

## **Understanding the reforms to the IR35 rules in the private sector**

**From 6 April 2020, the way in which the IR35 rules operate in the private sector is set to change. These reforms will see contractors lose the ability to determine their own tax status and place this burden on those who engage them. In this article, we discuss the new framework and the next steps for clients and contractors.**

### **What is IR35?**

The off payroll working rules – commonly known as IR35 – were introduced in 2000 to crack down on the problem of tax avoidance through “disguised employment”. Disguised employment is where a worker supplies their services to an end user client (**client**) via an intermediary (usually a personal service company controlled by the worker) to benefit from the tax treatment afforded to contractors, when, in fact, they are employees (or office holders) for tax purposes.

The IR35 rules sought to tackle this problem by requiring the intermediary to determine whether the worker would be deemed an employee (or an office holder) of the client for tax purposes if there was a hypothetical direct contract between them (the **status determination**). Where a worker *is* deemed to be an employee (or an office holder) for tax purposes, then the intermediary must tax the worker as an employee. This means they must operate payroll, deduct income tax and employee National Insurance Contributions (**NICs**) and pay employer NICs on the fees received for the worker’s services.

### **Why are the IR35 rules changing?**

The problem with the regime is that the responsibility for making the status determination rests with the intermediary. In practice, this means that the worker – with a vested interest in *not* being an employee (or an office holder) for tax purposes – is assessing his or her own tax status. The client in the equation has no role in the process and no potential liability.

A review by HMRC revealed that compliance was extremely low and tax avoidance was still commonplace. Accordingly, in 2017, the Government rolled out two key changes to the IR35 rules in the public sector which removed the intermediary’s role in the process. First, responsibility for making the status determination shifted to the client. Second, if the worker was deemed to be an employee (or office holder) for tax purposes, the obligation to deduct income tax and employee NICs and to pay employer NICs shifted to the person immediately above the intermediary in the contractual chain (the **fee payer**).

In a simple three-party chain (i.e. worker > intermediary > client), the client will also be the fee payer and so will have to make the status determination and, if necessary, operate payroll. In a more complex chain different parties would have different roles. For example, in a four-party chain (i.e. worker > intermediary > agency > client) the client would make the status determination but the agency, as the fee payer, would operate payroll.

From 6 April 2020, these changes will be extended to the private sector. The Government expects this to generate an additional £3.1 billion of tax revenue between 2020 and 2024.

## **Who will the new IR35 rules apply to?**

The new IR35 rules will apply to medium and large incorporated and unincorporated entities operating in the private sector, but small companies will be excluded. An incorporated entity that meets at least two of the following tests will be considered a “small company” and be excluded from the new rules:

- i. An annual turnover of not more than £10.2 million.
- ii. A balance sheet total of not more than £5.1 million.
- iii. An average number of employees of not more than 50.

For group companies, the small company test is applied to the parent company. Therefore, if the parent company (which includes overseas companies) is a medium or large company, all its subsidiaries will also have to apply the new IR35 rules irrespective of their size or number of employees.

A simplified test applies to unincorporated entities, meaning an entity will be excluded from the new regime where it has a turnover not exceeding £10.2 million.

Where an entity is excluded from the new regime, the old IR35 rules will continue to apply (i.e. the intermediary must make the status determination and, if necessary, operate payroll).

## **Who will be responsible for making the status determination and how must it be communicated?**

As in the public sector, responsibility for making the status determination will move to the client. Once the status determination has been made, the client is obliged to communicate a “status determination statement” to certain parties in the contractual chain.

In a simple three-party chain, the client must provide the status determination statement directly to both the intermediary and the worker and also provide reasons to the intermediary (and to the worker, if requested).

In a more complex contractual chain, the client must provide the status determination statement directly to the party it contracts with and the worker. It must also provide

reasons to that party (and to the worker, if requested). The party who has received the status determination statement and reasons is then responsible for cascading that information down the contractual chain. For example, if the chain consisted of worker > intermediary > agency > client, the client would pass the status determination statement and reasons to the agency and the status determination statement only to the worker. The agency would then pass the status determination statement and reasons to the intermediary.

The status determination statement must be provided by the client to the relevant parties before payment is made for services provided on or after 6 April 2020. The status determination must also be repeated if the worker is engaged for a significant period (e.g. for a year or more) and/or if the circumstances of the engagement change.

### **How should the client make the status determination?**

Determining whether a worker is an employee for tax purposes is not straightforward. It requires applying a complex set of tests to the facts of each case. Importantly, clients are required to take reasonable care and are prohibited from simply making a blanket determination for all contractors they engage.

The first step will be to review all the written contractual terms. In a simple three-party chain this will mean looking at the contract between the intermediary and the client, because, in most cases, there will be no written contract in place between the worker and the intermediary. In a more complex chain, this will mean looking at the written contracts in place between all the parties in the chain.

The second step will be to consider whether the written documentation truly reflects how things operate in practice. For example, if the written contract provides that the worker has the right to provide a substitute, but, in practice, this is not allowed, this will be a relevant factor to consider.

Taking all this information into consideration, the next step is to construct the hypothetical direct contract between the worker and the client and identify its key terms. Then the client must apply the legal tests to decide whether the worker is an employee (note that a different test applies for office holders). The kinds of questions that will come into play are:

- i. Is the client obliged to offer work and is the worker obliged to accept it (known as “mutuality of obligation”)?
- ii. Is the worker controlled by the client (e.g. over hours and place of work)?
- iii. Is the worker in business on his or her own account (e.g. do they have their own premises and equipment)?
- iv. Is the worker able to hire staff or engage sub-contractors?
- v. Is the worker able to send a substitute to perform the services in his or her place?
- vi. Is there an opportunity for the worker to make a profit?

- vii. Does the worker only get paid after sending an invoice?
- viii. Is the worker integrated into the client's business?
- ix. What is the intention of the parties?

Unfortunately, no single question is determinative. Instead, all the information needs to be gathered and an holistic view taken.

There are various free resources available to help with this process. HMRC's online "[Check Employment Status for Tax](#)" (CEST) tool poses a series of questions which are designed to help clients decide the status of their contractors. The CEST tool provides an outcome at the end of the series of questions, which HMRC says it will stand by provided the answers are provided by the client, are accurate and are not contrived to achieve a particular outcome.

However, feedback on the CEST tool has been mixed. For example, it currently fails to test whether there is sufficient mutuality of obligation in the relationship between worker and client. Further, in the 15% of borderline cases it is unable to produce an answer. HMRC is currently engaging with stakeholders with a view to improving CEST to reflect relevant case law and the more complex nature of the private sector. Other resources include the HMRC's [Employment Status Manual](#) and a confidential [IR35 helpline](#) to deal with ad hoc queries. HMRC also offers a contract review service for signed contracts only.

### **Is it possible to challenge a status determination?**

Under the new IR35 rules, the client must develop and implement its own procedure to resolve disagreements about status determinations. Under the process the client must:

- i. allow for the consideration of evidence put forward by the worker and/or fee payer; and
- ii. within 45 days of receiving the evidence, advise the parties of the outcome of the process and provide reasons for the decision. The client can either confirm its original status determination or withdraw it and issue a new one.

If the client fails to advise the parties of the outcome within 45 days, then they will be deemed to be the fee payer and become liable to operate payroll. The intention is that this process will reassure workers and fee payers that the client has not taken an arbitrary or blanket approach to determining status.

If a worker disagrees with the outcome of the process, they have the right to seek a determination of status from HMRC.

### **If a worker is deemed to be an employee for tax purposes will they acquire employment rights?**

A determination that a worker is an employee for tax purposes does not automatically mean that the worker will acquire wider employment rights (such as the right to claim unfair dismissal) in relation to the client, although it makes it more likely.

The client can seek to defend a claim that the worker has employment rights (either as an employee or worker) on the basis that there is no direct contractual relationship between the worker and client and there is an intermediary in place. However, the rebuttal to this is that the intermediary is a mere shell and it is necessary to imply a direct contract to reflect the reality of the relationship.

## **Who is liable if something goes wrong?**

### ***What happens if the client fails to make and/or communicate a status determination statement?***

Tax liability would move to the client until such time as it meets its obligations.

### ***What happens if a party in the chain fails to fulfil its obligations to communicate a status determination statement to the next party in the chain?***

Tax liability would move to the defaulting party until such time as it meets its obligations. If HMRC was unable to collect the outstanding tax from the defaulting party, then the liability would transfer to the next party up the chain. Ultimately, the client would be responsible for any outstanding tax.

### ***What happens if a party in the chain provides false information with a view to deliberately changing the status determination?***

Tax liability would move to the fraudulent party.

### ***What happens if the fee payer follows a status determination made by the client with reasonable care, but which turns out to be incorrect?***

In this scenario, it appears that the tax liability would remain with the fee payer. However, if the client failed to take reasonable care when making the status determination then it would become liable.

These measures act as an incentive for all the parties in the chain to comply with their obligations to make and/or pass on a status determination. It also highlights the importance of ensuring that contracts are made with reputable parties, who understand and will comply with the new rules.

## **What steps should clients be taking now?**

### ***Step 1 – Consider whether it is possible to limit or avoid the application of the regime***

Under the new regime, the client has the administrative burden of making the status determination and administering the dispute resolution process. If the client is also the fee payer, it will, in appropriate cases, need to operate payroll, deduct tax and employee NICs and pay employer NICs. How could a client reorganise its working practices to limit or avoid these burdens?

- i. **Engage the worker directly as a self-employed contractor with no intermediary in place:** this would take the arrangement outside the scope of the new rules as there would be no intermediary in place. However, the direct contract could raise the risk of the worker acquiring employment rights and the client would still need to consider their proper tax status.
- ii. **Interpose an agency in the chain between the intermediary and the client:** this would mean the arrangement was within the scope of the new rules and the client would still have to operate the determination and dispute resolution process. However, the payroll and tax liability would be with the agency as the fee payer. Depending on bargaining power, the agency may try to pass on the cost of employer NICs to the client.
- iii. **Engage the worker via an agency with no intermediary in place:** this would take the arrangement outside the scope of the new rules as there would be no intermediary in place. Depending on the relative bargaining power of the parties, the agency may try to pass on the cost of employer NICs to the client. Although the worker would be employed by the agency, he or she would acquire some employment rights in relation to the client under the Agency Worker Regulations 2010.
- iv. **Outsource functions rather than contract for labour supply:** this approach would mean that the service provider company would be viewed as the “client” for the purposes of the new rules and so the company which is outsourcing the services would have no obligations under the new rules.
- v. **Engage the worker as an employee:** this would avoid the burden of the new rules but would involve additional employment costs and the worker would acquire full employment rights.

Where clients are willing to work within the new regime, however, they should take the preparatory steps outlined in steps 2 to 5 below.

### ***Step 2 - Ensure all contracts are revised to work within the new regime***

Clients should audit all existing contractor engagements and ensure the contracting terms are ready for the introduction of the new rules.

Where the client engages the worker via the intermediary, the contract will need to cohere with the status determination statement. It will also need to reserve the right to deduct income tax and employee NICs now or in the future if things change. The client may also wish to negotiate a reduction to the worker’s pay rate to reflect the fact that the client must

bear the administrative costs and the cost of employer NICs and the Apprenticeship Levy (being the levy payable by certain employers which is calculated at the rate of 0.5% the total pay bill, meaning that the higher the employer's pay bill, the higher the levy they pay). The client should decide what contractual changes are required and open a dialogue with the contractor with a view to agreeing the changes to take effect from 6 April 2020.

Where the client engages contractors via an agency, changes to the contract with the agency will be needed. For example, the agency should be obliged to provide them with any relevant information and copies of contracts needed to make the status determination. They should also be obliged to pass the status determination statement and reasons down the chain. The client should also seek an indemnity from the agency if the tax liability is passed up the chain for any reason which is not the client's fault.

### ***Step 3 - Consider who will have ownership of the process and how determinations will be made***

Clients will need to allocate responsibility for managing the process within its business. Who will have ownership of the process? Will they require training on the new rules? How will they gather the information needed to make the status determination?

It's also important to decide how status will be determined. Will CEST be used? What will happen in a borderline case if CEST generates no result? When will legal advice be sought? The client should maintain a paper trail of the determination process and ensure that the process is applied in a consistent manner.

### ***Step 4 - Devise the dispute resolution process***

Again, clients will need to decide who has responsibility for administering the dispute resolution process. Who will own it? What will the process look like? The client has a great deal of flexibility here, provided it considers evidence and completes the process within 45 days. Will the process permit written representations only or will it allow for a face-to-face meeting? Will there be an appeal stage? It would be sensible to commit the procedure to writing so it can be passed to the fee payer and worker.

### ***Step 5 - Review payroll software***

If the client is also fee payer it will need to ensure its payroll systems are compliant and able to operate PAYE and NICs for contractors.

## **What steps should contractors be taking now?**

### ***Consider the importance of your tax status and discuss with the client / fee payer***

The contractor should proactively open discussions with the client (and fee payer if different) about several issues.

If it is vital that the contractor retains his or her self-employed tax status, but there is a risk that the client could determine otherwise, then the contractual terms and the way the relationship operates on the ground will need to change to move it closer to self-employment. Will the client be willing to agree to this?

The contractor may also wish to consider renegotiating the pay rate to offset any deductions for PAYE and employee NICs. However, it is likely that the fee payer (whether client or agency) will also be looking to offset their increased costs and so the contractor's ability to negotiate a higher rate will come down to their bargaining power.

If the contractor is willing to accept employee tax status, then they may wish to be regarded as an employee for employment law purposes as well and acquire employment rights such as paid annual leave.

***Ensure that the client has all relevant information before making the status determination***

The contractor should ensure that the person making the status determination on behalf of the client receives all relevant information before making the determination. This includes information about how the relationship operates in practice, details of any work done elsewhere and details of any relevant legal decisions concerning IR35.

***Impact on tax affairs in previous years***

Contractors who have their tax status changed from self-employed to employee may be concerned how this affects previous years where they declared themselves to be self-employed. HMRC has indicated that it won't automatically investigate contractors who have their tax status changed, save where there is evidence of fraud. Accordingly, contractors should ensure they retain any relevant paperwork to justify status determinations made previous years.

**BDBF can help businesses and contractors prepare for the new regime. Please contact Amanda Steadman or your usual BDBF contact for further advice.**