KPMG

Tax Matters Digest

Is changing the IR35 rules really the answer?

The Government's decision to press ahead with reform to the off-payroll working (IR35) rules in the public sector from April 2017 is going to mean a lot of people are going to be very busy between now and then. It could have serious implications for public sector bodies and their access to skilled talent. Given the wider reviews of working practices, is this the right time to implement such a policy?

Under the current IR35 rules individuals employed via their own personal service companies (PSCs) are treated as 'off-payroll', i.e. not as direct employees of the public sector body but as third party contractors. This structure means the public sector body has no responsibility to account for PAYE and National Insurance Contributions (NIC) on payments it makes for their services. Rather it is up to the contractor to decide whether the work they are doing via their PSC falls within the IR35 rules and, if so, to account for PAYE and NIC on the payments the PSC receives for that work (as if it was salary paid to the contractor).

Under the new rules, it is the public sector body (or an agency in the supply chain) that will be responsible for determining whether IR35 applies. But determining someone's status for IR35 purposes is not straightforward and, even with the automated tool which HMRC are currently building to assist with this (which they say will be ready for April 2017), the likelihood is that public bodies (and agencies) will be tempted to 'play it safe and deduct PAYE and NIC in most circumstances. This will then leave the contractor/PSC to pick up the pieces themselves if they disagree that deduction should apply.

Added to this, the resulting employer NIC cost will fall on the public sector body which will likely need to negotiate a reduction in the PSC's rate in order to cover the additional cost. This, coupled with the need to join-up the accounting and payroll departments, will all need to be done in time for April 2017…a tall order indeed!

In fact, the size of the task may lead some public sector bodies to have done with it and simply put everyone on the payroll as a traditional, salaried employee. But this in turn would crystallise additional employer NIC cost across the board for all contractors currently engaged via PSCs and provide far less labour flexibility for the public sector body. As such, contractors for whom the IR35 rules do not apply may decide instead to work in the private sector where they can judge the matter for themselves and so not have PAYE and NIC deducted where it is not due. That is, unless perhaps the public sector was to increase pay rates – something which would seem very unlikely when most are short of cash.

According to HMRC these reforms will bring in an additional £20m to £25m of tax annually which seems relatively small beer for such a great upheaval, impacting on so many contractors, public sector bodies and agencies. HMRC themselves will also be impacted when contractors seek to unwind PAYE and NIC they consider has been deducted in error. This then begs the question of whether this change is really proportional to the problem at hand. Well, the answer is that maybe this isn't all it seems – these changes could simply be a pilot for a changes across the board to apply to the private sector as well. Although the Government have said that their focus is on the public sector, we would certainly advise all companies to watch this space!

Looking further ahead than April 2017, the Government has said that it intends to look at wider issues in relation to the different ways we work and the impact on the tax take. And it's true that these days we may be employed, self-employed, agency workers, contracting via PSCs, setting-up micro-businesses, or a mixture of one or more of the above! But the choice of incorporation is certainly tempting to many given a corporation tax rate heading towards 17 percent, as compared to a top rate of income tax of 45 percent, and NIC to boot. In a letter to the Office of Tax Simplification published on Wednesday 23 November 2016, the Government latched on to this, commenting that "this not only causes complexity but also…is resulting in increased fiscal costs to the Exchequer", and that it wants to look at how it can ensure that the "taxation of different forms of working and different forms of employee remuneration is fair, sustainable and efficient".

This commitment chimes with the rise of the 'Gig Economy', the ongoing Business Energy & Industrial Strategy inquiry into the future world of work and rights of workers, and the anticipated report on Employment Status from a Cross-Government Working Group. Clearly, employment status and workers' rights are going to remain in the spotlight. And, indeed, aside from the public sector IR35 changes, this has the potential to trigger something of a perfect storm for many businesses, particularly in the retail and logistics sectors.

In this light we surely have to ask whether changing the IR35 rules for the public sector (and then the private sector?) is the right policy response. Arguably it would be better to await the outcome of the Government's review of the wider issues at stake, consider the right strategic approach and then implement it - rather than rushing through a tactical, and administratively costly, change in such a very short timeframe.

Contacts

Patrick Martin

T: +44 (0)20 7311 5709
E: patrick.martin@kpmg.co.uk

Seamus Murphy

T: +44 (0)20 7311 4330
E: seamus.murphy@kpmg.co.uk