Chapter 10 off-payroll working and contractual headaches for clients/other engagers

David Yates QC, Pump Court Tax Chambers

Tax and HR departments are no doubt rapidly familiarising themselves with the overall scheme of the revised Chapter 10 of Part 2 of Income Tax Earnings and Pensions Act 2003 (**"ITEPA 2003"**) which will be extended to "medium" and "large" persons who are "clients" and their labour chains, with effect from April 2021.

Prior to the modified Chapter 10 regime coming into force, outside of the public sector, every worker who supplied their services through an intermediary (typically a company) had to consider whether Chapter 8 of Part 2 of ITEPA 2003, more frequently known as "IR35", applied to them. The test was whether the worker was what might be termed a quasi-employee under the test imposed by s.49(1)(c) of ITEPA 2003, namely:

> "If the services were provided under a contract directly between the client and the worker would be regarded for income tax purposes as an employee of the client or the holder of an office under the client"

This test is replicated in Chapter 10 under s.61M(d) which, with effect from April 2021, will be applied in the private sector unless the engager is characterised as "small". HMRC have met with mixed success in recent cases concerning the application of this test; see for example their recent successes in *HMRC v Kickabout Productions Ltd* [2020] UKUT 216 (TCC) and the Eamon Holmes case, *Red, White and Green Ltd v HMRC* [2020] 2020] UKFTT 109 (TC) together their failure in the Lorraine Kelly case, *Albatel Ltd v HMR*C [2019] UKFTT 195 (TC). Given the fact specific nature of the test, there remains significant uncertainty as to how it will be applied in the myriad forms in which commercial life takes place.

The new legislation in Chapter 10 aims to do two things:

(1) To place on the ultimate client the burden of determining whether any worker who performs services to them (regardless of the chain of intermediaries) would fall within the scope of "quasi-employment" – i.e. to prevent this being "self-policed" by the worker. This is the "status determination statement" (**"SDS"**) system under s.61NA;

(2) To place the associated PAYE[1] and NIC payment and collection burden either (depending on the length of the payment chain) on the client or (if different) the person (known as the **"fee-payer"**) in the payment chain immediately above the entity (referred to as the **"intermediary"**) which pays or is obliged to pay the worker or in which the worker has a material interest; see s.61N.

No name is given in the legislation for a person in the chain between a client and an intermediary – for ease of clarity they will be referred to as **"middle chain member"**.

The aim of this article is not to go through these rules in detail – there are many detailed commentaries elsewhere. Rather I hope to focus on some discrete issues where, humour me, I suggest that matters may not operate as smoothly as HMRC envisage. In particular, it is worth considering areas of potential dispute between contracting parties which (unsurprisingly) will not have been a focus for HMRC.

The actual effect of a Status Determination Statement

Before turning to areas of potential dispute, it is important to remember that the substantive tests in s.61M must be met before Chapter 10 applies. An SDS is a bit of a misnomer since it does not determine, as a matter of law, whether the conditions in s.61M are met, rather its strict effect is to determine whose responsibility it is to account for PAYE and NICs **if** the legislation applies, in particular:

(1) By issuing an SDS, a client avoids PAYE and NIC obligations unless there is no one in the chain between it and the intermediary.
(2) A middle chain member passing on an SDS to another middle chain member, passes the responsibility of being the fee-payer.

However, as a matter of practicality (and one assumes this is very much HMRC's hope) if an SDS is issued which does state that s.61M(1)(d) is met, all parties in the chain (other than the intermediary and worker) are likely to proceed as if this is the final word in the matter.

One other point to bear in mind is that a negative SDS (i.e. one that concludes that s.61M(1)(d) is not met), if issued with reasonable care, absolves the client of responsibility for PAYE and NIC. However, it does not absolve the fee-payer if in fact Chapter 10 does apply.

[1] This potentially will also include Apprenticeship Levy at 0.5% as well.

Consequently, fee-payers may, if they are concerned with the correctness of a negative SDS, decide to deduct PAYE and NIC in any event.

What the legislation authorises in terms of deductions (and what is does not)

Section 61S provides that if the person who is treated as making a deemed direct payment is required under the PAYE Regs to pay an amount to HMRC, they may deduct an amount which is equal to the amount payable to HMRC.

Equally, if for some reason, a deduction has been made earlier in the chain, anyone who is a middle chain member may also make a similar deduction from a chain payment made by them (i.e. they will not pay anything to HMRC but they will not be out of pocket in making up the shortfall to the next person in the chain).

Note that the legislation only authorises deductions if Chapter 10 actually applies, not for example if merely an SDS has been issued. To avoid, disputes with other members of the chain, one should ensure that a contract permits deductions in, for example, the following scenarios:

(1) If Chapter 10 applies;
(2) If an SDS is issued by the client which determines that Chapter 10 applies;
(3) If the payer otherwise reasonably concludes that Chapter 10 applies (i.e. notwithstanding a negative SDS from the client).

Whilst point (1) already applies by virtue of s.61S, if the contract is governed other than by the law of one of the countries of the United Kingdom, it would be prudent to provide for this to avoid difficulties as to whether a contract governed by foreign law would recognise a right to deduct.

Even where the above precautions are taken, it will be important that the right amount of PAYE and NIC is in fact deducted. This will depend on whether the worker is issued with a starter checklist and returns it with declaration C completed (as would be expected on the basis of the worker's real other employment with the intermediary). If so, only a BR PAYE code should be applied, otherwise an 0T code will apply. Any overzealous deduction of PAYE will unlikely be permitted under any contractual arrangements.

Provision for recovery of tax/NIC where Chapter 10 is ultimately shown not to apply

As discussed above, an intermediary/worker is not obliged to accept an SDS which determines them to be a quasi-employee in respect of their own tax affairs with HMRC.

Let us assume the following:

(1) Withholding of PAYE and NIC has been carried out by the fee-payer in line with the SDS received by the client;
(2) The worker argues that they are not in fact a quasi-employee.

Absent any specific contractual wording, who should the intermediary/worker raise the issue with and recover from? Well if Chapter 10 did not apply, section 61S would not provide any basis for a deduction. Accordingly, it would be open to the intermediary/worker in any private law claim against the fee-payer:

(a) To contest the substantive issue of whether Chapter 10 applies; and
(b) To recover, if successful on the substantive issue, wrongly deducted PAYE and primary NIC.

This would then leave the fee-payer with seeking to reclaim overpaid PAYE, NIC (both primary and secondary) and Apprenticeship Levy from HMRC (with the potential risk that HMRC might dispute the conclusion reached in the private law claim). This shows the importance of shutting off a private law claim in any contractual wording.

Assuming that the contract permits deductions in line with the SDS (as suggested above, i.e. regardless of whether Chapter 10 did in fact apply):

(1) The worker would still be entitled to engage in any client-led status disagreement process under s.61T (if in time to do so).
(2) However if this process were exhausted unsuccessfully, if the worker still wished to persist, they would be forced to contest the issue with HMRC by submitting a claim under Schedule 1AB of Taxes Management Act 1970[2] for income tax and a claim under regulation 52 of the Social Security (Contributions) Regulations 2001 for NIC.

[2] If no self-assessment has been filed, this would need to be done instead; see s.711 of ITEPA 2003

I'm Spartacus…

Identifying the client is the key to applying Chapter 10 since it is only the client that can issue an SDS and identifying the client is required in order to ascertain the "chain" in s.61N (above which Chapter 10 will not apply). The "client" is identified in s.61M(1)(a) as the person for whom the worker "personally performs, or is under an obligation personally to perform, services". This may be clear in many instances. However, as HMRC's manual at ESM10010 acknowledges, this can be trickier to apply in the context of contracted-out services.

There is no easy test to apply to resolve these issues; rather it is more useful at this stage to consider what to do if two potential clients both consider that they are the client and/or issue SDSs as a precaution.

The situation is perfectly plausible given the incentives for "potential clients" to issue SDSs to avoid being liable for any PAYE and NICS themselves. As discussed above unless an SDS is issued, the client (whoever they may be) is automatically treated as the fee-payer, so one can certainly envisage persons at risk of being clients issuing SDSs just for good measure. The headache for everyone further down the chain is having two sets of SDSs which reach different conclusions. Which SDS is the person further down the chain supposed to follow (particularly if they are a "fee-payer" if Chapter 10 applies)?

It is worth noting that both the worker and the "deemed employer" (i.e. the fee-payer) are entitled to initiate the "client-led status disagreement process" in s.61T. In my view a complaint that the purported client is not in fact the client should be considered and responded to in this process.

However, let us assume that each client sticks to their original position in the respective SDS. It is worth noting neither the fee-payer nor the intermediary/worker are *obliged* to follow the SDS. However, prudence will inevitably dictate that the fee-payer will deduct and then leave it to the intermediary/worker to contest the matter with HMRC. Again, care will be needed from a contractual position to ensure that this is possible.

Employer's NIC and Apprenticeship Levy

It is a cardinal feature of UK NIC legislation that an employer cannot recover secondary NIC (employer's NIC) from an employee save where there is an agreement concerning restricted

securities or where liability arises from retrospective legislation; see paragraph 3A of Schedule 1 to the Social Security Contributions and Benefits Act 1992.

The prohibition is as follows:

> (a) make, from earnings paid by him, any deduction in respect of any such contributions for which he or any other person is or has been liable;
> (b) otherwise recover any such contributions (directly or indirectly) from any person who is or has been a relevant earner; or
> (c) enter into any agreement with any person for the making of any such deduction or otherwise for the purpose of so recovering any such contributions.

The same prohibition exists for Apprenticeship Levy in s.109 of Finance Act 2016.

Employer's NIC and Apprenticeship Levy are generally therefore an irrecoverable cost on the "employer" and at 13.8% and 0.5% combined this is not insubstantial.

Does this prohibition apply in the context of Chapter 10? The answer is very likely "yes" and it is difficult to see how this prohibition could be circumvented by a person deemed to be an employer by Chapter 10.

First, the NIC analogue to s.61R (which provides that the Income Tax Acts generally apply as if the deemed direct payment was taxable earnings for the purposes of ITEPA) is found in regulation 14 of the Social Security Contributions (Intermediaries) Regulations 2000 (SI 2000/727)[3]. These will provide that the fee-payer is treated as making a payment which is treated as payment of earnings for NIC purposes and hence for Apprenticeship Levy as well.

Given that these are "deemed earnings" which are treated as paid at the same time as the chain payment (as opposed to the chain payment itself being treated as earnings) there is a technical argument that a deduction of employers' NIC from the chain payment (which goes to the intermediary) does not constitute a deduction from any deemed earnings treated as paid to the worker. However, even if one could bypass prohibition (a) above using this argument, there are still difficulties with conditions (b) and (c).

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[3] These have not in fact been amended yet to take into account the new Chapter 10 but draft regulations have been published:
https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/859845/_Draft__The_Social_Security_Contributions__Intermediaries___Miscellaneous_Amendments__Regulations_2020.pdf

A court or tribunal would likely find that these are infringed due to the fact that:

(i) a deduction or right of compensation as against the intermediary will constitute an indirect recovery from the worker on the grounds that (a) if the intermediary is owned by 100% by the worker, the worker is in fact suffering 100% economically regardless of how he/she is compensated and (b) regardless of the worker's interest in the intermediary, unless there is good reason think that that the worker would not ultimately bear the cost, prohibited indirect recovery will occur; and in any event

(ii) the entering into of any agreement with the intermediary to deduct or have an indemnity in respect of employer's NIC would be "for the purpose of so recovering any such contributions" on the grounds that such a person would reasonably be expected to then pass on such a cost of recovery ultimately to the worker.

The above addresses the situation where the deduction is as against an intermediary but potentially the prohibition in paragraph 3A could be invoked by those higher up the chain (i.e. in circumstances where the fee-payer is not the person immediately above the intermediary) on similar reasoning.

Accordingly, persons likely affected by Chapter 10 would be well advised to reduce the overall contractual price rather than attempt to circumvent paragraph 3A. The difficulty obviously is where all the parties concerned do not believe Chapter 10 applies (so a contractual reduction is unreasonable) but the putative fee-payer does not want the secondary NIC risk in the event that the parties' expectations are proved wrong.

Recovery from other persons in the chain

The new legislation spends much time and effort identifying which party in the chain will be liable as a deemed employer. However, HMRC are proposing to amend[4] the PAYE Regulations and NIC Regulation to allow them to issue "recovery notices" against "relevant persons".

[4] See the draft amendment regulations: https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/859727/_Draft__The_Income_Tax__PAYE___Amendment__Regulations_2020.pdf. The amendments for NIC are contained in the draft NIC Regulations mentioned in footnote 1.

A relevant person is defined in s.688AA(3) of ITEPA 2003 as a person who is not the deemed employer and is either the highest (the client) or second highest person (referred to as agency 1) in the chain at the time the deemed payment was made.

HMRC may only recover (a) if there is no realistic prospect of recovery within a reasonable period of time and (b) from the highest person in the chain (i.e. the client) if there is no realistic prospect of recovery within a reasonable period of time from the second highest person in the chain. In other words, credit risk for Chapter 10 tax debts runs up the chain from the fee-payer (deemed employer), through any middle chain members, to the client. If the client is already the deemed employer under Chapter 10, no recovery notice can be issued at all (i.e. risk does not flow down to agency 1).

A recovery notice can only be issued in a "relevant period" – this is a 24 month period beginning on either 30 days following when a reg 80/section 8 decision became final and conclusive or when an HMRC officer had sufficient information to make a regulation 80 determination but it was impractical to make a determination due to liquidation, dissolution or other incapacity.

HMRC state in their manual at that they will not recover from the client or agency 1 using recovery notices if there has simply been a genuine business failure. However, there is nothing in the draft regulations to this effect. Consequently, HMRC's appraisal of a genuine business failure can only be challenged in judicial review (which will be extremely difficult on a *Wednesbury* review test).

One suspects that there will be large disagreements over what constitutes a "genuine business failure" and clients and those immediately beneath them in a chain will wish to ensure that they are protected (so far as possible) by the contracts insofar as HMRC seek to recover from them (i.e. as distinct from any liability which potentially could arise from being fee-payers/deemed employers).

Restitution against the worker

Leaving aside any contractual provision as between members of a chain, to the extent that these prove unsatisfactory to a person who accounts for PAYE and NIC (whether as a fee-payer or pursuant to a recovery notice), it should be possible for any fee-payer (or any person who ultimately pays HMRC) to make a claim in restitution as against the worker.

This will be in respect of PAYE and primary (but not secondary) NIC pursuant to the principles set out by the Court of Appeal in *McCarthy v McCarthy & Stone Plc* [2007] EWCA Civ 664. The fact that one is dealing with a deemed employment here makes no difference since the payer is still discharging the income tax and NIC liabilities of the worker. However, any right in restitution takes subject to whatever the contractual position provides for.

Again to avoid scope for argument later on, care should be taken in the contractual documentation to preserve and/or highlight any party's restitutionary rights to the extent that they either pay or otherwise bear the economic burden of discharging the worker's liability for income tax and primary NIC. In an ideal world, this burden ought to be passed on to the worker however it is not difficult to envisage problems arising where no deductions are in fact made and then HMRC belatedly come knocking. As ever it always better to anticipate these scenarios in advance when drafting the contract.

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The views above are set out without assumption of responsibility and does not constitute legal advice. Anyone who wishes to discuss these issues further is welcome to contact me at dyates@pumptax.com or via the clerks at clerks@pumptax.com.