Contractor guide to the UK public sector off-payroll rules

Contractors earning over £219 per day and/or on contracts lasting six months or more must work through a Cabinet Office process to show public sector clients that the off-payroll rules don't apply to their contract.

If the off-payroll rules are found to apply, then the contractor must either go onto the client's payroll and have income tax and National Insurance Contributions (NICs) deducted at source under Pay As You Earn (PAYE), operate inside IR35 or resign the contract.

The rules, which were written following the review of the tax arrangements of public appointees published on 23 May 2012, have been written into all new contracts issued by government departments after 23 August 2012 and all contract renewals after that date.

Cabinet Office guidance also urges government departments to apply the rules to existing contracts that started before the rules were introduced.

Categories of off-payroll workers in scope of the rules

The guidance on how to apply the off-payroll rules issued to government department finance director generals anticipates three types of off-payroll workers:

Self-employed sole traders. This type of worker will be required to demonstrate that they are outside the rules by taking HMRC's Employment Status Indicator (ESI) test. If they pass as self-employed, the rules won't apply, although they will be required to prove they are registered for and pay income tax and NICs. If they fail, the public sector client must engage them via its payroll

Umbrella contractors or secondments. This is designed to apply to Umbrella company contractors and employed workers on secondment from their employer, such as consultants supplied by, for example, one of the major IT or outsourcing companies. The umbrella contractor or employed consultant must demonstrate that the public sector client's fees are paid in full to the umbrella company or outsource company, and also supply payslips to show that the individual worker is making income tax and NIC payments at source via PAYE

Limited company contractors using a personal service company. How this kind of worker demonstrates their off-payroll status is more complex and outlined below.

Limited company contractors – the off-payroll rules process

The off-payroll rules guidance suggests that government departments use HMRC's business entity tests and IR35 itself to determine whether limited company contractors fall within scope of the rules.

The first step is for the contractor to prove that they are in the low-risk category of HMRC's business entity tests. This must be provided at the start of the contract, if on a day rate greater than £219, or at the six-month point if the contract lasts longer than six months. If they are low-risk, the off-payroll rules do not apply.

If contractors are in the medium- or high-risk categories of the business entity tests, then for the rules not to apply they must provide "assurance in a different way" that their contract is outside IR35. The guidance offers an HMRC contract review as an example of providing assurance that a contract is outside IR35, which many contractors would correctly view as a high-risk strategy to determine their IR35 status.

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Fortunately, the guidance then goes on to say that the contractor "will be able to provide evidence of a contract review to say that they are outside the scope of the IR35 legislation at the six-month point."

This wording does not specifically exclude evidence of a contract review by another organisation; and some IR35 consultancies will offer contractors an off-payroll rule contract review for the specific purpose of confirming to public sector clients that the contractor's contract is outside IR35.

Contractors who are in-scope of the off-payroll rules

Limited company contractors who cannot demonstrate that they are in the low-risk category after taking the business entity tests and who cannot secure an IR35 contract and working practices review that confirms that their contract is outside IR35 must operate the IR35 legislation.

Contractors can choose to pay their full monthly fee income less a small expenses allowance as a monthly salary and pay income tax and NICs via their own limited company's PAYE payroll. This immediately demonstrates to their public sector client that they are paying income tax and NICs at source and do not have to join their client's payroll.

Alternatively, contractors can opt to operate IR35's deemed payment less expenses. In this case, because the deemed payment is only made at the end of the tax year, they must make assurances to their client that this will be done and commit to "meeting the requirement".

The alternative is to join the client's payroll. But for most limited company contractors this could unnecessarily complicate their tax affairs, particularly if the public sector contract was paid above £219 but only for a short duration.

Despite the guidance, different public sector organisations have adopted differing strategies to their adoption of the off-payroll rules, with some taking longer to get up to speed than others. However, one thing appears certain – that the rules will come into force in every government department eventually, so contractors must be prepared.

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