ALERT MEMORANDUM

Personal Service Companies
New Consultation on UK Off-Payroll Working Rules From April 2020

29 March 2019

In the course of the ongoing reform of the UK off-payroll working rules, a new policy paper and consultation document was issued on 5 March 2019 (which can be accessed here). This finally provides some details on the proposed operation of the new rules and invites stakeholders to comment on the proposals by 28 May 2019.

If you have any questions concerning this memorandum, please reach out to your regular firm contact or the following authors.

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To recap, the 2018 UK Autumn Budget confirmed that the off-payroll taxation rules (commonly referred to as IR35) for the private sector and the public sector will be aligned, from April 2020. Draft legislation to implement this reform is expected to be published this summer, for inclusion in the next Finance Bill.

The reform will introduce significant changes for private sector arrangements where an individual is engaged through a personal service company (PSC). In particular, there will be a shift of responsibility for ensuring that the correct amounts of payroll taxes (income tax and National Insurance contributions (NICs)) are paid and accounted for to HM Revenue & Customs (HMRC). Subject to an exemption for small entities, such responsibility will shift from the PSC to the end client or, where the labour chain includes persons between the end user and the PSC (such as agencies), to the UK resident person closest to the PSC in the chain.

This alert aims to describe the principal elements of the current proposals and their implications for working arrangements in the private sector. For the reasons set out below, our view is that the new regime, as currently proposed, could make it considerably more onerous for businesses to engage consultants through PSCs, in particular where agencies are involved in the labour chain.

Interaction with employment rights

There is currently no direct link between tax and employment rights (although the respective rules for determining employment status use broadly similar concepts). Last year, the Government issued a consultation to explore whether there was a case for aligning the employment status definitions across tax and employment rights, including whether individuals deemed to be employees for tax purposes should receive employment rights. However, this has not yet led to any concrete proposal for alignment.

Although the Government has acknowledged that having separate frameworks for determining employment status for employment rights and tax can create confusion for individuals and employers, it nevertheless intends to press ahead with the proposed reform of the rules for taxing off-payroll working arrangements. It appears that the primary concern is to increase the tax take for the Exchequer and that any resulting incongruities between tax and employment rights are secondary considerations, which are unlikely to be resolved in the short term.

Scope of the new off-payroll working rules – exemption for small end clients

The smallest organisations will not be affected by the reform and will not need to determine the status of the off-payroll workers they engage. They will instead continue to be subject to the current rules applicable to the private sector.

Whether a corporate end client is "small" will be determined based on existing provisions of the Companies Act 2006. To be "small", the corporate end client must meet two out of the following three requirements: (i) annual turnover of not more than £10.2 million, (ii) balance sheet total of not more than £5.1 million, and (iii) number of employees not more than 50. Companies in "small groups" (again based on existing company law provisions) will also qualify as small.

Relevant criteria for non-corporate entities to which the Companies Act 2006 does not apply are under consideration, and the consultation requests stakeholder input in respect of the following two options: (i) looking at the number of employees or turnover, or (ii) looking at the number of employees and turnover.

Information requirements and compliance obligations

From April 2020, the end client will be required to make a status determination and then pass such determination (and, on request, the reasons for it) down the labour chain. In addition, the end client will be required to provide the status determination (and, on request, the reasons for it) directly to the individual off-payroll worker.

Where the status determination requires the individual to be treated as an employee for tax purposes and there is no chain (i.e. the end client contracts directly with the individual's PSC), the end client will be required to operate PAYE and account for employment taxes (income tax and NICs) to HMRC.

Where there is a labour chain (i.e. there are persons, such as agencies, in the contractual chain between the end client and the PSC), the obligation (if any) to operate PAYE would fall on the "fee payer", usually the person who contracts with (and therefore makes payments to) the PSC. If the person who contracts with the PSC is not resident in the UK, the UK resident person closest to the PSC in the chain will be the fee payer.

Importantly, the fee payer's obligation to operate PAYE will be subject to the persons higher up the labour chain (if any) complying with the information requirements. Essentially, it is envisaged that the obligation to operate PAYE will move down the chain to the fee payer with the status determination. Where a person fails to pass a status determination down the chain, that person would become liable for unpaid employment taxes. So in order to minimise the risk of liability for income tax and NICs, the end client (and any person in the labour chain between the end client and the fee payer) will need to ensure that any status determination is properly passed on.

The consultation recognises that compliance with the information requirements could be cumbersome where labour chains are long and complex. The Government is therefore considering an alternative approach to simplify information flow, where the fee payer would receive the information directly from the end client. The difficulty here is that this would require the end client to know the identity of the fee payer (in fact, the consultation asks for input as to how

the end client may be in a position to identify the fee payer).

It should also be noted that even full compliance by a person in the chain (other than the fee payer) with the information requirements may not eliminate the risk of liability for such person. This is relevant primarily in cases where the end client does not contract directly with the PSC, but the arrangement involves one or more intermediaries between the end user and the PSC. If (i) the person who would be liable to operate PAYE under the revised rules (i.e. a fee payer who has received a status determination or a person in the chain who has failed to pass on a status determination) does not discharge such liability, and (ii) HMRC is unable to collect the outstanding liability from that person (e.g. because such person has ceased to exist), the liability would transfer back to the intermediary closest to the end client in the chain (if different from the defaulting person). If there is no such intermediary, or if HMRC are unable to collect the outstanding liability from that intermediary, the liability would shift to the end client.

Clearly, there are a number of potential pitfalls in the proposals described above, in particular where the end client does not contract directly with the PSC. HMRC's view, as expressed in the consultation, is that dealing with any such pitfalls and associated risks will be an issue for the taxpayer (e.g. by using appropriate contractual arrangements or by "*choosing to only work with reputable and compliant firms*"), and that this should in fact incentivise taxpayers to comply with the new regime.

Addressing status determination disagreements between the end client and the off-payroll worker and/or the fee payer

The consultation seeks to address stakeholders' concerns expressed in responses to a previous consultation, that end clients may choose to apply a blanket approach and operate PAYE without due consideration of the individual circumstances of an arrangement. The concern is that such approach could lead to genuine consultancy arrangements being treated as employments for tax purposes (without the relevant individual workers qualifying for employment rights).

To counter this issue, end clients will (on request) be obliged to provide reasons for a status determination, as a "*first step in seeking to resolve status disagreements*". Beyond that obligation, the Government takes the view that any status disagreement process should be "*client led*", in other words be the end client's issue to deal with. Essentially, it is envisaged that end clients will be required to develop and implement a process to resolve disagreements based on a set of requirements to be specified in legislation.

The stated purpose of the process is to provide "*additional assurance to off-payroll workers and fee payers that the client has not taken an arbitrary approach to determining status and has considered any evidence they may have to the contrary*".

The Government does not consider this to be a disproportionate administrative burden for end clients (expressing the view that medium or large-size private sector organisations are likely to have relatively sophisticated HR processes in place in any event).

This does not take into account, however, that the potential for status determination disagreement, coupled with the need to establish a procedure for resolving such a disagreement, may well discourage end clients from engaging off-payroll workers for any but the most straightforward arrangements (even if this would otherwise be commercially desirable).

To assist end clients in making status determinations, HMRC are working with stakeholders to explore enhancements to their existing tool *Check Employment Status for Tax (CEST)* and associated guidance, both of which are intended to be made available to taxpayers before the new rules come into force in April 2020. It is hoped that such enhancements will make a meaningful difference, as the current version of CEST is not equipped to determine the status of arrangements correctly in all cases. For example, CEST appears to struggle where a PSC is used for the provision of services by high-skilled professionals to an end client which is subject to the rules of a regulator (such as the Financial Conduct Authority) or a professional body (such as the Solicitors Regulation Authority), as in those circumstances the question whether the off-payroll worker is subject to the end client's control is not straightforward.

Other points

Finally, the consultation provides an outline of how the new rules are expected to interact with employment laws and other aspects of the UK tax code. This includes the following:

- The deemed employment relationship under the off-payroll rules will not result in employment rights or statutory payments obligations for the deemed employer or fee payer.
- The fee payer will need to operate PAYE in accordance with normal PAYE rules, using the individual's national insurance number and tax code (which the individual will be required to provide).
- Where a liability for employer's NICs arises under the new rules, it will not be possible for the fee payer to use the employment allowance to set against such liability (the employment allowance is an allowance of up to £3,000 per tax year which businesses can generally set against their liability for employer's NICs, subject to certain exceptions).
- Where applicable, the amount treated as employment income of the off-payroll worker will be the VAT exclusive amount paid to the worker's PSC. Incidentally, this confirms that it is not intended for the application of the new rules to disturb the application of the VAT rules. So where the PSC is required to charge VAT before the rule change, it will need to continue to do so.
- The new legislation will include provisions to address double taxation so that a PSC does not pay corporation tax on income that is treated as employment income of the individual and taxed as such.
- Where the new rules apply to treat income of the PSC as employment income of the individual, there will be restrictions for the PSC with regard to making employer pension contributions (free of income tax and NICs) on behalf of the individual. It appears that the main reason for this is that it would make calculations too complicated to administer. The consultation is seeking input on whether it may be possible for pension contributions to be routed through fee payers.

Summary

It seems clear from the above that the application of the new off-payroll working rules could make it considerably more onerous for businesses, from a compliance perspective, to engage consultants through PSCs.

In addition to the increased compliance obligations, the end client's position with regard to the risk of liability for employment taxes may remain uncertain – even where a status determination is properly made and passed down the labour chain, unpaid liabilities could potentially revert to the end client.

As a result, off-payroll working arrangements could become considerably less attractive for the private sector, regardless of whether the arrangements are tax driven or based on commercial considerations. Depending on the individual circumstances, companies may choose to offer short term employment contracts as an alternative to engaging with a PSC.

Practical Steps

Affected companies who engage PSCs should consider their response to the proposed changes. In particular, they should conduct a general review of their existing workforce to establish their level of reliance on workers supplied via PSCs, and they should assess on a case by case basis whether the new rules would require deductions for income tax and NICs.

Depending on the outcome of such review, companies may even need to consider whether their non-employed workforce needs to be fundamentally restructured.

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