

HMRC - Written evidence

Further information on the reform of the off-payroll working rules

Economic context

The tax paid by individuals on income from their work varies significantly depending on the structure through which they work:

- employees face the highest tax burden on their employment income;
- self-employed individuals face a lower tax burden on their self-employment income;
- those who work through a corporate structure, i.e. a limited company they own, can arrange their affairs to face the lowest effective tax rates of all by paying themselves a small salary to build contributions to the state pension and taking the rest of their income as a dividends (taxed at a lower rate than earned income) or by retaining profits in their companies and extracting them later at much lower rates of capital gains tax.

A key driver of the tax differential is employer National Insurance Contributions (NICs), which is not paid by the self-employed or incorporations, but is paid by firms on the salaries of their employees. Individuals who have incorporated can further reduce their tax bill by splitting their incomes with partners or spouses by making them shareholders in the company to take advantage of tax-free allowances or lower tax rates.

Since the off-payroll working rules were introduced in 2000 we have seen rapid growth in owner managed companies and the IFS have found that the company owner-manager population almost doubled between 2008 and 2016.

Different ways of working and the increasing casualisation of the workforce, including in the gig economy, mean that operating through a personal service company (PSC) has become a common choice in many sectors, providing significant savings for both individuals and businesses. This also means that, particularly where an individual has a number of different contracts, determining their employment status may be more challenging. A common misconception that if you have your own company you are automatically self-employed has taken hold, supported by an industry that offers 'IR35 proof' contracts and insurance against investigations by HMRC.

Objective of the off-payroll working rules

The off-payroll working rules were introduced in 2000 and were designed to ensure that individuals working like employees, but through their own company, pay broadly the same tax and NICs as those who are directly employed.

Non-compliance with these rules is widespread; HMRC estimate only one in ten customers in the private sector apply the rules correctly. This estimate is based on analysis of selfassessment return information amongst the PSC population. HMRC estimates that approximately 230,000 PSCs could be in scope of the reform, with 170,000 likely to be within the rules.

Analysis produced in 2018 estimated that the loss to the Exchequer would amount to £1.3bn by 2023-24 if the reform was not extended to the private sector. The main reason for the increase in the cost of non-compliance is the growth in the number of PSCs, reflected in the growth in the number of tax motivated incorporations.

HMRC has faced challenges in enforcing the off-payroll working rules that stem from the fact that workers themselves are responsible for assessing whether the off-payroll rules should apply and then paying the correct taxes. Enquiries must deal with each PSC individually, even where numerous workers are engaged and working in the same way for a single client. There are also long time lags between when an engagement takes place and when tax on the income arising from it is due, creating difficulties for HMRC in collecting the information needed from the parties in the contractual chain. It is possible for individuals to liquidate their companies and so avoid paying any tax, when faced with an HMRC investigation.

To address this, HMRC has thoroughly explored all options on how it might tackle the problem differently. In line with HMRC's overall strategy, the department has looked at ways of effectively and efficiently closing the tax gap through the promotion of good compliance through the design of our systems and processes, as well as supporting intermediaries to play an active role in collecting tax and providing data. Since 2015, it has consulted on numerous occasions with stakeholders on options to address disguised employment and proposals for reform of the off-payroll working rules. A timeline of the consultation activity can be found in Appendix A.

Following consultation, the Government reformed the way the rules operate in the public sector in April 2017, making public sector bodies responsible for determining whether the rules apply to contracts and for ensuring that they and the individuals who work for them pay the right tax. Evidence suggests this has been successful in improving compliance without disrupting public services or reducing market flexibility. Independent research by IFF Research and Frontier Economics did not find evidence of staff shortages, significant project delays or wholesale

contractor walkouts, and this was reinforced by recent roundtable discussions with the public sector.

During our discussion, we informed the committee that the public sector reform was estimated to have generated an additional £550 million in revenue for the Exchequer in the first year of operation (2017/18). As explained, this additional revenue related to additional income tax and NIC remitted to HMRC. When factoring in the reduction in corporation tax and tax on dividends as a result of applying the rules, the net revenue increase was £250 million in the first 12 months. This is more than the £205 million estimated at Spring Budget 2017.

Following the public sector reform, the Government consulted widely on the proposed extension of the reform to other sectors. In response, it was announced at Budget 2018 that, from April 2020, similar reforms will be extended to all large and medium-sized organisations. These reforms are estimated to collect additional revenue of approximately £3 billion by 2023/24.

A number of changes to the rules were made both in response to our experience of the public sector reforms but also the subsequent consultations. Most notably:

- business and individuals have been given a greater lead in time, with the reform having been announced at Budget 2018, 18 months before the reform is due to take effect;
- introducing the concept of a Status Determination Statement (SDS) that clients should give to the party they contract with and the worker they are engaging. This also determines who is liable for deducting the income tax and NICs;
- the introduction of a statutory requirement for the client to provide a status disagreement process through which workers or agencies can challenge the client's determination;
- the ability to recover unpaid liabilities from the client or highest agency in the labour supply chain in cases of non-compliance.

Further, a number of additional technical changes have been made more recently in response to ongoing feedback from stakeholders, including as part of the review announced by the Government on 7 January 2020. This is covered in more detail at the end of this letter.

HMRC has also recently concluded a technical consultation of the draft secondary legislation on PAYE and NIC regulations, which may result in further technical changes to secondary legislation.

Umbrella companies

As the sub-committee is aware, there has been an increase in the number of contractors working through an umbrella company. Umbrella companies are often used by employment agencies. The agency places the temporary workers that it recruits into an umbrella company.

The umbrella company is responsible for paying the worker's wages, employer NICs and the provision of employment rights. Most umbrella businesses are compliant with tax and employment laws.

However, some promoters have used structures, which are self-labelled as umbrella company arrangements, to facilitate disguised remuneration avoidance schemes, which do not work. These schemes usually use a mechanism that sees part of an individual's earnings, often at or near the National Minimum Wage amount, subjected to PAYE/NICs, with the remainder described as "non-taxable", often characterised as a loan, annuity, credit, share etc. Avoidance scheme promoters market these umbrella companies directly to contractors as a tax-efficient means of engagement, often advertising or marketing these as an opportunity to increase their take-home pay, with significant monetary incentives to introduce fellow contractors/agency workers to the umbrella. Where HMRC discovers activity of a noncompliant nature it will act to shut it down using its existing powers.

Following the public sector reform, HMRC saw an estimated additional 58,000 PAYE employments in the public sector. Whilst it is not possible to provide a further breakdown of this figure, anecdotally we know that this includes contractors engaged through umbrella companies and agencies, as well as directly by public sector bodies.

HMRC has recently published a 'self-help' guide that contractors can use to help identify potential avoidance schemes. HMRC has also previously published a Spotlight article on umbrella companies explaining how to spot non-compliance.

The Government is also considering its general approach to tackling disguised remuneration schemes more widely and will announce its next steps at the Budget.

Employment Status rules

Employment status is not a matter of choice. There is no statutory definition of employment status but whether someone is employed or self-employed depends on applying case law criteria to the facts of each working relationship. Employment status is straightforward in most cases but can be complex in a minority of cases.

The following three main factors must be considered when determining an individual's employment status:

Mutuality of obligation – this is where a worker and their hirer form a contract by which the worker agrees to perform some work in return for payment.

Personal service - the individual is obliged to perform the work themselves (i.e. they do not have an unfettered right to substitute someone else to do the work).

Control – the client has the right to control the work the individual undertakes (e.g. what, how, when, where).

If the evidence suggests that these factors are met, then the individual is highly likely to be considered an employee for tax purposes. However, other factors should still be considered in reaching such a decision. These include business on own account, financial risk, provision of own equipment, part and parcel of the organisation and opportunity to profit.

A basic example case study of how the off-payroll working rules would apply can be found in Appendix B.

Check Employment Status for Tax (CEST)

HMRC has developed the Check Employment Status for Tax (CEST) online tool to help individuals and organisations determine an individual's employment status. The online tool works by asking a range of questions relating to the engagement and, depending on the responses provided, will provide a determination for that individual in the vast majority of cases

During 2019 HMRC worked with more than 300 stakeholders to improve CEST and address previous user criticism and an enhanced version of the tool was published in November. The changes made include making the questions and the results clearer, increasing the number of questions to provide a more thorough assessment and building in features to reduce user errors.

We have also published guidance to support customers use the CEST tool. It is not necessary to read the guidance to complete CEST, however the guidance explains why we are asking for the information, gives a fuller explanation of the questions and uses examples to demonstrate which box should be selected in each situation.

Since the enhancements were made, CEST has been used over 270,000 times by over 160,000 users and the tool has received generally positive feedback from stakeholders. In the more complex or marginal cases where CEST does not provide a determination, HMRC has detailed guidance and a dedicated helpline.

Out-sourced services

Out-sourced services generally refer to contracts where an organisation has entered into an arrangement with a third party to provide services (e.g. a maintenance contract). That third party may then engage an

individual through their own company to provide their own services (e.g. a plumber or heating engineer).

In these circumstances, the organisation that has out-sourced the services to a third party will not be caught by the rules. Therefore, an organisation can indirectly engage with contractors without needing to consider the off-payroll working rules.

However, where the third-party service provider is a medium or large organisation and engaging an individual through their intermediary, they may be caught by the rules. The service provider would be considered the client and will need to determine the status of the individual.

In the session, we discussed the example of a furniture maker to illustrate this point. For instance, if an organisation owns a vast range of ornate furniture that requires constant maintenance, the organisation may choose to contract out the maintenance to a medium sized maintenance company. Whilst the maintenance company will have to undertake any work at the organisation's premises, they will decide how and when they undertake the maintenance and the staffing decisions. The maintenance company recruit and pay workers, such as carpenters, upholsterers and engravers, agreeing their rates of pay and working hours. The workers wear the maintenance company's branded clothing but are also required to wear an ID badge given by the organisation.

This is an example of an out-sourced service because all control is devolved from the organisation to the maintenance company. The workers provide their personal service to the maintenance company and it is benefitting from the provision of the workers' labour. If the workers operate through intermediaries, the maintenance company will have to determine the workers' status under the off-payroll working rules.

HMRC published detailed guidance on this element of the rules on 7 February 2020.

Review of the off-payroll working reform

As you will be aware, on 7 January 2020 the Financial Secretary to the Treasury, the Rt Hon Jesse Norman MP, launched a review into the implementation of the changes to the off-payroll working rules. Having listened to a range of stakeholders, including businesses, agencies, public sector organisations and contractor representative bodies, on 27 February 2020, the Government published the findings of that review.

The Government is grateful for the contributions to the review. While there remains some opposition to this change, the Government believes it is right that the reform goes ahead on 6 April 2020 to address the fundamental unfairness of non-compliance with the existing rules.

The Government has listened to stakeholders throughout the review process and is making a number of changes to address concerns and

support the smooth and successful implementation of the reform. The key changes include:

- HMRC will take a light touch approach to penalties. Businesses will not have to pay penalties for inaccuracies in the first year, except in cases of deliberate noncompliance;
- detailed guidance on the reforms has been published by HMRC;
- HMRC will ramp up its communications efforts, including webinars and guides, to support contractors understand the rules. This will complement the significant work already in train to support businesses to prepare;
- the Government reiterates that new information from the changes will not be used to open investigations into PSCs for past tax years, unless fraud or criminal behaviour is suspected;
- the Government will also introduce a legal obligation on organisations to respond to requested information about their size from the agency or worker, to make it clearer who is responsible for determining the worker's tax status;
- HMRC previously announced an early change in response to the review, meaning that the rules would only apply to payments made for services provided on or after 6 April 2020;
- HMRC will commission external research into the impacts of the reform six months after implementation, including how status determinations are being made. This research will be presented to Parliament.

The full report can be found on [GOV.UK](https://www.gov.uk).

Appendix A: Summary of off-payroll working consultations 2015-2019

July 2015 – Intermediaries Legislation (IR35): discussion document

- This consultation set out the rationale for changes to the rules and options to improve their effectiveness, including a lead proposal of shifting responsibility for determining employment status to engagers.
- Changes made as a result: Responsibility for administering the rules was shifted from the individual to the engager, but this was limited to engagements in the public sector.

May 2016 – Off-payroll working in the public sector: reform of the intermediaries legislation

- This sought views on the impacts of the reform in the public sector and detailed design of the policy.
- Changes made as a result: Introduced a legal duty for engagers to inform relevant parties, such as agencies, whether the off-payroll rules should apply. The 5% tax-free allowance (which was previously given to PSCs to account for the costs of administering the rules) was withdrawn for PSCs engaged in the public sector as many respondents thought keeping it would be illogical and complex. After concerns were raised that if PSCs provided incorrect information the engager would still be liable for tax and NICs, legislation was introduced to allow for the liability to pass to the party who provided fraudulent information.

May 2018 – Off-Payroll Working in the private sector

- This asked for comments on options to address the compliance challenges with the Off-Payroll working rules in the private sector and asked stakeholders for their ideas about how best to improve compliance, and how the rules as they apply in the public sector could be adapted to work for the private sector. Suggested options also included:
 - o Improved record keeping;
 - o Legislating to require organisations to secure their labour supply chains and ensure they are compliant.
- Changes made as a result: The reform was extended to the private sector, taking effect from April 2020 instead of April 2019 to give businesses time to prepare. Small businesses are exempt from the changes due to concerns that changes were likely to be more onerous for smaller or new businesses than larger and established businesses.

March 2019 – Off-Payroll Working rules from April 2020

- This sought to understand how best to implement the reform to the off-payroll working rules in the private sector.
- Changes made as a result: The test for whether an unincorporated business is small was simplified and a 'two-year rule' was introduced to determine when a medium or large company which was previously small has to administer the rules. The government will legislate to set out the minimum requirements for the 'status disagreement process' through which clients must respond to off-payroll workers who disagree with their status determination.

Appendix B: Basic example of the off-payroll working rules

Deemed employee

Alan is a 35-year-old furniture repairer with years of specialist experience. He has a 'personal service company' (PSC), through which he provides his services to clients. Alan's PSC enters into an agreement with a large organisation, the client, to repair the organisation's range of ornate furniture. They agree the specifications of the contract and the timeframe for completing the work.

Alan receives a guaranteed daily rate for work completed. The client insists that Alan has to perform the services at its premises during hours stipulated by the client. Alan uses equipment provided by the client. Alan is unable to provide a substitute worker and also has management responsibility for a small maintenance crew who are all employees of the client.

Alan **is likely to be a deemed employee** of the client. Alan is required to carry out the work personally and works under the control of the client. Alan does not have any financial risk and does not appear to be in business on his own account. Alan is also directly responsible for a team of the client's employees.

Not a deemed employee

In a different example, Patrick enters into an agreement through his PSC with a medium-sized organisation, the client, to maintain and repair the organisation's catalogue of wooden furniture. They agree a price for the work, timeframes and some basic specifications. Otherwise Patrick is free to decide how, when and where he wishes to carry out the work.

Patrick will mainly work at the client's premises, although if further repairs are required, he takes the furniture back to his home workshop. Patrick has invested his own money in professional equipment to carry out the work. Patrick is free to work for other organisations but faces a substantial contractual penalty if he doesn't fulfil the contract as agreed.

Patrick **is not likely to be a deemed employee** of the client. This is because he personally bears a significant financial risk if he fails to deliver the work, as agreed, and has a large degree of freedom over how he conducts that work.