A contractor's guide to the off payroll working reforms (IR35)

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Dated: 11 February 2020

Contents

1. Summary

The phrase 'IR35' refers to Chapter 8 of ITEPA 2003 and was the original name of the press release used to announce the tax initiative (i.e. Inland Revenue 'IR' 35) back in 1999. This tax initiative was originally to counteract the growth of the use of a limited company to provide the services of an individual. This limited company has become known as a Personal Service Company or PSC, although it has no definition in statute.

For the past 20 years it has been the responsibility of the PSC to assess whether IR35 should apply to the engagement. The assessment is to determine whether the PSC, if they were providing their services directly to the client, would be a deemed employee for tax purposes. If the PSC believed that they were operating 'inside IR35', they would pay tax as if they were an employee but, would have no equivalent employment rights. This legislation has been largely unsuccessful in achieving the aims HMRC had desired.

Fast forward to 2017, the off payroll working reforms contained in Chapter 10 of ITEPA 2003 were brought into the public sector from 6 April 2017 and will be extended to the private sector from 6 April 2020. The new rules will apply to all engaging organisations in the public sector, but only to medium and large-sized businesses outside of the public sector. The main change in the rules are to require the end client to make the determination as to whether the PSC is inside or outside of IR35 and for the 'fee-payer' to make the deductions if the PSC is determined as inside IR35.

It must be remembered that currently the legislation is still in draft form and until the legislation is published, we will not know the final outcome. The Budget is expected on 11 March 2020 and the legislation should be published shortly thereafter. Although, having said that, it is not expected that the rules will change a great deal from the current draft.

Where the new rules do apply, the organisation, agency or third party paying the worker's company will need to deduct income tax and NICs from the worker's pay and pay the employer's NICs.

2. IR35 v. Off-payroll

Chapter 8 provides the details for when the assessment is made by the contractor, so applies up to 6 April 2020 in the private sector and will apply after 6 April 2020 for when the client is a small business. Chapter 10, however, provides the legislation for the assessment to be made by the client in the public sector and soon to be private sector.

So, technically 'IR35' refers to only the assessment by the contractor, although it is widely used to describe both Chapter 8 and Chapter 10. There is, however, a significant difference between the two chapters as will be explained later but being 'inside or outside IR35' is a phrase that is used to describe whether tax will be deducted or not.

IR35 was originally enacted in the year 2000. The then Inland Revenue, now HMRC, wanted to stop limited companies being used to provide the services of an individual where they considered that that individual was doing the same job as an employee. It must be remembered, however, that under IR35 you are only a 'deemed employee' for tax purposes. You are not 'an employee' and are not entitled to any employment rights.

In order to establish whether an individual should be a 'deemed employee', the legislation requires that the employment status test is used, which are derived from case law. These will be discussed later in Chapter 9.

3. Personal Service Companies (PSCs)

Where individuals used a limited company to provide their services, sometimes known as a 'one-man limited company', the phrase personal service company was coined. A PSC, however, is an ordinary limited company which supplies the services of an individual, it has no legal definition.

If the services are supplied using PSCs, the IR35 or off-payroll legislation has to be considered. If you are not supplying your services using a limited company but are, instead, a self-employed sole trader, then IR35 does not apply to you - although other legislation does apply to you which should be considered separately.

From April 2020, it will be the 'client' who has to make the assessment and the 'fee-payer' who makes the deductions, whoever the fee-payer is (which will be explained later).

4. Small Company Exemption

The reforms apply only to medium and large sized companies who are the 'client'. This does not apply to the size of the agency. Although there is no definition of client in the legislation, it is thought to mean the person who is in receipt of the labour from the services. So, if the client is under the audit threshold and qualifies as 'small' then the reforms will not apply, instead the old rules will remain. It will then be for the PSC to continue to assess their status.

4.1 Companies Act definition of "qualifying as small"

The qualifying conditions are met by a company in a year in which it satisfies two or more of the following requirements:

1	Annual Turnover	Not more than £10.2 million
2	Balance sheet total	Not more than £5.1 million
3	Number of employees	Not more than 50

If the company is in a group of companies and the company is small, the parent company would also have to be small for them to qualify as small.

5. Engagement options

5.1 Outside IR35

If you are deemed to be outside of IR35, there will be no change in the current arrangements. You will be paid on invoice with no deductions.

5.2 Inside IR35

Where the rules do apply, the fee-payer, who could be the client, the agency or another third party paying the PSC, will need to deduct income tax and NICs from the PSC's invoice and pay the employer's NICs, so:

- the party paying the worker's PSC (the fee-payer) is treated as a 'deemed employer' for the purposes of income tax and Class 1 NICs.
- the amount paid to the worker's intermediary for the worker's services is deemed to be a payment of employment income or of earnings for Class 1 NICs for that worker.
- The fee-payer is liable for secondary or employer's Class 1 NICs, and the employer's NICs must not be deducted from the deemed employee's income.

- The fee-payer must deduct income tax and primary or employee's Class 1 NICs from the payments they make to the worker's PSC in respect of the services of the worker.
- the person deemed to be the employer for tax purposes is obliged to remit payments to HMRC and to send HMRC information about the payments using RTI.

i. Employers' National Insurance Contributions (NICs)

As soon as the fees become employment income the deemed employer is not allowed to deduct the Employers' NICs from the deemed employees employment income.

Under the Social Security Contributions and Benefits Act 1992 – method of paying Class 1 – it states that where earnings are paid to an employed earner the secondary contributor shall deduct the earner's primary contribution on behalf of the earner. With regards to the secondary contribution, however, the secondary contributor is not entitled to make "…any deductions in respect of his own or any other person's secondary Class 1 contributions, or otherwise to recover such contributions from any earner to whom he pays earnings."

ii. PSC Payroll

If you submit an invoice, but are deemed to be inside IR35, you would be paid but with employee's NI contributions and income tax deducted. If the invoice has a VAT element, the VAT element is removed from the calculations, the taxes are deducted and then the VAT is put back on to the invoice.

The employer's NI contributions are <u>not</u> deducted from the PSCs invoice. The employer's NICs element has to be deducted by the fee-payer. When the PSC is deemed to be inside IR35, the fee-payer becomes the deemed employer and, as the income is employment income, the employer's NICs cannot be deducted from this and are paid by the deemed employer.

iii. Umbrella Company

The umbrella company is a convenient way for an individual with an inside IR35 contract to provide their services with certainty of the tax position. The umbrella company acts as the individual's employer and after deductions pays the individual a salary. The employer's NICs are also deducted from the employees pay, but as part of the assignment rate not part of the wages.

Some expenses may be allowable, but this depends on whether there is any supervision, direction or control element in the contract. These are dependent on the travel and subsistence rules.[1]

iv. Permanent employment

The client might consider employing an individual on a permanent contract of employment. If the client wanted to engage the individual on a permanent employment basis, it may be that there is a restrictive covenant in the contract which will prevent direct employment unless a fee is paid to an agency. So, it would be wise to check this.

v. Fixed Term Employees

An individual can be taken on on a fixed term basis, but as an employee. This would be governed by the Fixed Term Employees (Prevention of Less Favourable Treatment) Regulations 2002.

vi. Self-employed Sole Trader

If the services are supplied by a person who is self-employed, the off-payroll rules would not apply. It is likely, however, that another piece of legislation, the agency tax legislation may apply. This legislation relies on the quasi-statutory test of supervision, direction and control.

[1] Sections 337 to 339 of the Income Tax (Earnings and Pensions) Act 2003 (ITEPA).

6. Status Determination Statement (SDS)

From April 2020, it will be the responsibility of the 'client' to make the assessment as to whether the individual worker working through their own PSC is inside or outside of IR35. The assessment results in a Status Determination Statement or SDS. The SDS contains the determination itself and the reasoning for the determination. Unless and until the SDS has been given to the worker by the client, the client will be liable for making any deductions for tax.

6.1 Reasonable care

The first point to note is that under the draft legislation, the SDS will not constitute a statement "…if the client fails to take reasonable care in coming to the conclusion mentioned in it."

What is reasonable care?
Unfortunately, there is no further guidance at present on what constitutes reasonable care for the purposes of making an SDS. The only guidance is contained in HMRC's compliance manual concerning penalties for inaccuracies. In this manual it states that an inaccuracy that is careless incurs a penalty and the law defines careless as a failure to take reasonable care. Every person must take reasonable care, but reasonable care cannot be identified without consideration of the particular person's abilities and circumstances.

A large multinational company, for example, would have more resources and access to better professional services than perhaps a self-employed person. HMRC would also expect a higher degree of care to be taken over large and complex matters than simple straightforward ones.

In HMRC's view, it is reasonable to expect a person who encounters a transaction or other event with which they are not familiar to take care to find out about the correct tax treatment or to seek appropriate advice.

6.2 Making the assessment

So, although the entity making the assessment is changing, how to make the assessment remains the same. The assessment will be made by understanding the factors for employment status which are based on case law, looking at the working practices and the contractual terms. There are also various digital tools that can be used to speed up the assessment process and amongst them is HMRC's Check Employment Status for Tax otherwise known as CEST.

There are three types of assessment:

i. Blanket
It is considered that the blanket assessment does not constitute reasonable care. This is when the company decides that all of its contractors are inside IR35, regardless of circumstances.

ii. Role based
This is acceptable by HMRC, but it is unclear whether it constitutes reasonable care. This is based on a role that has very similar terms and working practices. It is wise to also include the details of the contractor when they are available, in order to constitute reasonable care.

iii. Indicative
This assessment is where all parties in the labour supply chain are involved in the assessment, so this is also called a collaborative assessment.

Whether you use a digital tool or assess the status manually, you will need an understanding of the employment status case law. There is no check list of factors and the various factors are weighted according to the circumstances. In the end, it is necessary to stand back and look at the whole picture to make a true assessment of the status of an individual. Ultimately, it is only the courts that can decide who is right or wrong.

6.3 Challenging the assessment

The new reforms have included provision for challenging the assessment made by the client. This can be challenged by either the PSC or the fee payer.

The challenge can be on the basis that the client hasn't taken reasonable care or that the client hasn't taken into account certain information. The client then has 45 days to consider the challenge and respond.

7. In business on your own account

Under the new reforms, the client organisation will have to make the assessment as to whether you, if you are providing your services through a PSC, are inside or outside of IR35. In making the assessment, the client should also consider whether you are 'in business on your own account'. This phrase comes from case law and has been developed over a number of years since the 1960s, when it was first mentioned.

The way that you conduct yourself in business is of importance. You need to prove that you are: "…in business on their own account." This might include:

- providing your own equipment
- carrying Professional Indemnity Insurance;
- having dedicated office space;
- working from your office or own location;
- having a website;
- own business cards;
- a LinkedIn profile.

Things to avoid are:

- having a client email address;
- having a client phone number;
- having a dedicated desk.

You also have to be prepared to work for a fixed price, on a project basis, with little or no notice period. You should also, as good business practice, make sure that you can continue to provide the services when you are not able to, by providing a substitute.

There are various companies that will provide IR35 reviews of your contract and working practices. It is worth investing in one of these to be able to present to your agency or client. You may also use CEST as a tool to test your status. CEST has an output that you can save and, again, you can send it on to the agency or client.

8. Check Employment Status for Tax (CEST)

The Check Employmet Status for Tax tool, or CEST, is HMRC's digital tool for checking employment status. It has been recently updated and has been designed to test limited companies for their

status under the new reforms. It must be remembered that CEST is biased towards HMRC: that is intentional, it is HMRC's view of status. The merits of this are that if you get an 'outside' assessment using HMRC's tool, it is more likely to be outside. There is no doubt that the questions are weighted in HMRC's favour and you do have to understand how to use the tool, as the questions can be divisive.

The tool can be used by the hiring organisation or the agency on the client's behalf, but in line with the new client led challenge process, HMRC says that the tool can be used by the worker to check the determination reached by hiring organisations and then challenge it.

It is not compulsory to use CEST and CEST should only be used for determining employment status for tax and NIC purposes, not for employment rights. There are certain situations that CEST should not be used for, primarily the self-employed working through an agency. In this case, s.44 ITEPA may apply instead.

HMRC says that it will stand by the results, provided the information is accurate and it is used in accordance with their guidance. This seems to be at odds, however, with HMRC's stance in recent case law where it has sought to disregard the evidence of its own tool and argue against its output. This includes fining NHS Digital £4.3m even though NHS Digital had used the tool as part of taking reasonable care.

There are many dissenting voices where CEST is concerned, not least because of HMRC's stance on mutuality of obligations, but what it does do is provide valuable evidence of what you need to do to remain outside of IR35.

9. Employment Status Test

This 'test' is made up of factors derived from judgments from court cases spanning the last hundred years or so. There is no one definitive test or factor which can determine an individual's employment status: all the factors are weighted differently, and the difficulty is that the tests are open to interpretation - the opinion of HMRC very often differing from that of the practitioner.

For over a century, the courts have attempted to come up with a decisive test for establishing the employment status of an individual. For many different reasons it has been necessary to establish whether the individual is to be regarded as working under a contract *of* service as an employee or under a contract *for* services as an independent contractor or self-employed person.

So, the test is often described as establishing whether you are "employed or self-employed" and despite it being called 'employment status' it also applies for tax purposes. To further confuse you, it applies equally whether you are employed or self-employed under IR35, despite the fact that you are not technically 'self-employed' because you provide your services through a limited company.

9.1 Founding cases

One of the founding and most quoted cases is that of *Ready Mixed Concrete v. Minister for Pensions* [1968] 1 All ER 433. In this case, the judge laid down three conditions which had to exist for there to be a contract of service:

- Consideration in return for personal service;
- The master had full right of control; and
- The other provisions of the contract are consistent with it being a contract of service.

Another founding case is that of *Market Investigations Ltd v. Minister of Social Security* [1969] 2 QB 173. This case launched the 'in business on your own account' test. The test seeks to establish whether you are in fact in business on your own account by looking at various factors such as:

- Do you provide your own equipment;
- Do you hire helpers;
- Is there a degree of financial risk;
- Is there an opportunity to profit.

In a recent case, whether the individual marketed their services was also a deciding factor and whether or not there was a notice period. Employees are entitled to a notice period, but if you are in business you would normally complete the contract term without giving or being entitled to a notice period without cause, unless there are certain circumstances.

However, in both these cases, mutuality of obligations was the predominant factor that was considered.

9.2 Mutuality of Obligations

Starting with mutuality of obligations, this factor divides opinion wildly. To some, it shouldn't even be used in tax cases, but HMRC has assumed via its CEST tool that mutuality exists in every contract. So, the CEST tool assumes that mutuality is already present and is, therefore, just trying to establish whether the contract is a contract of service (i.e. employed) or whether it is a contract for services (i.e. self-employed).

This is a unique view from HMRC, but in practice, mutuality usually pertains to whether there are any continuing oblgations on either party to accept further work. So, is your business obliged to find more work for the consultant and is the consultant obliged to accept it. The answer should be no on both counts, neither party is under any obligation because that would infer an employment relationship. The other point to watch out for is that mutuality may build up over a period of time. So, it may not be present at day one, but if the contract gets extended for a number of years, it may become present in year 4, for example. This is also true of the factors such as becoming part and parcel of the organisation, that they can develop over time.

9.3 Substitution

This factor has always caused difficulties and over-reliance on it is inadvisable. There are two parts to substitution – the right of substitution in the contract, and actual substitution in practice. It is important to have the right of substitution in the contract, but it needs to be in both the consultant contract and the client contract. Of course, if the consultant can substitute in practice and has done so, where the consultant pays the substitute – this will almost guarantee the contract is outside IR35. This rarely happens in practice, but in the absence of substitution, the client's lack of control can also mean the contract is outside of IR35.

9.4 Control

The control factor has come in and out of fashion over the years. In the days of master and servant, it was the predominant factor, but it waned in popularity in recent years. However, HMRC gives control a lot of attention in the Employment Status Manual and as with substitution, there needs to be both a right of control and control in practice. The corollary being that if the client lacks control especially in the contract, this is very persuasive evidence of outside IR35 status.

The elements of control are: what the worker has to do, where the worker has to do it, when it has to be done and how - although 'how' is far more important than the other elements. In the recent update of CEST, however, HMRC states that what is important is the existence of a right of control over all four areas.

9.5 Contracts and working practices

The factors of case law need to be applied by looking at both the contract and the working practices. The contract will show what the parties have agreed and what their intentions are, so it is important to have a properly drafted contract. The working practices have to mirror the rights that have been agreed in the contract. So, if the contract is simply trying to be 'IR35 friendly' but does not relate to what happens in practice, it will not prove employment status.

9.6 The whole picture

In another important case, that of *Hall v. Lorimer* [1993] 66 TC 349 it was necessary, having considered all the factors, to stand back and look at the whole picture. This is not a mechanical exercise of running through items on a checklist; the right approach is to see if the person is in business on their own account or whether they are a person working as an employee in someone else's business. Where the picture is ambiguous, then it may be the intention of the parties that will decide the issue.

10. Biography

I started my consultancy some 20 years ago when the tax initiative IR35 was announced in a press release in 1999. After a judicial review, IR35 became law in 2000 and I started advising companies on how to deal with IR35. Since then I have continued to advise companies both nationally and internationally on how to work with a non-standard workforce in the UK jurisdiction. I specialise in employment and tax status on all types of non-permanent positions including the self-employed, limb 'b' workers, LLP partners, personal service companies and the Construction Industry Scheme, amongst others. Currently, however, my time is dominated by preparing clients for the IR35 or off payroll reforms coming into force in April 2020.

I am a lawyer by trade but have knowledge of both the position for tax status and for employment rights. It is essential for businesses to understand their position from both perspectives in order to understand the pit falls.

I have lectured at the London School of Economics, spoken at many professional conferences, including the Labour Party conference and written many articles for the professional press.

I was seconded to the Office of Tax Simplification (an independent body of HM Treasury) in 2014 as a Senior Policy Adviser to advise the government on employment and tax status. Reporting direct to the Chancellor, I was part of a small team of experts who drafted the Employment Status Review (2015), then continued to advise on the review of Small Company Taxation, leading on the taxation of nano companies and the self-employed and published the Review of Small Company Taxation (2016). I also recommended the creation of - and became a representative on - the Cross Government Working Group on Employment Status. I then co-authored a focus paper into the taxation of the Gig Economy with John Whiting CBE in 2017.

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