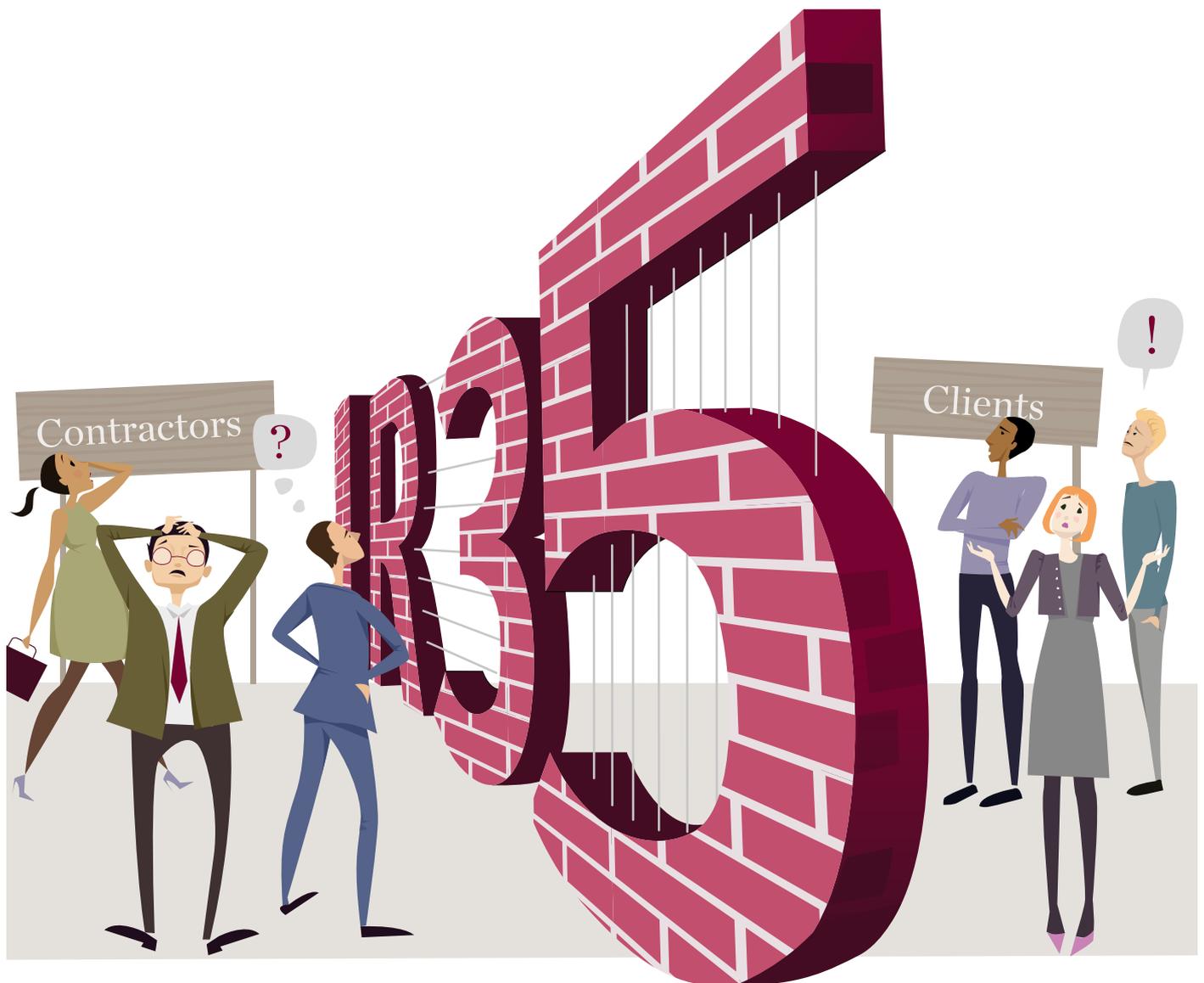


Guide to **IR35 in the Public Sector** *2017*



ipse

The Association of
Independent Professionals
and the Self Employed

Introduction

At the 2016 Autumn Statement, the Chancellor confirmed that from April 2017, in the public sector only, IR35 status will be determined by the client not the contractor. If the public sector client decides that IR35 should apply to the engagement, payment to the contractor's company will be taxed at source – as if they were an employee.

IPSE strongly opposed this proposal, both directly to the Prime Minister and senior officials, and via a written submission to the consultation. In addition we held several roundtables, and commissioned surveys and independent research. We provided evidence to the Government of the damage this measure will do: it will force contractors out of the public sector, damage the delivery of vital projects and ultimately cost the taxpayer more. Unfortunately, the Government decided to push ahead with the proposal regardless.

This guide explains what this change means and what contractors can expect when working in the public sector.



The fundamentals



What is IR35?

- Also known as the “intermediaries legislation”, IR35 is intended to stop “disguised employment”. This is where employers engage their employees through limited companies, thus avoiding the need to pay Employer’s National Insurance Contributions, Sick Pay, and Holiday Pay, with the disguised employee also potentially able to benefit from a reduced tax bill.
- Freelancers working through limited companies are often engaged by businesses because of the flexibility and skills they provide. The legislation creates risk and uncertainty for such individuals and it ignores the fact they are genuine businesses, not disguised employees.
- IR35 taxes the fees paid to limited companies in a manner similar to a salary where HMRC believes disguised employment is occurring.
- For IR35 to apply, HMRC has to determine whether the relationship between a freelancer and their client is in fact an employer–employee relationship, by referring to a number of complex and subjective tests established in case law.
- These tests are unclear, making it impossible for freelancers to determine with any certainty whether they are in scope of IR35 rules.

What are the changes to IR35 in the public sector?

The underlying IR35 rules are not changing, but the responsibility for determining whether they apply will shift from the contractor to the public sector end client. So, in the public sector only, the hiring organisation will determine the IR35 status of an engagement. If it decides IR35 does apply, the contractor business will be taxed at source, through the Real Time Information (RTI) system, exactly as if it were an employee.

Although contractors impacted by this measure may have to pay tax like an employee, their employment status will not change, so they will not receive the rights and benefits that go with employment such as pension contributions, holiday pay and unfair dismissal rights.

For now, the changes will only affect those engaged by public sector clients. Public sector clients are defined as set out in the Freedom of Information Act. In other words, if the organisation has to respond to Freedom of Information requests, it is a public sector organisation for IR35 purposes.

This change will be effective from April 2017.

Will clients be able to make an accurate IR35 determination?

This is IPSE's primary concern. We fear that because IR35 rules are so complex, clients will not be able to tell for certain whether the engagement is caught. Because clients will become liable if they make the wrong determination, they are more likely to take a risk averse approach and decide to apply IR35 if there is any doubt whatsoever (and there is usually an element of doubt). Some clients will work with hundreds of contractors at any one time and will be unwilling or unable to make a detailed assessment of each engagement, which may lead them to operate the new rules on all their engagements, regardless of their actual IR35 status.

We made these points to the Government many times during the consultation process. Its answer was an "online or digital tool" which clients, agencies and contractors will use to help them decide if IR35 should apply. At the time of writing, IPSE has not yet seen the tool, but we have grave concerns over whether it will work. We look at the tool in more detail later in this guide.

Can contractors appeal against the client's decision if they don't agree with it?

The consultation document made it clear there will be a route of appeal, but it provided very few details on how this would work. The suggestion was that the contractors could appeal at a tax tribunal. IPSE would be very interested to hear from contractors who are considering appealing a client determination. Contact us at policyqueries@ipse.co.uk.

It may be that individual public sector bodies will set up their own appeals procedures, but until the rules are implemented in April we will not know whether this will happen and how it will work.

How will this affect contracts that are already in place when the changes come into effect (April 2017)?

This will be particularly difficult. There will be cases where the engagement has been going for a few months and the contractor has been satisfied IR35 doesn't apply. After April the client might then declare it does apply. An IPSE survey suggested many contractors will not accept this and walk out. **IPSE is very interested to hear from any contractors who believe the IR35 rules are being applied to their engagement inaccurately.**

Will HMRC retrospectively investigate engagements that have now been determined to be inside IR35?

This question has come up a lot. Contractors are understandably worried that if their client decides in April that IR35 should apply, does that mean HMRC will be more likely to look at the months preceding April and ask "shouldn't IR35 have been applied to income received before then too?"

Certainly there is nothing in the legislation which prevents HMRC from doing this. Whether they actually will or not is unknown. Some contractors may feel compelled to terminate their contract because of this, after all to stay in the engagement even after the client has decided IR35 applies could be taken as agreeing with that determination. This then raises the question "why wasn't the contractor voluntarily operating IR35 previously?"

For this reason, IPSE has asked HMRC to declare an amnesty on engagements prior to April 2017. Unfortunately HMRC has refused this request and has robustly defended its right to retrospectively investigate all engagements, including any that may transition to the new tax arrangements in April.



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How will this affect new engagements, after April 2017?

We believe the Government's intention is to force public sector bodies to make an IR35 decision before the role is filled. So posts could be advertised as being either "inside" or "outside" IR35. There are advantages to this, particularly if contractors are offered an "outside" role. Effectively this would be a guarantee they do not need to consider IR35, which would be a great relief for that contractor.

But there are practical problems with this. It's easy to imagine that the roles which are pre-determined to be outside IR35 will have many more applicants than the ones which are advertised as inside. In addition, we feel there is an ethical question about whether it is right for a public sector body to advertise a role that they have pre-determined to be akin to employment, but not offer to actually employ whoever fills that role.

This cuts to one of the inherent contradictions of this measure. IPSE believes that if the Government wants to tax the people that work for it like employees, it should employ them. Instead it seems to want to take advantage of the flexibility provided by contractors, while denying them any tax incentive for taking on that risk.

How much worse off are individuals likely to be?

This is very difficult to say. It depends on your company's circumstances and the way it structures payments.

If you are currently claiming tax relief on travel and subsistence expenses, then that will be stopped so depending on the value of that relief, the impact could be significant.

There is no allowance for accountancy and insurance costs (this point is covered in more detail below). Again, depending on the amount of those costs, the increase in tax could be significant.

In addition, the direct tax impact will be greater if you currently take the maximum in dividends and if you have a spouse as a company director.

Will clients pay the Employer's NI?

Yes. The client or agency will pay Employer's NI, should it be determined that IR35 applies to the public sector engagement. If your company is paid by the client, the client will pay it; if an agency pays your company, they will pay it. Because the

agency will always push its costs back on to the end client, it will ultimately be the public sector body that has to foot the bill. So this measure will result in increased costs for the public sector, which is another reason why IPSE opposes it.

How likely is it that the government will look to implement this in the private sector in the future?

At the moment the Government has made it clear it has no plans to widen the scope of this change outside of the public sector. But public sector bodies might well put pressure on the Government to introduce it in the private sector if they have difficulties filling positions. For that reason, most independent tax experts believe the Government will look to apply the rules in the private sector in the not too distant future.

How will business expenses be taken into account?

The five per cent allowance which is made for business expenses in the normal IR35 rules has been removed for these public sector arrangements. Needless to say, IPSE believes this is extremely unfair. There is no allowance for legitimate business costs such as accountancy and insurance. This is particularly punitive as for many contractors these costs are necessary and substantial. IPSE has pressed the Government to reconsider these allowances.

The only allowable expenses are:

- the direct cost of materials used in performance of the services; and
- expenses that would have been deductible if the worker had been the client's employee.

What is the position regarding income tax and employer's/employees NICs for employer pension contributions made by the contractor's company?

Tax relief on pension contributions made by the contractor company (PSC) will be available via self-assessment. However, it is not clear whether relief will be made available for the NI part of the deduction. We are seeking further advice on this. In the meantime, IPSE members can ring the tax helpline for further advice - 0845 125 9252

Is there scope for a legal challenge?

IPSE is seeking advice on a range of issues thrown up by this ill-conceived measure. This includes how a contractor might challenge the status decision made by the client and whether



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there is an impact on employment status (and rights). It seems likely we will have to wait until the new regime in the public sector is up and running before we will know how this will pan out.

Instinctively, we feel the measure is unfair. Deducting employment taxes but not awarding employment rights seems wrong. We believe if the Government wants the people that work for it to pay employment taxes it should employ them.

However, the legal position on this is unclear. This is because tax status is considered quite separate from employment status. Nonetheless we are exploring legal options around this.

What happens with Agency Worker Regulations?

This is an interesting question which aligns with the employment rights issue. If the contractor is being taxed like an employee, will they:

1. Be more likely to claim parity of rights with employees under the Agency Workers Regulations?; and
2. be more likely to be awarded those rights?

We are seeking advice on this but, again, it looks likely we need a test case to know for sure. **IPSE is very interested to hear from any contractors who are interested in exploring whether they have the right to claim employment rights.**

How will agencies have to deal with and react to these reforms?

The liability to apply the correct tax treatment rests with the entity that pays the contractor. Often this will be an agency. But it is the end client that will determine the IR35 status of the

engagement.

If the IR35 determination is not received automatically, the agency can request it and the public sector client must provide it within 31 days.

The agency can query the decision. Again, the public sector client then has 31 days to respond.

The Online Tool: What is it and how will it work?

HMRC has built a tool which it believes will provide a definitive determination of IR35 status. According to HMRC it will give surety to bodies looking to engage contractors and will effectively dictate the tax treatment of each engagement. If the tool says the engagement is inside IR35, employment taxes will be deducted at source; if the tool says it's not within IR35, the contractor company will be paid gross and account for tax like a business, at year end – as it always has done.

Clients, agencies and contractors will be able to enter information about the engagement and the tool will provide an IR35 determination. However, we are sceptical as to how effective it will be. Essentially it comes down to the fact the rules around status and IR35 are based on case law, which is complex and open to interpretation. Applying them to real life engagements can only be done subjectively. It is hard to see how a generic tool will be capable of generating an accurate determination.

Is use of the tool mandatory (do clients have to use it)?

No. The tool is there to assist those that want to use it. In many cases this will be a public sector client which has a statutory

obligation to make a decision on the IR35 status of each of its engagements. Some public sector clients may decide not to use the tool. However, for many it will be an attractive option, as clients who make a determination based on the outcome of the tool will be absolved of liability – providing the information they enter into it is correct.

The tool can also be used by contractors, including those working in the private sector, that want to know if their engagement is caught by IR35. Similarly, it could be used by private sector clients that want to get a handle on the IR35 status of their contractor engagements.

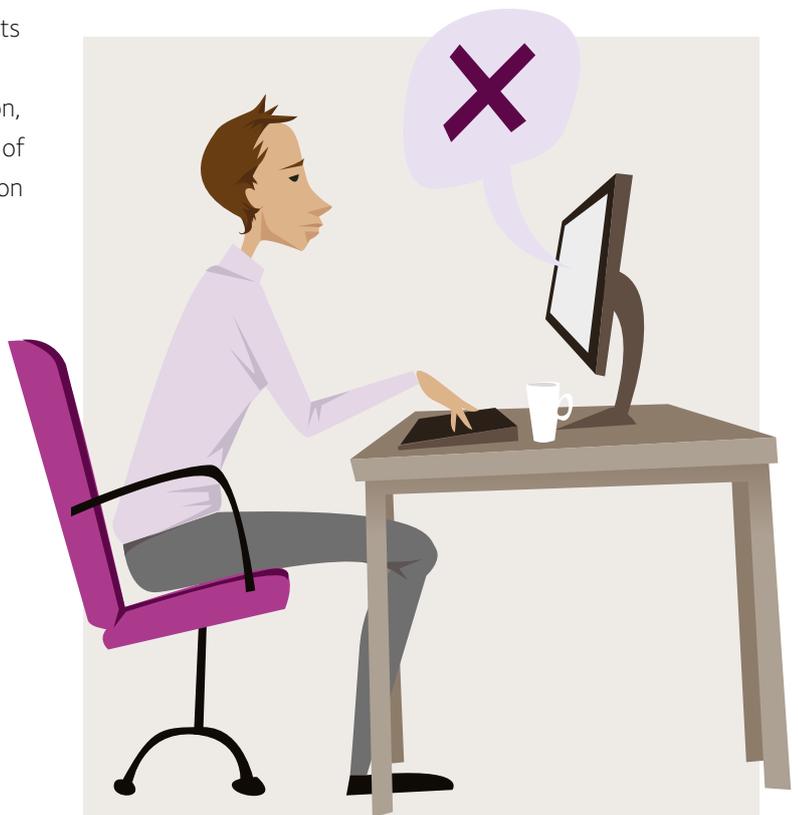
Will the tool be accurate?

IPSE has seen a prototype of the tool. The overall structure of it appears to be based on case law, which makes sense, although there are major concerns over the wording of the questions. We have explained these concerns to HMRC at stakeholder meetings. Because it is difficult, maybe even impossible, to compose simple questions based around such complex legislation, the accuracy of the outcome is bound to be compromised. We do not yet know how the different questions are weighted.

IPSE is very concerned by the timescale for publishing the tool. It is due to 'go live' on 20th February. Payments made after 6th April could be subject to the new tax treatment, subject to the outcome of the tool. In practice that is likely to mean work that starts on 1st March could be taxed via RTI (assuming invoices are sent one month in arrears on 30 day payment terms). That means all public sector engagements will have to be run through the tool in the last week of February, in order for contractors, agencies and client to know how that work will be taxed. This is an unrealistic timescale and we have explained this to the Government.

Is the online tool likely to be challenged in tribunal when it's eventually unveiled?

It would probably need a test case, and then it wouldn't really be the tool that was being challenged; it would be the client's assessment of the IR35 status of an engagement. But it would be very interesting if the client's defence of their assessment was based on the outcome the tool has given them. In such an example, the tool would indirectly be challenged. IPSE is very interested to hear from contractors who believe the tool, when used by their client or agency, has made a wrong decision.



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Conclusion

There is still much we don't yet know about how the new legislation will work in practice. The real extent of the difficulties it will cause will not become apparent until the middle of 2017. As we learn more we will update this guide. If IPSE members have any queries about how you will be affected, please make use of the free tax helpline.

You may also be interested to see a webinar which IPSE held shortly after the Autumn Statement 2016, available on our website.

IPSE is very interested to learn about how this measure is impacting freelancers so please do let us know how your public sector client is implementing it. You can contact IPSE via our website.

Please contact us:



www.ipse.co.uk



policyqueries@ipse.co.uk



Tax helpline: 0845 125 9252

About IPSE

IPSE is the largest association of independent professionals in the EU, representing over 67,000 freelancers, contractors and consultants from every sector of the economy. It's a not-for-profit organisation owned and run by its members.

We believe that flexibility in the labour market is crucial to the UK's economic success, and dedicate our work to improving the landscape for the freelance way of working through our active and influential voice in government and industry.

With highly professional staff working for you, IPSE has the unique ability to demonstrate the economic value of freelancing to those in power and ensure freelancing is both considered and supported in all areas of regulation and policy. As well as being a campaigning body, IPSE provides a wide range of support services to help its members succeed in business, including tax and legal helplines, IR35 support, and compensation for illness/injury.

Founded in 1999 by a community of freelance contractors, IPSE has become the leading authority on freelancing in the UK. The association is governed by its members and any member is eligible to stand for election to the Consultative Council, and from there, for election to the Board of Directors.

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