IR35 in the private sector – what can companies be doing now?

In April 2017, HMRC implemented new tax legislation which radically altered how public sector bodies engage with self-employed contractors. The Government believes the public sector changes have been largely a success, increasing tax revenues by an estimated **£410 million** in the first 10 months alone.

HMRC is now considering extending the same public sector rules to the private sector, though it is contemplating alternative options as well. HMRC has stated that while an extension of the current public sector rules is their preferred option, no final decisions have yet been made. We await the government's response to a recent public consultation at which point we will know more about their intentions and timings.

Given the current imbalance between the public and private sector, and the huge tax gains made as a result of the 2017 changes, there is a strong likelihood that the current public sector rules will be extended to the private sector (potentially with some minor amendments). We are actively lobbying the Government to minimise the impact of such changes and encourage a realistic timescale for implementation.

Below is a brief overview of IR35, the current public sector rules, the implications for our clients if the expected changes are implemented, and what you can be doing now to minimise your risk and disruption.

What is IR35?

IR35 refers to HMRC's 'test' for self-employment for tax purposes when contractors work via their own limited company (or partnership), normally referred to as a personal service company or PSC. Where a contractor provides services through a PSC, but who, in his/her working practices, would be an employee for tax purposes if he/she had been engaged directly, that individual is considered 'Inside IR35' and must pay income tax and NICs on the entire assignment income, just as an employee would.

While the basis of IR35 is relatively simple, its application is not. The criteria that dictates what is 'Inside IR35' or 'Outside IR35' is not included in the regulation itself, instead relying on decades of case law and employment status tests to flesh out the detail. The result is a complex, often highly subjective and case-specific piece of legislation that are difficult to interpret and apply. The Federation of Small Business (FSB) reported in February 2018 that small businesses found IR35 the most difficult tax legislation to understand. There are more than a dozen indicators of IR35 status; the three most influential factors are: Mutuality of Obligation, Control and Personal Service.

In the private sector, it is the PSC contractor him/herself who is required to assess each assignment for IR35 purposes and make the appropriate deductions for tax and NI (where applicable). Any liabilities for misclassification of IR35 also sit with the PSC alone; clients have no liability under the IR35 rules in the private sector.

The current public sector rules

Public sector bodies (ie the end user of the contractor's services) are now required to assess the IR35 status of each assignment. The liability for correctly deciding whether an assignment is 'Inside IR35' or 'Outside IR35' has therefore moved from the contractor to the end user. Furthermore, whoever pays the PSC must make the appropriate deductions for income tax and NI before making payment to the PSC.

Where a public sector body engages these PSCs directly, the public sector body is required to make appropriate deductions for tax and NI, remit them to HMRC on the PSC's behalf and report those payments via RTI. They are also required to pay the applicable Employer's NI payments and the contractor will count towards employee numbers for the purposes of the Apprenticeship Levy. Where an agency supplies the PSC to the public authority, the agency makes the deductions for tax and NI based on the IR35 assessment provided by the end client.

The implications for the private sector

The main concerns around the potential extension of the public sector rules to the private sector are:

1. **Knowledge**. Very few companies have sufficient in-house knowledge to undertake IR35 assessments. Even though HMRC undertook a substantial communications campaign to educate the public sector, independent research indicates that most authorities struggled to properly apply the new rules.
2. **Resource Types**. Many companies do not even know which of their contractors are PSCs (IR35 does not apply to umbrella, PAYE or sole traders).
3. **Costs**. Most companies expect the cost of engaging contractors to increase. The cost of the Employer's NI and Apprenticeship Levy alone is significant (14.3% of the contractor pay rate once the NI threshold is reached).
4. **Critical Roles**. How will companies cope if critical contractors choose to terminate assignments because their assignment is assessed to be 'Inside IR35'?
5. **Disruption**. For companies who utilise large numbers of PSCs, the upheaval and disruption that the changes may entail is cause for significant concern.
6. **Systems.** Most HR / payroll / contractor management systems do not allow for PAYE deductions when paying a PSC.
7. **Speed.** Many organisations believe that their 'time to fill' temporary vacancies will increase if the legislation goes ahead.
8. **Talent Availability**. Some studies have suggested that contractors currently operating as a PSC may, if deemed 'Inside IR35', look for permanent roles in future or move abroad.
9. **Employment Rights.** The evidence from the public sector changes is that contractors who are deemed as 'Inside IR35' for tax purposes prefer to move to umbrella or PAYE payroll method in order to gain employment rights. If they are being taxed as an employee, they want the associated rights.

What can companies do now?

1. **Identify your PSC contractors**. We offer a contractor 'Health Check' (or full contractor audit) that will help you identify your PSCs and other significant areas of risk.
2. **Identify your critical contractors**. Whether they are agency-supplied or direct, decide which contractors are critical to your projects and business success over the next 12-24 months. Consider undertaking an IR35 assessment on those roles now. We can support with IR35 assessments or you can use the Government's free CEST tool, though its reliability has been consistently questioned since its launch in 2017.
3. **Ensure you have a trusted and supportive supply chain**. Whether that relates to direct contractors or the agencies you engage with, you will need to work much more closely with your recruitment supply chain in the future. Do you have the right partners in place? If not, start the process of refining your supply chain now.
4. **Consider whether you have the skills in-house to assess IR35 status**. If not, consider how you might conduct assessments in the future.

Finally, remember this legislation is **not inevitable**. We suggest that you consider the above activities now in order to ensure you are best placed, with the right information and partners in place, to act if and when the changes are formally announced.

For more information on IR35, its potential impact on your business, and how we can help you identify, understand and mitigate your risks, please do not hesitate to contact us.