IR35 shake-up: major change to contractor tax and compliance rules announced

By Dan Pipe and Ben Smith - 31 October

In a move many have been expecting, on 29 October 2018 the Chancellor of the Exchequer announced a significant change to how large and medium-sized companies engage contractors through personal service companies (PSCs). The changes will take effect from 6 April 2020 and will shift the burden of ensuring compliance with the off-payroll working rules (known as IR35) from the PSC to the company engaging the PSC, meaning that deductions for any tax and National Insurance Contributions (NICs) due must be made via PAYE by the company engaging the PSC.

The changes place a significant tax risk and compliance burden on end clients engaging workers through PSCs. They are expected to generate significant additional revenue for the exchequer (with current predictions suggesting an increased revenue of £1.1bn in 2020/21). This change was already rolled out in the public sector in 2017 and is estimated to have raised an additional £550m a year in tax revenue.

What are the IR35 rules?

The IR35 rules were created to address a perceived form of tax avoidance, where individuals providing services to end clients via PSCs were not subject to employment income tax and NICs on payments made by the end client, whereas an employee would be (although the PSC and individual would still pay corporation tax, income tax, and NICs, in some circumstances the combined rate of these different types of taxes could be lower).

Under the existing law the IR35 rules apply where an individual worker is engaged by an end client through a qualifying intermediary, usually a PSC, and, if that PSC was removed from the picture, the relationship between the end client and the individual would be one of employment. Where the rules apply in the private sector, currently the PSC is required to deduct income tax and NICs from, and pay employer NICs by reference to, the payments it receives from the end client. Therefore, the burden of assessing the application of, and complying with, the IR35 rules falls on the PSC and it bears the liability for any failure to pay the proper taxes.

What is changing?

From 6 April 2020, this burden will shift and the obligation to apply the IR35 rules will fall on the end client (i.e. the company hiring the contractor), as will the liability arising from any failure to apply the rules properly. If the end client considers that IR35 applies, then it will need to deduct income tax and employee NICs from, as well as pay employer NICs by reference to, payments it makes to the PSC or risk expensive claims for back taxes, penalties and interest.

The changes will apply only to “medium and large” businesses and the Government intends that 1.2m small businesses will fall outside the scope of the changes. The definition of “small” has not yet been published, but as a rough guide we expect that businesses with fewer than 50 employees will be considered to be “small”.

A key aspect of the change is an expansion and improvement of HMRC’s online tool (“Check Employment Status for Tax” or “CEST”), which purports to check whether the IR35 rules apply to a particular engagement by analysing information about working arrangements provided by the consultant or end client. Most advisers feel that the tool often gives a cautious answer – i.e. that deductions must be made – when careful analysis of the legal framework might produce a different result. It is inevitable that an algorithm will have difficulty in correctly applying the subtleties of decades of employment and tax case law. It is not surprising that the tool is not perfect. However, it may prove difficult for companies to dissuade HMRC from simply accepting the result of CEST, creating an effective presumption in favour of IR35 applying.

How to prepare

In preparation for the implementation of these rules on 6 April 2020, you should consider auditing your existing workforce to assess compliance and identify risk areas. Depending on the results of that review, you should assess possible mitigation steps including adopting an alternative employment model, deducting tax and NICs at source, or engaging the contractors differently.

In many cases, there will be an additional cost to companies using contractors, because an employer NICs charge will now arise where one did not in the past. In principle, that is a cost that should have been borne by the PSC (if it correctly assessed that IR35 applied), but whether or not the end client can reduce the contract price to recover its additional cost will depend on the details of the contractual arrangement. In some cases, it is likely that renegotiation of existing arrangements with contractors will be needed.

The Government has made clear that this is not intended to be a retrospective change. HMRC will not necessarily launch investigations into previous years if individuals start paying employment taxes under IR35 for the first time from 6 April 2020. Businesses should therefore take the opportunity in the run up to 6 April 2020 to ‘get their houses in order’ and prepare appropriate policies and systems to ensure their compliance.

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