IR35 Special Report

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The new IR35 rules come into force as of April 2020 which may shift the burden of ensuring compliance with IR35 from your independent contractors' personal service companies to you as the end user. From that point onwards, if you do not operate IR35 correctly, you are at risk of having to pay out large tax and national insurance contribution bills for non-compliance, interest and penalties. There are options for end users to manage this new compliance burden, including accepting the risk; accepting that IR35 applies; changing practical arrangements; or converting contractors to employees. Our working assumption for most clients, especially those in the financial services sector, is that most contractors will become directly employed.

Read below for a high-level overview of the changes to the IR35 rules and our preliminary thoughts on what you could do about them.

What are the current IR35 rules?

The IR35 tax rules intend to address a form of tax avoidance where individuals set up a "personal service company" ("PSC") and provide services via that PSC to companies (the "end users"). This reduces the amount of employment income tax and National Insurance contributions ("NICs") they have to pay on the payments they receive from the end user.

IR35 applies where:

(i) an individual worker is engaged by an end user through a qualifying intermediary, usually a PSC; and

(ii) if that PSC was removed from the picture, the relationship between the end user and the individual would be one of employment.

The part (ii) test requires the construction of a 'hypothetical direct contract' between the individual and the end user, synthesised from the terms of the contracts between (i) the end user and the PSC and (ii) the PSC and the individual. The test then looks at the usual indicators of "employment" status. The courts will look at what happens in practice, not just what the contracts say.

If IR35 applies the PSC is required to deduct income tax and NICs from the payments it receives from the end user. They are also required to pay employer NICs. Currently, most PSCs (operated by the individuals who benefit from not applying IR35) usually take the view that the IR35 rules do not apply to them. This means they are able to benefit from the more favourable tax arrangements.

To date, most end users have (properly) taken the view that it is the independent contractors' and their PSCs' obligation to determine whether or not IR35 applies and, if so, to pay the requisite tax. Indeed, companies currently have no obligation to determine whether IR35 applies and no visibility over whether the PSCs fall within IR35 or not.

If the PSC does not pay the correct tax and national insurance contributions, it might be charged interest and penalties on any income tax or NICs owed. However, under the current rules, there are no (direct) consequences for the end user.

How is IR35 changing in April 2020?

As of 6 April 2020, IR35 is changing so that compliance with IR35 is for end users (i.e. the companies engaging the individuals) to determine and to make the appropriate income tax and NICs deductions and payments, rather than the PSCs. End users will be required to provide a status determination to the PSC. Such assessments will need to be carried out on all existing contractors before 5 April 2020, and thereafter on a rolling basis. The PSC will then have a right to ask for the reasons for that determination and, if they do so, the end user will need to provide those reasons in writing within 30 days.

The key risk is that most companies who engage their independent contractors using the above structures are now directly subject to a significant tax risk and compliance burden.

How large a risk this is will depend on how likely end users' arrangements with individuals are likely to be deemed as an "employment" relationship. Due to the way that most of these arrangements are set up and utilised, we anticipate that many independent contractors would be deemed to be employees (for tax purposes) and subject to IR35. As you can imagine, this is likely to be both expensive and unpopular for contractors who are currently carrying out the IR35 determination themselves

(Note: there is a 'small business exemption' which applies for end users who meet certain criteria. If you are unsure whether your business might qualify for the exemption, please contact your usual GQ|Littler contact.)

How to deal with IR35

So what next if, following an assessment of your workforce, you think most of your independent contractors would also be deemed employees under IR35? There are several options for end users to consider:

Option 1: Continue what you are doing in practice and accept the risk

This option requires no effort! And, if you have very few independent contractors, or your independent contractors actually operate in a way which means they are very unlikely to be deemed "employees" under IR35, then the risk might be an acceptable burden to bear, given the time and cost of implementing one of the other options below

The clear disadvantage is that, if HMRC later determines that IR35 does apply, you would have to pay out the unpaid tax and NICs, as well as pay interest on those payments and pay any penalties for not complying.

Option 2: Keep engaging the independent contractors as you currently do, but accept that IR35 applies

This approach would allow you to engage your independent contractors as you do now, and allow them to work in practice in the same way, whilst avoiding the risk of HMRC claiming back-dated tax and NICs payments in the future.

However, it is likely to be very unpopular with the independent contractors themselves. It will be less favourable to them than the tax treatment they have been used to and there is likely to be a certain amount of "friction" with individuals challenging the determinations made. End users will also either have to bear the additional cost of paying employer's NICs or seek to recover these costs from the independent contractors (also likely to be unpopular). Equally, the independent contractors may seek to renegotiate their contracts so that they receive a higher gross fee to account for the change in tax treatment.

Option 3: Change arrangements in practice so IR35 does not apply

This is the "Perfect World" solution, which would allow the end user to not deduct any tax or NICs, avoid payment of employer NICs, and retain a flexible contractor workforce contingent. Additionally, the individual contractors will likely prefer a world in which they retain their favourable tax treatment, and will therefore offer less resistance to any necessary changes.

However, in many organisations it may be very tricky to change the working arrangements that are in place with independent contractors (for example by encouraging substitution, or moving to fixed-fee pricing) in a way that is both commercially feasible and genuinely results in the non-application of IR35.

Option 4: Convert independent contractors to employees

The benefit of this approach is that the independent contractors can continue working in the same way in practice as they do currently, without any argument as to whether IR35 applies. If IR35 would apply in any event, employment might be the best of the options available, from the individual's perspective.

Of course, as employees, the individuals will become entitled to receive employee benefits and other rights associated with employment such as sick pay, holiday pay and unfair dismissal rights. However, employers could still offer a reduced employee benefits package to those engaged on a daily rate basis. Employment is also traditionally considered to be less flexible, as it is usually harder to dismiss an employee than to terminate an independent contractor's contract.

Despite the downsides, our expectation is that many companies may choose this option going forward.

Anything else?

Companies might elect to appoint an umbrella company to employ the individuals directly. Such a company would operate PAYE and pay national insurance in return for a fee. The agency worker tax rules will treat all the remuneration of workers engaged through this structure as derived from their employment with the agency and the IR35 rules are avoided altogether. The benefit of not employing the individuals directly is retained and a clear distinction between permanent employees and the workers you have previously hired as contractors is maintained.

However, this would be an administrative burden and would require the consent of the individuals who (as with many of these options) would suffer a reduction in their take home pay.

In summary...

Our expectation is that most institutions are likely to take a more risk averse determination than the PSCs would have done. Our working assumption for most clients, especially those in the financial services sector, is that most contractors will become directly employed.

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