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Contractor Guide to IR35 Reform (Off-Payroll Working) in the Private Sector

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IR35 Explained

Background

IR35 isn't new – it's a piece of anti-avoidance tax legislation that was introduced in April 2000.

It only applies to you as a contractor if you supply your services through a limited company (also referred to as a 'Personal Service Company' or 'PSC'). It doesn't apply to you if you are engaged via genuine Umbrella or PAYE models.

IR35 is a complicated piece of legislation, ultimately requiring assessment of whether a contractor is operating a genuine business operation rather than acting as an employee of the end client. There are a number of tests used to determine employment status for tax which have been developed through case law - however these are open to interpretation by contractors, end clients, HMRC, and the courts - creating confusion and uncertainty.

Historically, it has been the responsibility of the PSC to determine whether the PSC contractor supplied to carry out the services was working inside or outside IR35 and (if inside IR35) to pay the appropriate taxes and national insurance contributions (NICs) due. As a result, the existing IR35 legislation has been relatively ineffective because HMRC doesn't have the resources to pursue all incorrect assessments made by PSCs. Against this background, the government is planning to introduce reforms in the private sector.

IR35 Reform - When do the off-payroll working (IR35) rules apply?

The responsibility for determining the IR35 status of a contract will shift from the PSC contractor to any medium and large private sector end users from 6th April 2020 and the new rules will be applied to all payments made to a PSC on or after this date - regardless of when the contract started.

These off-payroll working rules have already been in place for public sector organisations since 2017 and the reform will bring the two sectors in line.

The off-payroll rules apply if you provide your services to a client through your PSC but you would be classed as an employee if you were contracted directly with the client.

Under current rules: Contractors are responsible for determining their employment status under the IR35 rules and paying the relevant tax and NICs.

Under new rules: End clients are responsible for determining the employment status of their contractors under the IR35 rules (i.e. they must perform a status determination for each assignment). The fee-payer is responsible for deducting the relevant tax and NICs at source. Depending on the contractual chain, this would usually fall to either the client or recruitment agency.

Hiring organisations classed as "small" for the tax year (based on Companies Act 2006 definitions) will be exempt from applying the new rules. Contractors engaged by a small client will need to consider IR35 and make the necessary deductions themselves (as now).

IR35 Explained

Small Company Exemption

Under section 382 of Companies Act 2006, a client qualifies as “small” if two of the following conditions apply:

- Annual turnover Not more than £10.2 million
- Balance sheet total Not more than £5.1 million
- Number of employees Not more than 50 employees

NB: the small company exemption applies to the end client, not the fee-payer or the PSC.

If you’re working through a recruitment business, it should inform you if the client is a small entity, but there is no statutory obligation to do so. Therefore, you must make enquiries when discussing the assignment details, as you will have the responsibility and liability to apply the off-payroll working rules (as you’ve been doing now) when the client is a “small” company.

Making the status determination - “inside IR35” or “outside IR35” – What will the client look at?

From 6 April 2020, it will be the client’s responsibility to determine whether the off-payroll working rules apply, i.e. is this assignment “inside IR35”?

You can refer to the [HMRC guidance and the employment status for tax \(CEST\) tool](#). Although much criticised, the CEST tool has been updated and enhanced by HMRC during the last couple of weeks and does give you a good steer of the approach taken by HMRC and the indicators that they are looking for when determining the status of the assignment. Clients are also likely to use the CEST tool as part of their evaluation. The types of thing that form the focus of the assessment are: the right of substitution, control and direction by the client; financial risk; mutuality of obligation (see the appendix to this note for more details on the employment status tests).

Assignments “Outside IR35”

When the client makes the status determination that an assignment is “outside IR35”, they must ensure that “reasonable care” was taken during the decision making and that the decision itself is reasonable. If the client doesn’t exercise reasonable care, the status determination statement will not be valid, and the client will be liable for the unpaid taxes if HMRC investigates and finds that reasonable care wasn’t taken in reaching the “outside IR35” conclusion.

Assignments “Inside IR35”

If the client determines that an assignment is “inside IR35”, your client or the recruitment business fee-payer will usually take one of the following approaches:

- Require you to engage via an umbrella company which would employ you directly. The off-payroll rules do not apply in this situation. You may be required to choose the umbrella from a list of preferred suppliers or otherwise await appropriate due diligence on your choice of umbrella.
- Require you to engage as a permanent staff member of the client (e.g. on a fixed term contract), or as a PAYE temporary agency worker (employed by the agency fee-payer for tax NICs purposes).
- Treat you as an inside IR35 PSC and calculate the ‘deemed employment payment’ using the RTI (Real Time Information) payroll system. The deemed employment rate is the income of the worker after deductions including both the Employers NICs and Apprenticeship Levy paid by the fee-payer. Neither worker rights or stakeholder pension rights apply and no expense allowance applies.

How the client and recruitment business fee-payer will engage you when inside IR35 is usually a decision made at policy-level by the client and recruiter and you should look to identify this when engaging in a new role, and with existing clients before April 2020.

Incorrect determination

If the off-payroll proposals are legislated in their current form, where HMRC disagrees with the determination made, it can investigate and insist on back payment of tax, as well as fines for late payment from the fee-payer.

Frequently asked questions

FAQs

I work for lots of clients, does IR35 still apply?

The off-payroll working rules will still apply irrespective of how many clients and assignments a contractor is working on. There is the argument that if you are working on multiple projects for various clients, this will demonstrate that you are in business on your own account as an independent contractor, and therefore fall "outside IR35". However, your IR35 status is assessed on an assignment by assignment basis – working for multiple clients is not a significant indicator of being in business on your own account; the IR35 status for each assignment is judged on its own merit.

You could feasibly be outside IR35 for one contract and inside IR35 for another. You can maintain your PSC for one engagement but be paid via an umbrella or employed for another as required.

The client does not understand/will not apply the new IR35 rules, do I need to worry?

From April 2020, all public sector authorities and medium and large-sized private sector clients will be responsible for deciding whether IR35 applies. If the client either 1) fails to make a status determination, 2) fails to pass the status determination down the supply chain, or 3) fails to take reasonable care when making the status determination; the client may be liable for the tax and NICs as the deemed "fee-payer".

You need to engage with your agencies and clients regarding the new rules to help to ensure that all parties are prepared for April 2020. It is important that clients exercise reasonable care when making a status determination, given the issues that arose from the public sector reform in April 2017 as a result of blanket "inside IR35" determinations.

If you are providing services to a small private sector client, they will be exempt, and they are not required to follow the new IR35 rules. Your PSC will remain responsible for determining your IR35 status and making the appropriate tax deductions and NICs.

Can I convert to working under a Statement of Work (SoW) contract?

Simply converting a current time and materials contract to a SoW contract is not recommended in our view. The contract must accurately represent the reality of what happens during the assignment. However, for new assignments with new clients this is an option for highly skilled contractors.

In an assignment where a contractor agrees to perform specific tasks or deliver certain outcomes for a set price and within an estimated delivery time, there is less likelihood of the client exerting control over the individual. A SoW contract, if appropriately executed, is likely to be "outside IR35", compared with the traditional time and materials-based contract on a set hourly or day rate.

It is more likely that an assignment will fall "outside IR35" if the performance of the services carries a genuine business risk, e.g. payment is conditional upon acceptance of services or satisfactory performance, and rectification of defects or poor performance are made at your cost. Although this may seem like an easy option to adapt to the new rules, you will remain at risk if the reality of the contractual performance does not reflect the contractual wording.

Please note that not all assignments are appropriate as a SoW contract, this will depend on whether the recruiter and the end client offer this option.

Barclay Simpson Solutions is working closely with a number of clients on SoW projects and so please do speak to your usual contact who can put you in touch with our SoW team.

Frequently asked questions

FAQs

Can I be involved in the client's status determination?

It is expected that you will be involved to some degree in the client's status determination process, as there are some questions in the HMRC CEST tool which require the contractor's input – for example questions on how you run your business. However, there is no statutory right for a contractor to be consulted during the status determination process.

I do not agree with the client's status determination, can I appeal it?

The legislation imposes an obligation on the client to provide a "client-led status disagreement process", either the recruiter or the contractor may disagree and follow the process. The client must respond to a request to review the status determination statement within 45 days. The client must either confirm the determination is correct, with reasons, or provide a new status determination statement reaching a different conclusion and withdraw the previous one.

If you disagree with the client's determination, you will need to write to the client and give reasons why. You need to ensure you keep records of status determinations and any corresponding disagreements. During the dispute process the client's determination stands.

NB: the requirement for a client led status disagreement process will only apply to assignments after 6 April 2020. Clients are already starting to review status and many are terminating assignments pre-April 2020 and imposing determination outcomes with respect to new arrangements now – for which there is currently no formal disagreement process requirement.

Will my rate be affected by the new rules?

If your assignment falls "inside IR35", the take-home pay will be less as the recruiter has a statutory duty to deduct the appropriate tax and NICs. Be aware that historically, PAYE rates have always been lower than PSC rates so you may find that in future pay rates offered are lower.

Can I be forced to pay for employer's NICs?

Recruitment businesses cannot lawfully deduct secondary NICs from an agreed fee, but recruitment businesses may adjust the contractor's pay rate to factor in the additional costs of supply which include employers' NICs. Depending on your contractual terms, there may be scope for the rate to be negotiated accordingly.

Do I get employment rights if I am "inside IR35"?

If you continue operating as an "inside IR35" contractor, you will not benefit from any "worker/employee rights" such as holiday pay, sick pay, auto-enrolled pension contributions, dismissal rights etc. You are only employed for tax purposes not for rights such as these.

However, if a client determines that the assignment falls "inside IR35", it is likely that you are no longer in business on your own account for the purposes of the assignment and could be within scope of the Agency Worker Regulations (AWR). Under AWR, you are entitled to comparable pay to a permanent employee on the client site and benefit from other day one rights.

If you opt to engage via an umbrella company, you are an employee of the umbrella company and therefore you will benefit from employment rights and AWR will apply to client assignments.

Frequently asked questions

FAQs

Can I set up a shared PSC to facilitate my right of substitution?

There are suggestions that contractors could set up a limited liability company with a small group of contractors to allow them all to effectively exercise their right to substitution and get around the rules. If a group of PSCs came together to form a new business this will not avoid IR35 and it will still need to be a consideration for each contractor working within the new company - IR35 could still apply to each worker individually. Attempting to use a tax avoidance measure is not advisable and this will not enable you to achieve the desired outcome and would undoubtedly attract greater scrutiny and potentially fines.

If you would like to explore these types of arrangements then we recommend that you take expert advice.

Will HMRC investigate into previous tax years if my client changes my status prior to April 2020?

HMRC has specifically stated that they will not carry out targeted campaigns into previous years when individuals start paying employment taxes under IR35 for the first time.

However, there have been a few isolated cases in the public sector in light of the recent GlaxoSmithKline compliance activity (where past and present contractors received letters from HMRC in August stating that they were believed to be inside IR35). As a result we'd recommend that you are cautious and ensure you have evidence of your due diligence in ascertaining your status prior to April 2020. Speak to your accountant or business advisers about this.

Things you can do as a contractor now to prepare for the changes

- Speak to your client and agencies that you work with now ahead of the reform – find out their plans giving you time to prepare and adjust.
- Understand your rights and minimum contract rates. If your role is inside IR35 what is the minimum day rate you'd accept for the role? Would you be willing to engage via an umbrella company?
- Review your status and record of evidence for pre-April 2020 assignments.

APPENDIX 1

The employment status tests

Determining whether the assignment is inside or outside IR35

To determine whether a contractor will be caught by IR35, key criteria are reviewed to establish employment status. A decision is made about a hypothetical contract between the contractor and the end-client, and whether, if those two parties were contracting directly, there would be an employment relationship. However, the route to determining employment status is fact-specific and in some cases, there is no clear outcome.

It is worthwhile working through [HMRC's employment status for tax test](#) and entering different responses to gain an understanding of the different outcomes. This tool is often used in the public sector when establishing IR35 status. Essentially, if a contractor has similar working conditions, responsibilities and control as an employee of the client would have, then they are likely to be classed as "inside IR35" (i.e. the off-payroll working rules apply). Case law is evolving constantly in the tax tribunals, courts and employment tribunals but the key factors that determine a contractor's IR35 status are as follows:

Substitution: A genuine right of substitution has long been deemed to be a very important factor when demonstrating that a contractor's assignment falls "outside IR35". For a substitution to be considered valid, the right to supply a substitute must be a genuine one. This means that the client must agree to it in practice, the contractor must pay for the substitute, and it should be an unfettered right. An unfettered right of substitution means that a client must accept a comparably qualified and skilled substitute if the initial contractor is unavailable. HMRC have now qualified the criteria within the CEST question on substitution, which states that a client's need to be satisfied that the substitute has the skills and experience required or to ensure the substitute is approved under their security processes does not negate the right of substitution.

Other factors include: provision of equipment; any absence procedures; continuity of the engagement; termination agreements; notice periods; and if the contractor has become "part and parcel" of the organisation.

Control and direction: In most cases where professional services are provided, it is important that a contractor can demonstrate a certain amount of autonomy in the way they undertake a project. Both the written contract and working practices must show that the client has no influence over how the contractor performs his/her services.

Control factors that may point towards an "inside IR35" status include:

- Indicating that the contractor will be supervised
- Including any "staff" benefits (including holiday or sick pay)
- Including start/end/break times
- Contractual clauses that specify any rights of control or supervision over the contractor.

The reality of the situation is that the individual is responsible for the delivery of the services. The individual will determine and control how and when they provide their services to the client, provided that they meet client specific targets or project completion dates. It is worth noting that any clauses referring to control should be reflected in both the first-tier (between recruitment business and client) and the second-tier contracts (between recruitment business and contractor).

Financial Risk: The contractor may take on a level of financial risk in undertaking the engagement. Contractors who don't take any financial risk, for example don't have to rectify poor quality services at their own cost, are more likely to be "deemed employees" for tax purposes. Contractors taking financial risk would also be expected to maintain appropriate insurances.

Mutuality of Obligation: This is a hotly disputed area of law, as the position of HMRC is different from that of many practitioners and case law. In essence, it is an obligation between the parties to provide and accept work. In an employer/employee relationship, mutuality of obligation is easy to establish. However, in client/contractor relationships, it is less clear. HMRC states that by having a contract agreeing to provide services, mutuality is established but most experts consider the legal picture to be more complex. It is likely there will be more clarity on this in the coming months.

**For further information or any other enquiries,
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