Off-payroll working rules – what do we mean by a ‘managed service’

Tax voice

25 March 2022

Nicola Pitcher looks at the off-payroll working rules and considers what is meant by a managed (contracted-out) service.

The reforms to the off-payroll working rules (IR35) were initially rolled out to the public sector in 2017 with the intention of allowing allow government bodies time to put their own house in order and for HMRC to learn lessons before extending change to the private sector. In April 2021, after some further amendments to the rules and a one-year deferral due to the Covid-19 pandemic, the government eventually extended the new off-payroll regime to medium and large organisations in the private sector.

NAO report and non-compliance in the public sector

In February 2022 the National Audit Office (“NAO”) reported on its investigation of the implementation of the 2017 reform in the public sector. The report identifies that public bodies had little time to prepare for the new rules. The government did not announce its decision to proceed with the changes until November 2016. HMRC guidance was not published until February 2017 and the full version of CEST was not available until March 2017. Both HMRC’s guidance and the CEST tool proved to be particularly problematic and public sector bodies struggled to comply. It is therefore not surprising that implementation errors by public sector departments are now coming to light. The NAO report reveals that the 2020-21 financial statements of government departments and agencies include a total of £263 million paid, owed or expected to be owed to HMRC in additional tax and NIC as a result of non-compliance with the new regime.

This focus on non-compliance in the public sector has centred around incorrect status assessments with substitution and financial risk being the main problematic

factors. On substitution, HMRC have found that in completing the CEST tool, hiring managers were not aware that government contractual frameworks gave them a right to reject a substitute. It is understood that public bodies have or are now taking steps to address non-compliance. As a result, many contractors engaged in the public sector previously assessed as “outside IR35” have been re-assessed as “inside IR35” and moved onto PAYE contracting arrangements. This shift of contractors is now causing some public bodies to question whether there is additional IR35 risk around “managed service” arrangements. This could be because contractors group together to supply their services as a “managed service provider” or they may seek to be re-engaged via a managed service contract that the public body has with another supplier. The challenge for the public body is to determine whether the managed or “contracted-out” service contracts that they have are genuinely outsourcing arrangements or whether there is a supply of resources which might present them with IR35 obligations and potential liabilities.

HMRC guidance

HMRC’s guidance on contracted-out services at ESM10010 is relatively brief. The guidance explains that the responsibility for assessing a worker’s status under the IR35 legislation (except in the case of small private sector organisations) sits with the end client of the worker’s services. Where a service is fully contracted-out to a supplier, the worker will supply their services to that supplier who will be their end client for IR35 purposes.

HMRC’s guidance goes on to say that “whether a contract is for a fully contracted-out service is a question of fact, based upon the commercial reality of the arrangements. Care should be taken to ensure that a labour supply contract has not simply been re-labelled as a managed service.”

Relevant factors to consider, according to HMRC, include the following:

1. The nature of the businesses

In HMRC’s view, “*where the type of service provided by the worker aligns closely with the nature of a business (or a department within a business), this will be an indicator that the business is the client*.” They give an example of a cook working for a catering firm. In practice, it is probably more useful to understand what is being supplied, and the nature and structure of the supplier’s business to assess whether it is capable of being a contracted-out service. For example, is there a management

structure in place which allows the supplier to take full ownership of its deliverables and to manage and direct its personnel?

2. The nature of the service provider's contract

According to HMRC, *"where a service has been fully contracted-out, the service provider will usually have responsibility for agreeing the specification of the service and ensuring the quality of the service."*The wording here is a little unclear, but I take it to refer to the specification and quality of the service being provided by the worker via their intermediary to the service provider. Where a business, or public body outsources a supply they would typically provide the specification and would also quality control the service being provided by the service provider via KPIs etc.

"*A fully contracted-out service will often involve the provision of goods and materials, as well as labour.*" This may be true in some sectors, but is less relevant in service industries and often may not be practical in IT environments where for security reasons the end user's systems and equipment need to be used.

"*A service provider will usually have an opportunity for profit, beyond taking a percentage of the worker's fee, where a service is fully contracted out.*" Yes, it is important to distinguish a service provider from an agency where the agency takes a percentage based on the worker's pay rate. However, in service industries it can be quite usual for the provider's fee to be calculated using an hourly or daily rate for its personnel. There is obviously greater risk to the supplier where their fee is fixed rather than being charged on a time basis and hence the arrangement is more capable of being outsourcing.

3. The relationship between the worker, the service provider and their customer

This is critical in identifying who the worker is personally providing their services to as that entity will most likely be the end client from the worker's perspective and for IR35 purposes.

HMRC go on to say, "*the extent to which the service provider or their customer control the worker, benefit from the provision of their services, bear risk, and integrate the worker into their business will all be relevant.*" Whilst I agree with this statement, how useful is this guidance to the business or public body examining a contract and trying to assess whether, or not, it is a fully contracted-out service? In my view, this guidance does not go into sufficient detail. Yes, HMRC do provide

some case studies, but they are relatively black and white.

HMRC conclude by saying that, "*when having regard to the factors, the actual working practices must be taken into account as well as contractual terms. Contractual terms alone will not decide the matter, they must also be followed in practice to have weight in making a decision*."

Further examination of working practices

As HMRC recognise, the relationships between the parties and the actual working practices must be taken into account in assessing whether or not a contract is for the supply of contracted-out services. In practice this assessment may not be as easy as HMRC's case studies suggest. Some public bodies have complex programmes, particularly in the digital arena, involving multiple suppliers, complex systems and varying levels of civil servant involvement.

Where a contracted-out service is being provided, the supplier will have sole responsibility for and ownership of the delivery and will provide all instructions and direction to their workers on a day to day basis. This may include prioritising tasks, methodologies to be adopted or instructions on how to perform the work and when and where the work should be delivered. The public body will sign off that the quality of deliverables are as expected; that milestones and KPIs are met etc., but will have no day to day operational involvement and will not have any control, directly or indirectly, over the workers' activities.

However, in practice, it is not so straightforward. For example, public bodies are required to use an agile approach to project management when building and running digital services. Agile methods encourage teams to build quickly, test what they have built and iterate their work based on regular feedback, typically involving two weekly sprint cycles and daily stand up meetings to manage progress. The agile approach means the supplier and the public body will often work in a collaborative fashion which increases the risk that the public body may be tempted to exercise a degree control and direction over the supplier. Agile teams may also include a blend of different supplier staff and civil servants working on different aspects of the project and with different areas of expertise. A careful examination of the operational interaction between the parties and the project dependencies is needed to assess whether a supplier has full ownership and responsibility for their deliverables such that their contract is capable of being outsourcing, or alternatively

whether the public body has simply put together a team of experts that they are managing.

Some suppliers have been working with public bodies over many years and have in-depth experience of their systems, possible having been involved in building and/or be-spoking them. This brings greater risk of dependency on the supplier and of their personnel becoming an integral part of a public body's teams. Further, if and when the public body decides to bring the service in-house there is likely to be collaborative working to facilitate knowledge and skills transfer. There may also be operational teams comprising a blend of civil servants and supplier staff.

These are just a few examples of situations where it may be difficult to determine who the end client of a worker's services is. The public body will need to understand at quite a detailed level where control and direction is being exercised and by who; what the supplier is responsible for delivering; and whether the arrangement is capable of being outsourcing.

This is a complex area that public sector and no doubt private sector organisations too are addressing. It is hoped that HMRC guidance will be stepped up to give greater comfort that organisations are reaching conclusions with which HMRC will agree.