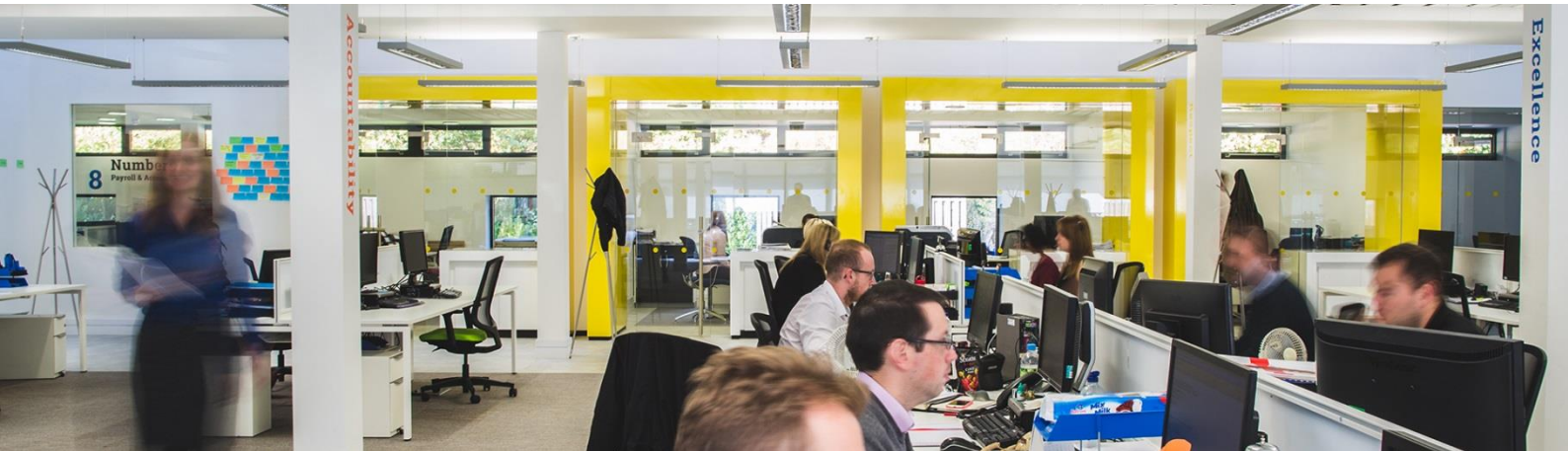




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Recent Tax Changes for Contractors Be Prepared



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Background

Successive governments have been consistent in expressing the view that there is far too much “false self-employment”. The narrative is that unscrupulous users of temporary labour are labelling temps as self-employed to avoid employer obligations and employee rights (PAYE, National Insurance, holiday rights, unfair dismissal claims), whilst at the same time contractors who should really be taxed as employees have declared themselves self-employed, often supplying services through their own limited company claiming and enjoying a more favourable tax regime.

Legislation aimed at tackling this perceived abuse has been introduced steadily over time, and has gathered pace since 2014.

Travel and subsistence changes 2016

April 2016 has seen further changes. This time in relation to the availability of tax relief. Under ITEPA income tax relief can be claimed in relation to travel and subsistence expenses where the contractor/employee is traveling to a temporary workplace.

Employees of end users cannot claim tax relief on any expenses incurred in their normal daily commute to their permanent workplace.

It has been very common for contractors to be engaged on the following basis: Contractor is employee of an umbrella company; umbrella contracts with agency to supply the contractor; agency contracts with the end user client to supply contractor.

In this model there is an “overarching” employment contract between contractor and umbrella, under which until 6 April 2016 any assignments were deemed to be at temporary workplaces unless lasting more than two years.

The government regards this as an unjustified tax advantage for contractors. Under the new law each assignment will be deemed to be a permanent workplace if the contractor employed by the umbrella company is under (or subject to the right of) direction, supervision or control of any party in the contractual chain (normally the end user client) relating to the manner in which the services are performed.

HMRC has produced a 15 page guidance note on supervision direction or control. Supervision is considered to apply to someone managing a contractor doing work to ensure it is being done to the specific standard. Direction means someone makes a contractor carry out their work in a certain way by providing instructions. Control means someone dictating what work a person does. As with confusion and uncertainty over employment status tests, the guidance will not provide everyone with clarity on whether the legislation applies in any given scenario.

The genuinely self-employed who are not subject to supervision, direction or control will be able to continue to claim tax relief for travel.

In this legislation it is the obligation of the umbrella to account for unpaid PAYE and national insurance, but that liability can pass to the end user client if it provides a fraudulent document as to supervision, direction or control which is relied on by the umbrella.

Note that HMRC issued a statement on 27 April to the effect that an error has been made in the drafting the 2016 Finance Bill which will need to be rectified as soon as possible. The error means that right now the legislation says that rather than looking at supervision, direction or control, the test is whether the contractor would be an employee of the end user client if directly engaged. Some umbrellas may see a window of opportunity to continue the pre 6 April travel and subsistence regime if they genuinely believe the employment test would not be satisfied. That window will be slammed shut as soon as the government can rectify the error.

Self-employed - right of substitution

Working out whether someone is genuinely self-employed has proven a very tricky legal concept, which has made the task for HMRC in tackling this perceived abuse difficult. But that works both ways. End users and contractors have also faced uncertainty. One definitive factor for self-employment had always been the absence of any contractual obligation to provide the services to the end user personally. No obligation of personal service meant the contractor would not be employed for PAYE or employment rights purposes.

Other factors which appear in case law and reflected in previously published HMRC guidance are lengthy and non-exhaustive including:

- Mutuality of obligation
- Right of control
- Provision of own equipment
- Whether there was any financial risk
- If there was opportunity to profit
- The length of engagement
- Their integration into the organisation
- If there were employee-type benefits
- Right to terminate contract
- Mutual intention and the label used

It became routine for contracts to include wording designed to make sure the contractor had no obligation to provide personal services. How? The inclusion of a clause allowing the contractor to send a substitute to perform the services for the end user. The problem is that often such clauses are a sham, and the higher courts have ripped up such contracts on this basis.

The position has been, therefore, that HMRC, contractors and end users have all been scratching heads on how to interpret any particular arrangement.

With uncertainty comes management of risk, which is one reason why end users engage agencies to keep some distance between them and the contractor.

Future changes

Further changes are also planned for April 2017 which if they go ahead will see a huge shift in the tax arrangements for contractors engaged through their own limited company if they carry out work for public sector bodies.

The so called IR35 legislation was introduced in April 2000. This was intended to prevent contractors using their limited companies to claim self-employed status where the real purpose of incorporating the company was to avoid liability for employed income tax and NICs. The IR35 legislation requires the contractor to consider whether he/she would be

employee of the end user client for tax purposes and/or be regarded as employed in "employed earner's employment" by the client, if they were engaged directly by the end user rather than via the limited company.

If the answer is yes the contractor's limited company is obliged to treat the contractor as its employee and apply PAYE to all the contractor's earnings.

Importantly as the law stands today, the liability for unpaid PAYE does not pass up the chain to an agency or end user client, but that will change in April 2017 under current proposals relating to public sector end users of contractor labour.

Under the proposals the public sector body which engages with the contractor's limited company will be responsible for assessing the IR35 status of the contractor. The public sector body will itself be responsible for accounting for unpaid PAYE and national insurance.

If, however the public sector end user client contracts with an agency which then contracts with the contractor's limited company, it will be the agency and not the public sector body that has the liability. In other words whichever party contracts with the limited company of the contractor has the liability.

At this stage public sector bodies will include:

- Government departments
- Legislative bodies
- Armed forces
- Local Government
- NHS
- Schools and further and higher education institutions
- Police
- Other public bodies (listed in a Schedule including bodies such as The British Museum, BBC, Channel 4)
- Publically owned companies such as Transport for London

The supervision, direction or control test applicable for the onshore intermediaries and travel and subsistence legislation is not the determining factor under current IR35 legislation and this is not due to change under the proposals. HMRC have promised that simplified guidance

along with a digital online tool will be made available to provide a real time HMRC opinion. It remains to be seen how effective this will be because history tells us it is extremely difficult to devise a test that is fool proof. Further HMRC will not be bound by any opinion it gives which is not surprising bearing in mind that any online tool is ripe for abuse by the input of misleading or incomplete information producing a false result.

The public sector body or agency/intermediary at risk will need to calculate an amount of deemed employment income and essentially proceed as if the contractor was its own employee.

However this will not mean the contractor will be charged twice for tax. When tax has been deducted the contractor will receive a credit against employment and dividend income drawn out of the personal service company so there should not be a second charge to tax.

The corporation tax liabilities of the contractor's limited company will remain unchanged by the measure.

Presumably the contractor's remedy, if disagreeing with the assessment, will be by seeking a rebate in tax returns rather than at the point the assessment is made. However if there challenge is rejected it is likely in practice to lead to the contractor focussing exclusively on engagements in the private sector as there is no proposed change in rules for any engagement in the private sector. However many commentators believe this is the inevitable next step.

Cost pressures in supply chain

The IR35 proposal is seen as a means of attacking false self-employment on the basis that public sector bodies and agencies/intermediaries will be risk averse when the primary obligation falls on them, so, if in any doubt, will pay the tax. Once HMRC has received the tax payment, then it becomes harder for contractors to claw it back.

This is likely to drive up costs for the public sector organisations, as in order to attract quality contractors, they may have to pay higher rates. Presumably the last thing the Government needs as it continues to look for ways to cut public expenditure.

If the proposal is extended in the future to private sector end users, the same costs pressure applies.

It should be said that there is already new pressure on limited company contractors preserving their take home pay in light of changes to the dividend regime effective April 2016. This pattern is expected to continue under this Government.

The travel and subsistence changes are now impacting on thousands of contractors employed under the umbrella model as the take home pay drops because the travel and subsistence expenses are no longer available. It is also expected that contractors will be reluctant to travel long distances to work and/or work in remote locations away from home if they can't get any tax relief on their travel expenses. This is an added costs pressure in the system generally which is likely to impact on end user clients if they want to maintain the same quality of contractor.

The 2014 changes made it more difficult to categorise contractors as self-employed for tax purposes and led to wholesale changes in engagement models. The umbrella model benefited from that but as outlined above the Government has now cut the legs from the travel and subsistence relief which was a key cost benefit of that model.

We have also seen auto-enrolment necessitate employer contributions. Auto enrolment applies to all PAYE engaged workers. This adds further costs pressures.

Debt transfer risk for unpaid PAYE/Nics

With the 2014 onshore and offshore legislation (referred to below) liability falls on the agency which contracts with the end user client to ensure PAYE and national insurance is operated properly. Under the travel and subsistence changes the umbrella which employs the contractor is liable.

End user clients can be liable under the travel and subsistence changes if they provide a fraudulent document (query the danger of a hiring manager signing something put under his nose on supervision, direction and control to assist his contractor friend) which the umbrella then relies on. The same is true under the 2014 onshore intermediaries changes. There is also a risk to the end user of assuming all PAYE and national insurance liabilities in engaging a contractor, perhaps unwittingly through an overseas intermediary which does not account for relevant taxes in the UK.

Use of a UK agency, rather than direct engagement, does provide end users with protection from any tax liabilities in the absence of the end user committing fraud.

It also minimises the scope for employment related claims from contractors, as explained below.

Overview of liability and how it transfers

The first table sets out the various engagement options that an end user client may choose from and who may be involved in the work arrangements. It refers to the position in April 2016.

The second table sets out where liability may fall in relation to various statutory claims and tax responsibilities.

The table is intended to illustrate the way in which the risks from certain employment related and tax claims can be mitigated by end user clients in utilising agencies in their supply chain. The table is not exhaustive, but gives a useful outline. PSC means personal service company being the contractor's own limited company. WTR is Working Time Regulations. AWR is Agency Workers Regulations.

| Engagement options | Client (A) | Employment Business (B) | Umbrella (C) | PSC outside IR35 (D) | Worker (E) | Employee (F) | Self Employed (G) |
|--------------------|------------|-------------------------|--------------|----------------------|------------|--------------|-------------------|
| 1 | X | X | X | | | X | |
| 2 | X | X | | X | | | |
| 3 | X | X | | | X | | |
| 4 | X | X | | | | | X |
| 5 | X | | | X | | | |
| 6 | X | | | | X | | |
| 7 | X | | | | | X | |
| 8 | X | | | | | | X |

| Liability for claims | Unfair dismissal/redundancy | WTR | AWR | Discrimination | Detriment | PAYE | IR35 |
|----------------------|-----------------------------|-----|-----|----------------|-----------|------|------|
| 1* | C | C | ABC | ABC | ABC | C | - |
| 2** | - | - | - | B | B | D | D |
| 3 | - | B | AB | AB | AB | B | - |
| 4*** | - | - | - | B | B | - | - |
| 5** | - | - | - | - | - | D | D |
| 6 | - | A | - | A | A | A | - |
| 7 | A | A | - | A | A | A | - |
| 8*** | - | - | - | - | - | - | - |

1* possible transfer of liability to B for PAYE if C fails to pay, under 2014 agency legislation

2 and 5** if the public sector IR35 proposals go ahead in April 2017 the agency or client would assume liability

4 and 8*** true self employed status would mean being genuinely in business on own account, in order to escape worker status at least. No supervision, direction or control.

Past changes

Onshore intermediary rules 2014

In April 2014 section 16 of the Finance Act 2014 made a subtle change to the scope of the so called “agency legislation”, which determines the tax status of individuals supplied via agencies to provide labour services to end user clients of the agencies. Where the agency legislation applies the contractor is deemed employed by the agency for PAYE and National insurance purposes.

Section 44 (1) of the Income Tax (Earnings and Pensions) Act 2003 (ITEPA) was amended to remove any reference to "*an obligation personally to provide services*".

With this wording removed, inclusion of a right of substitution in a contract between the intermediary and the client is no longer relevant for tax status purposes. What matters is that (whether or not contractually obliged to do so) the contractor personally provides services to the end user client and is under (or subject to the right of) direction, supervision or control of any party in the contractual chain (normally the end user client) relating to the manner in which the services are performed.

So the focus was taken away from whether there was an obligation to provide the work personally and instead the key issue is direction, supervision or control.

The 2014 legislation makes the agency which contracts with the end user client liable for PAYE tax and National Insurance deductions from the remuneration paid to the contractor.

Offshore intermediary rules 2014

Also in April 2014 there was the introduction of offshore intermediary rules. These were intended to tackle the problem of agencies and other intermediaries using overseas registered companies to contract with the UK contractor providing the services to the end user in the UK.

With the overseas employer being outside the powers available to HMRC, collection of taxes and enforcement became very difficult. Often the agency and its end user client would be unaware of the overseas entity further down the contractual chain.

The Finance Act 2014 provided that, where there was a UK agency in the contractual chain, that agency must operate PAYE and National Insurance.

If there is more than one UK agency in the contractual chain, the UK agency that contracts with the end user client is responsible for operating PAYE and National Insurance.

There was existing legislation which meant that an end user of labour supplied by an overseas intermediary could be responsible for operating PAYE for that contractor, so the change in 2014 was good news for end users and provides a further reason for the use of agencies to manage risk. Any failure to collect tax by a UK-based intermediary will not affect the position of the end-user.

Note that where the end-user does not contract via a UK intermediary, liability for operating PAYE for a contractor supplied through an overseas intermediary will still be with the end user client.

Reporting duties 2014

Legislation requiring agencies to supply quarterly reports to HMRC relating to contractors supplied through the agency but not taxed under PAYE by the agency was also introduced in 2014. The aim was in effect to force the agencies of the UK to help HMRC keep up to date details of the UK contractor market, making investigations and enforcement easier.

If you have any questions regarding the attached guidance please contact:



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