GUIDE

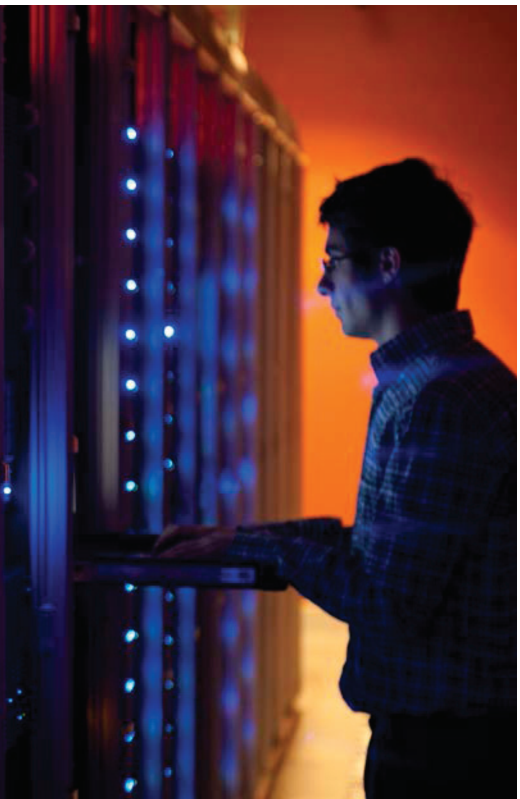
OFF-PAYROLL WORKING

HartleyFowler LLP
CHARTERED ACCOUNTANTS

London
4th Floor, Tuition House
27/37 St George's Road
Wimbledon London SW19 4EU
E: info.ldn@hartleyfowler.com
T: +44 (0)20 8946 1212

Brighton
Pavilion View
19 New Road
Brighton BN1 1EY
E: info.btn@hartleyfowler.com
T: +44 (0)1273 202311

W: www.hartleyfowler.com



Imminent Tax Changes for Personal Service Companies

Introduction

The Coronavirus pandemic has caused huge disruption to businesses in the last twelve months. For individuals providing services through their own company, there is more upheaval coming on 6 April 2021, when the 'off-payroll' working rules (which currently only affect public sector work) are being extended to include a lot of private sector clients too. Which private sector clients are affected depends on their size, as discussed later.

These changes are a further attempt to extend the reach of payroll taxes (PAYE, employer and employee National Insurance Contributions (NIC)) to those contracting with clients via their 'personal service company' (PSC).

Note that the rules can apply

- even if an agency is the fee-payer rather than the end-client; and
- if the worker uses a different form of intermediary vehicle than a PSC (e.g. a partnership) to contract for their services.

In this booklet, we will only consider the impact on PSCs. We will explain

- the background to the changes;
- how work for different clients may be treated differently for tax purposes;
- some of the new compliance procedures coming in from 6 April 2021; and
- how the new rules impact on extracting profits from your company.

We are here to help if you need any further information on the matters discussed below.

Employed or self-employed?

From a tax perspective, there are clear advantages in being self-employed rather than being in employment.

- Income tax is collected in arrears through the self assessment (SA) regime, rather than being due monthly or weekly under PAYE.
- Classes 2 and 4 NIC are payable through SA, rather than Class 1 employee contributions being deductible via PAYE. The total payable of classes 2 and 4 is likely to be less than Class 1 employee contributions.
- There are no employer NIC on self-employed earnings.
- The self-employed are not subject to benefit-in-kind legislation (i.e. no P11d reporting required), although private use of expenditure or assets will restrict the amount that is allowable as a business expense.
- The tax law on deductible expenses is much stricter against employment income than when claiming against self-employed income.

However, you cannot make a contract one of self employment merely by stating that it is so. Whether or not an arrangement is one of employment or self employment will depend on several factors, largely established over the years by the courts.

If a worker contracts directly with a client (i.e. no PSC involved) the tax risk for employment taxes lies with the client.

Example

Juliet, a soft skills trainer specialising in the hospitality sector, takes on a large contract directly with Kent Ltd to train its staff. The parties agree that it is a self-employed contract, so the company pays her invoices gross.

A subsequent HMRC enquiry determines that it was, in fact, an employment relationship, due to the nature of the arrangements in place. It is Kent Ltd that is liable for the income tax and NIC that should have been paid through PAYE (i.e. the tax risk is with the engager).

For this reason, many users of freelance labour have not wanted to contract directly with such workers. They have instead insisted on the worker setting up a PSC with which they can contract as, by contracting with a company, there was historically no employment taxes risk for the engager (unlike in the example of Juliet above).

PSCs - IR35 and off-payroll working

If you operate as a director of a PSC, you are employed by your company, not by the clients with which your PSC contracts. In theory, this means that your PSC's fees will be paid gross by its clients, enabling you to then draw income from your company as and when you wish, for example by taking a small salary and larger dividends (which are not subject to NIC).

IR35

However, governments have repeatedly tried to clamp down on those avoiding payroll taxes by running their business through a PSC. Over 20 years ago, the so-called IR35 legislation was introduced. This requires a person working through a PSC to consider whether, if there were no PSC involved (i.e. the worker were contracting directly with the client), the arrangement would be one of employment rather than self employment. (This will depend on the normal tests from case law, which are discussed briefly below.) If the answer is "yes, it would be employment", the legislation requires that (broadly) the PSC must pass on most of its income from those engagements to the worker (i.e. PSC director) through the payroll. To the extent that it doesn't, there is a 'deemed employment payment' on the 5 April each year, on which the PSC must account for actual income tax plus Class 1 NIC (both employee's and employer's) via PAYE.

Off-payroll working

After years of HMRC struggling to enforce compliance with IR35, on 6 April 2017 new rules came in for PSCs contracting with public sector engagers, referred to as the "off-payroll working" rules. The IR35 rules have always put the onus on the PSC to determine whether there is an underlying employment relationship with the client and to then self-assess tax accordingly. In contrast, the public sector off-payroll working rules make the client (such as an NHS trust or the BBC) determine whether there is an underlying employment relationship with the worker. If there is, then the public sector body (or, if appropriate, an intermediary such as an employment agency) must register the worker for PAYE and deduct the worker's payroll taxes when paying the fees that the PSC has billed (even though the worker is employed by the PSC, not the public sector body, and does not themself contract directly with the client or agency).

The deemed payment is the VAT-exclusive amount due to be paid to the PSC, less the direct cost of materials included in the invoice. The fee-payer may, at their discretion, also exclude from the deemed payment any expenses met by the PSC that, had they been incurred directly by the worker, would have been allowable against earnings if the worker were an employee.

This complicates both the tax position of the PSC and the way the worker can tax-efficiently withdraw funds from their company, as will be explained later. However, the good news is that responsibility for compliance rests with the engager rather than the PSC, so that the worker does not have the risk of an IR35 enquiry on their company.

The government regards these off-payrolling rules as having been so successful that they are extending them to many private sector clients of PSCs from 6 April 2021, having previously delayed this twice. Those PSCs that do not contract with the public sector will therefore be meeting the rules for the first time. The details of how this will work and what it will mean for you and your PSC are discussed later.

Determining a worker's employment status

We will not go into the detail of the relevant case law in this document. However, a decision requires a multi-factorial exercise that paints a picture of the overall relationship. This means that all the individual facets of the arrangement must be considered, some of which may indicate employment and some self employment, and then a view taken as to whether, on balance, these demonstrate an employment relationship.

If you operate via a PSC, answering "yes" to the following questions will indicate that you may be deemed to be an employee of the client for tax purposes:

a) Do you have to do the work that you have agreed to undertake yourself (that is, you are not allowed to send a substitute or hire other people to do it)?
b) Can someone tell you what to do, and when and how to do it?
c) Does someone provide you with holiday pay, sick pay or a pension?
d) Are you paid so much an hour, for a given number of hours a week or month?
e) Do you work wholly or mainly for one business? (However, remember that many employees work for more than one employer.)
f) Are you expected to work at the premises of the person you are working for, or at a place or places they decide? (However, of course, a self-employed person, such as a plumber, may by the nature of the job have to work at the premises of the person who engages them.)

In contrast, answering "yes" to the following questions will indicate that the contract is effectively a self-employed one that will not be subject to payroll taxes:

a) Are you ultimately responsible for how the business is run? i.e.
    - Do you risk your own capital in the business?
    - Are you responsible for bearing losses as well as taking profits?
    - Do you yourself control what you do, whether you do it, how you do it, when and where you do it?
b) Do you provide the major items of equipment you need to do your job (not just the small tools which many employees provide for themselves)?
c) Are you free to hire other people, on terms of your own choosing, to do the work that you have agreed to undertake? .
d) Do you have to correct unsatisfactory work in your own time and at your own expense?

Cases in this area are often nuanced and hinge on the specific details of the working arrangements. This has been evidenced by several recent IR35 cases, particularly involving broadcasters. Some of these people (including Joanna Gosling and various other BBC news presenters, Eamonn Holmes and TalkSport presenter Paul Hawksby) have ended up with substantial payroll tax charges on their PSCs, whereas for others, such as Lorraine Kelly and Kay Adams, their work has been found to be outside IR35.

Extension of off-payroll working rules to the private sector for 2021/22

From 6 April 2021, the off-payroll working rules will also apply to private sector work done via a PSC, unless the client is 'small' (see below). To fall within the new rules, the work must be performed and the payment for the work made after 5 April 2021.

The legislation largely rolls out the current rules applicable for public sector clients to medium or large (i.e. non-small) private sector clients that receive services from PSCs.

'Small' for companies or limited liability partnerships (LLPs) means that they must meet two of the following three tests:

- Turnover ≤ £10.2m,
- Assets ≤ £5.1m
- Employees ≤ 50

For other clients (e.g. an unincorporated partnership), only the turnover test is used.

Businesses will be legally required to provide information regarding the size of the business to agencies and contractors, upon request. Remember that, where the PSC's client is small, they continue to pay the invoices received in full and the PSC owner must decide if IR35 applies to the contract.

Exclusion for overseas clients

Note that where a large or medium-sized private sector client is based wholly overseas and has no UK connection, the off-payroll rules do not apply. The worker's PSC will remain responsible for deciding the contractor's employment status for tax purposes and self-assessing whether IR35 applies. "No UK connection" means that the client is neither UK resident nor has a 'permanent establishment' (broadly, a fixed place of business) in the UK.

Contractors operating under Construction Industry Scheme (CIS) rules

The off-payroll working rules take precedence over the CIS. Thus, if the rules apply, the fee-payer would not need to consider applying the CIS rules (which may also necessitate withholding of tax) to payments made.

If the party receiving the workers services is a small private company, the worker's PSC would be responsible for considering whether IR35 applies and self-assessing accordingly. Any deductions made by the client under the CIS when paying the PSC would be a separate matter dealt with under normal CIS rules.

Check Employment Status for Tax (CEST) tool

Introduction

Just over a year ago, HMRC amended its online CEST tool, which is designed to give a verdict on whether a worker can be categorised as self-employed or employed (or, if operating via a PSC, whether IR35 or off-payroll working rules need to be applied).

The starting page of the tool states:

"HMRC will stand by the result you get from this tool.This would not be the case if the information you have provided was checked and found to be inaccurate.

HMRC will also not stand by results achieved through contrived arrangements, designed to get a particular outcome from the service. This would be treated as evidence of deliberate non-compliance, which can attract higher associated penalties."

Overview

CEST can be answered by the worker, the engager or an agency. You are asked to specify which you are. It is answered anonymously and the final decision and answers that were input to the questions can be printed off.

The tool is split into different sections. Some of the questions will not get asked, dependent on how others have been answered, but most of the questions will get asked most of the time.

There are three possible outcomes of the tool in the context of IR35:

- inside the IR35 legislation,
- outside the IR35 legislation, and
- unable to determine the tax status of the engagement.

The questions are based on the case law principles referred to above and attempt to establish whether the arrangements being entered into between the worker and the engager represent effective employment or self employment.

A printout from CEST can be used as a Status Determination Statement (SDS - see below) by a client. It is sensible for a worker or their advisor to access the system themselves and, after inputting answers based on their understanding of the proposed working arrangements, check if the conclusion is the same as on the SDS.

Status Determination Statement

As discussed, under the new rules, large and medium-sized private sector clients must decide if the worker would be an employee, in the absence of their PSC, using normal tests of employment status.

The client must provide a Status Determination Statement (SDS) to the contractor and all relevant parties (e.g. recruitment agency) at the time the contract starts or before the off-payroll worker starts work. All such businesses using contractors must therefore make sure that they have the appropriate processes in place to produce and pass on the SDS to all relevant parties. In the absence of this, the PSC's client will take on the responsibilities of the fee payer (if they are not the fee-payer) to operate PAYE and NIC, where applicable.

If the client decides that off-payroll working rules apply, the client (or any agency responsible for paying fees to the PSC for the worker's services) must create a payroll record for the worker. This means that they must:

- obtain the National Insurance Number (NINO) from that worker;
- withhold PAYE and employee's NIC when paying invoices of the PSC;
- account for employer's NIC; and
- send the worker a P60 if still engaged at tax year-end, or a P45 if the engagement has ceased.

Although they must treat the worker as if they are an employee for payroll tax purposes, **the worker has no employment rights at all from the client,** which also

- does not make student loan deductions; and
- cannot use the Employment Allowance to exempt employer's Class 1 NIC on the worker's deemed salary.

Example

How the new rules impact on a PSC

Doug runs Doug Enterprises Ltd ("DEL"), of which he is the 100% shareholder. It has a year-end of 5 April and is registered for VAT.

DEL enters a one-year contract for Doug's services with Southwich Consultancy plc ("Southwich") in April 2021. Southwich gives Doug an SDS, which states that the off-payroll working rules apply to this contract.

DEL invoices Southwich for the agreed fees of £2,500, plus £500 VAT, per month.

DEL has other income in y/e 5 April 2022 of £18,000 plus VAT, derived from sundry private sector assignments for large and medium-sized clients undertaken by Doug. All these clients have issued SDSs confirming that this work is outside the off-payroll working rules (i.e. that if Doug had contracted directly with the clients, the work would have been self employment rather than employment).

What are the tax issues here?

Disputing a decision

If contractors disagree with the decision made by their client on their employment status for tax purposes, they will be able to raise concerns through a client's status disagreement process. All clients are required to introduce a process, from 6 April 2021, to allow contractors to disagree with the decision.

Under the Finance Act 2020, the client has 45 days to respond to representations by a worker who has received an SDS. During this time, the client (or other fee-payer) should continue to apply the rules in line with the original determination. HMRC will not get involved in any disputes.

After completing the client's status disagreement process, if you think you have paid too much income tax and NIC, you can follow existing self assessment and National Insurance processes to seek a repayment. HMRC may ask for the documents and records you have relied on to conclude that a repayment is due.

The client's responsibility

A client must take reasonable care when making a determination. HMRC guidance cites various examples of what does not constitute "reasonable care", including:

- determining that every worker who provides their services through an intermediary is caught by the off-payroll working rules without giving any consideration to the specific facts of each individual case;
- failing to reconsider determinations where there has been a material change in circumstances;
- inputting inaccurate information into CEST.

Discussion

Payments from Southwich

1. Southwich will treat Doug as an employee for employment tax purposes and will therefore need his NINO to set up a payroll record.
2. Although DEL will invoice Southwich for £2,500 plus £500 VAT per month, it will not receive this amount. Southwich will withhold income tax and employee's NIC from the £2,500 and pay them over to HMRC through the PAYE system.
3. Unlike when calculating an IR35 deemed payment, there is no 5% deduction for general expenses. All of the ex-VAT fees are subject to payroll taxes.
4. In addition, Southwich will need to pay employer's NIC @13.8% on the £2,500 fees, to the extent they fall above the 2021/22 monthly nil rate 'secondary threshold' of £737.
5. The monthly ex-VAT amount received by DEL from Southwich can be paid to Doug through DEL's payroll under Real-Time Information (RTI), without any further deductions. It should be recorded on a Full Payment Submission (FPS) as non-taxable income and the amount of gross taxable employment income recorded reduced accordingly. (Note: If running a payroll, to report non-taxable income, you should use the FPS data field 58A: Value of payments not subject to tax or NIC in pay period.)
6. Alternatively, this income from Southwich can be drawn as a tax-free dividend from DEL.
7. Either method of withdrawing the funds from DEL avoids a double charge to tax on the earnings, which suffered deduction of payroll taxes by Southwich.

Payment for other work

8. The £18,000 plus VAT billed for the other work will not suffer any deduction of payroll taxes by the clients; it will be paid gross.
9. As the these fees are from non-small clients, there is no IR35 risk for the PSC.
10. These fees can be withdrawn from DEL flexibly by Doug, either as salary (while accounting for appropriate payroll taxes) or potentially as dividends (which will be taxable, subject to the £2,000 dividend allowance).

Year-end

11. At the end of the tax year, Doug will get two P60s, one from Southwich and one from DEL. The latter will not include the income passed on to him by DEL for the Southwich work.
12. The taxable income from both P60s will need to be included as earnings on Doug's tax return.

Accounting

13. Although the contracted fees for the Southwich work are £2,500 per month, an adjustment is required to this figure to write off a part of the debtor balance that will not be received by DEL, due to the withholding of payroll taxes.

Corporation tax of DEL

14. The net income from Southwich that is included in the accounts can be omitted when calculating the turnover for corporation tax purposes. This is because it is treated as employment income of Doug and has already been taxed accordingly.
15. The £18,000 income from other engagements will be included in the corporation tax computation, along with normal allowable expenses of DEL.

VAT

16. The new off-payroll working rules have no impact on the VAT position of DEL. Its total VATable turnover for the year will be (12 x £2,500) plus £18,000, i.e. £48,000.

17. The payments received from clients, including Southwich, will include the full amount of VAT charged, for which DEL will account to HMRC in the normal way.

As you can see, the rules are complicated! They become even more so where some of the work done by the PSC is for a small client. Although this work would be outside the off-payroll rules, it potentially remains within the IR35 provisions. This means that the PSC will need to self-assess whether there is an underlying employment relationship with the client and, if there is, calculate income tax and NIC on a deemed employment payment, unless a sufficient amount of this income has been passed on through the PSC's payroll to the worker.

Also note that, if a PSC has all its income dealt with under the off-payroll rules, there will be no income assessable to corporation tax. This means there will be no tax relief for any costs incurred by the company, such as stationery or professional fees. In such circumstances, a PSC is unlikely to continue to be a sensible vehicle for running your business.

Becoming an employee of your client

Some contractors will understandably feel that, if their work is going to be subject to payroll taxes in any case, they may as well become a normal employee of that client. Although this may sometimes be an option, many clients will not offer it, as it would give you full employment rights (e.g. holiday pay and statutory sick pay). This is not the case with the off-payroll rules, where the client or other fee-payer merely pays over payroll taxes, but such statutory employment rights are given by the worker's own PSC.

Contractors who no longer need their PSC

It is believed that around 60,000 contractors were moved onto payrolls following the public sector changes in 2017/18. The extension of the off-payroll rules to the private sector will presumably have a similar effect, with many contractors no longer needing their companies.

There are two ways of getting rid of a company that is not needed. One is much cheaper than the other but can be less tax-efficient.

Striking-off

This is a relatively simple process, for which Companies House charges a fee of £10. If the total reserves of the company don't exceed £25,000, the distribution can be treated as a capital gains tax (CGT) disposal, with CGT rates applying. However, if the reserves being distributed exceed £25,000, the whole distribution is subject to income tax rates, which is likely to produce a much higher tax bill.

Members Voluntary Liquidation

This is a formal winding up. It is more expensive as the services of a qualified insolvency practitioner are required. The fees are likely to be at least £1,000 (and possibly a lot more). The advantage of this route is that, whatever the level of reserves, CGT treatment is available. This potentially reduces tax charges significantly, especially if business asset disposal relief (formally called entrepreneurs' relief) is available, which it should be if the liquidation is within three years of ceasing trading.

Note, however, that anti-avoidance legislation may, in some circumstances, mean that liquidation distributions are taxed as income, so specialist tax advice is needed in this area.

Compliance – Some good news!

HMRC will not normally open a new compliance enquiry into a contractor's tax return **for tax years before 6 April 2021** in circumstances where:

- a client decides that a contract is within the off-payroll working rules from 6 April 2021;
- a contractor changes the way they work from providing and invoicing services through a PSC to being employed directly by the client; or
- a contractor ends a contract because they disagree with a client's decision on status.

HMRC will only open an enquiry using information acquired through the changes to off-payroll working rules if it suspects fraud or criminal behaviour.

Conclusion

If you operate via a PSC, as we have shown in this document, the new rules from 6 April 2021 are complex and may have significant consequences for your business. It is important that you:

- Ask your clients to confirm whether or not they are medium/large or small (where it is not already clear);
- Make sure that any medium or large client issues you with a Status Determination Statement and check that you agree with it; If you disagree, raise your concerns with the client and expect a response within 45 days;
- Recognise that there is still employment status risk for your PSC under the IR35 rules, where a client is small;
- Consider whether a PSC is still the most appropriate vehicle for running your business if private sector clients are putting you on their payroll for tax purposes.

Please contact us if you need help with any of the matters raised in this document.

Summary of the changes

Client	Who assesses the worker's employment status?	Who deducts PAYE/NIC where appropriate?	When applicable?
Public sector	Client	Fee-payer	From 6 April 2017
Private sector: large or medium-sized	Client	Fee-payer	From 6 April 2021
Private sector: large or medium-sized	PSC	PSC (under IR35)	Until 5 April 2021
Private sector: small	PSC	PSC (under IR35)	Unchanged