False Self-Employment legislation - explained

Limited company and umbrella contractors are outside of the scope of the False Self-Employment legislation, which is mainly targeting the self-employed who are using their sole trader status to avoid employment taxes.

The **Onshore employment intermediaries: false self-employment legislation** was introduced in the 2014 Budget and came into effect on 6 April 2014. Its intention is to ensure that recruitment agencies hiring self-employed sole traders who are really employees on behalf of clients deduct income tax and National Insurance Contributions (NICs) from gross pay at source.

The test of false self-employment requires the agency to prove an absence of supervision, direction and control of the worker by the client. If any element of supervision, direction and control is present, then the legislation applies and the agency must deduct income tax and NICs.

Umbrella company contractors already pay income tax and NICs as employees, so the legislation does not apply. **Limited company contractors** are exempt as a result of a technicality because they are remunerated via **dividends**.

Why the legislation has been introduced

The tax avoidance measures were announced in the Chancellor's Autumn Statement in 2013 and HMRC released its consultation on 10 December 2013.

HMRC and the Treasury were concerned that there is wholesale tax avoidance by employment intermediaries that are providing the services of self-employed sole trader workers to clients. Such workers should be employed and paying income tax and NICs via Pay As You Earn (PAYE), either by the agency or by the end-user client.

The legislation is mainly targeting the construction sector and is in addition to the Construction Industry Scheme (CIS), which is effectively intended to do the same thing.

HMRC has specifically said that the measures are not aimed at targeting mainstream contractors and freelancers, although the taxman's **guidance on supervision, direction and control** unhelpfully gives an example of an IT consultant who in some scenarios is caught by the legislation.

How does the false self-employment legislation work?

Section 44 of the Income Tax (Earnings and Pensions) Act 2003 (**ITEPA**) previously said that a worker must pay income tax and NICs via PAYE if:

The individual is under obligation to provide personal services

The contract is via a third party agency contract

The worker is subject to*supervision, direction and control as to the manner the services are provided*

The payment would not otherwise be employment income.

All of these conditions must apply to the worker's situation, otherwise they can be paid gross by the agency.

The new legislation changed these rules to three amended conditions that must all must apply if the worker is to be paid via PAYE. These include requirement that "the individual personally provides, or is personally involved in the provision of services", so substitution is not a reason for the rules to apply.

The reference to 'agency contract' has been removed, saying "any third person" can now be defined as the agency. The third condition says, "if remuneration receivable under or in consequence of the agency contract is not otherwise already treated as employment income" then the worker must have income tax and NICs deducted by the 'third party' via PAYE.

However, a key new condition has been introduced by HMRC, which says that PAYE applies"if the agency cannot show there is no supervision, direction and control as to the manner the services are provided".

The agency must prove the absence of supervision, direction and control

Basically, it is the agency's responsibility to assess whether there is any supervision, direction and control by the client over the worker. HMRC assumes that supervision, direction and control is present, and it is the agency's responsibility to prove it is not.

> **"HMRC assumes that supervision, direction and control is present, and it is the agency's responsibility to prove it is not"**

Under the rules, the agency must automatically deduct income tax and NICs from the workers gross pay as if they were an employee. The rules also apply if the "individual personally provides, or is personally involved in the provision of services".

That means that even if there is a substitution clause and a worker uses someone else to do some or part of the work, because they elected and paid the substitute it qualifies as being “personally involved” in providing the services.

Industry reaction to the legislation has been negative, as the recruitment sector has highlighted the impracticalities of proving the absence of something, and the additional burden of compliance.

Limited company contractors are not within scope of the rules

Initially, it was feared that limited company contractors would be within scope of the rules. However, from the outset HMRC has made it clear that it is not its intention to go after highly skilled knowledge workers unlikely to be subject to supervision, direction and control.

HMRC has highlighted a technicality that means limited company contractors paying themselves a low salary and high dividend are not covered by the rules. The rules say that “if remuneration receivable under or in consequence of the agency contract is not otherwise already treated as employment income” then the agency must deduct income tax and NICs.

Limited company contractors who pay themselves mainly via a dividend do not meet the condition as the dividend does not qualify as remuneration according to the definition in the legislation. This is because there is no direct link between what the agency pays the contractor limited company and what the limited company then pays the worker

Umbrella company contractors already receive their fees as employment income, paying income tax and NICs via their umbrella company’s PAYE scheme, so the condition is not met and the proposed new rules would not apply. Limited company contractors who are paying themselves via a salary or deemed payment under IR35 are also receiving employment income, so they too are unaffected

Introducing a ‘TAAR’

A “targeted anti-avoidance rule”, or TAAR, will also be introduced. This is to prevent wholesale incorporation by self-employed sole traders to avoid the impact of the legislation.

The TAAR will be designed to "enable HMRC to consider both:

The motive for setting up the arrangements - whether it is set up with the motive of avoiding income tax; and

What it achieves – whether it results in tax being paid.”

HMRC’s guidance goes on to say:

“This means that people who set up PSCs for a reason other than reducing tax – such as the limited liability protections incorporation provides – would not be within the TAAR. However, HMRC would be able to use the TAAR in the most egregious cases where, for instance, an agency requires all of their workers to set up PSCs to avoid the new legislation.”

It is possible that the TAAR, when enacted, could be incorrectly applied to genuine contractors.

No conflict with IR35

The false self-employment rules will operate independently of and in parallel with IR35, so the classic tests of employment and principles of substitution, control and mutuality of obligation will still apply to limited company contractors.

Contractors already inside IR35 and either paying themselves a full salary or a deemed payment are already paying income tax and NICs, and so the legislation would not apply.

Published: Wednesday, May 21, 2014