

IR35 – Incoming Changes Present New Compliance Burdens for Employers

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KEY POINTS

- The off-payroll rules (IR35) aim to stop individuals from avoiding employee status for tax purposes (and thereby reducing the income tax and National Insurance Contributions (NICs) payable) by supplying their services through an intermediary (often a personal service company (PSC)) and paying themselves a dividend from the PSC, rather than supplying their services directly to a client in an employment relationship.
- From 6 April 2020, medium- and large-sized clients will be under an obligation to assess the status of workers who contract with them through a PSC or other intermediary – the client will have to determine whether a worker would be an employee if the worker were working directly for the client.
- If a worker is found to have a relationship with the client equivalent to one of employment, the client must account for pay-as-you-earn (PAYE) income tax and NICs to Her Majesty's Revenue and Customs (HMRC) in respect of the payment it makes to the PSC (or other intermediary).
- In practice, making assessments as to a worker's employment status will require extensive and ongoing compliance measures by clients, including due diligence on intermediary entities and making the worker aware of its deemed status (whether or not an employment relationship is deemed to exist).
- Medium- and large-sized clients should setting up internal procedures ready for the April 2020 change, and be aware that contracts entered into prior to 6 April 2020 may still be caught within the amended IR35 regime.

The Current Position

IR35 was introduced in 2000 to stop individuals ("workers") and their employers reducing income tax and employer's and employee's NICs by workers supplying their services through a PSC and paying themselves in dividends from that intermediary.

The relevant legislation is found in the Social Security Contributions (Intermediaries) Regulations 2000 (SI 2000/727) and Chapter 8 of Part 2 of ITEPA 2003 (for NICs and income tax respectively).

Mechanics

IR35 generally applies where:

- a) a worker personally performs, or is under an obligation to perform personally, services for a client (the “end client”);
- b) such services are provided under arrangements involving an intermediary as opposed to being provided directly;
- c) the end client pays a fee to the intermediary;
- d) the intermediary meets certain conditions of control (broadly that the worker has a material interest of at least 5 percent in the intermediary or a payment is received by the worker from the intermediary and this ‘can reasonably be taken to represent remuneration’);
- e) were the services provided directly to the end client, the worker would be regarded as an employee of the end client for income tax purposes/NIC purposes, or the worker is an officer-holder of the end client; and
- f) the worker receives payment from the intermediary that is not employment income.

The employment status of the worker in respect of the services, determination of which is required to address (e) above, is currently determined (outside the public sector) by the intermediary that provides the services of the worker to the end client. In assessing employment status, the IR35 regime will look for a contract of employment which would have existed between the worker and end user but for the PSC – a ‘notional contract’.

IR35 also applies in circumstances where the payment is delayed or an associate of the worker (e.g., spouse) receives the payment.

Consequences

Should IR35 apply, income tax and NICs must be paid as though the fee paid to the intermediary were employment income of the worker – the worker is treated as an employee of the intermediary and the intermediary must pay PAYE and NICs in respect of the fee received from the end client regardless of what is actually paid by the intermediary to the worker.

A change was introduced in 2017 in respect of off-payroll public sector workers to make the public sector end client, not the PSC, responsible for determining whether its relationship with the relevant worker would have been one of employment had no PSC been involved. From April 2020, where the end client is a medium- or large-sized organisation the end client will be in an equivalent position to a public sector client and will have to make the employment status determination. This is the crux of the April 2020 change and the primary legislation change discussed below.

The April 2020 Changes

From public to private

The Government has been concerned about non-compliance with IR35 legislation in the private sector, and thus lost public revenue, for some time. From April 2020, the law is changing in an attempt to increase private sector IR35 compliance.

ITEPA 2003 and Social Security Contributions (Intermediaries) Regulations 2000 will both be amended. The legislative changes will affect contracts entered into or payments made on or after 6 April 2020. Please note that the changes therefore affect arrangements made prior to 6 April 2020 where payments are made as a result of such arrangements on or after that date.

As outlined above, IR35 responsibilities which already apply to public sector contractors will be widened to include the private sector. **The changes to the IR35 legislation shift responsibility from 6 April 2020 for determining whether an engagement falls within IR35 from the worker's PSC to the end client. Should an arrangement be within the IR35 regime, the responsibility for making the appropriate income tax and NICs deductions will fall on the employer which pays the worker's PSC.**

The effect of the changes will be that where an individual works for a medium/large organisation (the end client) through their own PSC and falls within the IR35 regime, the corporation is treated as an employer, the amount paid to the PSC is deemed to be a payment of employment income, and the employer must remit payments to HMRC as appropriate.

Note that where a small (as defined by CA 2006) end client is involved, responsibility for assessing whether IR35 legislation applies and paying the relevant tax remains with the intermediary.

Employment status

A 'status determination statement' must be provided to the worker and include the reasons for the determination as to the worker's employment status. This statement must be provided whether or not the worker is deemed to be an employee.

The determination must be made with 'reasonable care' — failure to do so will invalidate the status determination provided to the worker and expose the end client to employee income tax and NIC liability if IR35 applies.

The reasons for the status determination must be passed by the end client down the labour supply chain to any employment agency and the intermediary sitting between the end client and the worker.

Who do the changes affect and how are they affected?

Persons affected by the changes

- Individuals supplying services through a PSC — in practice this is likely to be a consultant, whose PSC has a services agreement with the relevant end client
- Medium- and large-sized organisations (the end client) engaging individuals through PSCs
- Recruitment agencies/other intermediaries supplying staff through PSCs

Practical ways in which such persons may be affected

The end client must make a determination of the worker's employment status in order to apply IR35, if necessary. This needs to be done as soon as possible, as the worker must be provided with the status determination status before the end client may be taken outside of the IR35 regime, and the worker has the right to dispute the conclusion provided in the status determination statement. The process of 'onboarding' the worker will also be lengthier should IR35 apply to the worker.

The determination is a question of applying a fact-sensitive test which will be subjective, and the courts have found this assessment to be a question of balance, looking at the notional contract between the end client and the worker.

In practice, this will mean a significant investment of time and resources by the end client to ensure ongoing compliance with the IR35 regime, both in terms of investigating whether existing consultancy arrangements fall within the scope of IR35, and formalising a procedure for IR35 checks when new workers are brought on board.

Clients are able to use (and HMRC encourages the use of) the 'check employment status for tax' online tool (CEST), available [here](#). This tool asks the user a series of questions designed to elicit key employment status information, and then provides a determination. HMRC have stated that they 'will stand by the result given unless a compliance check finds the information provided isn't accurate'. It is important to note that both end clients and HMRC can challenge any CEST determination (and have done so with varying degrees of success in recent cases). However, a CEST determination, though rebuttable, provides an excellent rationale for an employment status determination made by an end client.

How should clients mitigate the risk?

Mitigating risk on an administrative level

1. Clients should immediately identify existing individuals supplying services through an intermediary, and implement procedures to ensure that any new individuals in the category are identified on an ongoing basis.
2. Clients should undertake appropriate due diligence on entities within the supply chain between an individual and the end client. It is crucial to note that, even if there are several entities in the supply chain between the individual and the end client, the end client must make appropriate checks on each entity in the chain: the end client may be held liable if any one of the intermediary entities fall short of their IR35 PAYE obligations, for example, by failing to pass the status determination statement down the chain resulting in an underpayment of PAYE. See *'Further Issues' below for more details.*
3. Clients should implement procedures to assess and document such individuals' employment status, using the CEST tool as appropriate, and provide individuals with a status determination statement clearly stating the rationale for the decision reached.
4. Clients should ensure the contract for services between the end client and the relevant intermediary properly reflects the working arrangements and gives the end client the right to deduct PAYE and NICs if necessary, and includes appropriate indemnities and warranties.
5. Clients should consider what internal system changes are needed (e.g., to on-boarding procedures, payroll or accounts payable systems).

Mitigating risk within the services contract

In order to reduce the risk of a relationship with a worker being captured by the IR35 regime, consider including the following provisions in the services contract between the end client and the PSC:

- a) a right of substitution;
- b) an element of financial risk/reward;
- c) the worker to bring own equipment (if relevant); and
- d) the contract should state that relationship is not one of employment.

The client should consider avoiding the following in drafting the services contract:

- a) any obligation to provide and accept work (i.e., mutuality of obligation);
- b) any control over the worker (e.g., working hours);
- c) open ended contracts;
- d) any rights to terminate other than for breach; and
- e) any employee benefits.

Further issues

An imperfect system (is CEST a pest)?

- As noted above, there is an ongoing debate as to how much reliance should be placed on CEST — it has been suggested that CEST is unable to analyse the subtleties of notional contracts as required, and instead sees key features (e.g., a right of substitution) as determinative. This issue is a symptom of the inherent uncertainty as to the balancing act required and the view HMRC/the courts are likely to take on employment status.

Liability beyond the end client's control

- The draft legislation provides that provisions may be made authorising the recovery from a relevant person (which includes the end client and other parties in the supply chain) of an amount that HMRC considers another person should have paid under PAYE in respect of the deemed income payment to the worker.
- During the consultation phase of developing the April 2020 legislation, HMRC confirmed that this meant that 'if HMRC were unable to collect the outstanding liability from [a party in the supply chain], for example, because it ceased to exist... the liability should transfer back to the first party or agency in the chain. Where HMRC could not collect from the first party or agency it would ultimately seek payment from the client... This proposed approach first places the PAYE and NICs liabilities with the party in the supply chain who has failed in their obligations, before moving the liabilities to the first agency in the supply chain if the initial party still does not comply'.
- In the responses to the consultation, concerns were raised about the ability of the first party/end client to enforce compliance with parties further down the supply chain – in other words, the end client could be penalised for a company's actions (or lack thereof) without any ability to control the situation.
- HMRC has not altered the draft legislation despite such responses, and so end clients may be secondarily liable for failure by an entity further down the labour supply chain to meet their PAYE obligations. The end client must therefore conduct due diligence on all entities in the chain, but its ability to do so effectively may be limited by circumstance, and entities who are currently complying with the regime may not continue to do so. The Association of Taxation Technicians and the Law Society are particularly concerned about the lack of legislative detail as to when an end client can be held liable for unpaid tax.

Tension between clients and workers

From a client perspective, there is likely to be tension between the end client taking the 'safe' approach by including workers in the IR35 regime (although this brings with it potential tax liabilities for the end client) and workers who have operated through a PSC previously outside IR35 who may be suddenly saddled with income tax and NIC liabilities. An ongoing collaborative dialogue with workers, keeping them up to date with the client's processes and conclusions as they develop, may help to alleviate any potential animosity.

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