EMPLOYMENT STATUS

Employment status: IR35 – the elephant in the room

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In March 2020, as Covid-19 first gripped the country, the UK government decided to delay the introduction of changes to the off-payroll working laws, commonly known as IR35, that were due to come into force in the private sector on 6 April 2020. It did so to help businesses and individuals deal with the economic impact of the pandemic and pushed the changes back to 6 April 2021.

Speakers at the Employment Lawyers Association's annual conference in June 2019 described the expansion of IR35 as 'the biggest shake-up of contracting in 20 years'. The government's acknowledgement of the need to protect businesses from the economic impact of the changes speaks volumes about the perceived effect they will have on private sector businesses, employment agencies, contractors and the public purse.

The impact will be seismic and the tremors will be felt in all sectors.

What is IR35 all about and why does it matter?

IR35 is the common name given to the legislation that became law in 1999, which had the aim of reducing large-scale tax avoidance when people work for end users through their own personal service company (PSC) or other intermediary (such as an employment agency) in circumstances where they might otherwise be regarded as the end user's employees or workers.

IR35's purpose is to prevent that avoidance of tax by constructing a hypothetical contract between the end user and the individual. It then asks whether, for tax purposes, that hypothetical contract is an employment contract or self-employment. Tax law is binary in this area: there is no recognition of the separate 'worker' status with which employment lawyers are very familiar.

Where the hypothetical employment contract is found to exist, income tax and National Insurance contributions (NICs) are due as if there was an actual employment contract, on a PAYE basis. The costs of getting this wrong can be severe, with penalties as high as 100% of the income tax and NICs that have been avoided (in addition to the unpaid tax).

The problem with the old law was that HMRC's enforcement powers were limited to enforcement against the PSC. This was often a shell company with few or no assets and so enforcement was a fruitless exercise.

End-user clients of contractors in the private sector had no responsibility to operate a payroll or to pay income tax or NICs for the contractors they engaged. This will change when the expansion of IR35 across the private sector takes effect on 6 April 2021. Similar changes to IR35 were implemented within the public sector in 2017.

What is changing?

With the exception of small businesses, end-user clients or other 'fee-payers' of individual contractors will have to do something they have not legally been required to do before: undertake detailed assessments to determine whether each contractor is caught by IR35 and so, in turn, should be taxed by them as if they were an employee.

For many this will not be a simple exercise. Businesses which have not yet begun their preparations to carry out the required status determinations ought not delay any longer. Employment lawyers know better than most that the legal tests to determine employment status (mutuality of obligation, control and other considerations) are demanding and multifaceted. The emergence of the gig economy and related status cases have illustrated that the application of these tests to modern working practices can be far from straightforward.

We also know that it is not unheard of for tax tribunals and employment tribunals to reach different conclusions about an individual's employment status. For example, in *Autoclenz Ltd v Belcher* [2011], HMRC had determined that a group of car valeters should all be classed as self-employed for tax purposes. However, this did not stop the Supreme Court from deciding that the same individuals were employees for employment law purposes.

Notwithstanding the legal complexities, from 6 April 2021, all medium to large businesses which engage contractors will be required to apply the law with all its intricacies to any relevant arrangements for the supply of services from individuals who are not already on the payroll.

When the end user considers that IR35 applies, it must notify the agency responsible for the supply or, if there is no agency, the PSC or intermediary. If the engagement is to continue, the end user must operate PAYE, taxing the payments to the intermediary as if they were income from employment. Without a renegotiation of terms, the end user and the individual will pay more tax. The end user will also, inevitably, assume other obligations to provide the worker with standard worker or employment benefits.

These decisions will have massive implications for the UK's contractor economy. The government estimates that non-compliance with IR35 will cost UK plc £1.3bn annually by 2023/24.

Which businesses are exempt?

Small businesses are exempt from the changes to IR35. These are defined in s382 of the Companies Act 2006 as companies that have two or more of:

- an annual turnover of not more than £10.2m;
- a balance sheet total of not more than £5.1m; and
- not more than 50 employees.

Status determination – data confirms CEST is by no means best

In an attempt to ease the challenge of status determination, the government's website encourages the use of HMRC's online Check Employment Status For Tax tool (CEST), which was revamped in 2019 in recognition that the previous tool was not fit for purpose.

End users and agencies may understandably seek to take some comfort from HMRC's website declaration that they:

> *… will stand by the result produced by the tool.*

However, their lawyers will note that this pledge is heavily caveated by the words that follow:

> *… provided the information inputted is accurate and the tool is used in accordance with our guidance.*

Wriggle room in abundance.

The HMRC guidance consists of the *Employment Status Manual*, which is divided into more than 35 parts of detailed material. It includes multiple links to past decisions by the higher courts which the reader (anyone who wishes to use CEST and benefit from HMRC's pledge to honour the result) is seemingly directed to read!

With the best will in the world, lay users of the CEST tool who do not possess detailed knowledge of the law on employment status determination will, through no fault of their own, probably lack the knowledge or ability to use the tool 'accurately', as HMRC requires.

Equally worrying was the acknowledgment in data released by HMRC in December 2020 that CEST failed to make any status determination in 19% of cases (185,330 of 975,416 total cases) over the prior 12-month period. This was despite the implementation of

enhancements to CEST that were designed in November 2019 in conjunction with some 300 stakeholders to:

> *… make the tool clearer, reduce user error and consider more detailed information.*

HMRC issued a statement admitting that:

> *In more finely balanced cases, CEST is expected to provide an undetermined outcome.*

Practitioners will draw their own conclusions from that statement about the value and reliability of CEST. They will no doubt urge their end-user and agency clients not to rely on CEST and to take careful professional advice, with some urgency given the fast-approaching 6 April commencement date.

There is, therefore, considerable concern among commentators that CEST does not cut the mustard.

Personally, I very much doubt that any form of 'one size fits all' status audit process or tool could reliably be used across differing styles of contractor engagements and across differing sectors. The terms of the hypothetical contract that businesses are required to construct in their analysis, and the respective significance of those terms, will naturally vary from case to case. Status determinations are a matter for skilled and experienced professional judgement – not robotic computer programming.

That complaint aside, there is at least one small mercy: the government has helpfully confirmed that the expansion of IR35 will only apply to the taxation of services provided from 6 April 2021. It will not apply to the payment of invoices submitted on or after 6 April for services provided prior to that date. There is still time to do the work that needs to be done.

Mutuality of obligation and control: recent tax tribunal decisions

Two recent decisions of the tax tribunals further illustrate the difficulties facing businesses when attempting to determine for themselves the complicated question of status.

HMRC v Professional Game Match Officials Ltd (PGMOL) [2020]

The decision of the Upper Tribunal (UT) in this case exposed worrying flaws in HMRC's interpretation of and guidance on the test of mutuality of obligation: *the* essential requirement for characterising any contract as one of employment.

HMRC had attempted to pursue some £583,874.07 of income tax and NICs which, it claimed, flowed from its determination that PGMOL was the employer of professional

football referees who provided their services during three football seasons. However, the UT concluded there was insufficient mutuality of obligation and control in the individual engagements to amount to employment. Referees could back out of any match-day commitments or be stood down by PGMOL without any consequences on either side and this was inconsistent with the obligations that employees owe their employers. It is worth noting that an employment tribunal might nevertheless have found on the same facts that the referees were workers.

HMRC v Kickabout Productions Ltd [2020]

In contrast, the UT allowed HMRC's appeal in *Kickabout Productions*. It found that the hypothetical contract between a radio presenter supplied through Kickabout and Talksport did have the characteristics of an employment contract. This was in spite of the finding of the First-tier Tribunal (FT) that Talksport was not obliged to provide any work to the presenter concerned. The UT found that this conclusion was wrong in law as the contract between Talksport and Kickabout:

- was for a fixed period;
- contained provisions for termination which made little sense if Talksport was entitled simply to stop providing shows; and
- contained provisions for suspension which made sense only if Talksport was obliged to provide work.

Setting aside the FT's decision, the UT went on to consider the 'control' test in *Ready Mixed Concrete (South East) Ltd v Minister of Pensions and National Insurance* [1968]. It held that this focused on the 'right of control', not on how, or if, that right was exercised in practice. So, while the presenter in question had a high degree of autonomy over the form and content of the show, this did not detract from Talksport's 'ultimate right' to decide on its form and content.

Other relevant factors

It is often the case that written arrangements between end users and intermediaries are silent about holiday pay, sick pay, maternity leave and pension (to which workers and employees are all entitled under UK law). The FT commonly considers the absence of such references to be a neutral factor when constructing the hypothetical contract. But, less than helpfully, this is not always the case. In *Albatel Ltd v HMRC* [2019] and *Atholl House Productions Ltd v HMRC* [2019], the FT considered that the absence of such employment-related benefits was generally inconsistent with the conclusion that a contract was one of employment.

Tribunals can also be swayed by:

- evidence that the contractor is genuinely in business on their own account;
- the contractor carrying genuine financial or other risk that employees would not be expected to carry;
- the frequency and pattern of payments made to the contractor; and
- the individual providing the equipment or other resources they need to do their work.

Risks for employment agencies

The Recruitment and Employment Confederation has called on agencies which supply workers to medium and large businesses in the private sector to act quickly to manage their risks as fee-payers or intermediaries which may flow from IR35 status determinations.

As things stand, an agency (or rather, an 'employment business' for statutory purposes) will become liable for the payment of income tax and NICs if it is:

- the fee-payer;
- not the fee-payer but fails to pass on the client's determination to the person or organisation it contracts with further down the supply chain; or
- the first agency in the labour supply chain.

Despite the importance of this issue for many agencies, it is interesting to note from HMRC's December 2020 CEST data that agencies accounted for just 2% of users of the CEST tool in the 12 months from 25 November 2019 to 24 November 2020.

This could suggest the agency sector has been slow to appreciate the importance of IR35 for its current business model. On the other hand, it could show that agencies are ahead of the curve and have chosen, wisely, not to put their faith in CEST.

Impact on employment rights

For many years, contracting has been a comparatively low-risk and low-cost method of engaging services from individuals. It offers, at least in theory, greater flexibility for all parties. The client has greater freedom to end or change the contract and can escape obligations for holiday pay, sick pay, pension contributions, redundancy pay and unfair dismissal compensation.

It is not at all uncommon for contractors to work exclusively within their clients' businesses for significant periods of time. One successful project leads seamlessly to another and the contractor is embedded as part of (or at least an extension of) the client's workforce. Yet the client operates under the impression (or in the hope) that it can let the contractor go on short notice without any significant risk of employment claims.

So, what if, as a result of its preparations for April 2021, the client reaches the inescapable conclusion that its long-term contractor is inside IR35 and should be taxed as an employee? If there have been no material changes to the way that engagement has operated for months or even years, how will the client convey the status determination without inviting a risk of claims? If the contractor is told they should have been taxed as an employee (IR35 has of course been around for 20+ years and the test is the same – only the liability will

shift in April 2021), will they not demand compensation for lost employment rights (ie paid annual leave and pensions)? This ‘elephant in the room’ may require careful handling.

Of course, a finding of employment status in the tax tribunal will not always be mirrored in the employment tribunal. We know that from cases such as *Autoclenz*. Equally, we should remember that the two propositions are not mutually exclusive.

In conclusion, there is plenty for businesses and their legal advisers to consider in preparation for 6 April 2021.

Cases Referenced

Cases in **bold** have further reading - click to view related articles.

- Albatel Ltd v HMRC [2019] UKFTT 195 (TC)
- Atholl House Productions Ltd v HMRC [2019] UKFTT 242 (TC)
- Autoclenz Ltd v Belcher & ors [2011] UKSC 41
- HMRC v Kickabout Productions Ltd [2020] UKUT 216 (TCC)
- HMRC v Professional Game Match Officials Ltd [2020] UKUT 147 (TCC)
- Ready Mixed Concrete (South East) Ltd v Minister of Pensions and National Insurance [1968] 2 QB 497

Citation reference:
'Employment status: IR35 – the elephant in the room', by Will Clayton, *Employment Law Journal* (February 2021 #217)

Accessed from:
https://www.lawjournals.co.uk/2021/01/29/employment-law-journal/employment-status-ir35-the-elephant-in-the-room/)