

# IR35 – WHY ARE U.K. BUSINESSES SO CONCERNED?

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**Tags**  
Employment Tax  
H.M.R.C.  
IR35  
U.K.

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## INTRODUCTION

New U.K. tax rules are being introduced from April 2020 to make businesses liable for determining the employment tax status of contractors and off-payroll workers who work through personal service companies (“P.S.C.’s”). The changes to the tax rules, known as IR35, will create significant costs and compliance challenges for businesses that rely heavily on specialized contractors.

- From April 2020, businesses engaging contractors through P.S.C.’s will become responsible for determining the contractor’s employment tax status.
- Businesses with large numbers of off-payroll workers face a huge compliance challenge to ensure that new systems are in place to deal with the new requirements.
- The new rules are driving changes in how U.K. businesses engage with contingent workers.

## CURRENT RULES FOR ENGAGING CONTRACTORS THROUGH P.S.C.’S

It has become common practice in the U.K. for businesses to encourage the use of P.S.C.’s to engage individual contractors – rather than directly engaging a contractor as a self-employed person or onboarding the contractor as an employee. While there is no legal definition of a P.S.C., typically, it is a company in which the same person is sole director and employee of the business and engages in the business of providing outsourced services to a client. The practice of using P.S.C.’s is so widespread that it cuts across the U.K. labor market and into most sectors.

The practice of engaging contractors through P.S.C.’s provides a business with increased flexibility, particularly where labor demands fluctuate throughout the year depending upon the requirements of particular projects. In addition, it creates important H.R. cost savings to businesses because company benefits such as sick pay and holiday pay for employees are not extended to the contractor engaged through the P.S.C.

Crucially, the use of P.S.C.’s generates significant U.K. tax savings. Currently, a private sector business that contracts with a P.S.C. does not deduct employment taxes through the U.K.’s Pay As You Earn (“P.A.Y.E”) collection mechanism from payments made to the P.S.C., and it is not required to pay employer-side social security contributions, known as N.I.C.’s. Employer-side N.I.C.’s are currently payable at 13.8% of the compensation base to an employee. Therefore, engaging contractors through a P.S.C. offers a business significant tax saving on its payroll costs.

Once effective, the changes to IR35 will require that P.A.Y.E. taxes and N.I.C.'s be paid with respect to a person who provides services through a P.S.C. if that person would have been regarded as an employee had it been engaged directly by the business. Currently, where a private sector business engages a P.S.C. to provide outsourced services, liability to decide whether IR35 applies and to pay any employment taxes rests with the P.S.C.

The IR35 rules were originally introduced in 1999 to target perceived widespread avoidance primarily in the I.T. sector. However, avoidance continues to be the rule rather than the exception. Over the past 20 years, the use of P.S.C.'s to engage contingent workers has grown exponentially and now is commonplace. Despite the existence of IR35, H.M.R.C. considers that compliance remains low under the current regime. It is estimated that only 10% of P.S.C.'s that should pay tax under IR35 actually do so.

In April 2017, reforms were introduced to the public sector, causing public authorities and other public sector engagers of P.S.C.'s to be responsible for P.A.Y.E. and N.I.C.'s if a contractor is engaged through a P.S.C. and the individual who performs outsourced services would be regarded as an employee under the IR35 rules. The changes triggered a seismic shift in the manner in which the U.K.'s public sector engaged contractors, with many public authorities and public sector organizations choosing to disallow further engagements with P.S.C.'s and instead opting to pay all contractors through payroll.

Following independent research commissioned by H.M.R.C. into the implementation of the amended IR35 rules in the public sector, the U.K. government considers that the public sector reform has been "successful" in terms of increasing tax compliance without enforcement action by H.M.R.C. Last year, it was estimated that an additional £410 million of P.A.Y.E. tax and N.I.C.'s were collected under the public sector reforms.

## PROPOSED CHANGES TO IR35

In its October 2018 budget, the U.K. government confirmed that the public sector changes to IR35 would be extended to the private sector from April 2020.

Following the publication of draft legislation in summer 2019, and notwithstanding the U.K. general election on December 12, 2019, it is now expected that, from April 2020, private sector businesses engaging contractors through P.S.C.'s will be responsible for determining their relationship with individuals engaged by the P.S.C. and collecting P.A.Y.E. tax and N.I.C.'s if they decide the individual would have been an employee if engaged directly. In these circumstances, the company that engages the contractor (referred to as the "client") will also be liable to pay employer-side N.I.C.'s.

The changes will not apply to small businesses that engage contractors through P.S.C.'s. Broadly, a "small company" will be defined as one that meets at least two of the following criteria:

- Turnover – not more than £10.2 million
- Balance sheet – not more than £5.1 million
- Employees – not more than 50

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Businesses covered by IR35 will be required to provide a statement (“S.D.S.”) to any contractor working through a P.S.C. The S.D.S. will reflect the determination of the contractor’s employment tax status, including reasons behind the determination. A contractor will then have the right to disagree with the determination through a new business-led status disagreement process. Businesses with large numbers of P.S.C. contractors are likely to be concerned by the proposed status disagreement process, as they could find themselves engaged in numerous IR35 status disputes.

Where a business engages a P.S.C. through an agency, the liability to make P.A.Y.E. and N.I.C. payments will transfer to the agency, which is referred to as the “fee payer.” Responsibility for determining the employment tax status of the contractor and issuing the S.D.S. will remain with the client. The client will be required to pass on the S.D.S. to both the fee payer and the contractor. If the S.D.S. reflects a determination that the contractor falls within the IR35 rules, the fee payer will be required to operate P.A.Y.E. and pay N.I.C.’s.

If the fee payer fails to make any of these required payments, the liability may pass back up the supply chain to the client. Further, if the client does not exercise reasonable skill and care when making a status determination, the liability for paying any employment taxes will also pass back to the client.

In complex supply chains, there may be a number of contracting parties between the client and the contractor engaged through the P.S.C. The fee payer will be the agency or entity that engages directly with the P.S.C. The S.D.S. must be supplied by the client to the contractor and also passed down the chain to the fee payer who will be responsible for P.A.Y.E. and N.I.C. payments. The possibility of liability passing back up the chain is troubling in such circumstances.

### **Guidance (or Lack Thereof)**

Both clients and fee payers are concerned by the expanded IR35 proposal, particularly where they are involved in complex supply chains with a number of parties between the fee payer and the P.S.C. The draft legislation provides little information about how this will work, simply providing for further regulations to allow H.M.R.C. to recover tax that should have been paid in relation to IR35. H.M.R.C. has confirmed that the ability to transfer tax liabilities up the supply chain is only intended to apply to cases of noncompliance and “deliberate tax avoidance” and not where there has been a “genuine business failure.” However, U.K. businesses still have cause for concern.

Much of the detail as to how H.M.R.C. will apply the rules has not been published as of December 10, 2019, although detailed H.M.R.C. guidance is expected prior to the implementation date. Basic guidance was published as a series of notes in August 2019; however, it includes little detail on how the rules should be applied in practice.

Although “extensive support” to ensure organizations are able to implement the new IR35 rules was promised by H.M.R.C., draft guidance published to date is so limited and for the most part simply repeats statements that have already been made. Without further guidance, businesses with complex supply chains and large, flexible workforces are expected to struggle to meet the April 2020 deadline.

It is anticipated that detailed guidance will be published after the U.K. general election and, hopefully, long before the April 2020 implementation date.

### *Transfer of Liabilities Up the Chain*

To date, the draft guidance provides very little information regarding how the provision to transfer tax liabilities back up the supply chain will work in practice. The guidance simply confirms that liability may be transferred to the top parties in the supply chain if H.M.R.C. “cannot collect any outstanding tax or N.I.C.’s from parties below them.” With only four months until the changes are introduced, it is concerning that this vital aspect of the new rules remains uncertain.

At this time, businesses remain unclear about the precise extent of their obligations under the new rules. It is particularly concerning that the published guidance does not include any information about how businesses can demonstrate that reasonable skill and care were exercised when making status determinations. To reiterate, where a business is deemed not to have taken “reasonable care,” tax liabilities will transfer back to the business. Therefore, it is vital that businesses understand what this term means. To date, H.M.R.C. has failed to deliver on promises of clarification regarding the steps businesses must take to demonstrate compliance and limit exposure.

Given the lack of clarity on reasonable care, there is also concern that contractors may seek to use the term as a weapon against businesses, when disputing an S.D.S. under the disagreement process.

### *Group Status Determinations*

When proposals for the new IR35 rules were first announced, it was envisaged that it would be possible for a client to make a single status determination for a group of contractors working in a similar way and on substantially the same terms. However, the draft guidance confirms that an S.D.S. will be required for every contract where an individual provides services through a P.S.C., casting doubt on the viability of group determinations under the rules.

H.M.R.C. has previously acknowledged that making group determinations may be acceptable for contractors with the same role, work practices, and contractual conditions, but even then, they caution that “it may [only] be appropriate in some circumstances.” H.M.R.C. has not expanded on those circumstances. Furthermore, notwithstanding previous assurances, the current published guidance is silent on the issue.

The ability to make group determinations where appropriate is essential to businesses engaging with large numbers of contractors on the same basis and would significantly reduce the compliance burden, whilst still ensuring that the new IR35 rules operate as intended. It is hoped that a mechanism for group determinations will be included in the final detailed guidance.

### *Who Is the Client?*

In most cases, it will be obvious who the client is and, therefore, which business has responsibility for making the status determination and issuing the S.D.S. However in the context of some “contracted out services” the position may be difficult ascertain. Broadly, the client is the entity that is in receipt of a “supply of labor” and to whom a worker is personally obliged to perform services.

Where a business contracts out a service, the business paying for the service will not be the client for the purposes of IR35 unless there is a supply of labor attached

to the provision of service. For example, where a business contracts with a security company for security services and the security guards engage with the security company through P.S.C.'s the question might arise as to whether the engaging business or the security company supplying the services is the client for IR35 purposes. The analysis is likely to turn on the specific facts. However, if the contract for the supply of security services specifies named individuals to be provided as security guards and those individuals become embedded in the business, it is possible that there could be a supply of labor in relation to those specified security guards, and therefore, the engaging business could be the client for IR35 purposes.

This is a significant point to bear in mind when assessing exposure under the new regime – is the client, or the business supplying services, the ultimate engager?

### **Check Employment Status for Tax**

When considering whether an engagement with a P.S.C. falls within the IR35 rules, a client must determine whether the contractor would be considered to be an employee for tax purposes if engaged directly.

In the U.K., there is no precise legal test to determine whether an individual is an employee for tax purposes. Rather, the concept has been developed by a series of court decisions and is dependent on a number of factors – not just the contract terms but also on how the individual is treated in practice, which can lead to a difficult fact pattern. Relevant factors might include the following:

- The level of control and supervision that the client has over the work that the contractor undertakes
- Whether the contractor could send a substitute if unable to perform the work
- Whether there is mutuality of obligation between the parties
- The length of the worker's engagement
- Whether the worker provides the equipment used to perform services

Determining employment status for tax purposes can be complicated. H.M.R.C. has published guidance on when it considers an employment relationship to exist for tax purposes. It has also developed an online Check Employment Status for Tax ("C.E.S.T.") tool, which uses a series of questions to determine employment status for tax purposes only. However, existing effectiveness of C.E.S.T. has been limited, as it has failed to give an answer in 15% of cases. A revised version of C.E.S.T. was published at the end of November 2019. It remains to be seen whether the updated tool will provide a definitive result where the facts are complicated.

It may still be advisable to use C.E.S.T. to determine employment tax status under the IR35 rules, since H.M.R.C. has confirmed that it will stand by a determination made under C.E.S.T. if the information provided is accurate.

## **SHIFTING MARKET PRACTICES**

In autumn 2019, some of the larger U.K. banks made it clear that they intended to take a risk-averse approach to the new IR35 rules and would not extend the contracts of contractors engaged through P.S.C.'s beyond April 2020.



It is not surprising that the banks have opted for this approach. Banks tend to have very large numbers of off-payroll workers. Deciding not to engage contractors through P.S.C.'s eliminates a significant compliance headache, since the obligation to make employment status determinations and issue S.D.S.'s under IR35 will not apply.

The decision by some of the larger banks to avoid the new regime is driving behavioral changes across the financial services sector. Some businesses are now opting for a blanket approach that avoids engagement with a contractor if a P.S.C. is involved in the supply chain.

In other sectors that are heavily reliant on a limited number of highly specialized contractors, a blanket approach may not be possible. Alternative models of engagement include routing all P.S.C. contractors through agencies. Although this may not solve the problem of making status determinations and issuing S.D.S.'s, it should reduce the risks associated with the obligation to make P.A.Y.E. and N.I.C. payments for a large number of contractors.

Ultimately, insurance companies may provide a product that addresses the risk of liability where appropriate steps are made to determine the status of contractors engaged directly or where liability passes up a chain of companies.

## WHAT SHOULD BUSINESSES DO TO PREPARE?

If not already undertaken, U.K. businesses with a contingent workforce should take action to prepare for the changes to IR35 and the increased tax risk that is faced. H.M.R.C. has outlined four actions that businesses should take to prepare for the reforms. These include identifying and reviewing current engagements with intermediaries such as P.S.C.'s and labor supply agencies and putting in place comprehensive processes to determine the employment status of contractors. H.M.R.C. also recommends that businesses should review internal systems such as payroll software, process maps, H.R., and onboarding policies to see if changes are required.

H.M.R.C. has published several notices advising businesses to take action to prepare. This should be seen as a clear warning to act immediately. Businesses can expect H.M.R.C. to begin robustly reviewing compliance as soon as the new rules become law.

In the first instance, a business must identify how many P.S.C.'s it engages and the divisions that engage P.S.C.'s. Once a business has identified its P.S.C. population, it must undertake a comprehensive risk assessment to establish its exposure to IR35 and review whether changes to H.R. and procurement processes are required. A comprehensive IR35 compliance project in a large organization is likely to include a review and possible alteration to a business's I.T. and compliance systems. This could take some time to implement and is another reason for starting the project as soon as possible is recommended.

Businesses must ensure that clear processes for making status determinations and issuing S.D.S.'s across the supply chain have been adopted prior to engaging contractors through P.S.C.'s. The adoption of a standardized policy for making determinations, the rationale for individual status determinations, and the potential for objections from individuals who frequently do not understand the complexities of the

law, could be an organizational nightmare for businesses engaging thousands of contractors. Careful thought should be given to managing these obligations (where relevant) in conjunction with any agencies.

Businesses may wish to consider the provisions already in place in existing sub-contracts, main contracts, and templates and assess potential IR35 issues and any required changes.

Embarking on this compliance exercise as quickly as possible will be crucial for businesses in sectors that rely heavily on a flexible workforce – where large numbers of contractors are likely to be engaged through P.S.C.'s.

An alternative to this problem is a return to employment and payroll policies that existed prior to the widespread use of P.S.C.'s.

## DO CONTRACTORS HAVE CAUSE FOR CONCERN?

There have been concerns that, under the new IR35 rules, if a business determines that a contractor is an employee for tax purposes that could open up the contractor's P.S.C. to H.M.R.C. challenges with respect to prior years if the P.S.C. had not been applying P.A.Y.E. In a recent news briefing, H.M.R.C. confirmed that it will not use information from employment status classifications under IR35 to open new enquiries into earlier years, unless there is reason to suspect fraud or criminal behavior. This news comes as a relief to many contractors concerned about being hit with a significant tax bill for previous years.

H.M.R.C. challenges to employment tax status decisions under IR35 have become commonplace in recent years. Most notably the British Broadcasting Corporation ("B.B.C.") has become embroiled in a number of tax tribunal decisions regarding the employment tax status of several of its television presenters previously engaged to provide services to the B.B.C. through P.S.C.'s.

## CONCLUSION

Given the complexity of supply chains in some sectors, the prevalence of contractors operating through P.S.C.'s, and the continuing need for a flexible labor market, the new IR35 rules are expected to have widespread implications. Despite the limited guidance currently available, businesses should take action now to assess supply chains and implement any necessary changes to policies, contracts, and procedures. H.M.R.C. is expected to begin robustly reviewing compliance as soon as the new rules become law in April 2020.

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