ICAEW

REPRESENTATION 91/18

OFF-PAYROLL WORKING IN THE PUBLIC AND PRIVATE SECTORS

Issued 26 July 2018

TEXT OF LETTER SENT ON 26 JULY 2018 TO HM REVENUE & CUSTOMS BY ICAEW TAX FACULTY

Internationally recognised as a source of expertise, ICAEW Tax Faculty is a leading authority on taxation. It is responsible for making submissions to tax authorities on behalf of ICAEW and does this with support from over 130 volunteers, many of whom are well-known names in the tax world. Appendix 1 sets out the ICAEW Tax Faculty's Ten Tenets for a Better Tax System, by which we benchmark proposals for changes to the tax system.

ICAEW is a world-leading professional body established under a Royal Charter to serve the public interest. In pursuit of its vision of a world of strong economies, ICAEW works with governments, regulators and businesses and it leads, connects, supports and regulates more than 150,000 chartered accountant members in over 160 countries. ICAEW members work in all types of private and public organisations, including public practice firms, and are trained to provide clarity and rigour and apply the highest professional, technical and ethical standards.

ICAEW Tax Faculty Chartered Accountants' Hall Moorgate Place London EC2R 6EA UK
T +44 (0) 20 7920 8646 icaew.com/taxfac

TEXT OF LETTER SENT ON 26 JULY 2018 TO HMRC BY ICAEW TAX FACULTY

Thank you for meeting us on 21 June to discuss the off-payroll working in the private sector consultation. At the meeting we agreed to send you our detailed comments regarding a number of issues experienced following the reform to the public sector rules. These were previously highlighted in our letter to the Financial Secretary to the Treasury dated 28 June 2018 (see appendix 1), to which we have recently received a helpful reply which is appreciated.

During the meeting we expressed our concerns about the practical difficulties faced by those involved with the public sector off-payrolling regime and recommended that the current focus should be to resolve these issues as a matter of priority. We have set out (in appendices 2 – 9 of this letter) some more detail on the issues we highlighted and have also included a number of suggested solutions to them.

We should welcome the opportunity to discuss these issues further and work with you to help resolve the problems we have highlighted, both within the public sector and more generally.

APPENDIX 1

TEXT OF LETTER DATED 28 JUNE SENT TO FINANCIAL SECRETARY TO THE TREASURY (published as ICAEW REP 73/18)

Following a meeting with HMRC officials last week to discuss the HMT/HMRC consultation on off-payroll working in the private sector, and in advance of our formal response to that consultation, we are writing to express our concerns about how the changes have been rolled out to the public sector.

Our understanding is that the preferred option is to roll out to the private sector an off-payrolling regime similar to that recently implemented in the public sector. While we appreciate the difficulty that HMRC has in policing IR35, we are concerned about whether this is the right approach given that there are a number of concerns about off-payroll working in the public sector that we think need to be resolved first. Accordingly, the current focus should be to resolve these issues before deciding whether or not the changes should be extended to the private sector:

The online employment status tool

The check employment status tool (CEST) is designed for public sector contracts with the result that is not suitable for use in the private sector. Even though HMRC has undertaken to be bound by CEST decisions, we are concerned that as currently designed it does not command public confidence and needs further work. In particular:

- HMRC has confirmed that CEST does not cover all scenarios, in particular mutuality of obligation (MOO), on the grounds that all contracts need MOO between the parties. However, CEST needs to cover the specific master and servant MOO test prescribed by the courts, namely whether there is an obligation on the worker to work and an obligation on the other party to pay the worker and to continue to make work available during the time of the contract.
- CEST does not take account of being in business on one's own account.
- In too many cases that are seen by our members, CEST does not make a decision. This does not help the worker.

Other issues that need to be resolved

- Workers classified as being inside IR35 have limited rights of appeal. We need more clarity about the rights of workers in these circumstances and whether these rights need to be strengthened.
- The default tax code for 'deemed employees' on a payroll is basic rate (BR). In the majority of cases, this results in tax arrears. We note that this is also a longstanding problem for all secondary jobs.
- HMRC needs to provide payroll software specifications to enable 'deemed employees' to be distinguished from true employees in payroll submissions to HMRC. One consequence of this is that automatic deductions for student loan repayments are being made when no such deductions should exist. Incorrect tax codes are also issued.
- Accounting by workers' personal service companies for fees from deemed employments which have been subject to PAYE, in a way that complies with the Companies and Taxes Acts and financial reporting standards, has proved problematic. We understand that the ongoing discussions involving the FRC and HMRC, facilitated by ICAEW, should soon resolve this, but this should have been resolved before the changes were implemented.
- Accounting by the public sector body remains problematic. The gross invoice received, including VAT, the net amount paid to the worker and the resulting VAT and PAYE deductions do not reconcile, creating difficulties for accounting systems.

- HMRC's track record on IR35 in the tax tribunals and courts is of concern. The fact that it has won only 11 cases out of 25 since IR35 became law, and just one out of four in the last eighteen months, highlights that there are fundamental problems with policing this legislation which need to be addressed.

It is too early to assess the success or otherwise of the public sector off-payrolling changes as there has not yet been a full year's cycle of compliance; PSC accounts and corporation tax computations and workers' self-assessment tax returns are not yet due for submission and HMRC has yet to issue workers' end-of-year tax calculations. This is work in progress affecting many workers who may not have chosen to work through a PSC of their own volition. It is therefore very important that the system supporting this change is reliable and that those using it can do so with confidence.

We should welcome the opportunity to discuss these issues with you and to work with your officials to help resolve the problems we have highlighted, both within the public sector and more generally.

APPENDIX 2

THE ONLINE EMPLOYMENT STATUS TOOL

The check employment status tool (CEST) is designed for public sector contracts with the result that is not suitable for use in the private sector. Although HMRC has undertaken to be bound by CEST decisions, we are concerned that as currently designed it does not command public confidence and needs further work.

CEST and mutuality of obligation (MOO)

HMRC has confirmed that CEST does not cover all scenarios, in particular mutuality of obligation (MOO), on the grounds that all contracts need MOO between the parties.

We do not think that this is a correct application of the law: there needs to be 'general' MOO (ie, acceptance of the terms of the contract which places obligations on both parties) for there to be a contract at all, and 'relevant' MOO for there to be a contract of employment (being the terms used by leading counsel for HMRC in a recent IR35 case). In a paper to the IR35 forum earlier this year, David Kirk (representing ICAEW) explained 'relevant' MOO:

> "Mutuality of obligation ('MOO') is essential for any contract, in that both parties must have obligations towards each other. For this contract to be a contract of employment, those obligations must be of a particular kind, ie.,
> - The worker must be obliged to 'provide his own work and skill in the performance of some service for his master';
> - The employer must provide a 'wage or other remuneration' to the worker.
>
> This comes from *Ready-Mixed Concrete*, which you cite. I would agree that the employer's side of the bargain would generally be met as long as the worker is paid (and take your point that HMRC is not really interested if he isn't); however I would point out that some authorities say that the employer's obligation is to provide work for the worker to do. This seems to be a minority opinion and in my view an incorrect one, so I shall not dwell on it – the arguments and authorities are laid out in *Cotswold Developments Construction Ltd v Williams* [2005] EAT 457, at paragraph 40.
>
> That case does accept what I wrote above, about a particular type of MOO being required, and the judgment comes from Langstaff J who has a particular interest in employment status and is a considerable authority on the subject (he was President of the Employment Appeal Tribunal from 2012 to 2015). I do also have a case currently running where I am arguing against employee status on the basis that the pay is not set until after the work is done, but I would accept that that is unusual (just for your further information it is of a director/minority shareholder taking out what I think are his dividends).
>
> The problem arises with the worker's obligations. It has to be his own work, which is why a right of substitution or delegation negates this. Substitution is covered by CEST, so I think that it is misleading to say that the tool does not cover MOO – it does, but only insofar as substitution is concerned (delegation is basically the same thing).
>
> The other possibility is that the worker is doing work that he is not obliged to do, so that he can walk off site at any time. This again would be very unusual, particularly in a public sector context. I do nevertheless have a public sector contract which I think does fall outside MOO for this reason – basically it is one that says 'you are not obliged to do any work, but if you do the rate of pay is £xx a day'. You might say that it is not a contract at all, but CEST assumes that there is a contract.
>
> I understand HMRC's reluctance to put this in the tool when so few cases will fall outside it, and there is scope for contracts to include clauses negating MOO that are not seriously intended to

be used; however I do think that something about this needs to be publicly stated, and I think that the solution would be to say something like this:

'The CEST tool does not cover mutuality of obligation ("MOO") except in relation to substitution. HMRC believes that there will be very few cases where MOO does not exist other than where a right of substitution does, and if you believe that this applies to you, you are advised to contact HMRC's IR35 Enquiry Unit at [give details].'

That would mean that any such cases are dealt with HMRC directly and they should be rare enough not to overload you."

We note in particular that HMRC has recently lost an IR35 case on this very point (see *Jensal Software Ltd v Commissioners for H.M. Revenue & Customs* [2018] UKFTT 6501 (TC), at paragraph 132).

Being in business on one's own account

On the face of it, CEST does not consider this test at all, despite it being generally agreed that being in business on one's own account is incompatible with employment (see *Market Investigations Ltd v Minister of Social Security* [1968] 3 All ER 732, at 737I). Nevertheless it does consider some of the factors normally applied to determine this test, in ostensibly different guises. It adopts a two-stage approach, looking first at financial risk and secondly about integration into the organisation, and it appears to be possible to be deemed self-employed by reference to the first of these but not the second (under the second, either one can be deemed employed or the tool says that it is unable to tell).

We believe that this is giving lopsided results, as the method of determining this given by the courts in *Hall v Lorimer* [1993] 66 TC 349 is 'to paint a picture from the accumulation of detail' (at 366G). The judge goes on: 'the overall effect can only be appreciated by standing back from the detailed picture which has been painted, by viewing it from a distance and by making an informed, considered, qualitative appreciation of the whole.'

We appreciate that this is not something that an on-line tool can easily do, but nevertheless the results that come from using this section do suggest a bias towards employment, and it may be that recalibrating it a bit would remove that. In this context, we understand that a number of decided status cases were run through CEST and that the tool largely came out with the same results as the judicial decision, the only two exceptions being *Novasoft Ltd v Commissioners for H.M. Revenue & Customs* [2010] UKFTT 150 (TC) and *Castle Construction (Chesterfield) Ltd v Commissioners for H.M. Revenue & Customs* [2008] SpC 723, both won by the taxpayer. We make no comment on *Novasoft*, but *Castle Construction* was arguably the most important status case that has ever come from the construction industry, and the decision that the workers were in business on their own account was made on broad criteria, not by looking in microscopic depth at a number of seemingly stand-alone tests. If HMRC does not properly understand why they lost this case, that is of concern.

Indeterminate results

HMRC has stated that CEST is unable to reach a status decision 15% of the time, which for a large organisation with say, 10,000 contractors, would be 1,500 cases with no decision reached. While we understand that this does not just represent IR35 determinations, we believe it is too high for a test which is designed to bring certainty to engagers and workers.

While we appreciate that CEST was built to be a simple and easy to use tool we are concerned that the black and white nature of the questions do not fit with the judicial approach of "standing back from the detailed picture which has been painted, by viewing it from a distance and by making an informed, considered, qualitative appreciation of the whole" and are not fit for a 21st century labour market, and in particular, the private sector.

APPENDIX 3

RIGHT OF APPEAL

Workers classified as being inside IR35 have limited rights of appeal. These rights need to be strengthened and made more accessible so that they can be exercised on a timely basis.

Contractors who disagree with an employment status decision taken by a public sector body (PSB), the end client, have little chance to have such decisions overturned quickly. Disagreements over status have led to soured relations between contractors, PSBs and agencies which have to apply end clients' status decisions.

Many contractors are not aware that they can seek a ruling from an HMRC status inspector even when they work through a personal service company (PSC). Most think that their only recourse is to treat the earnings in their self-assessment tax return as having come other than from an employment and then be faced with the prospect of HMRC opening an inquiry. Even though resolving status via HMRC's status inspectors can be a lengthy and stressful process and we understand that HMRC has limited resources, in the interests of enabling workers and deemed employers to pay the right amount of tax first time, we believe that HMRC should publicise and enhance this service. We do not believe HMRC could currently cope with the demand if these proposals were rolled out to the private sector.

We are aware that the issue has been exacerbated due to HMRC systems not being able to distinguish between deemed employees and true employees on the Full Payment Submission (FPS). This has led to HMRC staff on the helplines informing contractors that the PSB has incorrectly set them up as an employee, when in actual fact the PSB has not – it is just that HMRC is unable to distinguish between the two, which is unhelpful.

Our suggested solution

HMRC must give far more publicity to the existing right of appeal procedure with a view to addressing a long-term solution. This would include a process which allows a status determination to be disputed at the time it is made, as well as a box on the self-assessment return which if ticked would mean the status determination is disputed.

A flag is needed to mark deemed employees on the FPS so HMRC can easily identify these individuals. This will also enable the system to be programmed to stop incorrect student loan deductions notices being issued.

APPENDIX 4

TAX CODES

The default tax code for 'deemed employees' on a payroll is basic rate (BR). In the majority of cases, this results in tax arrears. We note that this is also a longstanding problem for all secondary employments where BR is also supposed to be used initially for a second job. However, BR rarely results in the right amount of tax being collected and frequently gives rise to tax arrears in these cases too.

We believe that a better initial code number would be 0T, as we have recommended to HMRC in connection with second employments. Changing the official instruction so that employers apply 0T initially, would collect nearer to the right amount of tax in real time from the start of an engagement and would avoid the financial difficulties for contractors and employees (and employers) that can arise from large over/underpayments of tax.

Our suggested solution

We would encourage HMRC to review the considerations for using 0T rather than the BR tax code.

APPENDIX 5

ACCOUNTING AND ADMINISTRATIVE ISSUES

Accounting for fees received in the PSC

This issue has now been resolved and ICAEW has advised members of the appropriate accounting treatment. HMRC is yet to update its guidance on gov.uk.

Accounting and reconciling VAT and expenses etc in the PSB

Accounting by the PSB remains problematic. The gross invoice received, including VAT, the net amount paid to the worker and the resulting VAT and PAYE deductions do not reconcile, creating difficulties for accounting systems.

Illustration

A PSB is invoiced £120 which includes £20 of VAT. The PSB must withhold the PAYE and employee NIC, paying the balance to the PSC. Assuming the tax withheld is £30, this means the PSB must pay £70 plus £20 VAT to the PSC. The accounts payable system has a number of automatic safeguards, one of which is a reconciliation of taxes to the amounts paid. The payment of £70 will not reconcile with the VAT payment of £20 as it is not the right VAT rate for the supply. Before compiling the VAT return, the PSB would need to manually reconcile with the payroll data every entry where there is a VAT mismatch.

This is creating major administrative problems for end clients. In many organisations, fee invoices rendered by PSCs have to be accounted for simultaneously by two separate departments, normally payroll and procurement/finance. For payroll, VAT and expenses need to be removed and accounted for separately from amounts subject to PAYE and NIC. Some organisations have sufficiently integrated procurement and payroll systems to be able to make a single payment to the PSC, but this is by no means universal. The fee notes need to be recoded to enable the VAT to reconcile. In the private sector, at least a 12-18 months lead time is needed to rearrange manual processes and IT procurement for 2019 may well have already been finalised. For global - organisations, a rule change to the UK's off-payrolling regime may not be priority.

Complications may arise for contractors where fee-payers pass on the cost of employer NIC, instead of absorbing it, by insisting on the use of umbrella companies. Often the worker is unaware of the impact this will have on their net pay. Contractors have no legal right to prevent this because a deemed employee is not an employee, although we are aware that some contractors refuse to be paid through an umbrella (whether they get any more work from that agency is, of course, another matter). We understand that, as part of the Matthew Taylor review, the government is considering the use of more transparent payslips which will go some way to addressing this issue.

APPENDIX 6

ENFORCEMENT

There are two issues here. The first is that HMRC's track record on IR35 in the tax tribunals and courts is of concern. The fact that it has won only 11 cases out of 25 since IR35 became law, and just one out of four in the last eighteen months, highlights that there are fundamental problems with policing this legislation which need to be addressed.

HMRC needs to be seen to be on top of this and should be winning the majority of cases at the tribunals and courts. Otherwise the less scrupulous will take HMRC's failings as a green light to push the boundaries and take cases.

Secondly, it is apparent that, with regard to the National Health Service in particular, a number of aggressive umbrella company operations have been set up, many of them (but not all) offshore, that pay people through contractor loans. It is absolutely essential that HMRC are seen to be countering this effectively before extending the public sector rules to the private sector, as otherwise this 'solution' will also extend there and probably in far more virulent form. We understand that HMRC is taking action, but it needs to explain what action this is and how and over what timescale it is expected that it will be successful. We are concerned in particular that legislation may be needed here, as with an offshore umbrella HMRC may have difficulty finding out whether the contract between that company and the worker is a contract of employment or not. This in turn gives rise to the question as to which party to pursue for arrears of tax: the end client if it is a contract of employment (under s689, ITEPA 2003), or the agency if not (under s 44, ITEPA 2003).

APPENDIX 7

OPERATIONAL PROCESSES

It is not possible currently to identify 'deemed employees' from 'true employees' on the payroll for tax purposes. HMRC needs to provide payroll software specifications to allow a marker to be assigned against 'deemed employees'. This will ensure those individuals are not reported incorrectly, for example, by including them in the company's headcount, internal management information, KPIs, gender pay gap reporting etc. It will also ensure that they are excluded from automatic deductions for student loan repayments (largely because in many payrolls SL1 start notices are processed automatically.)

Engagers must set an exclusion against deemed workings in the payroll software to ensure they are not assessed as employees for auto-enrolment purposes. We believe this should be better communicated to engagers.

A flag is needed to mark deemed employees on the FPS so HMRC can easily distinguish these individuals. This will avoid incorrect student loan deductions being made.

Our suggested solution

To allow businesses and HMRC to differentiate between true and deemed employees, some form of marker is necessary which should be built into the payroll software.

APPENDIX 8

WHICH PARTY TO BE MADE LIABLE

Under the current public sector rules, the liable party is the 'fee payer'. Where there is no agency involved this is the end client, but where there is an agency involved it will be the agency or other intermediary.

We note that the bulk of the money expected from this reform is employer's National Insurance Contributions, at least 80%. Also, the only two parties really in a position to tell whether the contract is inside IR35 or not are the end-client and the worker: intermediary parties will have little (if any) knowledge of what the actual working practices are. This last point is acknowledged in the legislation, whereby there is an obligation on the client to give its view on the status of the contract. Both these considerations point towards the idea that it should be the client's responsibility to operate IR35 not the agency's or any other intermediary's.

Also supporting this contention is the fact that agencies are unable to absorb a margin of 13.8%, the rate of employer NICs: their *gross* profits will rarely be higher than that and their direct costs are almost entirely staff. Where the fee-payer is an umbrella company the margins will be even lower. Bearing in mind that the purpose of the legislation is to get people to pay tax that is not currently being paid, the extra money has to come from somewhere, and this means that it can only in practice come from either the client or the worker.

Given the choice, we believe that it is much fairer, and more transparent, for this impost to be paid by the client. We understand that the theory behind IR35 as it was originally conceived was that contractors would charge, and clients pay, higher rates so that the contractors would be able cover this extra charge. We have seen no evidence that this has happened in practice, and indeed it seems to be the case that the fact that it has not is one of the main reasons behind the PSCs' failure to pay it. The fact that clients are not obliged to pay it themselves seems to have made some of them disinterested in the fact that other people have to pay what is essentially an employer's tax, and so the agencies and umbrellas have – out of necessity – forced the workers to bear the cost. This strikes us as very unfair, particularly to people on lower pay. It is probably this factor more than any other that has made the public sector reform as contentious as it has been.

Our suggested solution

We believe that a policy decision needs to be explored which would make the end-client liable in all cases. A road map is needed to include re-aligning the rules for off payroll working in the private and public sectors.

Responsibility and liability must sit with the same party.

APPENDIX 9

MEASURING SUCCESS

It is too early to assess the success or otherwise of the public sector off-payrolling changes as there has not yet been a full year's cycle of compliance; PSC accounts and corporation tax computations and workers' self-assessment tax returns are not yet due for submission and HMRC has still to issue workers' end-of-year tax calculations. This is work in progress affecting many workers who may not have chosen to work through a PSC of their own volition. It is therefore very important that the system supporting this change is reliable and that those using it can do so with confidence.

The private sector consultation document cites an estimated tax gap of £700m in 2017/18 growing to £1.2bn by 2022/23.

The OBR policy measures database report at http://obr.uk/download/policy-measures-database/ contains the following figures:

		2017-18	2018-19	2019-20	2020-21	2021-22
Off-payroll working: transfer liability to public sector employers	Income tax	+145	+55	+90	+100	
Off-payroll working: transfer liability to public sector employers	NICs	+140	+145	+155	+165	
Off-payroll working: transfer liability to public sector employers	On-shore CT	-20	-135	-140	-145	
Off payroll working: implement consultation reforms	Income tax	+20	+20	+20	+20	+20
Off payroll working: implement consultation reforms	NICs	+10	+10	+10	+10	+10
Off payroll working: implement consultation reforms	On-shore CT	0	-10	-10	-10	-10

We note that by 2021, OBR expects the exchequer to be collecting £120m more income tax and £155m less corporation tax. The relatively small difference between these two figures suggests that income tax has nothing to do with this in revenue terms, and that it is all about NIC. We should therefore welcome a breakdown of the NIC to show how much of the NIC is employer NIC.