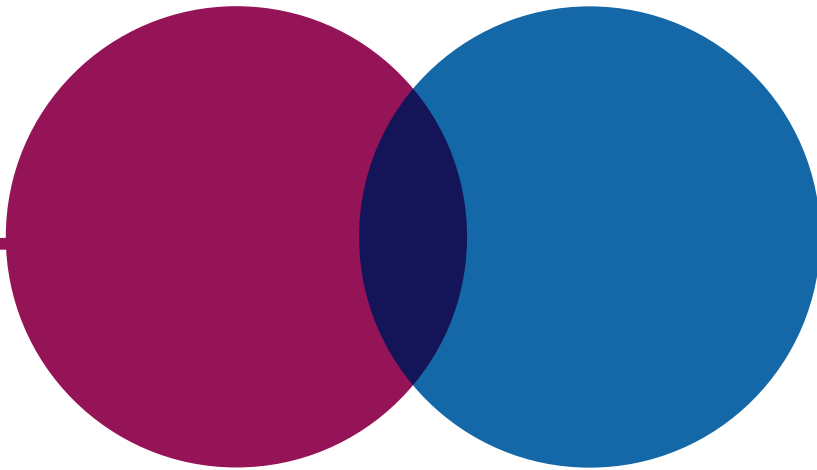




National Audit Office



Investigation into the implementation of IR35 tax reforms

HM Revenue & Customs

REPORT

**by the Comptroller
and Auditor General**

**SESSION 2021-22
10 FEBRUARY
2022 HC 1103**

What this investigation is about

- 1** This investigation examines lessons from the implementation of 2017 reforms to tax rules for off-payroll working in the public sector. The government initially introduced these rules, commonly known as 'IR35', in the Finance Act 2000. Its objective was to prevent tax avoidance by 'disguised employees' – people who do the same job in the same manner as an employee but who avoid income tax and National Insurance contributions (NICs) by providing services through an intermediary such as a personal service company (PSC).
- 2** Central to the application of the IR35 rules is the assessment of an individual's employment status for tax purposes. Assessing employment status can be complicated. There is no single statutory definition of employment, and each role must be assessed on its own merits against several factors. Before April 2017, responsibility for assessing the employment status of individuals engaged via an intermediary and ensuring that the correct tax was paid rested with the intermediary.
- 3** In April 2017, the government introduced reforms that made public bodies responsible for determining the employment tax status of all those they hired through intermediaries. The government introduced this change to increase compliance with the IR35 rules after previous changes between 2007 and 2015 had not been successful in doing so. In May 2016, HM Revenue & Customs (HMRC) estimated that only 10% of PSCs were applying the IR35 rules correctly. We previously reported on the BBC's engagement with personal service companies both before and shortly after the 2017 reforms.¹
- 4** In April 2021, the government made further reforms and extended the requirements on determining tax status to medium and large organisations in the private and third sectors. This significantly increased the number of organisations in scope of the legislation.

¹ Comptroller and Auditor General, *Investigation into the BBC's engagement with personal service companies*, Session 2017-19, HC 1677, National Audit Office, November 2018.

5 In the course of our 2021 financial audit work, we noted that several government departments and arm's-length bodies had recognised losses or provisions in their financial statements for payments to HMRC relating to IR35. This was because HMRC had determined that they were not correctly determining the tax status of off-payroll workers. Research that HMRC commissioned suggested that many public bodies may have experienced challenges in implementing the requirements but did not indicate how widespread non-compliance might be.

6 This investigation sets out how HMRC introduced the 2017 reforms, the approach it has taken since, and what lessons it has learned and taken forward when extending the reforms to the private and third sectors in 2021. Our report is in five parts, covering:

- The new IR35 requirements on public bodies from 2017.
- What HMRC did to mitigate risks it identified to compliance, public bodies and workers, including guidance and support, monitoring and adaptation.
- What impact the roll-out has had on public bodies, workers and tax revenue.
- How HMRC assesses public bodies' compliance with the IR35 rules and what it has found to date.
- How HMRC has adapted its implementation of the next phase of the roll-out based on lessons from the public sector experience.

7 This report is an investigation into how the IR35 reforms have been implemented, and we did not seek to make an overall assessment of value for money. We have not sought to evaluate the design or policy intent of the regulations, nor have we examined the processes that individual public bodies use to make status determinations.

Summary

Key findings

Managing implementation and risks

8 The government reformed the administration of IR35 rules to address widespread and longstanding non-compliance. It first introduced the IR35 rules in 2000 to correct for incentives on workers to avoid tax by providing services through PSCs. Despite these rules and later attempts to prompt compliance, HMRC found that non-compliance remained widespread and estimated that this cost the Exchequer £440 million in 2016-17. HMRC identified that the need to examine each PSC for each engagement meant it could never successfully assure overall compliance, and that this could increase incentives for non-compliance. The government therefore reformed how the rules were administered in 2017 by transferring responsibility for determining employment status from the PSC to the end client (paragraphs 1.7, 1.10, 1.11, 1.13 and 1.15).

9 The government rolled out the reforms in phases, starting with the public sector in 2017. It initially limited the 2017 reforms to the public sector. This gave HMRC the opportunity to learn lessons if the government chose to extend the reforms to the private sector. In advance of the 2017 changes, HMRC consulted publicly and engaged with public bodies, including running a series of awareness-raising events to support them with determining the tax status of their off-payroll workers. It also provided guidance and a new online tool called 'Check Employment Status for Tax' (CEST) to help users assess employment status for tax purposes in all sectors of the economy (paragraphs 1.14, 2.2 and 2.4).

10 Public bodies had little time with the new guidance and tools before the rules came into effect. The government proposed reforms in the public sector in March 2016 and announced its decision to proceed in November 2016. HMRC published its guidance in February 2017, two months before the rules came into effect. Furthermore, it made available the full version of CEST – a key tool to help public bodies determine the tax status of off-payroll workers – in March 2017, with only one month to go. HMRC research in 2018 found that a little under half of surveyed public bodies thought they had enough time to prepare, but a similar proportion did not (paragraph 2.5).

11 While most public bodies found HMRC's guidance and online tool helpful, some experienced problems using them. HMRC's 2018 research found that 78% of surveyed bodies operating centralised payroll (those administering payroll for multiple organisations) and 91% of bodies operating their own payroll considered CEST helpful. However, around half of all respondents found the reforms difficult to comply with. The most common reason given by bodies operating centralised payroll (21% of those surveyed) was difficulties using CEST. Public bodies and other stakeholders we interviewed highlighted the following examples of challenges they faced (paragraphs 2.6 to 2.8 and 2.17):

- The original version of the guidance was general in scope, and the examples it included covered roles not relevant to most public bodies (such as pilots) rather than those widely used in the public sector (such as IT specialists).
- Users found some questions in CEST difficult to interpret correctly. For example, the tool asked whether the hiring manager would “ever reject” a substitute of equivalent skill and security clearance. If they answered that they would always accept such a substitute and also that the worker had to pay the substitute, CEST determined that the worker was self-employed. However, if the recruiting organisation always had a right to reject any substitute, they should not have answered that they would always accept one even if they would in practice.
- The technical guidance on employment status was long, detailed and not integrated into CEST. This made it difficult for hiring managers to identify the relevant guidance for the particular question they needed to answer.
- CEST is not designed to produce a clear outcome in all cases as some are too marginal for a tool to determine. HMRC estimates that, between March 2017 and October 2019, the tool delivered an ‘unable to determine’ outcome in 15% of cases. Since the tool was updated in 2019, this has risen to 20%.

12 HMRC made changes in 2019 to improve its tool and guidance and to work more collaboratively with public bodies and other stakeholders. Following feedback and the results of the research it had commissioned, HMRC made several changes to its approach. It launched an updated CEST tool in November 2019, which changed some of the questions and answers that users had identified as causing difficulty. HMRC also made several updates to its technical guidance, including new information on how to use and interpret CEST and on other matters such as HMRC's compliance approach. HMRC also began working more closely with stakeholders such as central government's Tax Centre of Excellence (a forum of tax experts involving several departments). Public bodies we interviewed reported that HMRC's approach has become more collaborative over time (paragraphs 2.15 to 2.18).

Impacts of implementing the reforms

13 Following the reforms, HMRC observed an increase in tax revenues and numbers of workers deemed to be employed for tax purposes. HMRC estimates that in the first two years, at least 50,000 additional individuals were on the payroll of public bodies having previously provided services through a PSC and paid less tax. HMRC initially assessed that an additional £550 million of income tax and NICs was collected in the first year. It later estimated that, offset against taxes that workers and their PSCs would have paid otherwise, the net increase in tax revenue was £250 million, more than HMRC had previously expected (£150 million). It is difficult to identify the exact extent to which this is due to the reform itself, as opposed to other factors. Some stakeholders have also expressed concern that some public bodies incorrectly assess people as being employed for tax purposes for fear of getting it wrong. However, there is not clear evidence to indicate how far this has occurred in practice (paragraphs 3.2 to 3.4 and 3.7).

14 Some workers disputed their tax status, but they did not have a clear legal route to appeal the determinations. HMRC's 2018 research indicated that, shortly after the reforms, 46% of surveyed bodies operating centralised payroll and 31% of bodies operating their own payroll had at least one dispute with contractors or agencies regarding status assessments. In our own 2021 survey, 26% of respondents from central government said that workers had frequently or occasionally challenged status determinations. Following the reforms, workers can raise a dispute with the organisation that made the determination, but there is not a clear legal route to appeal further. If workers believe they have been taxed incorrectly, their recourse is to use HMRC's self-assessment and NIC reclaim routes. This is the same as for any worker considered an employee, but differs from the previous system whereby the worker's PSC made the determination and so the worker would have no reason to dispute it (paragraphs 3.5 and 3.6).

15 Public bodies have reported incurring additional costs and challenges in recruiting or retaining contractors. Public bodies we interviewed explained that they had dedicated a lot of ongoing resource to employment status determinations, such as full-time staff, supporting teams and review panels. They also indicated that managing disputes with contractors, and more generally engaging with them to answer queries about the reforms and changes in employment status, has taken additional time and resource. Some public bodies have also reported difficulties in finding contractors, and that fee rates have risen. HMRC's 2018 research found that 32% of bodies operating centralised payroll and 22% of bodies operating their own payroll reported increased difficulty in filling contractor vacancies after the reform. Public bodies we interviewed and surveyed provided examples of difficulties finding contractors and rates increasing, particularly in sectors where specialist skills are in demand. However, those we interviewed noted that, while they consider this is at least partly due to the IR35 reforms, it is difficult to disentangle this effect from wider labour market trends affected by COVID-19 and EU Exit. Public bodies were also competing with the private sector where, until 2021, contractors could continue to work under the previous rules. Following the private sector roll-out of the reform this incentive is likely to have reduced (paragraphs 3.8 to 3.11).

Compliance by public bodies

16 The 2020-21 financial statements of government departments and agencies include a total of £263 million paid, owed or expected to be owed in additional tax for failing to administer the reforms correctly. This includes losses recognised in 2020-21 by the Department for Work & Pensions (£87.9 million), Ministry of Justice group (£72.0 million in total), Home Office (£29.5 million), Department of Environment, Food & Rural Affairs (£19.0 million) and NHS England (£4.2 million). Three central government bodies have also recognised provisions for potential liabilities not yet confirmed (totalling £50.0 million). These figures follow a loss previously recognised by NHS Digital (£4.3 million) for failings in implementing the reforms (paragraph 4.10).

17 The financial liabilities resulted from HMRC's assessment that those departments and agencies were getting status determinations wrong. In all cases of non-compliance, HMRC found that the public body had not taken reasonable care to prevent errors, including when answering questions in CEST. However, it had not set out how it would interpret reasonable care for the new requirements when they first took effect, and no public bodies have challenged the decisions in court so there is no case law to guide the definition. HMRC has so far found that the most common errors public bodies made were wrongly considering that they would always accept a substitute when they had a right to reject one, and overestimating the extent of financial risk that contractors bore. On substitution, for example, HMRC found that departments had failed to ensure that hiring managers were aware that the contractual framework in place gave them a right to reject a substitute (paragraphs 4.6 to 4.8).

18 HMRC's compliance work has focused mainly on central government bodies. The reforms meant that HMRC's oversight role became focused on ensuring that public bodies determined tax status correctly, rather than pursuing individual contractors and their PSCs on a case-by-case basis. HMRC has therefore taken a risk-based approach to identify potential non-compliance and uses this to prioritise investigations. Its early work examined 16 public authorities of different types, which found that central government bodies seemed to have more difficulty complying than other parts of the public sector. Compliance checks have focused mainly on central government up to 2021 and HMRC is now examining more local bodies (paragraphs 4.2 to 4.4).

19 HMRC's current approach to correcting cases of non-compliance results in it collecting more tax in total than is due, and it does not yet have a plan to address this. To calculate the historic taxes that departments owe, HMRC estimates the amount that should have been paid at the time based on workers' deemed wages. Its approach assumes that all workers will have fully used their tax-free personal allowance on income earned elsewhere. HMRC collects the amount due in accordance with the law at that time. It does not offset the total amount against any tax the worker or their PSC already paid and told us this was not allowed within the current legislation. This means that HMRC collects more tax in total than is due. Once the non-compliant client organisation accepts that its determinations were incorrect, the workers become entitled to claim back the tax that they and their PSCs have already paid. If they do, they in effect pay no taxes on that income because these are borne in full by the non-compliant public body. However, HMRC does not actively promote this and it is unclear how many workers reclaim their taxes in practice (paragraphs 4.12 to 4.14).

Learning lessons

20 When extending the reforms to the private sector, HMRC used a dedicated programme team, focused more on awareness-raising, and made further changes that apply to all sectors. It approached the 2021 extension of the reforms differently from the 2017 roll-out, based on the experience in the public sector (paragraphs 5.4 to 5.7):

- It set up a dedicated programme team to actively manage the changes, something it did not do in 2017.
- It continued seeking to improve its guidance and how it works with stakeholders, and it focused more on educational activities to help raise awareness and understanding of the reforms. It has also allowed the private sector a one-year grace period during which companies will not have to pay penalties for mistakes unless HMRC finds evidence of deliberate non-compliance.
- It introduced further changes to the rules for all sectors to address aspects of the 2017 reforms that were not working as intended. These included measures to mitigate alternative arrangements that might be used to circumvent the IR35 rules (such as multiple workers each having a small stake in a jointly owned company) and a more formal process by which recruiting organisations were required to communicate status determinations to workers and resolve disputes.

21 HMRC may have underestimated the cost to employers of implementing the reforms. When introducing the 2021 reforms, HMRC expected new administrative burdens for the private sector to be small. This was based on what HMRC considered to be the minimum effort required for compliance and it did not consider any need to use external consultants or assessment tools. Its final estimates in 2020 were that ongoing costs would be £8.4 million a year in total, smaller than the costs saved by PSCs no longer having to make determinations (£8.7 million). HMRC also assumed that resource requirements would diminish with time. However, emerging good practice in the public sector suggests that significant investment may be needed in contracting organisations to set up dedicated staff, independent review structures and formal approval at senior levels. Public bodies we interviewed explained that in some cases a lot of staff time had to be put into administration and ongoing compliance work (paragraphs 5.8 to 5.10).

22 Despite improvements HMRC has made to its guidance and tools, public bodies and other stakeholders told us it could go further to support implementation. Public bodies that answered our survey gave mixed views on the CEST tool and guidance. Most found it useful and some welcomed the improvements that have been made since it was first launched. HMRC's research also indicates that the proportion of organisations finding CEST helpful has increased since 2017. However, based on our survey and interviews with public bodies and other stakeholders, there are opportunities for HMRC to continue refining its guidance and CEST. This includes making the tool easier to use accurately (for example, by making relevant parts of the guidance more accessible within each question), ensuring the questions used in CEST's weightings genuinely relate to the role assessed, and providing more clarity on what good implementation looks like (paragraphs 2.16 and 5.11).

23 Inherent differences between the public and private sectors mean that HMRC faces new and challenging risks with the wider implementation of IR35 reforms. Stakeholders have identified several challenges for the private sector roll-out (paragraphs 5.12 to 5.14). For example:

- Labour markets in the private and third sectors are larger – HMRC estimates that the 2021 extension of the reforms will affect around 180,000 PSCs, almost four times the number affected by the 2017 reforms. This creates a bigger challenge for HMRC to identify and monitor risks of non-compliance.
- Complex supply chains are also more common, such as those that cross international borders or involve overseas workers. This may mean a greater risk of companies making errors when determining tax status, or of knock-on effects resulting in workers changing careers or business moving overseas.
- There is uncertainty over HMRC's approach to non-compliance in the private sector. HMRC has published its compliance approach for the 2021 reforms and established a framework for penalties. However, its assessments and penalties have not yet been tested because it has so far only found central government bodies to be non-compliant, none of which have challenged it in court.

Concluding remarks

24 Rolling out the IR35 reforms to the public sector first has meant an opportunity for HMRC to learn lessons and adapt its approach. The 2017 reforms have achieved their primary purpose of reducing non-compliance and therefore increasing tax revenue. However, the public sector faced challenges with the initial roll-out: public bodies had little time to prepare; some found it difficult to use the original guidance and tool that HMRC had provided; and there was a limited understanding on all sides of how much time and resource were needed to get it right. As a result, it was highly likely that some public bodies would make mistakes.

25 By changing its approach, both in the public sector and when extending the reforms to the private and third sectors, HMRC appears to have learned several key lessons and addressed some of the more significant difficulties, including enabling more support and time for the transition. Questions remain about the system for addressing incorrect determinations, with routes of appeal untested and tax burdens in cases of non-compliance likely to fall on employers. There are also differences between the public and private sectors that increase the inherent challenges. HMRC faces new risks that will make it harder to identify, monitor and address non-compliance, including larger and more complex labour markets in the private sector. HMRC will need to manage these risks if it is to ensure the reforms are successful.

Recommendations

26 There are opportunities for HMRC to continue to improve the customer experience and compliance. It should:

- a Further develop the CEST tool and accompanying guidance to make it as easy as possible to use accurately.** This includes:
 - taking a structured approach to analysing sources of mistakes and user feedback to improve the questions and limit the scope for misinterpretation;
 - embedding or linking to relevant parts of the detailed guidance within each question to make it easier for users to understand the questions and identify the relevant guidance; and
 - ensuring there is a clear and efficient process for users to follow when CEST cannot provide a determination, including from HMRC's own helpline.
- b Assess the usefulness of CEST to different sectors.** Stakeholders report that questions used in CEST's weightings are not equally relevant for all roles and sectors. HMRC should monitor and evaluate the accuracy and usability of CEST for engagements in different sectors. It should identify where there may be more risk of non-compliance, and whether more tailored guidance and support may be needed.

- c Identify and set out case examples of good implementation to promote compliance by helping organisations get determinations and tax deductions right first time.** To do this, HMRC should work with stakeholders such as the Tax Centre of Excellence, the Government Internal Audit Agency, and tax and payroll experts. For example, public bodies and other stakeholders told us they would welcome more clarity and case examples on:
- good practice in training staff to understand and administer the rules;
 - ways to link together different parts of the business to ensure the right information is used when determining employment status; and
 - ways to work with others in the supply chain to ensure tax deductions are calculated correctly when workers are deemed to be employed.
- d Update its estimate of compliance costs to hiring organisations based on actual experience, to help all parties understand the scale of activity needed and how HMRC can best support implementation.** Emerging good practice and HMRC's compliance work suggest that significant investment may be needed – for example, in dedicated staff and independent review structures. HMRC needs to send a clear signal to hiring organisations about the level of resources and administration needed to be compliant. It should reassess and communicate the resources and processes required in practice to reliably ensure compliance on an ongoing basis rather than minimum implementation costs.
- e Develop a more effective and efficient system to ensure HMRC accurately collects the total taxes due from workers and hiring organisations when errors have been made.** This covers situations both where HMRC has found an organisation to be non-compliant and where workers have appealed an incorrect determination. The current arrangements for cases of non-compliance involve HMRC collecting the estimated full amount owed from deemed employers and leaving it to workers to reclaim taxes already paid. HMRC should:
- consider how it can efficiently and effectively ensure that it collects the correct taxes due in total; and
 - explore how it can better estimate the amount due from client bodies for workers incorrectly assessed as self-employed. HMRC should test its assumption that all workers will have used their tax-free personal allowance on income earned elsewhere. It should consider how it can collect better data on the contractors affected and whether it would be appropriate to use whole population data to make estimates where there is a large number of workers.

f Build on its improved collaboration with stakeholders to enable constructive discussions and pre-empt challenges in the public and private sectors.

This could involve further working with:

- representatives of specific sectors to develop sector- or role-specific guidance and examples based on an analysis of where this would be most helpful; and
- private sector stakeholders on the risks and challenges they face to understand what impacts the reforms may have on complex supply chains, particularly in essential or high-risk areas.