Off-Payroll amendments could pose problems for payroll companies

Final changes to the Off-Payroll legislation could pose a significant problem for umbrella companies and other payroll intermediaries, research by IR35 Shield reveals.

Introduced to Chapter 10 of the Income Tax (Earnings and Pensions) Act 2003 via the Finance Act 2020, which reached Royal assent on 22 July 2020, the amendment broadens the legislation's definition of an 'intermediary', the scope of which umbrella companies now appear to fall into.

The legislation requires that remuneration is treated for employment tax purposes before reaching the intermediary, which would effectively render the role of the umbrella company redundant. The amendment therefore poses numerous challenges and potential knock-on effects for the contractor supply chain.

"The change to the statute appears to mean that agencies will assume the role of fee-payer, even if the contractor is engaged via an umbrella company," says IR35 Shield and ContractorCalculator CEO Dave Chaplin.

"Agencies will therefore need to make tax deductions before sending the remaining amount to the umbrella company. This negates the need to interpose an umbrella company and effectively means the agency would need to run their own internal payroll for contractors deemed 'inside IR35'."

Updated 'intermediary' definition poses Off-Payroll problems

The substantial ramifications hinge on an amendment to section 61O, which assists in defining an intermediary for the purposes of the legislation. Prior to the amendment, section 61O(b) offered the following criterion: *'It is the case that the worker has a material interest in the intermediary.'* This clause was evidently intended to identify personal service companies (PSCs).

However, changes introduced to the Finance Act 2020 expand upon this definition, adding a further two alternative criteria, with section 61O(b)(ii) stating: *'The worker has received a chain payment from the intermediary.'*

Notably, the amendment only requires that one criterion be met to satisfy this clause. Consequently, umbrella companies, other payment intermediaries and potentially even agencies remunerating contractors directly now seem to meet the Off-Payroll definition of an intermediary, the significance of which is found elsewhere within the legislation.

The fulfilment of the conditions in section 61O is a prerequisite for the satisfaction of 'Condition A', detailed in section 61N(9). Meanwhile, section 61N(1) outlines measures that parties must take to establish the supply chain for payment purposes in instances where *'one of Conditions A to C is met'*.

Section 61N(1)(b) requires that a chain be identified where *'the lowest person in the chain is the intermediary'*, while section 61N(2)(b) distinguishes the 'fee-payer' as *'the person in the chain immediately above the lowest'*. As defined elsewhere in the legislation, the fee-payer is responsible for calculating, reporting and processing tax via Pay As You Earn (PAYE) for contractors deemed 'inside IR35'.

What this effectively means is that, from April 2021, an umbrella company is an intermediary as defined in 61M(1)(c) and the agency is a fee-payer as defined in 61N(2).

This would not have caused an issue if Chapter 10 had included a specific carve-out for monies already treated as employment income, which was included in the original IR35 legislation, in section 54(1), Step 2. Unfortunately, this wasn't possible because Chapter 10 applies to monies about to be paid, not monies that have been paid.

What does the Off-Payroll amendment mean for umbrella companies?

Whereas the original clause sought to ensure that income was taxed prior to reaching the contractor's PSC, the legislative amendment would appear to effectively circumvent the involvement of any party directly engaging an 'inside IR35' contractor from supply chain responsibilities.

Take the following example. A recruitment agency sources a contractor for a client whose subsequent status assessment returns an 'inside IR35' determination. The client provides a Status Determination Statement (SDS), freeing them of fee-payer responsibilities, while the agency invites the contractor to trade via an umbrella company for the duration of the contract. The supply chain now consists of the client, recruitment agency, umbrella company and contractor.

According to the amended legislation, the umbrella company would be considered the intermediary in this scenario as it is the party from whom the contractor receives payment. Meanwhile, the agency – the party in the supply chain immediately above the intermediary – becomes the fee-payer and assumes the associated responsibilities, including the deduction of tax at source via PAYE. This allocation of responsibility prevents the umbrella company from carrying out one of its core functions and may ultimately be viewed as rendering the role redundant.

This might seem counterintuitive given the fact that umbrella company engagements facilitate the tax treatment required by an 'inside IR35' determination under the Off-Payroll legislation. However, as tax and employment status expert David Kirk, of David Kirk & Co, observes, it is the correct approach by the letter of the law:

"Where there is an employment relationship, then on the face of it, PAYE applies to payments from the umbrella to the worker. However, Chapter 10 also applies, so PAYE also operates on the payment from the agency to the umbrella. To avoid a double tax charge, we go to section 61W, where we learn that it is the payment from the paying intermediary to the worker that is not charged again."

Not only are the recent legislative changes potentially bad news for umbrella companies, but they could also create complications throughout the rest of the supply chain. Many agencies were expected to enlist the assistance of umbrella companies in response to the Off-Payroll legislation, under the premise that it would absolve them of 'fee-payer' status and its associated risks.

The involvement of an umbrella company was also viewed as a means by which recruitment agencies could avoid operating their own payroll, an administrative hassle that many agencies prefer not to accommodate.

Martyn Valentine, legal expert at The Law Place agrees: "The Finance Act 2020 eliminates the principle reason for an umbrella company's existence, i.e. processing of payroll, and transfers this obligation to the legal person above the umbrella company. Employment businesses and clients will henceforth face an added administrative cost when dealing with umbrella companies and may decide that umbrella companies no longer offer a benefit."

Why has the Off-Payroll amendment been introduced?

The legislative issue and the extent of its repercussions have been documented in an IR35 Shield-produced technical paper that has been shared with HMRC, as part of Chaplin's efforts to assist HMRC with its education programme, as well as with some specialist tax and legal advisors.

"We are unsure what the purpose of the change to 61O was intended for, but we find it hard to believe that the plan was to shut down the entire umbrella industry," notes Chaplin. "There has been historic controversy surrounding the use of tax avoidance schemes operating under the guise of umbrella companies which has led to the controversial Loan Charge.

"It may be that the legislators have decided that agencies should be responsible for all tax deductions, removing the opportunity for non-compliant payment intermediaries to enter the supply chain."

When pressed on the matter by ContractorCalculator, an HMRC spokesperson commented: "Chapter 10 of ITEPA 2003 is intended to apply to situations where an employment relationship does not already exist between the worker and the client or an agency in the chain." The

spokesperson added that the amendment to section 61O was intended to mirror provisions contained within Chapter 8, section 51 of the ITEPA – the original IR35 legislation.

HMRC also told us that “The amendment to section 61O was made in response to stakeholder concerns raised about potential avoidance of the rules by entering into an arrangement to circumvent the intermediary conditions, but still receive a chain payment for the services provided.“

However, Kirk warns that differences between Chapter 8 and Chapter 10 mean mirroring the provisions won’t work out in practice as HMRC supposedly intended, adding that the changes could give the taxman additional room for manoeuvre when pursuing engagements under the legislation:

“In Chapter 8, the intermediary is responsible for paying the tax on payments made to the contractor. It does cover umbrellas, but it does not make them deduct any more than they would do under the normal employment status provision. Chapter 10, by contrast requires the fee-payer to deduct tax on the payment that it makes to the intermediary.

“What matters is not whether it is intended to apply but whether it does apply. To quote the leading case on the subject, HMRC can only fail to collect tax in cases where there are: ‘minor or transitory anomalies, cases of hardship at the margins or cases in which a statutory rule is difficult to formulate or its enactment would take up a disproportionate amount of Parliamentary time’.Somehow I don’t think this qualifies.”

Experts call for remedy to flawed amendment

Roger Sinclair of contractor specialist law firm Egos agrees, commenting: “HMRC has indicated that it doesn’t intend for umbrellas to be caught. However, one might question whether HMRC guidance can override the express wording of the legislation.”

Regardless of intent, Sinclair is adamant that the legislation needs addressing urgently: “We now clearly have a lack of certainty, with only six months to go before the law becomes active. There may have to be an amendment to the statute, perhaps putting it back to what it was.”

“That’s the million-dollar question,” adds Sinclair, when asked what firms and agencies should do if the legislation isn’t rectified, whereas Chaplin encourages parties to exercise caution while the industry awaits clarification:

“For the time being, it would be sensible for agencies to seek professional opinions from their advisors and to decide whether to continue using umbrellas or operate an in-house payroll where possible.”

The HMRC spokesman has said: "We continue to work closely with stakeholders to understand any concerns and will act to provide further certainty if necessary.”

Chaplin concludes: “The industry has pivoted before and it will pivot again, so we expect to now see a land grab from providers who are able to offer in-house payroll services for agencies that cannot run their own. This could be quite an upheaval if agencies choose to collapse their current preferred supplier lists (PSLs) into one provider.”

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