Think Ahead ACCA

Off-payroll working in the public sector: reform of the intermediaries legislation

A consultation document from HMRC

Comments from ACCA to HMRC
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ACCA welcomes the opportunity to comment on the proposals. The ACCA Global Forum for Tax has considered the matters raised and their views are represented in the following.

GENERAL COMMENTS:

In the light of current economic uncertainty, arising both as a result of a general slowdown in the global economy and the recent referendum vote to leave the European Union, it is of paramount importance that the UK demonstrates that it remains an attractive location for businesses of all sizes. We consider that the proposed changes to IR35 would result in reducing the attractiveness of public sector contracts to all but the largest of service providers. We would strongly urge the Government to reconsider the proposed changes, which will disproportionately affect a sector whose continued flexibility and profitability is an essential foundation for the future economic security of the country.

IR35 is an anti-avoidance measure, designed to operate in situations where parties insert an intermediary into an employment relationship in order to disguise its true nature, thereby depriving the exchequer of the related taxes and the individual of their employment law rights and protections.

Although IR35 does not operate to restore any of the legal protections to the “employee”, it does require an amount broadly equivalent to the taxes otherwise due to be accounted for by the intermediary. In an attempt to deal with the recognised issues surrounding public sector contracting, contractors with public sector bodies have been placed under an obligation to confirm that they have had their position reviewed and that the correct tax is applied.

The current proposals invert the burden of proof, and will require public bodies or their agents to consider the relevant evidence and come to a justifiable and documented conclusion on the applicability of IR35, if necessary operating the charge via the RTI mechanism.

While ACCA has a number of technical concerns regarding the viability of the proposed review process, the most fundamental issue is the potential response of the public sector to the imposition of financial risk and administrative burden if they contract for services with SMEs. There is a significant risk that public sector bodies will seek to distance themselves from the risk of liability under these provisions by ensuring that

they cannot be the “entity adjacent to the intermediary” for IR35 purposes by contracting only via large, publicly listed outsourcing service providers.

The proposals risk increasing costs across public sector contracts. Evidence suggests that contractors will increase the costs to the public sector in response to the reduced flexibility and economic returns. Recent surveys undertaken by industry bodies indicate that contractors who are currently engaged on terms which would trigger IR35 are likely to either increase their rates or decline to contract, negating the net benefit to the exchequer whilst compromising the ability of public bodies to engage the services of the widest range of appropriate contractors.

In addition, there are specific issues in respect of public sector audit. The performance of the office of statutory auditor should not be within the scope of legislation targeted at disguised employment. Domestic and international standards are clear that a statutory auditor must be independent and cannot be, or in any way be seen to be, an employee of the audited entity. The implementation of an equivalent to s1214 of the Companies Act would clarify the position and remove potential anomalies and unintended consequences.

Our detailed comments in respect of specific questions within the consultation are set out below.

AREAS FOR SPECIFIC COMMENT:

Question 1: Are there other easily understood definitions that work better than the FOI Act and the FOI (Scotland) Act?

While the FOI Act and FOI (Scotland) Act have the advantage of being well established and easily checked, the breadth of bodies covered is considerably broader than the existing Public Procurement Note and this will therefore have an impact on the application of IR35

There are a number of “public bodies” which remain “private” unless acting in respect of information held in connection with the execution of certain aspects of their roles. Likewise, there are “private” bodies which are public only in respect of certain functions. The legislation should be clear as to whether such bodies are always to be considered public sector, or whether the parties to the relevant contract must first assess whether it relates to functions which would trigger the application of provisions of the FOI Act.

Question 2: Are there any public sector bodies which are not covered by the FOI acts which should be included in the definition for the proposed rules?

Given ACCA's concerns about the indirect impacts of these measures on the cost to the public purse of providing outsourced services, we would not want to see them extended to any additional bodies.

Question 3: Should private companies carrying out public functions for the state be included in this definition? Why?

No. In particular, consideration should be given to ensuring that the private guarantee companies charged with appointing auditors for public sector bodies are excluded from the scope of these provisions if other measures are not taken to exclude the performance of statutory audits from the scope of IR35.

Question 4: Are there any public bodies caught by this definition who would face particular impacts which should be considered?

HMRC will need to ensure that adequate education is available for all Public Sector bodies in order to support their compliance with the additional burden of establishing whether IR35 might be in point for any services they contract to receive. It is debatable whether Parish Councils for example will be aware of their new obligation and of how to properly undertake the IR35 assessment unless HMRC take steps to publicise the changes.

Question 5: Are rules needed to ensure that engagers have the information they need to make the decision? If so, what should they be?

The difficulties of passing sufficient information to engagers to be sure that in every case they have adequate information to make a properly informed decision on the application of IR35 are considerable, particularly where it may not be clear at any given link in the chain whether the analysis needs to be undertaken.

As an anti-avoidance measure, IR35 should be relevant only in borderline cases. The existence of the measure is in itself an admission of contradictions between aspects of the underlying tax law, which are subsequently, exacerbated by the interaction with other provisions of UK business law, in particular employment and company law codes. The reliance of the tribunals on evidence after the event to determine the terms of the hypothetical contract between the individual and the end user demonstrates the

difficulties in attempting to determine absolutely the status of the parties simply by reference to documentary evidence before the contract commences. Where a contract allows for sub-contracting which could create an IR35 risk in the future it is not clear at what point the analysis should be undertaken, or by whom; the level at which the intermediary comes into existence will depend upon whether it is s51, 52 or s53 ITEPA which is engaged and on what basis.

Even if it were possible to generate a universally applicable list of information needed to make an accurate assessment of the application of IR35 to any relevant engagement, incorporating that into statute in a clear and unambiguous form would be time consuming, difficult and may not be supported by the net benefits realised.

If the necessary information can be passed to engagers, they will then have the challenge of processing and analysing it within a very short timeframe while maintaining an adequate audit trail of evidence to subsequently justify their decision in the event of challenge by either the party or HMRC. The economic burden of overcoming those obstacles to compliant completion of the contract are so great that in many cases it may no longer be economically viable.

Question 6: How would accounting for the 5% allowance work in practice?

The 5% deduction will remain problematic, not least because of the failure to take account of the Employment Allowance and interaction with auto-enrolment provisions.

Question 7: Does the first part of the test work to quickly rule out engagements that are clearly out of scope?

No.

The first question is simple, clear and can be established by reference to the relevant FOI Act. However, the other two substantive questions – 20% materials, and existence of a company, are not considered to be effective.

The proportion of contract value ascribed to consumables may well be a strong indicator that the nature of the contract is not one that would typically fall to be classified as employment, but has no basis in the intermediaries' legislation or wider employment status law. More practically, unless it becomes a standard question in procurement documentation, it is not necessarily something that an agency, or even necessarily the procurement officer at a public body, would have any way of knowing. It may well be a

figure that may change depending on how the contract turns out, and crucially may differ across separate elements of an overarching contract which could themselves fall to be subcontracted.

The final question is fundamentally flawed because it fails to account for engagements with an individual who then subcontracts or a partnership. In the first situation, the individual will either become the intermediary themselves in which case the engager should, on the logic underpinning this proposal, become the adjacent entity and subject to the full range of tests, or will be contracting with a partnership or body corporate which would then itself become the PSC, shifting the burden of RTI reporting down the chain (quite possibly to the individual themselves). In the second situation, of engagement with a partnership, IR35 will clearly be in point as an intermediary under s52 ITEPA could easily exist, depending on the terms of the partnership agreement. The relevant terms are likely to be a sensitive matter subject to commercial confidentiality which the partnership is unlikely to want to share with a body that is subject to the FOI request regime. However, simply inserting a private sector commercial body which is not subject to FOI into the contractual chain is equally unlikely to be attractive, since that body would have to assume the IR35 liability in addition to the administrative costs of compliance. Where no IR35 liability can arise because the partnership is outside the scope of the s52 definition there is no economically sensible way to implement the requirements of the new proposals; they simply create risk and cost for nil net benefit to the Exchequer; no Exchequer risk is countered as none existed in the first place.

While the question could easily be recast to identify partnership situations, there is no simple resolution to the “creation of individuals as a s53 intermediary” issue. It would clearly be counterproductive to have a supposedly definitive test which returns the wrong answer through failure to properly analyse the legal environment. Equally, it would defeat the object of the “simple gateway” test to expand its scope to cover the substitution question.

Currently, the proposed test proceeds on the basis of the most common model and as a consequence does not take account of the breadth of the anti-avoidance law as it is drafted. An agency or public sector body contracting with an individual would fail to identify cases where the individual becomes the intermediary, or creates another intermediary further down the chain. The diagrams attached at appendix A set out some plausible scenarios for a GP surgery contracting for maintenance of its grounds. In

practical terms, the most likely outcome will be that the surgery will choose to contract with a large corporate supplier and incorporate a term prohibiting any subcontracting of services as this will be the only way to avoid a wholly disproportionate compliance burden on them and their suppliers.

In theory, the incorporation of simple written contractual term allowing a right to provide substitutes, displacing the obligation for personal service, could operate to protect the parties, but previously HMRC have been reluctant to admit the efficacy of such written terms, preferring instead to rely on actual conduct or other non-written indicators of the intentions of the parties when contracting. It is not clear how the reviewing party is meant to establish the existence of such indicators, or how they will be incorporated into the definitive HMRC online tool. While it may objectively appear “obvious” that IR35 would not apply in the vast majority of cases, a prudent public body, knowing that it is responsible for taxpayers funds, will take care to comply fully with the law and restrict its potential liability.

Question 8: Are these the right questions in the right order of priority?

The order of priority is logical, but still runs the risk of returning false negatives and indicating to procurement officers that IR35 is irrelevant when it may in fact apply.

Question 9: Are the questions simple to understand and use?

At a superficial level the questions are simple and easy to answer for the vast majority of situations. However, there are plenty of scenarios, such as the valuation of the materials element, where they may be harder to use. As set out above, the “existence of company” question is not considered appropriate. The alternative accurate question would be far less simple to operate; unfortunately, complexity is an inevitable feature of IR35.

Question 10: Do the two parts of the test give engagers certainty on day one of the hire?

No. Case law has consistently shown that it is the day to day performance of the duties of the engagement which determine whether it is equivalent to a contract of employment, or some other form of engagement and therefore outside the scope of IR35. That simply cannot be “certain” on day one of the contract, as the potential always exists for subsequent acts to change the nature of the contract (see eg JLJ Services Ltd

v HMRC Commissioners [2011] UKFTT 766 (TC)). A purported substitution clause may turn out to be unenforceable, while the wording of any “control” question is notoriously susceptible to subjective interpretation. HMRC have been quite clear that there is no intention to change the underlying law around employment status for tax purposes or the contractual circumstances which would trigger application of a charge under s54 ITEPA. As the JLJ Services Ltd case shows, the law as it stands is fundamentally incompatible with the concept of definitive prospective assessment.

In particular, the risk that some element of the contract may be subcontracted to a third party and thereby create an IR35 analysis requirement, and potentially even liability, will create a contingent liability which many prudent actors might simply consider to be unacceptable. The potential prohibition on subcontracting of public sector service provision is an unintended consequence of the current proposal and would be counter to other government initiatives.

Question 11: How can the organisation completing the tests ensure have the information to answer the questions?

The entity completing the tests (which could in theory be a sole trader subcontracting services) can do no more than request the required information from the public sector body (where that is not itself) and the entity adjacent to them in the chain. While there may be indicators which could indicate to a prudent reviewer that IR35 may be in point, if the relevant “signposts” are not present, or for some reason not communicated, then it will be impossible for the reviewer to be aware that they do not have all the relevant information without submitting a fully exhaustive list of questions to all of their subcontractors.

Question 12: How could the new online tool be designed to be simple and straightforward to use?

The tension between simplicity and certainty is well recognised in the tax field. Previous attempts at a “simplified” filter for IR35 have proved unsuccessful despite the best intentions of these creating them, and any future tool will face similar difficulties. While it may well be the case that difficulties with the current ESI stem in part from its roots in determining the status of directly engaged individuals, it would equally be a mistake to assume that a revised model designed to capture the factors relevant to engagements via a personally owned limited company would be applicable to partnership or sole

trader scenarios which will as a matter of law fall within the scope of the IR35 legislation and are not apparently excluded by law from the current proposals.

Question 13: Where should the liability for tax and National Insurance (and penalties and interest where appropriate) fall when the rules haven't been applied correctly?

The liability should fall on the party responsible for the failure to comply. It is important to distinguish between situations where it is the application of the rule which has failed (administrative shortcomings in the process) and situations where correct processes were applied to incorrect or incomplete information.

Liability should follow responsibility. If the public sector body fails in its duty to ensure that those working in the public sector body have paid the correct amount of tax and national insurance, then the public sector body should bear the liability for that failure.

Question 14: Should the liability move to the PSC where the PSC has given false information to the engager?

Any transfer of liability would need to consider the reason for the false Information, the timing of any declaration and the impact of subsequent events. Considerations by a tribunal will always have the benefit of hindsight and the full facts; any attempt to decide ahead of time whether any possible future subcontracting of some element of the services supplied under a contract might happen to create a hypothetical contract of employment between the public sector body and some currently unknown provider of the services will not be successful.

Question 15: What one-off and on-going costs and burdens do you anticipate will arise as a result of this reform?

The risks and administrative costs identified in the answers to the questions above will significantly reduce the attractiveness of public sector contracting to many SMEs. Likewise, the public sector bodies will be bringing themselves within the scope of an expensive and potentially troublesome regime if they contract directly with any commercial operation which could be an intermediary within the scope of the legislation.

As discussed above, there will be difficulties in assessing the balance of costs elements at the beginning of a contract in order to consider the "20% materials" test. This would be particularly problematic where for example, one overarching maintenance contract

with a sole trader is then split into discrete subcontracted elements, some of which incorporate materials supply and some of which don't. As a matter of law, the tests must be completed in respect of service only contracts for public sector end users, but until the commercial decision is taken to subcontract elements of the tender it will be impossible to know where and when the tests should be applied.

In practice, the risks of engaging any sole trader business on a public sector contract are likely to significantly reduce their attractiveness to engagers, whether public sector bodies or agencies/outsourcers. In August 2015, central government set itself the target of spending “£1 in every £3” with SMEs. However, the current proposals will hinder that aim. In any situation where a public sector body is in need of services which do not comprise more than a 20% materials cost on the contract, the engager or their agency will be forced to undergo a full IR35 screening process if the supplier is either an individual or partnership, or a corporate which could satisfy the due diligence requirements of the current proposal, irrespective of whether such a burden is proportionate and commensurate to the public sector obligation to ensure that its suppliers bear the appropriate burden of taxation on their activities.

The most significant difficulties will be faced by a business providing outsourced services to a mixture of private and public sector bodies. The outsourced service providers will be faced with applying different tests for otherwise identical work passed onto contractors who perform services for both public and private bodies. While current contractual terms enable them to manage liability by contracting only with self-employed individuals on receipt of UTR, such contracts also often allow for subcontracting (perhaps to specifically offset the risk of conventional status challenge being applied at that level; IR35 will not be in point for a direct SE relationship). However, the transfer of obligations to a subcontractor directly by the individual currently engaged by the outsourcing contractor would make the individual a PSC in the terms of the consultation document (under s53 ITEPA) and put the outsourcing provider under an obligation to operate the proposed new tests.

By extension, any public sector body (ie Parish Council) which engages the services of an individual to perform any service (hedge trimming, plumbing, secretarial support) will need to consider whether the terms of the contract permit subcontracting. If they do, then the current proposals will require them to establish whether any party further down the chain is, or would be, paid directly as an individual and then apply the tests accordingly. If the contract forbids subcontracting then they could perceive a risk of

HMRC status challenge on the relationship, however inappropriate that might otherwise be.

In situations where an individual might be the intermediary for IR35 purposes, the requirement to operate RTI on the payments to their subcontractor for public sector contracts will potentially impose a significant burden which will not arise on private sector contracts. This could serve to discourage sole traders from tendering for public sector contracts.

The practical implications of the proposal may discourage smaller businesses, whether private limited companies, partnerships or sole traders, from providing public sector services, unless they are prepared to introduce a “super provider” into the chain. Since that new body will itself be obliged to undertake the IR35 due diligence in respect of each such subcontracted service itself, the administrative cost will still exist in the contractual chain; it is therefore debatable whether the new body’s economies of scale will offset the profit margin which it will charge on the due diligence service.

This approach would reduce the cost and risk to the public sector body. However, introducing an additional profit taking administrative step into the process cannot be the best outcome. There is also a risk that the new body may have its own preferred subcontractors and as a result smaller businesses would have to negotiate the provision of their service not just with the public sector body itself, but also with that body’s preferred supplier.

There is therefore a risk that the proposed measures will reduce choice, increase costs to the public sector, and divert taxpayers’ money from those providing that actual public service to those administering the red tape surrounding it. The additional costs of having to demonstrate that every public sector contract is outside IR35 would significantly offset, and quite possibly outweigh, any net additional inflow to the Exchequer from reduced avoidance.

One specific area of concern is public sector audit. With the demise of the Audit Commission, there is a theoretical scope for public sector bodies to appoint their own auditor.

Since the 2013 revisions bringing performance of the duties of an office within scope for tax under IR35, all auditors have in theory been susceptible to challenge from HMRC. In practice, the majority of large audit firms operate on terms which exclude their partners

from IR35 while HMRC have indicated that where the audit practice cannot exempt itself under s52 then they will be likely to look favourably on a request to apply the administrative practice embodied in EIM03002.

Demonstrating either that there is no intermediary, or that the tests in EIM 03002 are satisfied, will involve passing details of the practices' remuneration agreements or management structure to the body assessing IR35 status. Currently, this would be HMRC, who would already have access to all the relevant details via partnership returns, if necessary supplemented by confirmation on enquiry.

Under the new proposals, where a public sector body appoints its own auditor demonstrating compliance could involve communicating commercially confidential information to an entity (by definition) within the FOI regime, which is unlikely to be acceptable.

In addition, the EIM 03002 route is unsatisfactory for three key reasons. Firstly, it relies on non-binding guidance to displace statute. Secondly, it requires the cumulative meeting of 6 tests - some of which are likely to cause difficulties for many practices. Finally, it runs counter to the fact that HMRC guidance cannot be relied upon where HMRC considers that there is or may have been tax avoidance (this is the very basis of IR35). It is not clear that EIM 03002 (which operates on the treatment of sums paid) can act to displace the charge under IR35 (which is based on the characteristics of the individual rather than the treatment of sums paid in respect of their services). This is likely to make public sector audit considerably less attractive to audit firms. In practice, we understand that it is likely that the vast majority of auditors to the public sector will be appointed by PSAA Ltd or SAAA Ltd. This will insulate the public bodies from the direct risk of IR35 charges or having to carry out the assessment. We understand that statutory bodies carrying out the appointing functions of the Audit Commission do not fall under the FOI Acts, and as a consequence the sensitivities that audit firms might feel about sharing commercially confidential sensitive information will be reduced.

The appointing companies currently operate with a small panel of audit firms. This significantly reduces the overall administrative burdens as they will only need to undertake a small number of assessments, which can then be relied upon for each of the thousands of public sector audits for which they will be needed. Moreover, the EIM 03002 route is unlikely to be needed for any of the firms currently on the panel.

However, the current IR35 proposal means that the direct appointment of an audit firm by a public sector body will not be attractive to an audit firm, effectively neutering the future intention to devolve appointment of auditors to public sector bodies.

The analysis of the Comptroller and Auditor General's position is likely to be particularly problematic in respect of NAO audits of central government since the IR35 legislation is framed entirely in the context of private sector contractual arrangements. The position of subcontracted C&AG audits would be similarly problematic, in particular where no fee directly passes to/from the consolidated fund; sums paid to the individuals on behalf of C&AG or subcontracted audit firm might be seen to represent the services performed, but operation of s54 would be potentially troublesome. While there would clearly never be an actual "deemed payment" in the case of a salaried Officer of the House of Commons, the public bodies subject to statutory audit would nevertheless have to undertake the analysis. The issues relating to public sector audit would be resolved if a clause was included in line with s1214 of the Companies Act, confirming that for the purposes of ITEPA and SSCBA the intermediaries legislation would not apply to the performance of the duties of a statutory audit.

The provisions creating the office of auditor under UK legislation and the relevant international standards and regulations are clear that to support auditor independence tthe requirements explicitly preclude any actual or perceived employment relationship between the auditor and the audited entity. Attempting to extract employment taxes under an anti-avoidance provision in such a situation stretches the doctrine of purposive construction to its very limit. The simple step of confirming that individuals who can never be employees should not be taxed as if employees would resolve the potential difficulties where the IR35 or EIM 03002 position might be unclear, and also remove the redundant and otiose administrative burden in respect of those audits (likely to include the vast majority of public sector audits) where the constitution of the audit practices is such that no intermediary exists.

CONCLUDING COMMENTS:

HMRC have not published evidence to support the estimate of losses accruing in the public sector. As outlined in this response the known costs of implementing the proposal would be significant and the potential unintended consequences of it far ranging and will seek to discourage the public sector from contracting with SMEs. Moreover, the current proposals focus entirely on incorporated intermediaries and fail to address the issues posed by individuals in the chain. Finally, the feasibility of creating a reliable and effective online tool to define status has not yet been demonstrated.

We recognise the complexity of reforming IR35 however we do not consider that the current proposal as drafted achieves its stated objectives and will adversely impact on both the public sector and SMEs. We would recommend that HMRC reconsider the proposal to address the unintended consequences in its application and the inherent inconsistency with auditing and ethical standards which are incorporated into UK Law.