

**Report for:** Staffing & Remuneration Committee, 18 April 2017

**Item number:** 9

**Title:** Reform of legislation governing off-payroll in the public sector (IR35) - LBH Implications

**Report authorised by :** Richard Grice, Assistant Director Transformation & Resources

**Lead Officer:** Julie Amory, HR Policy Manager

**Ward(s) affected:** N/A

**Report for Key/  
Non Key Decision:** N/A

**1. Describe the issue under consideration**

1.1 This report is presented to inform the Staffing and Remuneration Committee of the changes to the Off-Payroll Intermediaries legislation that came into effect in April 2017.

1.2 The report considers how the changes will impact on the Council as an employer and on its current workforce strategy, which will require strategic planning to minimise the impact.

**2. Cabinet Member Introduction**

Not applicable.

**3. Recommendations**

The report is for information and for the Committee to note.

**4. Reasons for decision**

Not applicable

**5. Alternative options considered**

Not applicable

**6. Background information**

6.1 This report covers the legislative changes to the Off-Payroll Intermediaries legislation (commonly known as 'IR35'), which aims to ensure that individuals who work off-payroll who would have been taxed as employees had they been engaged directly, pay employment taxes on their income.

6.2 The Government believes that within the public sector there is widespread non-compliance with the legislation therefore it is implementing changes that shift the responsibility for assessing IR35 status to the public sector body engaging the worker.

- 6.3 This responsibility will also include the duty to deduct and pay the correct tax on this income for the worker. Where an agency or contractor is supplying the worker to a public sector body then the duty to deduct and pay the correct tax will rest with the agency/contractor.
- 6.4 The changes to IR35 will not affect fully contracted out services delivered in the public sector (e.g. TUPE'd services) or where a third party employs the worker directly through a Managed Service Company (MSC).
- 6.5 The current IR35 rules apply where an individual performs services through their own intermediary, e.g. a personal service company (PSC), limited company or partnership; and were it not for this arrangement the individual would be classified as an 'employee' for tax/National Insurance Contribution (NIC) purposes (the employment test).
- 6.6 Under the current rules, the intermediary is required to determine whether the IR35 rules apply to a contract and where they do the intermediary must deduct and pay tax and NICs equivalent to an employee.
- 6.7 From 6<sup>th</sup> April 2017, the duty to assess the employment status and whether IR35 applies passed to the public sector body.
- 6.8 The employment test considers how the contract operates on a day-to-day basis and the working relationship between the engager and the contractor; as such it is an on-going duty. This means that where the nature of the work changes it will be necessary to complete an additional employment status check to identify whether the new duties given to the worker by the engager have changed the employment status.
- 6.9 Contracts that fall under the revised regulations do not mean that the individual has employment rights for other purposes e.g. holiday pay etc and does not create any new pension obligations for the individual therefore pension auto-enrolment obligations will remain with the intermediary.
- 6.10 To support the legislative changes and assist in identifying the employment status for tax and NICs purposes, the Government has produced an online Employment Status Service that asks a series of questions about the working relationship between the worker and the engager.

## **7. Implications of IR35 changes**

- 7.1 It is to be noted that where an off-payroll worker has already been assessing their engagement with the public sector as in scope of IR35 the revised rules should not ultimately result in an increase in the tax and NICs payable.
- 7.2 Workers that have not treated income from public sector engagements as in scope will see a decrease in what they receive where the engagement is assessed as in scope for IR35 due to the deduction of employee rate tax and NICs contributions that will be due.

7.3 Furthermore, contractors operating in the public sector will experience a reduction in take-home pay as a result of the withdrawal of the current 5% notional tax-free allowance.

7.4 These impacts on workers' income pose the risk that contractors might attempt to increase day rates. The Council's starting position is that it will not consider an increase in rates, but it is considering this from a workforce planning perspective to ensure that the Council has staff with the right skills to progress the work. The Council has also been working to ensure effective knowledge transfer processes are an essential part of the off payroll contracts it operates.

**7.5 Risk/considerations**

The following table summarises the risks and issues that the Council is considering.

Possible risk areas	Risks	Mitigations and issues for consideration
Off Payroll workers may leave	<ul style="list-style-type: none"> <li>• New IR35 obligations only apply to the public sector therefore highly experienced or specialist contractors may decide to choose private sector engagements;</li> <li>• Social workers - Although the London Councils Memorandum of Understanding (MOU) regarding Children's social worker day rates is likely to assist in keeping rates consistent across the Boroughs it is recognised that there may still be a drive to increase the collectively agreed rates and it is understood that some Boroughs are no longer signed up to the MOU;</li> <li>• Finance - The Council is required to have adequate financial cover at all times, some roles in Finance remain covered by interims and we are approaching year end;</li> <li>• Regeneration and legal roles - Income generating, regeneration projects depend on having skilled planners, surveyors etc and the Council is competing with the private sector for skilled planners;</li> <li>• Lawyers leaving could present a risk of complying with statutory duties in</li> </ul>	<ul style="list-style-type: none"> <li>• The Council continues to reduce reliance on off payroll workers and numbers have steadily declined over the past 12 months (there has been a 153 overall reduction);</li> <li>• HR has been liaising with the agencies to confirm which workers are engaged via PSCs to identify the scale of the issue;</li> <li>• Attempts are being made to fill roles permanently or via fixed term contracts;</li> <li>• The MOU and the limited options for social workers to move to the private sector assists in suppressing the risk related to social workers.</li> </ul> <p><b>Risk Level – MODERATE/HIGH</b></p> <ul style="list-style-type: none"> <li>• Assessed as moderate/high due to timing – year end and IR35 changes will coincide.</li> </ul>

Possible risk areas	Risks	Mitigations and issues for consideration
	relation to children and adults.	
Maintained schools	<ul style="list-style-type: none"> <li>Where the Council runs school payroll it will have to add any workers engaged directly by the Schools onto its system to ensure that necessary deductions occur at source;</li> <li>The Council may also bear the risk as the employer if HMRC view a maintained school to have erroneously assessed an engagement as out of scope.</li> </ul>	<ul style="list-style-type: none"> <li>HR have had informed Secondary and Primary Heads of the implications of the changes. Meetings are also planned with the School Business Managers;</li> <li>HR and SSC (HR) develop a process to address the nuances of workers engaged by maintained schools.</li> </ul> <p><b>Risk Level – MODERATE / HIGH</b> Assessed as MODERATE / HIGH as we will require the schools to provide this information in a timely manner to ensure payments can be made.</p>
Financial risks - incorrectly assessing engagements as out of scope	<ul style="list-style-type: none"> <li>Penalties include repaying HMRC the tax and NICs due, and a fine ranging between 30% to 70% of the value of the tax due and the reputational damage.</li> </ul>	<ul style="list-style-type: none"> <li>Implement a process that will allow managers to receive a determination on whether an engagement is in/out of scope.</li> </ul> <p><b>Risk Level – MODERATE</b> Assessed as MODERATE as an independent process should provide consistency in outcomes; and minimise risk of errors occurring. The risk is assessed as moderate as the process still depends on engaging managers accurately describing the activities given to the worker and remembering that it is an on-going duty that needs reassessing if there are changes to the engagement.</p>
Reputational	<ul style="list-style-type: none"> <li>The Council's reputation will be at risk if we are seen not to be complying with the spirit as well as the detail of the new regulations.</li> </ul>	<ul style="list-style-type: none"> <li>HR has provided a briefing in response summarising the steps that it is taking;</li> <li>An agreed Corporate response</li> </ul>

Possible risk areas	Risks	Mitigations and issues for consideration
		<p>will provide necessary clarity.</p> <p><b>Risk Level – LOW</b> Assessed as LOW because new processes should ensure that widespread increases in rates is avoided.</p>
<p>Converting workers to permanent/Fixed Term Contracts (FTC)</p>	<ul style="list-style-type: none"> <li>• Workers who convert will accrue employment rights e.g. same redundancy rights as a permanent employee after 2 years;</li> <li>• May impact on the MTFS headcount reduction as worker may become permanent on attaining four years' service;</li> <li>• Temp to perm agency fees may be payable;</li> <li>• May lead to increased pressure on budgets if FTC rates increase;</li> <li>• Will increase Council's Apprenticeship Levy bill as workers convert to permanent roles;</li> <li>• Potential equal pay claims if worker(s) treated more favourably while performing 'like work' – particularly relevant as some workers are indistinguishable from employees (i.e. part/parcel of the Council).</li> </ul>	<ul style="list-style-type: none"> <li>• HR is liaising with agencies to ensure that there will not be any temp/perm charges;</li> <li>• FTCs really be used to fill temporary gaps, e.g. for project work, maternity cover or while Council waits to fill permanently.</li> </ul> <p><b>Risk Level – LOW/MODERATE</b> Assessed as LOW/MODERATE as the majority of workers come via Hays which has confirmed there are no charges.</p> <p>Priority Boards can provide challenge on rates. FTCs can be carefully managed with managers reminded to diarise when FTC could attain permanent status and assess in advance of this date whether or not keeping them on a FTC past this date is objectively justified.</p> <p>No funding has been set aside in the MTFS to accommodate the increase in Apprenticeship levy.</p>
<p>Request to increase worker day rates</p>	<ul style="list-style-type: none"> <li>• Difficult to map as it varies depending on how in demand skills are within the sector and/or how critical the role is to the Council;</li> <li>• Needs to be considered in light of the above information on Finance/Regeneration.</li> </ul>	<ul style="list-style-type: none"> <li>• Hold position adopted by London Council's Heads of HR network and create a panel that considers increases on a case-by-case basis</li> </ul> <p><b>Risk Level – LOW</b> Assessed as LOW as London wide agreement to not increase mark ups places the Council in a</p>

Possible risk areas	Risks	Mitigations and issues for consideration
		stronger position to resist the increases.
Increase in agency mark up rates (incl passing on Secondary NICs and apprenticeship levy)	<ul style="list-style-type: none"> <li>Agencies may attempt to pass on the costs they are incurring in implementing the changes leading to increases on mark up rates.</li> </ul>	<ul style="list-style-type: none"> <li>Hold position adopted by London Council's HofHR network and not increase mark up rates.</li> </ul> <p><b>Risk Level – LOW</b> Assessed as LOW as London wide agreement to not increase mark ups places the Council in a stronger position to resist the increases.</p>
HMRC's right to retrospectively assess IR35 compliance	<ul style="list-style-type: none"> <li>HMRC could later deem an engagement as 'in scope'.</li> </ul>	<p>Council considered 3 options</p> <ol style="list-style-type: none"> <li>Set aside a contingency fund to cover off-payroll worker NIC and tax payments to cover the situations where HMRC later views the Council erroneously assesses the engagement as not in scope - no funding has been set aside in the MTFS to accommodate this;</li> <li>Consider <i>all</i> off-payroll worker engagements as in scope for IR35. The consequences is that engagements could attract an uplift and be more expensive, also engagements that should have been out of scope will be captured;</li> <li>Create an independent process to assess IR35 status. This can be achieved via use of the Shared Service Centre and use of an independent panel that would consider any request for an increase in day or mark up rates.</li> </ol> <p>The Council adopted option 'c'.</p> <p><b>Risk Level – LOW</b> Assessed as LOW as the Council is formalising processes to</p>

Possible risk areas	Risks	Mitigations and issues for consideration
		address its new responsibilities stemming from IR35.
Duty to collate and provide employment status test information to agencies	<ul style="list-style-type: none"> <li>Duty on public sector bodies to assess the employment status of the worker and pass this information onto the agency who is then responsible for deducting and paying tax and NICs where an engagement is in scope of the IR35 rules;</li> <li>If the public sector body has not informed the agency whether the IR35 rules apply, then the agency can make a written request for the information and the public body must respond within 31 days of the date of receipt of the request;</li> <li>The agency can also make a written request for the engager's reasons for deciding whether or not the IR35 rules apply, and if so the same 31-day deadline for a response applies.</li> </ul>	<p>HR &amp; SSC (HR) are finalising a process that will address these new rules and provide assurance of the Council's compliance with the new duties.</p> <p>This will include retaining where relevant Off-Payroll Worker records detailing for example, when the worker was engaged and when the individual leaves; copies of any P45s for the worker or relevant record confirming the worker's tax status; and a copy/record of the completed Employment Status Check for the relevant worker.</p> <p><b>Risk Level – LOW</b> As above this is assessed as LOW as the Council is formalising processes to address its new responsibilities stemming from IR35.</p>

## 8. Government consultation on IR35

### 8.1 Consultation

8.1.1 The Government initially ran consultation from 26<sup>th</sup> May 2016 and closed on 18<sup>th</sup> August 2016. As stated above, the final rules are that:

- The public sector, agency or third party engaging off-payroll workers will be responsible for checking the employment status;
- The public sector or agency will be responsible for deducting and paying associated employment taxes and National Insurance Contributions (NICs) to HMRC;
- The 5% allowance will be removed for off-payroll workers in the public sector; and
- Public sector bodies will be required to provide information to agencies and workers about whether an engagements is within IR35.

8.1.2 Current concerns have been raised regarding the planned legislative changes. IPSE (the Association of Independent Professionals and the Self-Employed) has commented that the changes are 'worrying' as it will deter contractors from working in the public sector. It also commented that the public bodies will be less likely to "risk" engaging

contractors due to the hurdles with IR35, a view which is echoed by the online publication 'Contractor UK', which believes that the 'public sector could lose almost 10,000 of its most skilled digital workers from April 2017'.

- 8.1.3 London Councils Heads of HR network sought to identify a list of key roles supplied by agencies or delivered by consultants that are likely to fall within IR35 rules. The network has suggested it expects 95% of the roles to be within the rules.
- 8.1.4 The Local Government Association raised concerns that the planned changes are only targeted on the public sector and how it may potentially increase costs. Other comments received during the consultation stated that whilst it was agreed that there is an issue with the levels of compliance with the current rules another option would be to create a new tax status for freelancers. Some agencies who responded to the consultation stated that they do not operate payrolls or have the expertise or software to calculate, deduct and pay employment taxes, which will result in them incurring costs. The Government responded to the initial comments by stating that it is aware that this will place new responsibilities on engagers and agencies, and that they have until April 2017 to prepare.
- 8.1.5 The Government reopened consultation to allow the sector and agencies to respond to the amendments listed at 8.1.1 above. This closed on 1<sup>st</sup> February 2017.

## **8.2 Implementation date**

- 8.2.1 Although the legislative changes came into effect on 6<sup>th</sup> April 2017, as it covers payments made on this date, it included contracts made before this date, for example, if the work was completed before 6<sup>th</sup> April 2017 but payment was made on or after this date then the engagement falls within the revised legislation.

## **9. Contribution to strategic outcomes**

- 9.1 The proposed legislation will impact on the Council at a time when it is receiving less funding from Central Government, it will therefore be essential for the Council to have a robust and strategic approach to workforce planning to ensure it has the right people with the right skills.
- 9.2 Although, the focus of the Workforce Plan is to continue to attract and retain the skills and talent to deliver the Corporate Plan, the levers available to expedite change may no longer have the same impact and at the pace required in light of other legislative changes affecting the public sector.
- 9.3 The IR35 changes must be considered against the backdrop of the public sector cap on exit payments, and the requirement to repay an exit payment for employees who earned £80,000 or over, which both are expected to come into effective in 2017.

## **10. Statutory Officers comments (Chief Finance Officer (including procurement), Assistant Director of Corporate Governance, Equalities**

### **10.1 Chief Finance Officer comments**

- 10.1.1 This report highlights a number of key financial risks in relation to the changes to the IR35 rules implemented by the Finance Act 2017.



- 10.1.2 The use of agency workers broadly falls into three categories: to fill permanent establishment posts, to temporarily provide supernumerary establishment posts or to provide supernumerary posts either because specialist skills are required or there needs to be capacity for project-based work.
- 10.1.3 The use of the new HMRC tool has broadly indicated that the first two categories fall within the scope of IR35 and this has applied to a vast number of the agency workers supplied to Haringey. A significant proportion of these workers have previously been operating under a personal services limited company arrangement.
- 10.1.4 As a general rule moving from a personal services company invoicing arrangement will result in additional tax and NI. This is because individuals would have had other mechanisms available to them to draw down funds from the limited company e.g. dividends, which may attract lower rates of tax and/avoid employers national insurance.
- 10.1.5 As highlighted in this report, there is the risk that individuals and agencies (now responsible for the Employer's NI) would seek to pass on these additional costs Haringey.
- 10.1.6 At time of the formulation of the new Medium Term Financial Strategy (MTFS), it was indicated that Haringey would adopt a position of not accepting any increases to day rates as a result of the changes and any service based exception decisions (because of general market rate conditions) resulting in additional costs would need to be contained within service budgets. No provision was therefore made within the new MTFS.
- 10.1.7 Whilst, moving agency workers to fixed term contracts is an option, this results in the Council becoming the employer rather than the agency or consultancy and potentially additional costs such as employer pension costs. If this option is pursued then careful consideration needs to be given to the amount that is agreed to be paid under the fixed term contract and costs that the Council is committed to.
- 10.1.8 Adequate controls will also need to be in place, if not already so, to ensure that supernumerary workers converting to fixed term contracts do not result in a permanent expansion of the establishment list. This is to ensure that this does not result in increased MTFS funding pressures including additional costs associated with employees such as HR and IT support.
- 10.1.9 Those agency workers that are within scope of IR35 are subject to the Agency Worker Rules. This means that they become entitled to additional rights after 12 weeks working with the same organisation in line with certain employee rights. An example of this is a right to be paid the same holiday entitlement as an equivalent establishment post. This will usually result in an increase in the day rate paid as Haringey's holiday entitlement for staff members is higher than the statutory minimum which would be paid to the agency worker for the first 12 weeks. No provision within the MTFS has been made for this and therefore any additional costs will need to be contained within existing budgets.
- 10.1.10 To support the Council's new MTFS and the difficult financial challenges it faces, a review of the Council's financial standing orders is being undertaken which will include consideration of the implementation of limits for amounts payable to agency workers taking into account the equivalent establishment post annualised costs.

## **10.2 Assistant Director of Corporate Governance**

- 10.2.1 The current IR35 rules are contained in the Income Tax (Earnings and Pensions) Act 2003 and the Social Security Contributions (Intermediaries) Regulations 2000. The

legislative changes mentioned in the report are proposed by the Government to brought in by the Finance Act 2017 (as regards income tax) and by social security regulations ( as regards National Insurance contributions “NICs”).

- 10.2.2 The case law surrounding whether an individual is a employee for the purposes of income tax and NICs is complex. A variety of factors need to be considered. Although in the majority of cases it will be clear if an individual is an employee for these purposes, in some cases this will not be clear , where for example some factors point to employment status, and others point to the worker not being an employee for these purposes. Accordingly there will always be a risk that in a retrospective assessment HMRC will disagree with the Council’s assessment that the employee was not an employee for income tax/ NICs purposes. The Council’s assessment is not binding on HMRC. It is not clear whether HMRC would in such an assessment seek to depart from the results provided to the Council when carrying out its assessment by its online Employment Status Service .
- 10.2.3 The draft legislation envisages that if the public sector body does not respond to an agency’s written request re whether or not the IR35 rules apply to a worker’s engagement, within 31 days of receiving the request, then the duty to deduct and to pay tax and NICs in respect of the worker’s income will transfer from the agency to the Council. Accordingly it will be important to ensure such requests are responded to within that deadline. The duty to respond to an agency’s written request only applies if the Council has a contract with the agency in connection with the engagement.
- 10.2.4 It is possible that agencies who are advised by the Council that the IR35 rules do not apply to a worker’s engagement, and who rely on that advice in deciding not to deduct tax and NICs from their payments to the worker’s intermediary, may seek indemnities from the Council against the risk of a subsequent assessment by HMRC that the IR35 rules did apply to the worker’s engagement. This is particularly likely to be the case where the agency is not in a position to come to its own view regarding whether the IR35 rules apply to that engagement.
- 10.2.5 In addition to applying the employment status test, in order to decide whether a worker’s engagement falls within the IR35 rules the Council will have to consider other issues. For example, it will have to consider if the worker personally performs, or is under an obligation personally to perform, services for it. If this requirement is not met – for example because the worker has a broad genuine right to provide a substitute- then the IR35 rules will not apply. It will also need to assess whether the third party through which the worker performs services for the Council is an “intermediary” for the purpose of the IR35 rules. Where the intermediary is a company, it will be sufficient if the worker owns more than 5% of the shares in the company.

**11. Use of Appendices**  
None

**12. Local Government (Access to Information) Act 1985**  
Not applicable.