now required to payroll the contractor and is responsible for paying employment tax costs such as employer NIC and the Apprenticeship Levy. In some cases, agencies have been able to pass on these costs through an increase to the margin charged to the end client, However, that has not always been possible (at least not without renegotiation of contract terms, and in any event not all contracts were able to be renegotiated) and, therefore, those costs hit agencies’ profitability.

Operating a payroll for contractors (and bearing responsibility for the consequential tax and NIC costs) changed the nature of the commercial arrangements between agencies and their clients. The working relationship may also have altered as it is the client who makes the determination but the agency who operates PAYE and NIC based on that decision. Situations where the agency and the client disagreed with the assessment that a deemed employment existed, may have had an adverse impact on the ongoing working relationship between agencies and their clients.

Some of these disputes have arisen due to the HMRC Check Employment Status for Tax (CEST) tool. While HMRC has confirmed it will stand by the result produced by CEST, that position only stands where the fact pattern matches the answers given. Leaving aside changes of circumstances, ambiguity in the phrasing of some

questions have resulted in differences of opinion as to whether the facts exactly match the questions themselves. I will not dwell on problems encountered with CEST (the range of questions asked, the absence of questions on mutuality of obligation, etc.) beyond noting that public sector bodies have often assumed its output to be binding on them – without any separate qualitative assessment by tax professionals to support.

Under the rules relevant to the public sector, there is no formal mechanism for appealing the public body's decision on deemed employment, nor a dispute resolution process. In the absence of an appeal process (and which the April 2020 reforms appears not to be taking steps to address beyond trying to minimise the number of conflicts in the first instance – an adjustment which applies to both the private and public sectors), agencies disputing determinations and not willing to operate PAYE and NIC must effectively invite an enquiry from HMRC to resolve the matter. This route is time consuming and increases the agency's risk profile with HMRC – potentially increasing the likelihood of future enquiries on other tax matters. Should HMRC be successful in those enquiries, the agency would also be liable for interest on late paid duties and penalties for failure to operate, report and pay those duties on time.

Another major challenge faced by agencies following the introduction of the public sector specific IR35 legislation in April 2017 was the volume of employment status determinations issued on a 'blanket' basis rather than individual assessments per contractor. The reason for this approach varied – in some cases it was simply lack of time and resources: the determination needs to be made and communicated within 31 days otherwise any PAYE and NIC risk would sit with the end user. Whatever the underlying reason for making blanket assessments, the fact remains they are counter to the obligations placed on the public body by the legislation and have a negative impact on themes we have already covered such as relationship management, budgeting/squeezed margins and the lack of an appeals process. Agencies placing large numbers of workers with big private sector clients will no-doubt be concerned that these issues will recur from April 2020.

As well as managing the relationship with the end client, a determination that a deemed employment arises, has also had an impact on the relationship between agencies and contractor, especially where a contractor joined before April 2017 and there was a change in the PAYE and NIC basis mid-contract. This is particularly the case where the contractor's expectation on joining the agency was to be outside

IR35 and/or the contractor disagreed with the deemed employment decision (whether or not that determination was made using CEST).
Managing the relationship in both directions of a supply chain, where the dynamic has shifted clearly involves additional time and resources but the alternative is the loss of contactors – something many agencies have experienced since April 2017. This included the loss of contractors not only to other organisations that were more willing to give an assessment with which the contractor concurred but also contractors abandoning the private sector entirely. It is anticipated that the impact of the April 2020 reforms will not be as significant in terms of loss of contractors for two reasons:

1. Consistent application of IR35 across the public and private sector means there are few alternatives for contractors (unless they leave the UK),
2. The issue of blanket assessments (a problem with parts of the public sector) for whole classes of contractors will probably be less prevalent because it is expected private sector organisations will make individual assessments in all cases.

There is also the hope that the extension of the public sector rules to the private sector will herald improvements to CEST.

As a final practical point, while the IR35 rules take precedence over both the Offshore Intermediaries legislation and the Employment Intermediaries reporting obligations, agencies must nonetheless consider these requirements in cases where the contractor is not classified as in deemed employment.

The future

While the April 2017 IR35 changes were specific to the public sector, it was widely expected that those changes would be extended to the private sector. At the 2018 Budget, the Chancellor announced that, following consultation, these rules would be extended to the private sector with effect from 6 April 2020. The consultation was published on 5 March 2019 and runs until 28 May 2019. While the public sector legislation will essentially be extended to the private sector (as opposed to having two sets of rules), one important difference (and as confirmed in the consultation) will be that small businesses are to be scoped out of the private sector reform rules: for them, the determination of employment status and PAYE and NIC obligation will remain with the contractor/PSC. Small business in this context uses the Company

Act 2006 definition of “qualifying as small” under Section 382 but extends to unincorporated entities too – although how that extension is to be effected is being consulted on.

The exemption for small businesses is designed to ease the burden on small organisations of assessing employment status and operating PAYE and NIC where required and so should be viewed as a positive. However, in the context of agencies, the exemption is based on whether the end client is a small business rather than the agency. Agencies will, therefore, need to have an even greater understanding of a client to determine whether they would be deemed a small business for these purposes. They will also need an understanding of a client’s growth strategy and business goals to predict when a business will cease to meet the ‘small’ criteria (and the consequences for the application of the IR35 legislation). In short, up-to-date client knowledge will be even more important.

The 2020 changes also make the agency liable for PAYE/NIC debts if another link in the supply chain fails to pay the liabilities due. There is a similar provision in the Offshore Intermediaries legislation and will require agencies to fully understand who is in the supply chain and ensure the whole chain is compliant to avoid debt liability being transferred.

In any event, the exemption for small businesses and supply chain liability in particular and the changes in general are currently being consulted upon and any further adjustments taking into account the consultation feedback will be subject to Parliamentary scrutiny – leaving much scope for potential alterations before April 2020.

Next steps

The 2017 changes for public sector clients added both technical and practical complexities for agencies supplying contractors via PSCs. These technical and practical issues continue and look set to be rolled out into the private sector from April 2020. While the final details of the private sector rules may not be confirmed until next spring, agencies need to bear in mind and build on the lessons learnt from the 2017 changes and start planning for April 2020 now.