



Working with contractors

Due to COVID-19 these changes will not start until 6 April 2021

Introduction

It is common practice for organisations to use the services of contractors, either directly with individuals or through an intermediary company or agency. The use of contractors enables organisations to respond to demand for staffing resources without the need to increase permanent staff numbers. This may be particularly useful to fill resources on short term contracts or for specific pieces of work that require attention on an ad hoc basis.

Contractors can be: –

- An individual contractor directly with the entity
- An agency supplying workers
- An intermediary or a personal service company of the worker or an LLP

It is important to know which the services are being supplied through as there are different tax regimes applying in each circumstance. In addition, new changes will apply to services through agencies and intermediaries from April 2021.

A labour chain may consist of only one contractor or it may be more complex with several participants. The following terminology explains who is who: –

- **The Client**
This is the organisation that needs the work done
- **The Agency**
A third-party intermediary. An agency supplies workers to a client. Workers sell their services to the agency either as individuals or through another intermediary. There may be no agencies or more than one involved in the chain of contracts between the client and the worker
- **Personal Service Company (PSC)**
A company set up by a worker through which they supply their services. Often they are the sole director and shareholder although it is not unusual for their spouse or partner to also be shareholder directors
- **The Fee Payer**
The organisation that pays the worker's PSC. This may be the same person as the client or the agency

- **The Worker**
The person who performs the work

Employment versus self-employment

There are different UK tax regimes for the employed and self-employed. A key feature of this is that employers NIC is not due on payments made to the self-employed. Therefore, the use of self-employed contractors can be cheaper than hiring permanent staff. In addition, contractors can offset certain expenses against income from contracts which can also lower their own direct tax liability.

HMRC are aware that this can create a preference to treat engagements with contractors as self-employment rather than employment. This is further complicated by the fact that there is no definitive definition of employment in the UK, rather an arrangement is deemed to be employment or self-employment if it meets a sufficient number of indicators of employment. Therefore, each contract needs to be assessed on its own merits and care needs to be taken when the working arrangements change. The indicators of employment are summarised in the appendix to this help sheet.

Circumstances where a worker would satisfy sufficient employment criteria, and therefore would be considered an employee, are referred to as disguised employment.

What are the implications of disguised employment?

If HMRC decides an arrangement is one of disguised employment, then they will seek to recover the tax and NIC which would have been due had the payments been processed through the PAYE system. Legally both the client and worker are liable for their share of these taxes but in practice HMRC will often seek to recover the entire amount from the client.

The IR 35 Rules

Use of personal service companies (PSCs)

One means by which workers have sought to limit any liabilities arising from the work, and to minimise their tax liabilities, has been through the use of personal service companies (PSCs). When supplying services through a PSC, the worker contracts with and invoices the client or intermediary in the name of the company. The worker then extracts dividend payments from the company. This arrangement avoids the need for employer's NIC on the dividend payment and produces a lower tax burden as the rates of corporation tax are typically lower than those of income tax.

Disguised employment and PSC's

The issue of whether the arrangement is one of employment or self-employment still remains if the services are supplied within a PSC. To address the tax losses created by this HMRC introduced anti avoidance rules, referred to as IR35 rules, which applied from 2000 to contracts of disguised employment supplied through PSCs.

When the rules were introduced the onus was on the worker to assess whether the contract managed through the PSC with the client is one of employment or self-employment. If the assessment was one of employment, then the worker is required to calculate a formula based deemed payment at the end of each tax year. PAYE and employers NIC are then due on this payment in addition to corporation tax on profits and income tax on dividends.

The IR 35 rules were introduced to address the loss of tax from disguised employment. HMRC considers that the majority of disguised employment remained hidden. In 2017 the responsibility to assess the employment status of public sector contracts was transferred to the client.

Where a contract held with a PSC is identified as one of employment, then the fee payer is required to process any payments to the PSC through the PAYE system and naming the worker as a deemed employee.

What is changing?

From April 2021 the responsibility for determining the employment status of a contract with a worker will also be extended to large or medium sized private sector clients. This will include charities that are considered large or medium. For contracts where IR35 rules would apply, the fee payer is required to process payments to the PSC through the PAYE system.

Small private sector companies do not need to comply with the changes and can continue to pay PSCs gross. Qualifying PSC's contracting with small companies will continue to operate under the current IR35 rules for contracts with private sector employers and continue to make deemed payment calculations at the year end.

What qualifies as small?

A company will be considered large or medium sized if it is a commercial company which requires an audit under the Companies act 2006. If it does not need an audit, then it will be considered small. It is the size of the client not the PSC which determines the size.

Groups of companies must take into account the size of the entire group, including UK and non-UK group members, when considering whether the group qualifies as small. It is only the group itself looking to consolidate that needs to meet these requirements, if the parent

of the group is a subsidiary within a larger group, it is not necessary to consider the size of the larger group.

Other organisations that require an audit under other legislation, such as charities, have to assess themselves against the definitions of size contained within s382 of the Companies Act 2006. Under the Act a company is small for its first financial year. From then on, a company is not small if it meets two of the qualifying conditions for two consecutive financial years: –

- Annual turnover of more than £10.2M
- Balance sheet total of more than £5.1M
- Average number of employees of more than 50

Unincorporated companies are not small if they satisfy one of the criteria but over two consecutive periods. Non– corporate entities are small if they meet the turnover conditions alone. The qualifying definition of turnover is that derived from the sale of goods or provisions of services; therefore, it excludes grant and donation income.

What will employers be required to do?

Clients who engage with contractors will be required to review every contract to determine whether that arrangement satisfies one of self – employment or deemed employment.

What clients must do now

From 5 April 2021 all large and medium private sector clients must review every contract for all contractors and determine whether that arrangement would be one of employment but for the use of a PSC or other intermediary in the supply chain. All contracts must be reviewed on a case by case basis. The need to identify whether the contract is one of employment is required for all contractors, irrespective of whether they are conducted directly by the individual or through an intermediary.

The client must take reasonable care in this assessment and upon reaching a decision must issue a Status Determination Statement (SDS). The SDS must include the decision as to whether the arrangement is one of employment or self–employment and the client’s reason for reaching the decision. A copy of the SDS must be given to the worker and the intermediary contracting with the client.

The fee payer and the worker can challenge the SDS and clients must have a process in place for managing a disagreement. Once challenged the client has 45 days to consider the reasons it has been challenged and then to state whether they disagree or agree with this new evidence.

Check Employment Status for Tax Tool (CEST)

HMRC has an online tool which both clients and workers can use to determine whether a contract is one of employment or self-employment. Clients can therefore use this tool to assess the employment status of the workers. HMRC will accept the results of CEST provided they have been entered in good faith and reflect the arrangements. Clients therefore need to be careful if working arrangements change. The results of the CEST tool currently cannot be saved as a pdf and therefore clients need to print out the results and save them in hard copy or as a screen print. The tool does allow the results to be dated and have the workers name entered as part of this record.

Transfer of liability

The client is required to pass the SDS onto the worker and the next person or intermediary in the chain. Each intermediary passes it down the chain until it reaches the fee payer. If an intermediary does not pass it down, then the liability for operating PAYE will pass to them. There is therefore an incentive to pass the SDS down the chain. There is no obligation for the client to ensure the fee payer in a chain receives the SDS therefore there is further incentive to ensure the SDS is passed to the fee payer.

If a fee payer does not receive an SDS they will not be required to pay the worker through the payroll and will continue to settle the PSC's invoices gross. As the fee payer is required to operate PAYE if the SDS states the worker would be an employee but for the PSC. The SDS must be passed down the chain reasonably quickly to ensure they can ensure the correct deductions are made.

PAYE requirements for Fee Payers

If a contract would be one of employment, but for the PSC, then the fee payer must process the payments to the PSC through the payroll and treat the worker as a deemed employee. The fee payer then deducts income tax and employee national insurance from the payments made to the PSC. The fee payer then accounts for this to HMRC and pays employers NIC and apprenticeship levy fees if relevant. The fee payer then recovers the employer NIC and apprenticeship levy fees from the client.

As this is a deemed employment auto enrolment and student loan deductions do not apply and employer NIC payments made do not count towards the employment allowance. Deemed employees are also not entitled to statutory payments, such as sick pay or maternity leave from the fee payer. They are also not covered by national minimum wage legislation and the payments are not included within gender pay gap calculations.

Due to the different treatment of deemed employees this raises practical issues for fee payers as it will be necessary to be able to identify deemed employees from legal employees

on the payroll. Fee payers will need to decide whether to use some functionality within the payroll system to tag these employees or whether it may be easier just to run a separate payroll system for them.

The amounts to be taxed are those that would normally constitute earnings from employment. Therefore, VAT and deductible expenses are excluded from the amounts processed through the payroll system.

Transfer of liability for tax

The liability to operate PAYE and pay the tax resides with the fee payer. If HMRC cannot receive these amounts from the taxpayer, then this liability transfers back up the chain to the intermediary next to the client. The liability therefore leapfrogs all other intermediaries in the chain. If the tax is not settled by the intermediary next to the client, then it transfers to the client.

Implications for PSC's

The amounts received by a PSC net of employees NIC and income tax now have the following features: –

- If the amounts paid to the worker equals the net fees received no corporation tax arises on these amounts to the PSC or income tax to the worker
- If the amounts paid to the worker exceed the amounts received net, then the excess income is taxable in the hands of the worker
- If the amounts paid out are less than the amounts received, then the remaining amounts will be liable to corporation tax
- If the PSC has received any amounts received gross, then these amounts are liable to corporation tax and the year-end formula based deemed payment

Implications for workers

- The income tax and NIC deducted remains theirs and counts towards any self-assessment amounts
- No further income tax and NIC is due on the amounts received from fees arising from deemed employment

Further guidance regarding the changes can be found on HMRC's website [here](#).

Indicators of Employment

Indicator	
Control	The greater the control a client has over a worker indicates a greater chance of employment. For example, can the client tell the worker what days to work, where to work and how things are done?
Substitution	Is it a contract of personal services from the worker or is the worker able to send someone on his or her behalf? If the worker can send a substitute there is a greater likelihood the contract is one of self-employment.
Financial risk	Does the worker carry the financial risk? If the worker is required to rectify any of the work in their own time, then this will indicate the contract is one of self-employment.
Supply of equipment	If the worker supplies their own equipment, then this is an indicator of self-employment.
Basis of payment	If the worker is paid a fixed sum for the work done this is an indicator of self-employment.
Mutuality of obligation	Is the client required to provide the worker with work and the worker required to accept it? The greater the degree of mutuality of obligation the stronger the indicator of employment.
Receipt of payments and benefits	If the worker is paid statutory payments and receives annual leave and other staff benefits, then this is a strong indicator of employment.
Integral to the organisation	If a worker is integral to the organisation, for example how 'part and parcel' are they perceived by the other staff. The more integrated the worker is then the higher the likelihood they are employed.
Right to terminate the contract	The right to terminate the contract for reasons other than a serious breach, through means of a specified period of notice may be an indicator of employment.
Business in their own right	If the worker is in business in their own right, for example do they work for many other contractors, then this may be an indicator of self-employment.
Managerial responsibilities	If the worker has managerial responsibilities, then this is an indicator of employment.
Length of engagement	The longer the engagement the more likely it is one of employment.