IR35 - Off-payroll working in the private sector

Are you prepared for changes to the IR35 rules?
Exactly a year later than planned, changes to the off-payroll rules – known as IR35 – will take effect in the private sector next month. The emergence of COVID-19 put paid to the changes affecting large and medium-sized private-sector organisations this time last year, but now it's for real.

They were originally introduced back in 2000 to ensure that someone working like an employee, but through a company, pays similar levels of tax to other equivalent employees.

Non-compliance was forecast to cost the Treasury around £1.3 billion by 2023/24 if not tackled, prompting the Government to reform the rules starting with the public sector from April 2017.

This shifted the responsibility for determining employment status from an individual contractor to the organisation engaging them, with the aim of increasing compliance.

Now it's the private sector's turn.
From 6 April 2021, organisations that engage contractors through personal service companies (PSCs) or other intermediaries, such as partnerships or limited liability partnerships, will need to assess whether the rules apply to contracts they enter into.

Where the IR35 rules do apply, the private-sector organisation paying the PSC or other intermediary needs to deduct income tax and National Insurance contributions (NICs) at source before making the payment, and pay employers' NICs.

With lockdown restrictions still in place as the UK grapples to get on top of COVID-19, hopes were high that the Government might be considering kicking the can further down the road. But that seems to have evaporated with less than a month to go until the changes come in.

Who does this affect most?
The rules will affect medium and large-sized organisations, third parties or intermediaries, and contractors operating in the private sector. Small organisations are exempt.

A company is considered 'small' if it satisfies two of the following criteria: annual turnover of less than £10.2 million, a balance sheet of less than £5.1m or fewer than 50 staff.

HMRC estimates around 60,000 private-sector businesses in the UK utilise contractors, plus 20,000 recruitment agencies, which supply workers who operate through intermediaries like a PSC.

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Since announcing the one-year delay in March 2020, HMRC has directly written to more than 40,000 medium-sized organisations and offered one-to-one support for larger businesses.

Employers and other organisations that use private-sector contractors and other forms of contingent labour will have to assume responsibility for determining employment status from next month. They will be responsible for deducting tax and NICs before paying contractors.

As many as 170,000 contractors in the private sector who operate through their own PSC will also be affected, along with some charities and third-sector organisations.

The rules only apply to individuals who are considered to be working like employees under the current employment status tests, and do not affect the self-employed.

There are some key employment indicators which should be considered in determining status.

Mutuality of obligation
The rules require employees and employers to sign employment contracts that oblige the former to work and the latter to offer and pay them for that work. This is the mutuality of obligation.

There is, however, no ongoing obligation on either side when it comes to self-employed agreements because the self-employed can pick and choose projects with no obligation to accept them.

A customer who is looking into hiring a self-employed worker is under no obligation to offer work to keep them busy as they might with an employee.

Substitutions
Private-sector contractors who operate through a limited company and want to remain outside of IR35 after April 2021 should ensure a genuine right of substitution exists throughout each contract.

To stay outside of IR35, you need to be able to show HMRC that someone of equal competence, supplied by you, could have carried out the work to the same standard – that they're paying for a service, not for you specifically.

Should a client specifically ask for you to do the work and reject a colleague who is equally qualified, HMRC might interpret this to mean that you are inside IR35.

Other common indicators
Bringing your own equipment is one way of proving to HMRC that you are self-employed, as is having several different customers at the same time.

Similarly, taking on financial risk by being willing to correct work in your own time and at your own cost, or being paid after submitting an invoice following completion of the task, is acceptable proof.

Checking employment status
Following the rollout of IR35 reforms to the public sector in April 2017, HMRC developed an employment status for tax tool (CEST) to determine whether or not a contract falls inside or outside of the rules, which was described as not fit for purpose.

The CEST test was slammed for not taking into account mutuality of obligation, which led to the ICAEW giving it a vote of no confidence.

In November 2019, HMRC launched an "enhanced" CEST tool in a bid to address these concerns. Since then, the tax authority claims the CEST test has been used more than 230,000 times by over 160,000 users.

Improvements were made to language and presentation, while guidance was added to ensure questions are clearly understood. Crucially, none of those questions are on mutuality of obligation and this is therefore assumed.

Expenses allowance
If the CEST tool deems a private-sector contract to be inside IR35, the contractor's PSC will still be able to use the 5% expenses allowance of gross annual income earned in respect of calculating the deemed salary. This is to cover any administrative expenses incurred.

These expenses include costs relating to premises, admin support, accountancy advice, professional indemnity insurance, computer equipment, training, seeking contracts, printing and stationery, and bank or overdraft interest. You do not need to demonstrate this expenditure.

The 5% allowance is not available to employees as an expense they can draw from the company and is not taken into account in respect of calculating corporation tax.

Penalties
From 6 April 2021, accidental breaches of the off-payroll rules in the private sector will not be penalised for the first 12 months – unless there is evidence of deliberate non-compliance.

In February 2020, HMRC said it would not open new investigations into PSCs for tax years prior to 6 April 2020, unless there is reason to suspect fraud or criminal behaviour.

While this was before the COVID-19 pandemic took hold in the UK, this should remain the case from next month onwards.

Options
With HMRC adopting a light-touch approach towards penalties, you have 12 months before it starts really cracking down on non-compliance.

If you haven't already prepared, start by using the CEST tool as soon as possible to see if any of your 2021/22 contracts will fall within the IR35 rules. If they do fall within the rules, would it be better engaging the contractor as a permanent employee?

Another option would be to get to grips with the finer details of your contracts in the event HMRC sends you a full inquiry letter or formal information request.

Some limited companies have already closed down before the rules extend to the private sector, while other contractors are deciding to close down their PSC to take on temporary assignments through an umbrella company.

Talk to us about IR35 in the private sector.

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