



HM Treasury, 1 Horse Guards Road, London, SW1A 2HQ

The Lord Bridges of Headley
Chair, Economic Affairs Finance Bill Sub-Committee
House of Lords
London
SW1A 0PW

09 March 2022

Dear George,

GOVERNMENT RESPONSE TO THE HOUSE OF LORDS ECONOMIC AFFAIRS FINANCE BILL SUB-COMMITTEE, OFF-PAYROLL WORKING FOLLOW-UP INQUIRY

I would like to thank the House of Lords Economic Affairs Finance Bill Sub-Committee for their inquiry into the impacts of the reform to the off-payroll working rules in the private and voluntary sectors.

I am pleased to attach the Government's response to the Sub-Committee's letter of 9 February 2022, which set out the conclusions and recommendations from their follow-up inquiry into the off-payroll working rules.

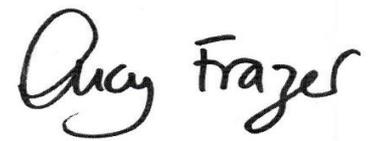
As you know, the purpose of the reform was to improve compliance with the off-payroll working rules by moving the responsibility for operating the rules from the worker's intermediary (such as their own limited company) to the client who is engaging the worker's services. These rules are necessary to ensure fairness within the tax system by ensuring that people working like employees, but through their own limited company, are taxed like employees. Since the reform was first introduced in the public sector in 2017, compliance with the off-payroll working rules has improved, resulting in additional tax revenue of £250 million in 2017/18 and £275 million in 2018/19, funding vital public services.

Ahead of the implementation of the reform in the private and voluntary sectors in 2021, HMRC actively communicated, listened and responded to stakeholders and customers affected by the reforms, and has continued to do so since. Learning lessons from the public sector reform, HMRC adapted its education and support to suit the needs of specific stakeholders and customers. This included guidance for different audiences, increased stakeholder engagement and sector-specific material.

Monitoring the impact of the reforms continues to be a priority for the Government. The specific impacts of the 2021 reform continue to be examined in detail through external research, where fieldwork has begun with medium and large-sized organisations in the private and voluntary sectors. This will gather information on the effects of the reform on the way contractors are engaged, rates of pay for contractors, challenges and administrative burdens with implementing the rules, and the effectiveness of HMRC's support and guidance.

I thank the Sub-Committee for its continued interest in this area.

Yours sincerely,

A handwritten signature in black ink that reads "Lucy Frazer". The signature is written in a cursive style with a large, looping initial 'L'.

THE RT HON LUCY FRAZER QC MP



HM Revenue
& Customs



HM Treasury

Government response to the House of Lords Economic Affairs Finance Bill Sub-Committee: Off-payroll working follow-up inquiry

Introduction

The Government welcomes the House of Lords Economic Affairs Finance Bill Sub-Committee's follow-up inquiry into the recent reforms to the off-payroll working rules, also known as IR35. The Government has carefully considered the conclusions and recommendations of the Sub-Committee and this response seeks to address each of these in turn.

By way of background, the way the rules are administered was reformed in the private and voluntary sectors in April 2021, following early reform in the public sector in 2017. These reforms move the responsibility for determining whether the rules apply from the individual contractors to the clients engaging them.

The off-payroll working rules were put in place to ensure fairness within the tax system. They aim to ensure that two people working in similar ways pay similar taxes.

Implementation and communication

Changes to off-payroll rules are challenging for many businesses and workers, especially against the backdrop of the economic impact of COVID. The Sub-Committee welcomes the efforts HMRC has made to communicate these changes via multiple channels and the continuing support to businesses through implementation. (Para 9)

We welcome the fact that HMRC has also learned lessons from the roll-out of the off-payroll working rules in the public sector and that the department is conducting research into the short-term effects of the changes. We look forward to seeing the results of this research. (Para 10)

The Government welcomes the Sub-Committee's recognition of the lessons HMRC has learned in implementing the off-payroll working reforms in the private and voluntary sectors, and the efforts HMRC has made to communicate to, and educate, clients and contractors about the change. HMRC continues to support clients and contractors to comply with the rules through its dedicated helpline, ongoing education, guidance and a supportive approach to promoting compliance. HMRC will continue to work with its stakeholders, including the IR35 Forum, to ensure that guidance and support is effective and targeted at those who need it.

The Check Employment Status for Tax (CEST) tool

The Sub-Committee believes it is critical CEST's limits are clearly acknowledged by HMRC. It cannot and should not be a substitute for law. HMRC needs to ensure that, in its compliance work, it recognises that the use of other means to assess employment status is both legitimate and reasonable. (Para 21)

CEST is a free, publicly available tool to help clients and contractors decide whether an engagement should be treated as employed or self-employed for tax purposes, and whether those working through intermediaries are subject to the off-payroll working rules.

CEST is designed to be easy to use. HMRC will stand by determinations produced by CEST, provided that the information supplied by users was and remains accurate, and the tool has been used in accordance with the guidance.

It is not compulsory to use CEST to reach a status determination, which is clearly stated on the CEST landing page on GOV.UK. Engagers, employers and individual workers who have to make status determinations are required to take reasonable care in doing so. Accurately using CEST and HMRC's guidance is one way of doing this but it is not the only way. Clients can use other tools or other forms of tax advice to help them discharge their responsibility.

Regardless of whether a client has used CEST or not, HMRC's compliance checks will always examine the actual working arrangements and contractual frameworks in place for the engagement in question to reach a view on whether status has been correctly determined in line with the relevant case law. Where CEST has been used to decide employment status for tax purposes, HMRC's compliance checks will ensure that the correct information was inputted to get the determination, and that the tool was used in accordance with the guidance; HMRC will stand by the result of CEST in these circumstances.

We acknowledge that CEST has been designed to be easy to use, and cannot be expected to cater for every possible scenario. However, a 20 per cent "undetermined" rate means a significant number of people need additional support to identify their status if the off-payroll working rules apply. We consider that more must be done to improve the advice and support available for those who receive a CEST "unable to determine" outcome. (Para 22)

In 80% of uses, CEST will be able to give users a clear status determination. However, applying the rules for employment status to the facts of some, more complex engagements can be finely balanced. In these cases, CEST may state that it is unable to reach a determination. Users who receive an undetermined outcome are signposted to further sources of support, including guidance on determining employment status in the Employment Status Manual¹ and a dedicated helpline – which answered 98.6% of calls between March 2020 and November 2021, with an average call waiting time from selecting the option for the IR35 Helpline to being connected to an advisor of approximately 45 seconds.

In response to the Sub-Committee's conclusions, HMRC will review the current signposting for customers who receive an 'unable to determine' outcome from CEST, to ensure that customers are clearly directed to further sources of support to reach a status determination, including supplementary guidance and helplines.

The Government notes that several witnesses raised concerns about the accuracy of CEST with the Sub-Committee. However, HMRC remains confident that CEST is accurate in the cases where it gives a determination. This is why HMRC will stand by its results. CEST has been rigorously tested against case law and settled cases by officials and external experts and HMRC remains confident that it is an appropriate and accurate status determination tool, provided that the information supplied by the user was and remains accurate. A detailed breakdown of this testing has been published on GOV.UK². The entire decision-making engine that sits behind CEST is also available publicly so it can

¹ HMRC Employment Status Manual, ESM0500: <https://www.gov.uk/hmrc-internal-manuals/employment-status-manual/esm0500>

² <https://www.gov.uk/government/publications/check-employment-status-for-tax-cest-2019-enhancement/check-employment-status-for-tax-cest-2019-enhancement-summary>

be fully and independently vetted³. HMRC will update CEST whenever there are changes to the existing case law on employment status.

The continued absence of questions on mutuality of obligation within CEST means that many of those impacted by the off-payroll working rules do not have confidence in the accuracy of its results. We recommend that HMRC work with stakeholders through the IR35 Forum to agree modifications to CEST to reflect the test of mutuality of obligation properly. (Para 23)

Mutuality of obligation (MoO) refers to the obligation on the client to provide work, and on the contractor to provide that work, in exchange for a wage or some other consideration. The significance of MoO is that it determines whether there is a contract in existence at all. Without MoO there can be no contract of any kind.

Whilst CEST does not specifically ask questions relating to MoO, it does account for MoO by starting from the presumption that there is a contract in place between a client and a contractor (and therefore, that the requirements of MoO are met) before asking questions to determine whether that contract is one of employment or self-employment. The CEST landing page states clearly that the tool assumes that a contract is in place and links to specific guidance on this point and on MoO in the Employment Status Manual⁴.

HMRC keeps CEST and all other guidance under continual review. HMRC will continue to engage with the IR35 forum and other external stakeholders on an ongoing basis to ensure that CEST and related guidance strikes an appropriate balance between ease of use and giving clarity on complex areas of case law.

Status Determination

You told us that it is quite legitimate for companies to decide not to use contractors working through personal service companies if they do not wish to do so. It is regrettable nevertheless if such decisions are driven by tax, rather than commercial, considerations. (Para 26)

Prior to the reforms, non-compliance with the off-payroll working rules by personal service companies (PSCs) had created a distortion where different contractors and clients have paid different taxes for work that is identical. Previously, nine out of ten of those working like employees through PSCs paying less tax than either compliant PSCs or directly engaged employees. These reforms are aimed at correcting this distortion.

Following the reforms, the decision by some clients to no longer engage contractors through PSCs is a legitimate business decision. It is right that a client's choice of the most appropriate way to engage with contractors for their business is not distorted by tax non-compliance.

While a light-touch approach is admirable where engagers are making honest mistakes, we suggest tougher compliance action is needed where engagers are effectively evading their obligations under the rules to make individual determinations. (Para 28)

HMRC compliance activity needs to focus on the handling of appeals by engagers to ensure satisfactory processes are put in place for the proper consideration of appeals. (Para 30)

³ <https://github.com/hmrc/off-payroll-decision>

⁴ HMRC Employment Status Manual, ESM0543: <https://www.gov.uk/hmrc-internal-manuals/employment-status-manual/esm0543>

The Sub-Committee shares the concerns raised by witnesses about blanket assessment and the engager-led appeal mechanism. HMRC needs to take steps to address these problems through its compliance activity. (Para 33)

In February 2021, HMRC published its compliance approach to strengthen its commitment and provide transparency for customers and tax agents. This set out clearly for customers how HMRC would take a supportive approach to help them comply with the rules and correct any errors. However, it also set out that any deliberate non-compliance or avoidance activity would be challenged to create a level playing field for all.

The Sub-Committee raises concerns regarding blanket decisions, whereby status determinations are made without regard to the individual engagements. The Government has always been clear that blanket determinations are against the off-payroll working rules. Clients must undertake status determinations based on the facts of the engagement, to do otherwise would represent a failure to take reasonable care. Furthermore, where a client takes the decision to make blanket determinations regarding their contractors, they will incur unnecessary employment costs for workers who may in fact be working outside the rules. Therefore, there is a financial consequence for the clients in taking this approach.

Where the working arrangements are the same for a number of people doing the same role, the client can undertake role-based determinations. This is entirely acceptable under the OPW rules.

Both ahead of the reform taking effect and afterwards, HMRC undertook a significant amount of education and support to make the clients aware of their obligations under the legislation. This included webinars, workshops, online guidance and factsheets setting out how determinations should be made. This is something that the Sub-Committee has welcomed.

In the independent research commissioned by HMRC into the implementation of the public sector reform, it found the use of blanket determinations to be extremely rare. HMRC's research into the impacts of the 2021 reform will also look at this issue.

HMRC has already commenced compliance activity, in line with its published strategy⁵, to ensure that clients are complying with the rules. This activity includes checking a client's decision-making process for status determinations. This will typically involve checking a sample of both inside and outside determinations.

Where HMRC does identify instances of blanket determinations, it will ensure that incorrect determinations are corrected and, where the client has weak systems and processes, HMRC will provide relevant education and advise of best practice to improve their systems.

Furthermore, as part of its compliance checks, HMRC asks for information on the client's process for resolving disputes and how it has dealt with any disagreements with its contractors. This helps HMRC form a view on whether a client is taking reasonable care in making status determinations and therefore complying with the rules.

Impact on the Labour Market

The Sub-Committee is very concerned about the impact that these changes are having on the labour market. We are not convinced that the Government is confronting the challenges that both

⁵ <https://www.gov.uk/government/publications/hmrc-issue-briefing-supporting-organisations-to-comply-with-changes-to-the-off-payroll-working-rules-ir35>

businesses and workers face because of the new rules. The research to show the real impact of these rules should therefore be conducted expeditiously. (Para 45)

As we recommended in our 2020 report, research into the impact of the measures must take into account the wider impact of the changes on the UK's labour market and the broader economy. The Sub-Committee believes that the scope of this research should be more comprehensive and in particular should invite input from affected contractors as well as engagers and intermediaries. (Para 46)

The Government notes the Sub-Committee's concerns about the impacts of the reforms on the labour market, which remains a significant policy focus. We are presently conducting specific research work to assess the labour market impacts of the 2021 reform by examining the ability of private sector clients to fill vacancies, along with associated fees.

Before considering the specific research being undertaken, it is worth setting out the Government's view on the relationship between the off-payroll working rules and broader labour market pressures that have followed the pandemic. As the Sub-Committee will be aware, there has been a sharp tightening in labour markets across advanced economies, with vacancies rising above pre-pandemic levels. Firms across economies in the OECD have faced challenges in finding workers. However, there remains no compelling evidence that greater compliance with the off-payroll working rules is significantly contributing to these labour market pressures in the UK in comparison to the economic pressures that have played out internationally as the global economy has rebounded from the pandemic. Firms across economies in the OECD have faced challenges in finding workers. While there are challenges to assessing the total number of PSCs, some of which are discussed below, on any estimate they constitute a small part of the overall workforce, inherently limiting the impact of the reforms on the wider economy.

More specifically, external research into the effects of the 2017 reform show that the overall demand for, and supply of, contractors following the reform has remained broadly stable in the short and long-term; and many public authorities continue to engage individuals working as contractors, including through the use of PSCs.

Looking forward, the Government notes the Sub-Committee's support for the external research HMRC has commissioned into the impacts of the 2021 reform, and agrees that this should be conducted expeditiously. By way of update, fieldwork is currently being conducted with clients, as they have the most responsibilities under the reform and the clearest understanding of how they are engaging contractors. More broadly, the research will also seek to understand any changes to how contractors are engaged and changes to rates of pay for contractors, as well as insights into how determinations are made and disputes handled. It has been supplemented with research into other parts of the supply chain – qualitative research with agencies was published in March 2021, while work with contractors, which predominantly focuses on tax information and advice but also asks questions about the impacts of the off-payroll working rules, is ongoing and will be published later this year.

The Government notes the Sub-Committee's view that the scope of the research should be wider. The scope of this research, which was defined to make the most effective overall assessment of the impacts, is challenging to change now that fieldwork is underway. We would expect the findings to be published once complete, this year; the Government will sight the Sub-Committee when this is published, and will consider the case for wider research on an ongoing basis.

We would also like to take this opportunity to clarify our assessment of the number of PSCs. HMRC provided further written evidence to you on 13 December 2021, setting out that there was a wider population of companies that had the characteristics of PSCs. In that same note, HMRC described to you the further data and analysis that was used to arrive at its estimate of 240,000 PSCs whose administrative burdens were to be reduced by the 2021 reforms and the 180,000 PSCs whose engagements would be properly categorised as "employment" after the reform. The estimate of those whose engagements would properly be categorised as "employment" was shared with the Office for Budget Responsibility (OBR) as part of the costings process for the reform

HMRC also undertakes internal monitoring of the impacts of the reform which focusses more directly on contractors as well as the additional tax revenues generated, which will continue.

Impact on workers and businesses

We believe that HMRC has failed to appreciate the burden of costs that the new rules are imposing on compliant companies. It is right that this issue is revisited by HMRC in the research into implementation of the rules. (Para 49)

The Government notes the Sub-Committee's view that HMRC may have failed to appreciate the full cost of the administrative burden of the rules, and that there will exist anecdotal evidence of some organisations spending larger amounts in connection with the change to the rules. However, 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's assessment looks at the overall picture of administrative burdens across the impacted population. It recognises that organisations will take different approaches to the reform, and that there will be a range of costs incurred by different client organisations, depending on their size, workforce and industry. This is why HMRC's Tax Information and Impact Note (TIIN) described the burden as 'significant but varied'.

As you set out in your letter, following the previous inquiry, HMRC has revised their initial estimates for the administrative cost of the reform to £19.7 million one off-cost and an ongoing £0.3 million per year saving. Within this ongoing saving, HMRC does recognise that there will be ongoing costs to clients and estimates these to be £8.4 million per year. There are, however, also savings for a greater number of personal service companies, giving a small net saving per year. This methodology was shared with the Administrative Burdens Advisory Board (ABAB) who commented that "the approach was sound and reasonable"⁶.

It would be inconsistent for HMRC to apply a different methodology for estimating administrative costs for this reform, using what organisations may choose to spend on complying with the rules, as opposed to what they need to spend to be compliant. HMRC is focussing its resource on evaluating of the impacts of the reforms, including the administrative burdens on organisations, and its ongoing research looks to understand the actual amounts being spent on complying with the rules by clients.

One of the drivers behind the tax avoidance, which IR35 and the off-payroll rules were designed to address, was engagers' desire to avoid paying employers' NICs. Yet in practice it seems many engagers are still not accepting this responsibility, but passing it on to contractors via reduced

⁶ ABAB 2021 Annual Report, p16:

https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1029978/Administrative_Burdens_Advisory_Board_annual_report_2021.pdf

rates of pay. It is lower paid contractors with the least bargaining power who are most disadvantaged. (Para 53)

The Government also notes the Sub-Committee's interest in who ultimately bears the cost of any tax or NICs for a particular engagement following the reform, and this is something that HMRC is looking at in its ongoing research.

It is worth reiterating that the purpose of the reforms is to remove the opportunity for non-compliance with the rules and correct the distortion that this created. The reforms ensure that those who are working like employees pay broadly the same tax and National Insurance as those engaged directly, regardless of the structure they are engaged through.

At an economy wide level, it is standard for employers to set wages with regard to the overall tax bill, and this will be the same whether someone is engaged directly or as a contractor. The Office for Budget Responsibility makes a set of assumptions about the pass-through of employer NICs to wages whenever a change to employer NICs is made. However, on a case-by-case basis particular incidence of a tax change will differ, depending on the particular market and sector, and could be affected by other factors. While not necessarily representative of the private sector reform, the external research into the effects of the reform in the public sector show that the majority of organisations did not change the rates paid to contractors following the reforms, and those that did were more likely to increase pre-tax rates than decrease them.

Umbrella companies

The Sub-Committee is very concerned that to note that the extension of the off-payroll rules to the private sector is resulting in greater numbers of people using umbrella companies; and increasing the risk that some individuals, particularly those on low incomes, will become involved with rogue umbrella companies associated with tax avoidance. Paradoxically, this appears to substitute one form of tax avoidance for another. (Para 60)

The Sub-Committee welcomes the call for evidence but we would have liked to see a greater focus on the protection of workers using the services of umbrella companies and a clearer indication of the Government's intentions. The Sub-Committee feels that the Government has been slow to act against the harm caused by the activity of non-compliant umbrella companies. (Para 65)

We recommend an early indication of what use the Government intends to make of the information it collects, what action is proposed and to what timescale. (Para 66)

The Government agrees with the Sub-Committee that the recent growth in the use of labour market intermediaries, including umbrella companies, alongside accounts of poor market practices in the sector, merit further investigation. The Government welcomes the Sub-Committee's views on the Call for Evidence (CfE), which acknowledged the legitimate role umbrella companies can play in the labour market, and the complexity that can be a part of business' labour supply chains.

Officials are working to build up a detailed and up to date understanding of the market and how it is continuing to evolve, building on existing information received from stakeholders. This includes seeking views on how umbrella companies can support a flexible labour market – for end clients, employment businesses and workers themselves.

The Sub-Committee is very concerned that the off-payroll rules are encouraging the insertion of unnecessary intermediaries into the supply chain, adding to costs and opportunities for "rogue" operators. We believe that effective action requires a stronger focus on worker protection. (Para 69)

The purpose of the off-payroll working rules is to remove the distortion within the tax system created by the use of intermediaries, such as PSCs, where they are used to avoid employment taxes.

The Government has already taken action in a number of areas to tackle umbrella company non-compliance. This includes bringing forward anti-avoidance measures in Finance Act 2021. The Government has also taken the first step towards better protecting individuals working through umbrella companies by introducing the Key Information Document (KID) in April 2020.

HMRC is also taking robust action against tax avoidance schemes through its promoter's strategy. Further, HMRC has helped workers stay clear of tax avoidance schemes by publishing a tax avoidance explained campaign. HMRC's Fraud Investigation Service is using both its civil and criminal powers to challenge those who are involved in and facilitating mini umbrella company fraud and has made a number of arrests in relation to this fraud.

The Government will need to carefully consider industry and stakeholder feedback to the call for evidence to inform any future policy decisions in this area. The Government will update the Sub-Committee once this has been fully considered.

In the absence of effective statutory action, umbrella companies are proliferating. More and more individuals are at risk of getting caught up in tax avoidance schemes. The Government needs to commit to a date for bringing forward legislation to create the proposed single enforcement body to regulate umbrella companies. (Para 70)

Primary legislation is required to create the Single Enforcement Body (SEB), and this will be brought forward when parliamentary time allows. Creating a new body is a substantial organisational change and the government are working to ensure that all aspects of this reform have been thoroughly considered, including through the responses to the CfE on umbrella companies. This is essential to ensure a smooth transition and improved enforcement for both vulnerable workers and employers.

Employment Status

It is disappointing that nearly two years on from our earlier report, no significant progress appears to have been made in addressing the wider issues around employment status or implementing the Taylor Review's proposals. (Para 73)

The mismatch between tax law and employment has resulted in a situation where individuals are treated as employees for tax purposes but without the rights which are normally associated with employment. In taking forward the off-payroll working reforms, the Government has focussed too narrowly on tax issues and not enough on wider issues of fairness. (Para 74)

The Sub-Committee reaffirms its earlier recommendation that the Government should implement the Taylor Review proposals. There is now even greater urgency in defining employment status for both tax and employment rights purposes. (Para 75)

The Government notes the Sub-Committee's concerns about employment status for tax and rights. Similar tests are used to determine employment status for tax and rights, based on the nature of the relationship between an individual and the person for whom services are provided but as highlighted in the Sub-Committee's conclusions, these frameworks are separate. The tax framework determines how much tax is due and how this is paid, and the employment rights framework aims to protect workers without putting unnecessary burden on businesses.

The Government recognises stakeholder interest in employment status and notes the range of views on this complex and important topic. We are working cross-Government on these issues and how

best to address them in the current context and will set out more detail in due course. The Government remains committed to working with stakeholders to ensure that the employment status frameworks continue to support the policy intent of ensuring the UK continues to be one of the best places in the world to work and grow a business.