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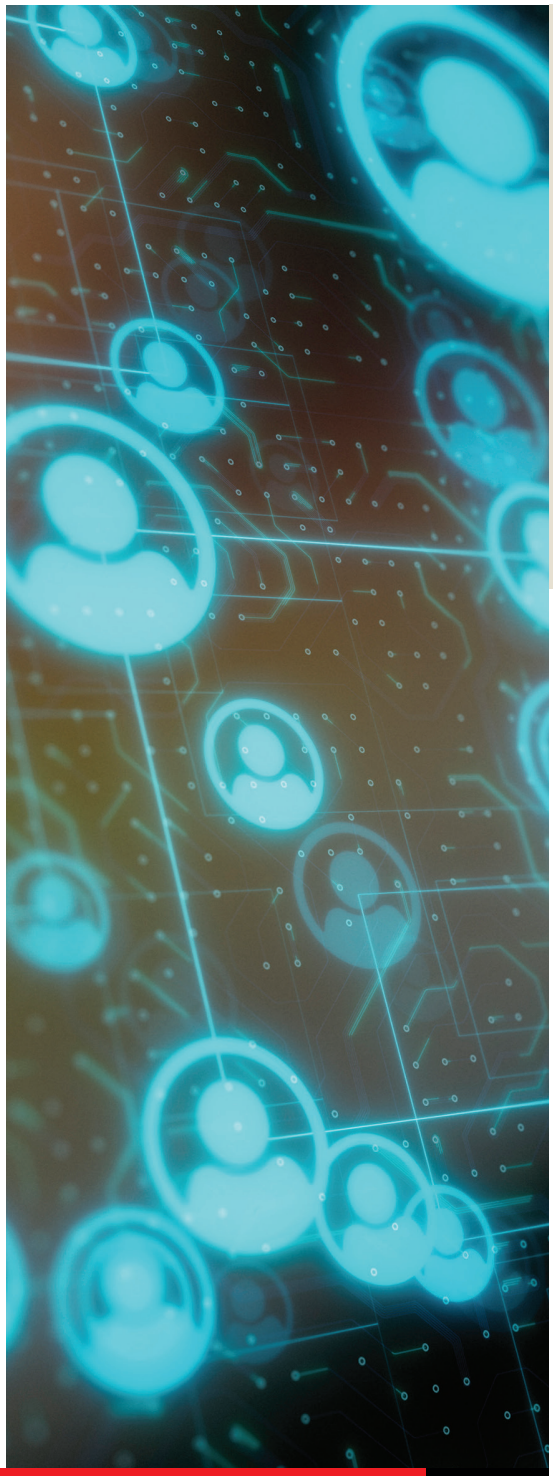

IR35 imminent

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Analysis

IR35 changes imminent: what do they mean?

Speed read

Following a one-year delay because of the covid-19 pandemic, the off-payroll worker tax rules for private sector clients are due to be introduced from 6 April this year. The rules set out two principal obligations for the private sector client under which it must: determine whether, had it contracted with its contractor directly on terms reflecting the actual arrangements, the contractor would be regarded as an employee of the client; and produce a 'status determination statement' (SDS) in respect of each contractor and the associated contractual engagement. While the questions raised by the new rules are complex and technical, as a practical matter they are likely to simply result in a game of contractual pass the parcel in relation to the new tax payment, risk and administration obligations away from the private sector clients and onto the contractors except where the contractors have very specialist skills required for specific projects.

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Development of the IR35 rules

Changes to the IR35 rules in ITEPA 2003 Part 2 Chapters 8 and 10 have been introduced by FA 2020 Sch 1 with effect for payments from 6 April 2021.

The IR35 rules were first introduced in 2000 in an attempt to counter the perceived employment tax avoidance resulting from individuals providing their services through an intermediary (often their personal service company or PSC) on terms such that the individual would be treated as an employee had she contracted with the end client directly. The way that these rules operated (and will continue to operate after 6 April 2021 when services are supplied to 'small' private sector clients) was that it was up to the PSC to determine the individual's deemed employment status and account for any income tax and national insurance contributions if the individual was treated under the rules as an employee (a deemed employee). No risk rested with the client if it engaged with the individual through an intermediary, and this led to many businesses which engaged with contractors demanding that the contractor engage through a PSC.

In 2015, the government communicated its concern that non-compliance with the rules was widespread and raised the possibility that the clients, rather than the PSC, might be required to determine the deemed employment status of their contractors. This led, in 2017, to changes to the rules for clients in the public (but not private) sector.

The new public sector rules were introduced in ITEPA 2003 Part 2 Chapter 10. They provide that the deemed employment relationship is between the public sector client and the contractor rather than the contractor's intermediary and the contractor, so that the question of whether the contractor should be treated as an employee transferred from the PSC to the client. Where the client engages with the contractor through a chain of intermediaries and the contractor is a deemed employee, the last intermediary before the contractor (or their PSC) has to operate PAYE and pay national insurance contributions as if the contractor were its employee. Where the public sector client engages with the PSC directly, it is the client that has the employment tax obligations.

These changes brought home to end clients just how difficult it can be to determine the deemed employee status of a contractor as a result of the assessment having to be made by large organisations which generally want to avoid any residual risk related to incorrectly deciding that a contractor was not a deemed employee. We discuss these difficulties in more detail below.

What do the current changes do?

Building on the 2017 changes for public sector clients, FA 2020 has introduced further changes, effective from 6 April this year, which align the position for private sector clients which are not small (i.e. large or medium clients) with that of public sector clients and introduce some new obligations for both public sector and medium and large private sector clients. (We assume in the rest of this article that the private sector client referred to is not small.)

The new rules set out two principal obligations for the private sector client under which it must:

1. determine whether, had it contracted with its contractor directly on terms reflecting the actual arrangements, the contractor would be regarded as an employee of the client; and
2. produce a 'status determination statement' (SDS) in respect of each contractor and the associated contractual engagement giving its conclusion on whether the contractor should be treated as a deemed employee or a self-employed contractor.

Where there is a chain of intermediary entities between the end client and the contractor (or their PSC), the SDS has to be passed down through the chain to each intermediary and the last intermediary (before the PSC) has the employment tax payment obligations (i.e. income tax and national insurance contributions) to the extent that the SDS concludes that the contractor is deemed an employee (such intermediary known as the 'fee-payer' under the rules). The rules also state that the client must take reasonable care in preparing each SDS and must explain the reasons for concluding that the contractor should or should not be treated as a deemed employee. The client must also have a process through which the contractor can appeal the conclusion in the SDS.

If either an SDS is not provided or the SDS is not prepared using reasonable care, the end client is considered the fee-payer under the rules and so remains primarily responsible for any employment taxes that should be paid to HMRC if it is determined that the contractor should have been treated as a deemed employee.

Consequences and practical steps for private sector clients

So, the new rules have a number of significant consequences for relevant private sector clients engaging contractors through PSCs or other intermediaries:

- the obligation to determine whether a contractor is a deemed employee now rests with the client;
- the client must take reasonable care when making the deemed employee status determination and so will need a functioning in-house process and policy in order to do this;
- the client must also have an appeals process under which the contractor can question the conclusion in the SDS; and
- if the client does not fulfil its SDS obligations it will retain the primary obligation to account to HMRC for any employment taxes associated with the contractor's services.

The consequences of the changes mean that private sector clients that use contractors will, to the extent that they haven't done so already, have to:

- review the nature of the work that they use contractors for and the terms under which the contractors are engaged;
- try to assess whether they are likely to have any deemed employees amongst their current contractors;
- establish a process that will allow them to make SDSs, on an individual and reasonable basis, and to introduce an appeals system available to contractors who wish to question determinations;
- consider the contractual protections in their contracts with PSCs or other intermediaries in the chain between the client and contractor to ensure that they are protected from liability resulting from any failure by any of those intermediaries to comply with their obligations under the rules; and
- having considered these matters, decide whether they want to impose particular requirements on contractors who want to work for them (whether through changes to the way in which they engage the contractors, additional indemnity protections or changes to fee arrangements).

There is, however, one important way in which the private sector client can avoid all of these obligations. That is if the contractor engages with the end client not through their PSC but, rather, through an agency or umbrella company which engages the contractor as its employee and pays them subject to employment taxes. This is because such an agency or umbrella company is not treated as an intermediary under the rules. This particular scenario was the subject of intense discussion between HMRC and the contractor sector in October 2020 because the drafting of the new rules is defective in such a way as to cause concern that an umbrella company would be treated as an intermediary. HMRC issued a statement on 15 October 2020 confirming that the intent behind the rules was that they did not apply to end clients that engaged with contractors through agencies or umbrella companies which accounted to HMRC for the relevant employment taxes. We refer below to umbrella companies as encompassing all such agencies and umbrella companies.

From the contractor's perspective, engaging through an umbrella company will mean that the contractor will (or should) be paid subject to employment tax deductions and will have to pay the relevant service fee to the umbrella company.

Keeping this in mind, we consider some practicalities in respect of the new rules below.

How to do an SDS

Where the rules apply, the end client must produce an SDS. This is an assessment of whether or not an individual contractor under the terms of a specific engagement would be treated as an employee of the client if they engaged directly with the client on hypothetical terms reflecting the overall terms of the engagement between the client, the PSC (and other intermediaries if relevant) and the contractor (referred to as the 'hypothetical contract'). This requires an application of the specific facts and terms of the engagement to what is not a straightforward analysis of what constitutes an employment relationship. That analysis is informed by a large body of case law, from which it is, unfortunately, difficult to draw conclusions.

The author considered the difficulties around mapping particular client/contractor relationships onto the body of case law in a previous article in this journal ('Paint me a picture: employment or self-employment?' (Stephen Pevsner), *Tax Journal*, 17 January 2020).

As discussed in that article, and in simplified terms, the case law shows that there are two specific and one general characteristic(s) to apply to any client/contractor relationship to assess whether it should be treated as one of employer/employee (a contract of service) or of client/self-employed contractor (a contract for services). These characteristics (taken from *Ready Mixed Concrete* [1968] 2 QB 497) are that there is:

- mutuality of obligation between client and contractor;
- sufficient control exercised (or able to be exercised) by the client over the work performed by the contractor; and
- nothing in the contract or arrangement being inconsistent with a contract of employment.

Recent case law developments

There have been a number of cases in recent years seeking to apply these tests to client/contractor arrangements in the context of the existing IR35 rules, many of them involving well-known television and radio personalities. There are some common themes arising from these cases. Namely, they are long judgements seeking to apply the *Ready Mixed Concrete* tests through a detailed assessment of the terms of the relevant arrangements, transposing those terms into the hypothetical contract that would have existed between client and contractor had they contracted directly and applying the tests to those terms. What is not consistent among the cases, and even between the various courts considering a particular case (or, on occasion, the judges in a single court), is how that process should be approached, what the important elements of the hypothetical contract are and what the conclusion on deemed employment status is.

Since the beginning of last year, a number of further cases have considered the question. In *HMRC v Kickabout Productions Ltd* [2020] UKUT 216 (TCC), the Upper Tribunal (UT) allowed HMRC's appeal against the First-tier Tribunal's (FTT's) decision that the contractor in question should not be considered to be a deemed employee. The FTT had decided that there was insufficient mutuality of obligation for there to be an employer/employee relationship because the client was not required to provide the contractor with work, notwithstanding that the contractor had regularly presented a radio programme for the client over a long period of time. The UT considered the terms of the two contracts under which the contractor had provided his services and decided that the client was, in fact, required to provide work once a contract was entered into. On that basis, the UT decided that the FTT had made an error in law and that the contracts had created a deemed employment contract.

In *Red, White and Green* [2020] UKFTT 109 (TC), the FTT decided that Eamonn Holmes was a deemed employee of ITV in relation to his job as a presenter of This Morning because ITV had the right to exert sufficient control over his work (even though members of the programme's editorial team gave evidence that, in practice, they had very little control

of what he did on air and ITV did not accordingly exercise the rights that it had in this respect). This approach to control can be contrasted with that taken by the FTT in the *Albatel* [2019] UKFTT 195 (TC) case (involving Lorraine Kelly) in which the court decided that the relevant broadcaster did not have sufficient control over how the individual carried out her work. One can expect Mr Holmes to appeal the *Red, White and Green* decision given the inconsistency of approach between tribunals in this respect.

In *Professional Games Match Officials Ltd v HMRC* [2020] UKUT 147 (TC), the UT agreed with PGMOL that the relevant contracts between referees and PGMOL did not contain sufficient mutuality of obligation to create a deemed employment contract.

In *Northern Lights Solutions Ltd v HMRC* [2020] UKFTT 100 (TC), the FTT decided that a contractor providing IT services through a number of contracts with the Nationwide Building Society was a deemed employee by reason of each individual contract meeting the mutuality of obligation requirement and the contractor being subject to overarching control by Nationwide over when and where the work was performed (even though Nationwide did not, in practice, exercise any such control). The FTT dismissed the right of substitution of worker provision in the contracts as having no realistic prospect of being used.

In *Atholl House* [2021] UKUT 37 (TCC), the UT has recently upheld the FTT's decision that Kaye Adams was not a deemed employee. While both decisions found that there was mutuality of obligation in the hypothetical contract between Ms Adams and the BBC and the UT considered that the BBC had control of her work, both courts took an overall view of the indicia against deemed employment on the basis that her long working activity as a freelance journalist meant that she was carrying on that business for her own account when presenting for the BBC.

As shown by the above cases, the range of approach, complexity and contrasting conclusions continues. Although recent case law provides further insight into the importance of considering mutuality of obligation (where an individual is required to do work which is required to be offered to them by the client), the decisions remain varied in approach when examining the specific facts and terms of arrangements. This gives very little clarification to the contractor sector trying to remove ambiguity from this question, particularly in difficult or borderline cases.

So, while the continued variety and complexity of the case law is of interest to advisers in the field, it will serve to make the task for organisations engaging with contractors extremely difficult.

Practical difficulties

The difficulty that clients will face can be highlighted by a number of consequences arising from the previous changes to the IR35 rules for public sector clients in 2017.

It was widely reported that, following those changes, National Health Trusts and the BBC, for example, started to apply a broad presumption of deemed employment status to their contractors without considering each contractor's status on an individual basis. Following threatened litigation by the Independent Health Professionals Association (IHPA), NHS Improvement issued guidance to the NHS Trusts reminding them that they needed to apply individual assessments to each individual contractor and engagement.

In order to assist the public sector clients with their assessments, HMRC introduced a 'check employment status for tax' (CEST) tool as an online resource which allows the user to answer a number of questions about the relevant engagement and be given a conclusion as to deemed employment or not. HMRC has said that it will be bound by the conclusion if correct and truthful answers are given to the questions. It has also said that the use of CEST in preparing an SDS will evidence that the client has taken reasonable care.

However, the CEST tool has been, and continues to be, severely criticised since its introduction for taking an overly simplistic approach to a complex issue and erring heavily on the side of concluding that there is deemed employment. In particular, CEST does not ask about mutuality of obligation, as HMRC considers that this requirement is satisfied simply by the existence of a contract. As the recent case law demonstrates, this is not the view taken by the courts, which have held that the mutuality of obligation has to relate to an obligation on the part of the client to provide work and on the part of the contractor to perform it. So, taking into account the difficulty of the question, the requirement to assess the deemed employment status on a reasonable and individual basis, the right of contractors to appeal SDSs, the administrative burden that the new rules will place on private sector end clients and the potential tax risks associated with getting it wrong, it is understandable that many businesses that use contractors will seek to avoid coming within the scope of the rules at all to the extent that they can do so.

What is the likely effect on the contractor market?

The approach of medium and large private sector clients to their contractor workforce is likely to divide into two, depending on the nature of the engagements:

1. single, identifiable and specific engagements requiring particular individuals with specialist skills, where the contractor has reasonable bargaining power; and
2. more routine engagements, where the client has a continuing requirement for a particular class of worker (in a single or number of engagements) and where the skills required are generally available.

While the clients are likely to have to take on the full burden of the new IR35 rules when engaging with specialist contractors under the sort of engagements referred to in (1) above, they are much less likely to accept additional responsibilities and risk in respect of the sort of engagements referred to in (2).

Where the 2017 changes to public sector arrangements led to blanket deemed employee determinations because it was considered the safer course of action for public sector clients, anecdotal evidence (backed up by the approach that the authors have seen on recent transactions) shows that the affected private sector client market is likely to want to avoid the new rules altogether. This is likely to be an unfortunate consequence resulting from the difficulty of the question that they are being asked to answer regarding deemed employment status and the potential liability that might fall on them if they do not carry out any deemed employee assessment with the required reasonable care.

As discussed above, the new rules do not apply to an end client if the final intermediary in the chain between the client and the contractor is not, effectively, an entity in which the contractor has at least a 5% interest and that intermediary pays the contractor subject to employment taxes. This is likely to lead to end clients demanding that their main body of contractors either become actual employees of the end client or that they engage through an umbrella company which, in each case, employs them and deals with the employment tax obligations.

This approach will then allow the private sector clients to put in place focused processes that allow them to assess the limited number of contracts under which they engage with

their specialist contractors, the nature of those engagements, whether they can come to a reasonably conclusive and confident determination of the contractor's deemed employee status and the contractual protections that they might need in their contracts in circumstances in which they can be more confident that the conclusion will be that the contractor is not a deemed employee and that they can relinquish the sort of day to day control that they might require in more routine engagements. Even in these circumstances, clients are likely to take a very conservative approach to the question of deemed employment or self-employment.

This overall approach is likely to have the unfortunate consequence for some contractors whose arrangements should properly be characterised as self-employed where they are conservatively assessed as deemed employees or will become de facto employment under an umbrella company arrangement, with additional tax and fee costs as a result. Those additional tax costs will include employer NICs and, where relevant, apprenticeship levy charges, as well as increased income tax and employee NICs for the contractors. It will be interesting to see who bears these costs under such arrangements. Will it be the end client (through increasing contractor payment rates) or the contractor? Again, anecdotal evidence is that in many cases they were likely to fall on the contractors.

As a final note, while engaging with an umbrella company might be the end of the matter for the client, the contractor should also think carefully about the arrangements that they are entering into and, in particular, the possible movement to more umbrella company arrangements in the sector.

HMRC has been concerned about tax avoidance schemes offered by certain umbrella companies since 2018 (as discussed in its Spotlight 45). These schemes involve the contractor (including, according to recent reports, some engaged by HMRC) being paid a proportion of their pay outside the umbrella company's payroll through loan arrangements or similar and, as far as HMRC is concerned, falling four square within the disguised remuneration anti-avoidance rules in ITEPA 2003 Part 7A. Where they apply, those rules can lead to immediate employment tax charges for the contractor with interest and, possibly, penalties applied.

So, where the terms under which the end client is willing to engage with the contractor require the contractor to work through an umbrella company, the contractor would be well advised to make sure that the umbrella company is making all required employment tax payments and uses any bargaining power that they might have to ensure that they receive an acceptable amount after all of the additional tax is taken into account.

All in all, what are portrayed by HMRC as minor changes of emphasis (because the underlying intended effect of IR35 has not changed), transferring the difficult question of deemed employment status from the contractor's PSC to the end client is likely to have significant impact on the contractor market with many pushed into de facto employment for either the client itself or an umbrella company. ■

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- IR35 and umbrella companies (D Kirk, 21.10.20)
- News: HMRC clarifies scope of off-payroll working rules where intermediary is a company (21.10.20)
- *Professional Game Match Officials*: clarity on mutuality of obligation (M Groom, 12.5.20)
- IR35: far from a fallow year (M Groom, 21.4.20)
- Paint me a picture: employment or self-employment? (S Pevsner, 17.1.20)