

IR35 AND ENGAGING
CONTRACTORS: **PREPARE
NOW FOR CHANGES IN
APRIL 2021**



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Are you a private sector organisation that engages individual contractors who work through a personal service company (PSC)? If the answer is 'Yes', you are likely to be affected by new tax rules which will come into force on 6 April 2021. Originally, these rules were expected in April 2020. However, the start date was delayed for a year due to the Covid-19 pandemic.

INTRODUCTION

While there are many urgent demands on businesses at the moment, from managing Covid-19 to preparation for Brexit, the Government has confirmed its intention to proceed with changes to the IR35 tax regime and 'off-payroll' working rules next April. Under the new rules the responsibility for determining employment status and accounting for tax and National Insurance Contributions (NICs) of contractors who work through a PSC (or other intermediary) is shifting from contractor to client in the private sector (unless a small business exemption applies).

Failure to prepare for the rule changes could risk significant tax liability and, in some cases, an increased risk of fines imposed by HM Revenue & Customs (HMRC). If your organisation put this compliance project 'on hold' earlier in the year, now is the time to put it firmly back on the agenda. Significant lead-in time will be needed to review current contractors' arrangements and introduce new processes and procedures. It may even be necessary to re-negotiate some of your current contractors' terms and conditions.

This quick guide is intended to help you understand the new rules and kick start (or re-start) preparation for any changes you might need to make ahead of April 2021.

WHAT IS IR35?

IR35 tax rules were first introduced by HMRC in 2000 as a means of reducing tax avoidance by individuals who work, effectively, as employees of their client but claim to be self-employed contractors providing services through a tax efficient intermediary, usually their own PSC.

While there are genuine contractors operating through PSCs, the IR35 rules are designed to catch those who are in "disguised employment". Using a PSC intermediary in these circumstances can provide a contractor with a more tax efficient way of working. It also avoids their client having to deduct tax through PAYE, as well as paying employer NICs.

HOW DOES HMRC DECIDE IF IR35 APPLIES?

The IR35 rules apply if a contractor provides their services to a client through an intermediary, but would be classed as an employee if they were contracted directly.

There is no single, straightforward test which determines whether IR35 applies. However, HMRC does provide guidance on the factors it takes into account when determining whether an individual is a genuine self-employed contractor or a "disguised employee". For example, key factors include:

- **Personal service:** Is there an obligation on the individual to provide their services personally (rather than using a substitute)?
- **Mutuality of obligation:** Is there a mutual obligation on the individual to complete his or her work and on the client to provide work and pay the individual for their work?
- **Right of control:** Does the client control the way in which the work is performed? Does it supervise the individual and direct which tasks have to be carried out and where and when the work must be completed?

Other factors such as the length of the engagement, degree of integration into the business, exclusivity of the arrangement, provision of equipment, level of financial risk, means of payment and entitlement to employee benefits may also be relevant. However, the HMRC guidance stresses that the factors it lists are not exhaustive.

HMRC also make it clear that the actual working practices, and not just the provisions of any written contract or label given to the working arrangement, will be relevant to whether a particular arrangement is caught by IR35.

To assist employers, HMRC provide an anonymous online checking service (Check Employment Status for Tax tool (CEST)) <https://www.gov.uk/guidance/check-employment-status-for-tax> which helps determine if an individual working on a specific engagement should be classed as employed or self-employed for tax purposes. Although CEST has been criticised for inaccuracies, it is a useful indicator of how HMRC is likely to view a particular engagement.

WHAT HAPPENS IF IR35 RULES DO APPLY?

Currently, if HMRC finds that there is "deemed employment" the IR35 rules will apply and the individual contractor will be required to pay broadly the same tax and NICs as an employee.

HMRC may also look at whether or not IR35 applies to any previous work the individual has carried out (going back at least six years) and can request payment of any necessary additional penalties and interest.

HOW IS THE IR35 TAX REGIME GOING TO CHANGE IN APRIL 2021?

Until 6 April 2021, it is the responsibility of an individual contractor (and not its clients) to self-assess and declare their employment status under IR35, for tax and NICs purposes, to HMRC.

HMRC claims that this self-assessment regime has been ineffective and that there is widespread non-compliance, with an estimated cost of £1.3 billion in the private sector by 2023/24. To tackle non-compliance, HMRC is shifting the onus to prove self-employed status from the contractor to the “end-user” of contractors’ services (i.e. the client). The change is being introduced under the ‘off-payroll working rules’, which sit over and above the IR35 tax regime.

WHO IS AFFECTED?

This shift in responsibility for determining employment status for tax purposes will affect medium to large end-user clients in the private sector. A similar change already took place in the public sector in 2017 when the off-payroll working rules were first introduced.

A client will be a medium or large-sized company if it meets at least two of the following conditions for two consecutive financial years:

- turnover of more than £10.2 million
- a balance sheet total (assets) of more than £5.1 million
- an average of more than 50 employees

However, if a client is part of a group of companies (or connected to other entities) or part of a joint venture special rules will apply for determining its size.

Where the client is a small company (which does not meet the above criteria for being medium or large), the individual contractor will continue to be responsible for declaring their employment status under IR35 to HMRC.

If contractors are unclear as to the size of their client (and, therefore, where responsibility lies for declaring employment status to HMRC), the new tax rules allow them to make a formal request to the client for confirmation of its size in any given tax year.

WHEN DO THE CHANGES APPLY?

The new rules will apply in respect of those engagements where payments are made on or after 6 April 2021 but only where the contractor’s services were also provided on or after 6 April 2021. If the contractor’s services were all provided prior to 6 April 2021, (but payment was made on or after 6 April 2021), the payment would not be subject to the new rules.

If a payment is made for services which were provided both before and after 6 April 2021, HMRC state that a ‘just and reasonable’ apportionment should be made and the new rules will apply to the part of the payment which can be reasonably seen to be for the contractor’s services provided on or after 6 April 2021.

WHAT IS THE PRACTICAL EFFECT OF THE CHANGES FOR CLIENTS?

In summary, the new rules require medium and large private sector clients who use contractors working through a PSC (or other intermediary) to:

- Determine, using reasonable care, the employment status of each its contractors for IR35/off-payroll working purposes (i.e. whether or not the contractor would be an employee for tax and NICs purposes if they were directly engaged by the client).
- Produce a Status Determination Statement (SDS) which sets out the employment status of the contractor and the client’s reasons for coming to this conclusion.
- Pass a copy of the SDS to the contractor (and any third party that the client contracts with for provision of the contractor’s services such as an employment agency).
- Keep detailed SDS records in accordance with HMRC’s document retention rules.
- Establish a status disagreement process to deal with SDS disputes.

If the SDS concludes that the contractor is not self-employed and the client is the ‘deemed employer’, the client will be responsible for the deduction of tax and NICs, and paying these to HMRC.

WHAT HAPPENS IF THERE IS A LABOUR SUPPLY CHAIN?

In cases where a labour supply chain is involved, the situation is more complicated. Under the new rules, the client is required to pass a copy of the SDS to the contractor and any third party it contracts with for provision of the contractor’s services (e.g. an employment agency). Agencies in a supply chain that sit between the client and the contractor’s PSC all have a responsibility to pass the SDS to the next party in the contractual chain. When the SDS reaches the agency which sits immediately above the contractor’s PSC, this last person in the chain (also known as the “fee-payer”) will normally be the deemed employer who is responsible for the deduction and payment of tax and NICs.

Failure to pass on the SDS can result in tax and NICs payment responsibilities resting with the party that has failed to pass it on. If it is the client that has failed to pass on the SDS, HMRC may also consider this to be evidence of a lack of reasonable care when calculating any penalties that may be due.

Other factors can also affect who bears the responsibility for tax and NICs, for example, if any parties in the contractual chain are based overseas or the contractor has a material interest in them. HMRC’s recovery rules can also apply if the deemed employer has failed to meet its responsibilities.

WHAT ARE THE NEW RISKS OR BURDENS TO CLIENTS WHO ENGAGE CONTRACTORS THROUGH PSCS?

Hiring contractors will involve more administrative burden and associated risks for private sector clients under the new tax rules. In particular, clients should be alert to the following:

- **Producing a SDS for every contractor:** The requirement to produce a SDS applies to all contractor relationships where a PSC (or other intermediary) is involved unless the client can rely on a small business exemption. (If there are material changes to a contractor's terms and conditions or working practices, the client must also reconsider their original SDS to see if it still stands.) Failure to produce and pass on a SDS will result in the client being responsible for the deduction of tax and NICs, and paying these to HMRC.
- **Taking 'reasonable care':** HMRC requires clients to take reasonable care when producing a SDS as a failure to do so can result in a contractor's tax and NICs payments becoming the client's responsibility. Clients may also be subject to fines for these compliance failures.
- **PAYE/NICs withholding obligations:** If a client is the 'deemed employer', it will need to put in place mechanisms for withholding tax and NICs.
- **Dealing with labour supply chains:** Clients will need to take extra care when using a labour supply chain, ideally checking the identity and credentials of any parties or employment agencies in the chain. In some cases an agency's failure to meet their obligations under the new rules could result in the responsibility to pay tax and NICs landing back with the client.
- **Responding promptly to disagreements:** From April 2021, clients will be required to handle disagreements with contractors (or third parties who are the 'deemed employer') regarding the contractor's SDS. Failure to respond to a disagreement within 45 days will mean that the obligations to pay tax and NICs become the client's responsibility.
- **Responding promptly to formal requests for confirmation of size:** Clients must respond to requests from contractors (or the person a client contracts with, e.g. an employment agency) if they are uncertain about the size of the client for a particular engagement. If the client does not respond, confirming its size within 45 days of receipt, the requestor can apply to the courts for an injunction.

WHAT IS HMRC'S APPROACH TO COMPLIANCE?

HMRC has committed not to use information acquired as a result of the rule changes to open new compliance checks for previous tax years, unless it has reason to suspect fraud or other criminal behaviour. It has also promised a 'light-touch' approach to penalties for inaccuracies relating to the new rules in the first 12 months (unless there is evidence of deliberate non-compliance).

HOW CAN CLIENTS PREPARE FOR THE NEW RULES?

For clients with contractors who are affected by the new rules, it is important to start laying initial groundwork now in preparation for the changes in April 2021:

- **Audit:** Carry out an audit of the workforce (including those supplied through agencies) to identify individuals who are supplying their services through PSCs (or other intermediaries).
- **Assessment:** Make initial assessments of employment status and whether the new tax rules could apply to any contractors that will be supplying their services beyond 6 April 2021. Clients could use the HMRC CEST tool (see above) as a first step in the assessment process.
- **Review:** Review existing contractual obligations (including those with third parties such as employment agencies in a labour supply chain) and consider whether these can or should be changed where an initial assessment suggests that the new tax rules apply to your contractors who operate through a PSC (or other intermediary).
- **Communications:** Start communicating (and potentially negotiating) with contractors (or third parties that you contract with for the supply of contractors' services) where the new tax rules apply and you intend to make changes to existing arrangements.
- **Policy:** Establish an internal policy on engaging future contractors and the process for making SDS on new engagements. Also establish procedures for handling SDS disputes or formal requests to confirm the size of the client.

HOW CAN WE HELP?

Our team of 70 HR solicitors, lawyers and HR consultants can help you get to grips with IR35 and ensure you comply. We can provide one-to-one support or self-help tools to assess any potential risk to your operations and to manage contractor relationships in your business. We will also be running workshops for HR, senior managers and payroll managers.

Call 0808 168 5874 or visit

www.makeuk.org/services/hr-and-legal/ir35-support-for-your-business

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