

# PERSONAL SERVICES COMPANIES - TAX CHANGES

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Proposed changes to IR35 from 6 April 2021



## BACKGROUND

The off-payroll working rules – commonly known as IR35 – were first introduced in 2000 and are intended to ensure that individuals who work like employees pay broadly the same employment taxes as employees, regardless of the structure they work through. HM Revenue & Customs (**HMRC**) has, for a number of years, sought to combat the perceived tax avoidance of workers supplying their services to clients through an intermediary (such as a "personal service company" (**PSC**)). As the use of PSCs has increased over the years, so has HMRC's scrutiny of such arrangements and this is reflected in the introduction of legislation in this area over the last few years.

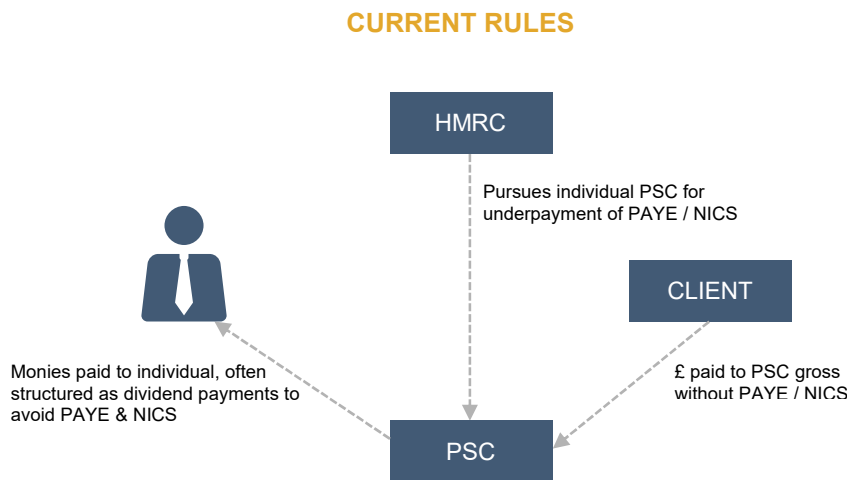
The government announced during the 2018 Budget that, in order to increase compliance with the existing off-payroll working rules in the private sector, businesses (rather than the intermediary) will become responsible for assessing the employment status of the off-payroll workers they engage and accounting for any necessary employment taxes.

Draft legislation implementing the proposed changes to the off-payroll working rules was first introduced in July 2019, with the intention that those changes would take effect from April 2020. That implementation date was pushed back to April 2021 due to COVID, and the government has taken the opportunity to publish further draft legislation.

The effect of the legislation will be for the private sector to be brought in line with the public sector, although it is worth noting that the changes will apply equally to engagements in the public sector and will amend the existing law governing off-payroll working in the public sector which was subject to fundamental change in April 2017.

## THE CURRENT LAW

Broadly, the current IR35 rules impose obligations on a PSC to account for PAYE income tax and NICs (including employer's NICs) on payments made to the PSC if the individual's status would be one of employment were the individual to contract directly with the client. As a result of this the PSC bore the tax risk of incorrectly assessing the status of an individual, rather than the client.



Under IR35, therefore, clients were often at a tax advantage when they hired off-payroll workers through a PSC, rather than directly, as the PSC, rather than the client, would be pursued by HMRC for any incorrect assessment of the individual's status.

However, the government considers that compliance by PSCs is low, and that this lack of compliance would have resulted in lost tax revenues of up to £1.2 billion by 2022/2023. In addition, enforcing the current rules is time intensive for HMRC – HMRC must pursue individual PSCs for underpaid tax (rather than going after the end client who may engage a large number of workers via their PSCs).

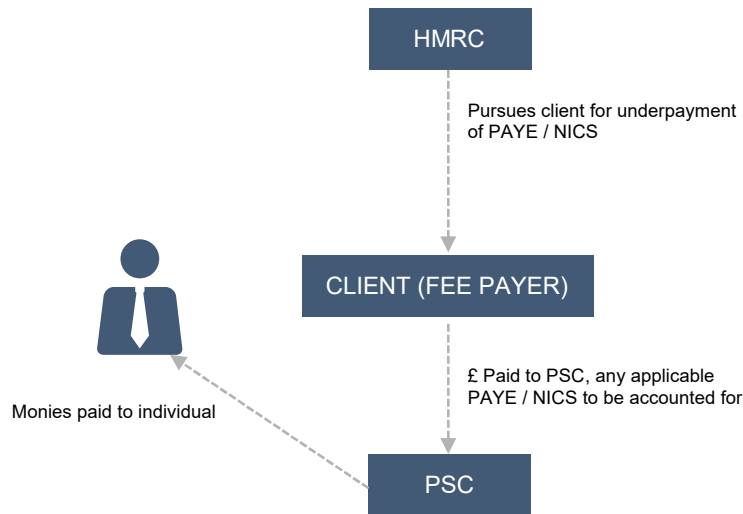
## KEY PROPOSALS

From April 2021 the way IR35 operates will change for large and medium sized businesses which have a "UK connection" and who engage workers via "intermediaries", so that:

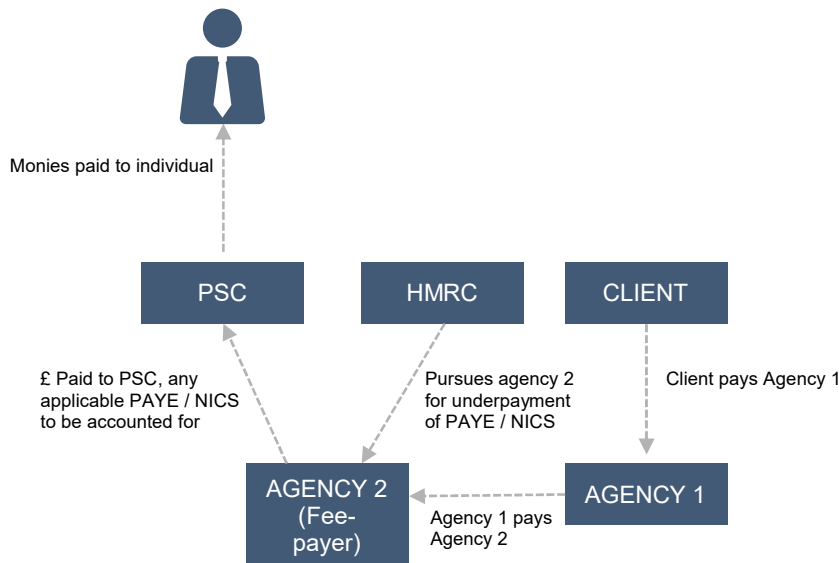
- the end user of the services (**client**) will be required to make a determination of an individual's (**worker**) employment status and communicate that determination to both the worker and the entity it engages with (whether the PSC or another intermediary such as an agency); and
- if the client determines that the worker would be an employee for tax purposes if engaged directly by the client, the organisation paying the worker's PSC (**fee-payer**) – who may or may not also be the client, depending on the complexity of the supply chain – will need to account for income tax and NICs (employees' and employer's) in respect of such payment.

These changes will bring large and medium sized businesses which have a "UK connection" in line with public sector bodies engaging workers via their PSCs (who have been subject to similar rules since April 2017).

### NEW RULES (DIRECT ENGAGEMENT WITH INTERMEDIARY)



### NEW RULES (AGENCY IN THE SUPPLY CHAIN)



As a result, businesses will no longer be able to safeguard themselves against PAYE/NIC risk relating to employment status by simply engaging individuals through an intermediary.

## WHO WILL THE NEW RULES APPLY TO?

The new rules will apply to all public sector and medium and large-sized private sector clients that have a "UK connection" who contract with "intermediaries".

### *Medium and large sized clients*

In determining whether a company is large or medium sized, the usual company law "small companies' regime" definitions apply. Therefore, a corporate client that satisfies two or more of (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, will be excluded from the new rules and the current rules will continue to apply to these smaller companies.

Where the client is a non-corporate entity, only entities with a turnover exceeding £10.2 million will be within the scope of the new rules.

### *UK Connection*

A client will have a "UK connection" for a tax year if, immediately before that start of that tax year they either (i) were UK tax resident; or (ii) had a UK permanent establishment.

Where the new rules do not apply (i.e. to clients that are outside the public sector and are either small or have no "UK connection"), the existing IR35 rules will continue to apply.

### *Applicable "Intermediaries"*

The legislation does not refer to "PSCs", but rather "intermediaries" and this term has wide application. An "intermediary" is defined as being not just a company in which the worker has a "material interest" but also a company in respect of which the worker has rights that entitle them to receive payments or benefits that can reasonably be taken to be for the worker's services to the client. As this definition is a recent addition it is considered that its breadth is deliberate and aimed at circumventing any tax planning designed to bring a worker's PSC outside the previous definition of "intermediary", although it could also capture typical "umbrella companies".

## STATUS DETERMINATION STATEMENT

In all cases where the personal services of a worker are being provided to a client through a PSC, the new rules will require the client to issue a status determination statement (**SDS**). In some cases (for example, in the case of services agreements) it is not always clear whether the arrangement is one for the supply of a worker or the supply of services. However, in cases where specific individuals are named in the contractual documentation, it is likely that an SDS will need to be made in respect of such individuals.

The rules will require a client to provide an SDS directly to:

- the party that the client directly contracts with (which is currently the case for public sector clients); and
- the worker.

In addition, the client must give the reasons for the determination to the party it contracts with and, on request, to the worker. It will then be the responsibility of each party in the chain to cascade the determination and the reasons for the determination along the supply chain.

Concerns had been raised as part of the consultation that clients may be inclined to be risk averse in making status determinations, and therefore make blanket decisions without consideration of the specific circumstances of particular workers. To address these concerns, the legislation provides a framework for the worker or the fee payer to challenge a status determination by making representations to the client. The client must respond to such representations within 45 days, either confirming the previous decision (and giving reasons for such decision) or substituting a different status determination.

In addition, the client is also under an obligation to respond to requests (either from the worker or the party it contracts with) as to whether the client is "small" for these purposes. Under the legislation this obligation is to be enforced by way of injunction (or specific performance in Scotland) if it is not complied with within the requisite time limits (broadly being 45 days from receipt of the request).

## LIABILITY FOR INCOME TAX AND NICS

As outlined above, it will usually be the fee-payer that is liable to account for income tax and NICs where a client has provided a deemed employment SDS. However, there are certain circumstances in which those liabilities could rest with either the client or another entity within the contractual chain.

Firstly, there is an obligation on clients to take reasonable care when making an SDS. If a client makes a determination that a worker is not a deemed employee, but failed to take reasonable care, any liability for income tax and NICs (if HMRC disagrees with the determination) would revert to the client rather than the fee-payer.

A client may also be liable for income tax and NICs where it failed to respond to an SDS challenge by the worker or the fee payer within the required 45 day period.

Liability for income tax and NICs may also be shifted where a party in a contractual chain has not met its responsibilities to pass on an SDS to the next party along in the contractual chain. Where HMRC does not receive the tax and NICs due, the liability would initially rest with the party that has failed to fulfil its communication obligations, until such a time that it does meet those obligations. This means that liability would move along the labour supply chain as each party fulfils its communication obligations.

If HMRC considers that there is no reasonable prospect of recovery from the party primarily liable within a reasonable time, for example, because it ceased to exist, the liability would transfer back to the first party or agency in the chain (i.e. that closest to the client) and, if HMRC could not collect from the first party or agency, the liability would ultimately rest with the client.

The government considers that the advantages of this approach are that it would provide a clear incentive for all parties to comply with their obligations and ensure a determination is passed fully down the chain as well as encouraging all parties to contract with reputable and compliant firms.

## EDUCATION AND SUPPORT PROVIDED BY HMRC

HMRC launched the Check Employment Status for Tax (CEST) service in 2017. It is designed to help clients decide the employment status of their off-payroll workers and to check whether the off-payroll working rules apply.

The consultation stated that CEST has been rigorously tested and is able to determine employment status in 85% of cases. However, there has been much dissatisfaction with CEST, in particular with CEST's ability to take account of existing employment status for tax case law and its ability to reflect the complex nature of the private sector (including different types of business model).

Therefore HMRC has been working with stakeholders to improve CEST and provide additional guidance on how it should be used. The updated CEST was made available in November 2019, expanded to a list of around 30 questions, along with detailed guidance on each of the questions.

It remains to be seen whether the updated CEST will be sufficient for businesses to be able to confidently rely on the outcome in making an SDS. However, use of the CEST in making status determinations may be helpful in showing that reasonable care was taken in making a determination.

## TRANSITIONAL PROVISIONS

Where a payment made after 6 April 2021 relates, in part, to services performed before that date the payment should be apportioned on a "just and reasonable" basis with the new rules and obligations applying to the proportion of the payment relating to services provided on or after 6 April 2021.

## WHAT CLIENTS SHOULD BE DOING NOW

Set out below are some of the steps that clients should be taking in preparation for the introduction of the new rules. There will be different considerations for intermediaries and agencies in the supply chain.

### Stage 1

- Identify all engagements directly with intermediaries and make sure they are aware of and understand the changes
- Identify all engagements with agencies where workers may be provided through intermediaries and ensure that you have all the necessary information in order to make an SDS
- Review arrangements for the supply of services which involve the supply of labour and review whether you may be considered an end client for the purposes of the new rules

### Stage 2

- Review all contractual arrangements which may be affected by the new rules:
  - to ensure, where necessary, employment taxes may be withheld
  - to ensure that you have the right to request all necessary information in order to make an SDS
  - to understand whether any additional employment taxes can be passed onto other parties in the supply chain
  - to ensure that contracting parties are required to impose equivalent obligations on other parties in the supply chain
- Start the process of amending any such contracts as required, and negotiating any revised terms (including who will bear the economic costs of any additional liabilities)
- Update all template contracts to reflect the above issues

### Stage 3

- Put in place processes and policies for determining employment status for affected roles including:
  - determining roles for which it may be appropriate to make standard role-based decisions
  - training for those individuals who will be responsible for determining employment status
  - documenting status decisions
  - use of CEST
  - a system for referral of 'tricky' cases to either internal or external legal advisers
  - how to deal with challenges to status determinations
- Put in place any necessary payroll arrangements for IR35 roles

### Stage 4

- Inform relevant parties of any employment status decisions (either formal determinations or an indication of what the determination is likely to be) and ascertain whether the contractors would like to change the way in which they provide their services (for example, through an umbrella company or employment business)
- Consider whether any contractors will be offered direct employment with the client

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