Second Report of Session 2022-23

HM Revenue and Customs

Lessons from implementing IR35 reforms

Introduction from the Committee

The government originally introduced the IR35 off-payroll working rules in April 2000, with the objective to prevent tax avoidance by 'disguised employees'. These are people who do the same job in the same manner as an employee but avoid income tax and National Insurance contributions (NICs) by providing services through an intermediary such as a personal service company (PSC). The legislation therefore introduced a requirement for workers engaged through intermediaries to assess their employment status for tax purposes. If they are deemed to be a 'disguised employee' they will be subject to income tax and NICs at source in the same way as regular employees.

However, HMRC found that adherence to these rules was low, despite government efforts to improve compliance between 2007 and 2015. In 2016, HMRC estimated that only 10% of PSCs were applying the IR35 rules correctly, costing the exchequer £440 million in the 2016–17 financial year. To improve compliance, the government introduced reforms that shifted responsibility for making status determinations from the worker to the hiring body, which also became liable for any unpaid tax where it had failed to comply. These reforms initially applied to the public sector from April 2017 (affecting around 50,000 PSCs) and were extended to include the private and third sectors in April 2021 (affecting an estimated 180,000 further PSCs).

Based on a report by the National Audit Office, the Committee took evidence on 30 March 2022 from HM Revenue & Customs. The Committee published its report on 25 May 2022. This is the government's response to the Committee's report.

Relevant reports

- NAO report: Investigation into the implementation of IR35 tax reforms - Session 2021-22 (HC 1103)
- PAC report: Lessons from implementing IR35 reforms – Session 2022-23 (HC 60)

Government response to the Committee

1: PAC conclusion: High levels of non-compliance in central government reflect poor implementation by HMRC and other government bodies.

1: PAC recommendation: HMRC should develop robust estimates of non-compliance for the public sector as a whole and use this to identify areas where it can reduce the inherent challenge of complying with the reforms, for example by improving its guidance and tools. It should adopt a similar approach for the private sector as the reforms bed in and write to us with an update in six months' time.

1.1 The government agrees with the Committee's recommendation.

Target implementation date: December 2023

1.2 Although the government agrees with the Committee's recommendation, it disagrees with the Committee's conclusion.

1.3 HMRC (the department) undertook an extensive programme of customer education and support during the implementation of the reforms, and already provides additional support to address inherent challenges faced by customers where these are identified. For example, in response to customer insight gathered from a range of sources, HMRC has increased communications on contracted out services and international supply chains, including delivering webinars on both, and produced flow charts for those who operate with supply chains that are not wholly within the UK.

1.4 HMRC agrees there is value in building on this foundation and is committed to continuing to support customers with compliance. However, it does not agree that developing an overall estimate of non-compliance is the best way to achieve this outcome.

1.5 Instead, HMRC will expand its work to obtain customer insight, for example by collating outcomes from its existing compliance work to identify common issues, and by building on existing engagement with representative bodies and via the department's network of customer compliance managers. It will consider what additional customer support is required depending on the outcome of this work. This may include, for example, updates to guidance or targeted communications.

2: PAC conclusion: We are concerned that it is too difficult for workers to challenge incorrect status determinations.

2: PAC recommendation: HMRC should ensure there is a fast and independent process for contractors to resolve disputes over status determinations. As part of this, it should assess the extent to which workers are using existing appeals routes, and how well they are working.

2.1 The government agrees with the Committee's recommendation.

Target implementation date: December 2023

2.2 The best result for workers, engagers and the Exchequer is where employment status is treated correctly from the start. The government remains confident that the reforms to the off-payroll working rules were the best way to achieve this.

2.3 There are established appeal routes for customers who disagree with tax assessments. The legislation creates an additional right for workers to challenge their employment status for tax determination with their client, who is required to respond within 45 days.

2.4 If a worker still disputes the determination, they can file their Self-Assessment return reflecting their own assessment. HMRC has 12 months from the date the return is received to open an enquiry, during which it may consider whether the employment status is correct. These enquiries can vary in length depending on their nature and complexity. HMRC will ensure this process is clearly set out in its guidance. Where HMRC disagrees with a customer's Self-Assessment, all customers have the right to have the decision reviewed, and to appeal to an independent tribunal.

2.5 HMRC's compliance activity already assesses the effectiveness of clients' disagreement processes, and the outcome of any disagreements. HMRC will also monitor the number of customers who dispute their status through their Self-Assessment return and carry out checks to ensure the process is being used appropriately.

2.6 HMRC's external research into the short-term impacts of the 2021 reform will provide details about the number of disputes clients are having with workers regarding their status determinations. This will be published, once completed.

3: PAC conclusion: HMRC is not doing enough to understand the impact of the reforms on workers and labour markets.

3: PAC recommendation: HMRC should conduct and publish specific research into the impacts of the IR35 reforms on contractors and labour markets, to check it is being applied as intended and not adversely affecting employment opportunities.

3.1 The government agrees with the Committee's recommendation.

Target implementation date: December 2023

3.2 Although the government agrees with the Committee's recommendation, it disagrees with the Committee's conclusion.

3.3 The government has already published research on the short and long-term impacts of the public sector reform and is committed to publishing research on the impacts of the reform in the private and voluntary sectors later this year.

3.4 A central part of the government's research into the impacts of the off-payroll reforms is with client organisations, as they have the best understanding of the overall picture of how they are engaging off-payroll workers. This research gathers data on changes to the way off-payroll workers are engaged, and changes to their rates of pay and to the ease of recruitment.

3.5 The government is also already supplementing this with research with other parts of the supply chain: research with agencies was published in March 2021, and research with off-payroll workers will be published once complete. The research with off-payroll workers will primarily focus on tax information and advice but also gathers insight into the impacts of the off-payroll reforms.

3.6 In addition to research, HMRC is conducting internal analysis to identify off-payroll workers who may have been affected by the reforms, and what changes may have occurred in the labour market following the reforms. This will be published once complete.

4: PAC conclusion: We are not confident that HMRC works proactively to establish whether any sectors have been affected disproportionately by the reforms and why.

4: PAC recommendation: HMRC should proactively identify and work with sectors that have been particularly affected to understand the challenges, establish how to address them and make it easier to comply. HMRC should write to us with an update in six months with the outcome of this public engagement.

4.1 The government agrees with the Committee's recommendation.

Target implementation date: December 2023

4.2 HMRC undertook an extensive programme of customer education and support during the implementation of the reforms and continues to engage with stakeholders, including through the Employment Status and Intermediaries Forum.

4.3 HMRC has also already provided additional support to address inherent challenges faced by specific sectors where these have been identified. For example, it has produced sector-specific factsheets for the transport and construction sectors and has published guidance on umbrella companies in response to customer insight gathered from a range of sources. HMRC agrees there is value in building on this foundation and is committed to continuing to support customers with compliance – including at sector-specific level.

4.4 In addition, HMRC will develop and implement a stakeholder engagement strategy. This will set out how it will proactively engage with its stakeholders, to develop its understanding of the specific challenges faced by particular sectors. This will build on existing customer insight to inform targeted education and communications with the aim of further supporting customer compliance.

5: PAC conclusion: HMRC has not made a robust assessment of the additional costs of implementing the reforms.

5: PAC recommendation: In light of actual experience, HMRC should produce and present to Parliament a cost-benefit analysis of the reforms that reflects the actual costs of compliance to HMRC itself, hiring organisations, workers, and others in the supply chain.

5.1 The government agrees with the Committee's recommendation.

Target implementation date: December 2023

5.2 HMRC follows a well-established methodology for estimating administrative burdens, which looks at what organisations are required to spend in order to comply with their tax obligations. HMRC has already revised its initial estimates for the administrative cost of the private sector reform, with the Administrative Burdens Advisory Board (ABAB) commenting that the approach was "sound and reasonable".

5.3 HMRC is also interested in the amount that organisations have spent to comply with the reform in light of actual experience. HMRC is already exploring this through external research with client organisations, which includes insights into the administrative burden of the reforms. The government has already published research into the short and long-term impacts of the reform on public sector client organisations and research with the private and voluntary sectors is currently being conducted.

5.4 HMRC will consider the findings from this research and will share with the Committee and publish analysis setting out the estimated actual amount spent to comply with the reform by client organisations, alongside estimated additional receipts generated from the reform. Based on the data currently available, HMRC does not believe it will be possible to publish a full cost-benefit analysis taking account of all parties in the supply chain.

6: PAC conclusion: Despite years of reforming the IR35 rules, there are still structural problems with how they work in practice.

6: PAC recommendation: HMRC should review how the system is working and whether it can be made more efficient and effective. In particular, it should develop solutions to address problems with how the IR35 rules work in practice, including ensuring that:

- ***HMRC has the data it needs to accurately reflect each worker's tax position in cases of non-compliance; and***
- ***HMRC does not end up taxing the same income twice, or unwittingly contributing to workers not paying their fair share in tax.***

6.1 The government agrees with the Committee's recommendation.

Target implementation date: to be confirmed

6.2 HMRC has already implemented a process to reduce the circumstances where it collects tax twice in respect of the same engagement in cases of non-compliance. Where

HMRC has sufficient information to identify them, it will notify the worker and their intermediary if they are entitled to claim a repayment of taxes overpaid in relation to the specific off-payroll working engagement.

6.3 Relevant information is needed from the client organisation to enable HMRC to operate the process, as they are the party who engages the worker. HMRC is seeking the required information from client organisations at the outset of a compliance enquiry to increase the chances of obtaining the relevant data. HMRC will continue to review this process to ensure it works as effectively as possible.

6.4 The legislation does not provide for a set-off for the client or deemed employer of any income tax, NICs or corporation tax paid by the personal service company or worker. However, HMRC has already set up a working group with external stakeholders to consider whether a legislative solution can be found to allow HMRC to take account of taxes that have already been paid by workers and intermediaries, ensuring that HMRC does not tax the same income twice and that workers pay a share of the tax liability. HMRC will continue with this work.

6.5. HMRC will notify the Committee of a target implementation date for meeting this recommendation as soon as this work has concluded.