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IR35: the new regime for contractors

It's all about tax and employment status, and who makes the decision on status.

The overhaul to the IR35 rules, postponed because of Covid-19, is now less than six months away. For most off-payroll workers, it adds up to a big change to procedure from 6 April 2021.

Who is impacted?

The change applies if you provide your personal services to an end client through an 'intermediary'. The most common type of intermediary is a worker's own 'personal service' company (PSC), and PSCs form the focus of this Briefing. But please note that an intermediary can also be an individual, partnership, or unincorporated association, and all intermediaries are potentially impacted by the change.

Determining employment status: moving the responsibility

The off-payroll rules, often called the IR35 rules, came in because of government concern about loss of tax revenue, particularly National Insurance Contributions (NICs), arising through the use of intermediaries in the labour chain. The government believes widespread misclassification of off-payroll workers who should really be treated as employees is to blame.

It's therefore moving responsibility for making the decision on employment status on each contract away from contractors and PSCs, and on to the client receiving their services. This has already been done for engagements in the public sector.

When it will affect you

From 6 April 2021, you are no longer responsible for deciding your employment status if working for a 'medium' or 'large' client in the private sector. It becomes the client's responsibility instead. The change also has consequences for tax and NICs.

Companies and LLPs are considered large or medium if they meet two of these conditions for two consecutive years:

- annual turnover more than £10.2 million
- balance sheet total (assets) more than £5.1 million
- they have an average of more than 50 employees
- note: for unincorporated businesses, only the turnover test applies.

If your client doesn't meet these conditions, it will be considered 'small'.

Overseas clients: the new procedures don't apply if your client is based wholly overseas. Your PSC will still determine the employment status.

Small clients: there's no change if you contract with a small client. Even after the changes are introduced from 6 April 2021, you remain responsible for deciding if IR35 rules apply to contracts in such cases.

Action point: check client size

Clients must respond within 45 days if you ask for information on size. But the onus is on you to ask. Be clear on your client's size at the outset, so you know who's responsible for making the status decision and paying tax, and where liability lies if there's an error.

Asking the critical question

The employment status determination question is this: would you be an employee if any intervening entities, like the PSC, didn't exist, so you were engaged directly by the client? In many cases, the question is easier to ask than answer, and the factors to weigh up are frequently complex. HMRC's online status checker tool (CEST) can be used to make a determination.

CEST: the tool has come in for criticism over the years, and has been refreshed to support the new regime <https://bit.ly/2ECbM1M>. Despite this, many commentators remain sceptical about its ability to determine status in all cases.

CEST can be used anonymously, by you or your client, for a decision on whether you should be treated as employed or self-employed for tax purposes on a particular contract. You can input your details to get an opinion, regardless of whether your client does so. The type of questions asked include:

- whether you have a right to use a substitute to do your work
- how much control your client has over how and where you work
- about your financial risk: whether you buy your own equipment, and how you are paid, for example
- how involved you are in the client's business, for instance in its management
- whether you have done similar self-employed work for other clients in the last 12 months.

HMRC pledges to stand by the results produced, if CEST is 'used in accordance with its guidance and the information entered is accurate and remains accurate'.

Action point

To get to grips with what CEST is driving at, see HMRC's Employment Status Manual <https://bit.ly/3b8esjQ>.

The Status Determination Statement (SDS)

The SDS is a new part of the status determination procedure. If your client decides your engagement amounts to employment, it should provide you with an SDS, setting out its employment status decision, and giving the reasons underpinning it. If you are part of a longer labour supply chain, the end client should also pass the SDS information to the next entity it deals with, and so on, so that the information flows along the chain as required. There is no hard and fast rule about how the SDS is issued, but it should be in a format that you can 'receive or access'.

Your rights

Reasonable care: your client must take 'reasonable care' making the status determination. HMRC

advises, 'What is necessary for each client to discharge that responsibility must be viewed in the light of their abilities, experience and circumstances'. More will be expected of a large multi-national company, for example, than a smaller business.

In practice, you should have the right to expect staff making the decision to be trained to know what to consider, seeking professional support if needed. They should examine each contract individually, rather than making a 'blanket' determination treating all contractors the same. Simply advertising a role as being 'inside' or 'outside' IR35 rules is not, on its own, sufficient.

HMRC advises that using CEST accurately is one example of taking reasonable care. Ultimately, if a client fails to take reasonable care, your tax and NICs can become their responsibility. The same is true if they fail to respond to a disagreement over the SDS (below).

SDS dispute process: you have a right to disagree with the SDS, and your client must have a process to deal with this. Written disagreement is prudent: give details of the SDS you disagree with, explain why you disagree, and keep a record of proceedings. Your client must respond within 45 days. They should review the SDS, either upholding it, and explaining why they have done so; or alternatively, withdrawing it and providing a new one, with confirmation of the date it is valid from. If you still disagree, only then can you revert to existing self assessment and National Insurance processes. You have the right to lodge a disagreement at any point during your engagement, but the client is not obliged to respond after the final payment for the engagement.

HMRC: if you now fall within IR35 for the first time, HMRC has undertaken not to use this information to review your status for previous tax years. This is subject to there being no reason to suspect fraud or criminal behaviour.

Tip: public sector engagements

The new requirement to issue an SDS, and put a dispute process in place, will also apply if you work on an engagement in the public sector from 6 April 2021.

What about tax?

Where a medium or large client decides your contract is within scope of the IR35 rules, it (or the agency paying you, if the labour supply chain is longer) will then:

- calculate a 'deemed direct payment', based on the fees charged by your PSC
- deduct PAYE and employee NICs from your fees, reporting and paying these to HMRC
- pay employer NICs based on the deemed payment.

This effectively means the end of the tax advantage of receiving income via a PSC, with its traditional profit extraction strategy of low salary plus dividend payments. If your contract falls within IR35, you are essentially treated as an employee of the party paying your PSC for tax purposes. You won't be taxed twice, and you can still choose to extract a combination of salary and dividends from your PSC, though the historic benefit is lost.

Though you will still invoice your client, you are on their payroll, and your deemed payment is charged to PAYE and NICs on a monthly basis in the same way as a direct employee. If your invoice includes VAT, or expenses which would be allowable for an employee, you should receive these without PAYE deducted. Student loan repayments should not be deducted by the client, nor auto-enrolment pension contributions. If your contract ends during a tax year, you should get a P45, showing the total deemed direct payment and deductions for PAYE and NICs. Where a contract continues into a new tax year, you should get a P60, showing total payment and deductions in that tax year. You then show the amounts from the P45/P60 as an employment on the employment pages of your self assessment tax return.

When taking from your PSC salary or dividends representing fees charged to your client, the salary is free of PAYE tax and NICs; and dividends free of income tax, up to the level of the deemed direct payment. Report the salary payment on the payroll for your PSC. Use box 58A on the Full Payment Submission, so it is treated as a non-taxable payment on which no NICs are due.

This non-taxable remuneration from the PSC does not have to be entered on your self assessment tax return as dividend or salary from your PSC. Instead, the deemed direct payment from the client and the income tax deducted, go on your self assessment return as employment income. Your PSC will get a special corporation tax deduction, as dividends are not usually deductible when calculating income for corporation tax.

What should you do now?

Expect communication from clients you work for, asking for information about your working practices and outlining what they intend to do - as well as increasing HMRC publicity. Be aware, too, of HMRC warnings about schemes purporting to minimise income tax and NICs legally. These can constitute tax evasion and pose a real risk to contractors. You may also want to think about:

- using CEST now to check any contract running beyond 6 April 2021. HMRC advises that 'any preparation done now will remain valid for April 2021'
- whether it's possible to renegotiate fees where clients consider your engagement will be within IR35
- checking the size of clients you work for, to see if the changes will apply
- whether operating via a PSC is still optimal for the long term.

Please do contact us to discuss the impact of the new legislation on your business.