The Chartered Institute of Taxation

Application and Professional Skills

Human Capital Taxes

November 2022

Suggested solution

Report to Claire Swan, Head of Tax, RDJ Pharmaceuticals UK Ltd prepared by AZA LLP on 30 October 2022

1. Introduction and scope

This report was requested by RDJ Pharmaceuticals UK Ltd following the receipt of a letter from HMRC about the Off-Payroll working rules that were introduced from 6 April 2021.

It covers our recommendations on responding to the letter, the potential impact on Peter Wong and options going forward.

In preparing this report, we have relied on the information contained in an email from Claire Swan dated 29 October 2022 and the attachments thereto.

This report is based on the law as at 30 October 2022.

This report is prepared for RDJ Pharmaceuticals UK Ltd ('the company') and no other person or entity may rely on it without our prior consent.

2. Executive Summary

Based on the information provided by the company in HMRC's Check of Employment Status Tool 'CEST' it would appear that Peter Wong's historical employment status is unclear. However, when you factor in the additional information provided which is not reflected in the original CEST this will help to indicate self-employment. We would expect that if you rerun the CEST including this additional information this will indicate self-employment and we would recommend you should do this and respond to HMRC on the basis that no action is required for the past. We would be happy to meet with Peter to gather additional information for this and draft an appropriate response on your behalf.

As employment status can be subjective there is a risk HMRC will not accept this position and as requested we have calculated a worst case scenario outcome in section 4. This confirms a potential liability of £52,697 for 2021/22 and £42,563 for 2022/23 up to the end of October 2022.

Under current laws, it is not possible to offset taxes paid by Peter and his PSC against the company's PAYE and NICs liabilities. However, in the worst case scenario Peter and his company would be in a position to reduce tax payments or receive refunds and we would recommend you discuss this with Peter with a view to mandating these to RDJ Pharmaceuticals UK Ltd.

We would also recommend you undertake an analysis of the position in relation to any other contractors.

Given the new and extended duties and the covering of Jane's duties which are proposed for Peter from November 2022, we are of the view that Peter's relationship will be of one akin to employment and you will need to deduct PAYE and National Insurance Contributions on payments made to him going forward.

You should discuss options with Peter. These options are to maintain the current position, review the engagement to see if changes could be made to ensure it is no longer within the off-payroll working rules or employ Peter directly. There is an evaluation of the options in section 6 of the report.

Employment is our recommended option as it is simplest from an administrative point of view and it also comes with the added benefit of an increased Research and Development (R&D) tax deduction. However, this will need to be negotiated and agreed with Peter.

3. Dealing with the HMRC letter

New rules called 'Off-payroll working' rules were introduced to medium and large sized businesses from 6 April 2021.

A corporate entity will be medium or large-sized if it meets at least two of the following criteria for two consecutive financial years:

- turnover of more than £10.2 million
- a balance sheet total (assets) of more than £5.1 million
- an average of more than 50 employees

It is important to note where a UK company is part of a worldwide group, the criteria must be assessed for the group as a whole.

Whilst RDJ Pharmaceuticals UK Ltd alone would be regarded as 'small' the inclusion of turnover and employee data of RDJ Pharmaceuticals Inc means that it is a medium or large sized business.

Under the rules, RDJ Pharmaceuticals UK Ltd is required to:

1. Identify any workers it contracts with via a third party
2. Issue a Status Determination Statement (SDS) to the third party and the worker and take reasonable care in completing it
3. Establish a client-led status disagreement process
4. Deduct Income Tax under Pay As You Earn (PAYE), National Insurance Contributions (NICs) and pay the apprenticeship levy on any deemed employment income to HMRC

Failure to issue the SDS results in the engaging company being responsible for the deduction of tax and NICs and the payment of the apprenticeship levy.

In applying the above to Peter:

1. Peter contracts with RDJ Pharmaceuticals UK Ltd through a third party (his company)
2. RDJ Pharmaceuticals UK Ltd has not issued a SDS to Peter or his company since 6 April 2021
3. RDJ Pharmaceuticals UK Ltd has recently undertaken an employment status check based on its view of the facts of the arrangement but the output is undetermined.

HMRC may argue the company is liable for tax and NICs from 6 April 2021 as no SDS was issued to Peter. We recommend that you review and provide all of Peter's facts to HMRC. HMRC may accept the rules should not apply to the arrangements to date. If HMRC does not accept this, there are consequences to deal with and these are set out further below.

Whilst HMRC's CEST tool is reasonably comprehensive, it may be the case that other factors will need to be reviewed given it did not conclude on Peter's role. Individuals can make mistakes or make incorrect assumptions in providing answers. A change to one of the answers such as the question on exclusivity that Peter raised in his email can lead to an output of deemed employment. Cumulative changes can also lead to a change in outcome.

Here is a summary table of Peter's position to help you identify the areas of consideration.

Mutuality of obligation	HMRC does not accept that a lack of mutuality of obligation indicates there is self-employment

Right of control	From the answers given in CEST Peter seems to have a high degree of control over what he does. For example, he can choose when and where he works. This is helpful.
Provision of own equipment	Peter mentions that he maintains his own specialised equipment. This is a clear indicator that he is in business on his own right and doesn't seem to have been reflected in your CEST input. However, this will not be the case going forward.
Right of substitution and engagement of helpers	Peter has not used a substitute
Financial risk	Peter's company has an insurance policy which suggests there is some risk and he does have costs of maintaining his equipment and advertising costs. Again, these factors don't seem to be reflected in the CEST tool and will not be relevant going forward.
Opportunity to profit	Peter's company provides services at a daily rate which does not give an opportunity to find efficiencies and increased profit for his company
Degree of integration	Peter appears not to have been undertaking managerial responsibilities to date. Going forwards clearly Peter will have managerial responsibilities and be involved in team development. He will also attend the Christmas parties.
Right to terminate the contract	This appears to be a rolling arrangement with both parties free to terminate. It is not a limited contract to provide a specific service. As such this could be an indicator of employment.
Number of paymasters	Peter had other clients in the past but is unlikely to going forward.

There are indicators both ways in Peter's case. However, as noted in the summary above there are indicators pointing towards self-employment which have not been included in the original CEST analysis. These additional factors should point the determination toward self-employment as they are clear indicators that Peter was in business in his own right. The CEST analysis should therefore be rerun including these additional points and we would expect that this will indicate self-employment. We would therefore recommend responding to HMRC confirming that there is no issue with the past treatment and self-employment status.

However, in light of the new proposed responsibilities from November 2022, it is our view that the degree of integration, exclusivity and pay arrangements will be sufficient to reach a conclusion that the off payroll working rules apply going forward and we have included our recommendations on how to deal with this in section 6 below.

4. Potential exposure – worst case scenario

Whilst we would recommend responding to HMRC on the basis that Peter has been self-employed in the past, you have asked us for a worst case scenario and this is outlined below.

If HMRC concludes Peter has been providing services in an employment capacity, PAYE, NICs and the apprenticeship levy should have been accounted for. Appendix 1 shows the calculation of these amounts from 6 April 2021, being a liability of £52,697 for 2021/22 and £42,563 for 2022/23 up to the end of October 2022.

Given the rules were introduced in April 2021, HMRC has announced that it should not seek to charge a penalty for errors in respect of the off-payroll working rules for the 2021/22 tax year, unless there is fraud. Nor should it use information provided under the disclosure to challenge Peter's position for earlier years although that remains a risk for Peter and his company.

Impact of worst case scenario on Peter Wong & his PSC

As highlighted above should HMRC successfully argue that Peter has been providing services as a deemed employee it will have an impact on Peter and his PSC.

It is not possible to offset taxes paid by Peter and his PSC against RD Pharmaceuticals UK Ltd's liabilities.

To the extent HMRC pursues the PAYE and NIC liability, we would recommend that Peter and his PSC amend the following:

1. Peter's income tax return for 2021/22. In that return he included employment income of £24,000 and dividend income of £70,000. It should now include employment income of £111,200 and dividend income of £0. After the credit for PAYE paid by RDJ we have estimated this results in a potential refund of £4,910. There would also be no requirement to settle his 2021/22 payment on account of £8,382. Please refer to Appendix 2 for the calculation.
2. Peter Wong Services Ltd should file a PAYE amendment to its PAYE submission for 2021/22 to reclaim the PAYE and NICs accounted for on salary paid to Peter.
3. Peter Wong Services Ltd should file an amended corporate tax return for its year ended 30 April 2022 to claim a deduction for the additional £98,700 of employment income as a consequence of this review. The estimated tax adjustment for this at 19% is £18,753. His company may also need to amend the corporation tax return for its year ended 30 April 2021.

This means that Peter and his company would be in a position to reduce tax payments or receive refunds. You would need to consider entering into an arrangement with Peter and his company to agree to mandate any such refunds received to you as he would benefit from the PAYE credit on his personal returns. Should he agree to this, it has the potential to reduce overall exposure for RDJ Pharmaceuticals UK Ltd significantly.

For 2022/23, RDJ Pharmaceuticals UK Ltd's liability for the year to date would be £42,563 (Appendix 1) but the cost of this would be mitigated by adjustments to Peter's personal and his PSC's position. Peter has not yet filed a personal income tax return or made payments on account for 2022/23. His PSC would adjust PAYE filings to reflect zero PAYE and NICs for the year to date. The company tax return for the year ended 30 April 2022 would claim an expense of deemed employment income for April 2022. We would recommend, similarly to 2021/22 above, that you discuss and agree with Peter the amount and timing of his contribution to the funding of the PAYE and NICs due.

5. Any other cases

We note you have mentioned you have contracted with others from time to time. We would recommend that you review all arrangements with contractors and complete an SDS for all workers in your supply chain and provide this information to HMRC with your response. If you did engage with workers via a relevant intermediary the failure to issue a SDS could lead to HMRC requesting PAYE, NICs and the apprenticeship levy. However, HMRC may accept retrospective SDSs where you have taken reasonable care in concluding the individuals were not providing services in an employment capacity.

6. Recommendations going forward

With the conclusion reached in section 3 that the off payroll working rules apply going forward, there is a significant administrative burden for RDJ Pharmaceuticals UK Ltd due to the requirement to apply PAYE and NICs to Peter Wong's invoiced amounts (see below). This also includes the requirement to pay employer NICs at 13.8% adding to RDJ Pharmaceuticals Ltd's costs. Peter Wong and his PSC's cash flow and net pay will also be impacted as a consequence of the application of PAYE as his company will be paid net of PAYE and NIC applied to each invoice. With the cost and complexity of complying with the new rules, it may be advisable to review the current arrangement and weigh up alternative options, these being:

1. Maintaining the current status quo and the accompanying administration of deemed employment
2. Ending the current engagement and employing Peter directly under a contract of employment
3. Reviewing current arrangements to see if there can be adjustments to it so that it does not fall within the off-payroll working rules.

In reaching a decision on each of the arrangements, and to assist with any discussions with Peter, the key issues to be weighed up are as follows:

- Administrative burdens
- Costs for RDJ Pharmaceuticals UK Ltd
- Impact on Peter's cash-flow, net income and benefits
- Tax treatment of any share options granted
- Employment rights gained
- Risk of HMRC challenge
- Any research and development (R&D) tax deduction available

We appreciate the company and Peter may have competing perspectives on the best option for each party and thus we shall evaluate below, each of the three options within this framework to assist with your discussions.

Administrative burdens

The off-payroll working rules required RDJ Pharmaceuticals UK Ltd to deduct PAYE and NICs from each invoice after VAT. Peter files PAYE, Corporation Tax, VAT and Personal Income tax returns. Should option 3 be viable, Peter's and his PSC's obligations will continue but RDJ Pharmaceuticals UK Ltd's will cease if there is no deemed employment. Under option 2, Peter will be added to the company's regular payroll and his company's filings would cease. Best option – option 2 (employment). If Peter becomes an employee, he may wish to consider closing his company to remove the administrative burden than comes with it.

Costs

The baseline is the current position where the off-payroll rules apply (option 1). Under option 2, Peter would gain additional benefits as an employee such as employer contributions to the pension plan as well as medical insurance and potentially stock options at a cost to RDJ Pharmaceuticals UK Ltd. This increase in costs is mitigated by a potentially greater corporate tax deduction for research and development costs (see below). The company would not be liable to employer NICs under option 3 which is currently due under option 1. Best option – option 3 (arrangement outside off-payroll working rules. However, this is unlikely to provide the operational need the business is looking for.)

Peter's net pay

Peter has had significant control over when he takes income from his company and therefore the timing of his tax payments. By using a PSC, he pays a lower rate of income tax and no NICs on dividend income as compared to employment income. However, his company does pay corporation tax. The consequence of RDJ Pharmaceuticals UK Ltd having to apply PAYE and NICs to the deemed employment income is that he will now be paying tax earlier and potentially more than has been paying historically. Option 2 (employment) will be similar but the additional benefits provided by employment, as well as his reduced costs, are likely to mitigate any difference. Option 3 maintains the position he is used to and may be his preference.

Tax treatment of any share options granted

If Peter is awarded options as an employee you should note share options granted to employees are generally not subject to income tax and NICs at grant but instead at exercise. However, options granted to personal service companies or consultants give rise to a receipt by that company or consultant equal to the market value of the option granted even where there are vesting conditions associated. For this reason, the best option for both parties here would be option 2 if you are considering awarding options to Peter under an employment agreement.

Employment rights gained

It is important to note that the assessment of the off-payroll working rules applies for tax purposes only. They do not establish any rights for workers under employment law. By taking option 2, Peter will be gaining significant employment rights including:

1. Holiday pay
2. Pension auto-enrolment
3. Statutory sick pay
4. Statutory redundancy payments

Risk of HMRC challenge

Clearly this is relevant to option 3. Employment status is very subjective and always open to challenge. It may well be possible that Peter's company and RDJ Pharmaceuticals UK Ltd could identify changes to the arrangements both within the engagement and its operation where an argument could be made that there is no longer a deemed employment. But on review of the completed CEST you provided, significant changes may be required that may not be practical to do so. Best option – Options 1 and 2 where PAYE is applied.

Research and Development relief

One point that should be considered is the potential cost savings that may be achieved for claiming a deduction for the costs of employment related to qualified research and development (R&D). A small and medium sized company can claim an additional deduction equal to 130% of such costs in calculating its profits for tax purposes. This means that such an organisation can claim a deduction equal to 230% of staffing costs. The additional deduction is limited to 65% of subcontracted costs (options 1 and 3).

A company is regarded as small or medium sized if it:

1. Has fewer than 500 employees; and
2. Either has an annual turnover not exceeding €100 million or an annual balance sheet figure not exceeding €86 million

Again you need to include RDJ Pharmaceuticals Inc's numbers in this analysis and it would nevertheless appear that the conditions are satisfied.

There are limits to the additional deduction. Whilst Peter Wong is Head of R&D, you can only claim the additional deduction of his staffing costs (excluding benefits) for the proportion of time he spends on R&D. So for example, if he works on qualifying R&D for 50% of his time, then 50% of his qualifying staffing costs are eligible to the additional deduction.

Summary and conclusion

Our view is that an employment arrangement is likely to be the most straightforward as it has the least administrative burden. The additional costs for RDJ Pharmaceuticals UK Ltd may be mitigated by the availability of the R&D tax deduction

Nevertheless, Peter may prefer to continue with his current engagement as it provides flexibility and a higher rate of net income.. It is important to note that you can continue with the current arrangements as they are and comply accordingly, there is nothing within the tax rules stopping both parties from continuing to operate under the current engagement. However, the benefits of simplicity and the R&D tax credits are likely to be significant and we would recommend negotiating the position with Peter to agree moving to a contract of employment as soon as possible.

APPENDIX 1

Assessment of RD Pharmaceuticals UK Ltd liabilities

Peter Wong	2021/22	2022/23
Fees net of VAT	£114,000	£150,000
Expenses allowable as an employee (*1)	£(2,800)	£(2,800)
Deemed Employment Income	£111,200	£147,200
Tax Code 1257L	£(12,570)	£(12,570)
Taxable Income	£98,630	£134,630
Tax:		
£37,700 @ 20%	£7,540	£7,540
£60,930 / £96,930 @ 40%	£24,372	£38,772
Total Tax	**£31,912**	**£46,312**
NICs		
Employee NICs		
£9,568 @ 0%	£0	£0
£40,702 @ 12%	£4,884	£4,884
£60,930/£96,930 @ 2%	£1,219	£1,939
Total Employee NICs	**£6,103**	**£6,823**
Employer NICs		
£8,840 @ 0%		
£102,360 / £138,360 @ 13.8%	**£14,126**	**£19,094**
Apprenticeship Levy @ 0.5%	**£556**	**£736**
Total Liability	**£52,697**	**£72,965 (*2)**

*1 – Insurance and travel costs not allowable, however stationery, printing and phone calls costs for RDJ work should be allowable

*2 – 2022/23 liability to 31 October 2022 is £72,965 @ 7/12 = £42,563

APPENDIX 2

Peter Wong Self Assessment – Estimated re-filing position 2021/22

	As filed	Tax	Proposed Amendment	Tax
Employment income	£24,000		£111,200	
Dividend Income	£70,000			
Total Income	£94,000			
Personal Allowance	£(12,570)		£(6,970)	
Taxable Income	£81,430		£104,230	
Employment income taxed @ 20%	£11,430	£2,286	£37,700	£7,540
Dividend income taxed @ 0%	£2,000	£0		
Dividend income taxed @ 7.5%	£26,270	£1,970		
Dividend income taxed @ 32.5%	£41,730	£13,562		
Employment income taxed @ 40%			£66,530	£26,612
Total tax		£17,818		£34,152
Less payments on account		£(7,150)		£(7,150)
PAYE deducted by Peter Wong Services Ltd		£(2,286)		
PAYE due from RDJ				£(31,912)
Balance due / refund		£8,382		£(4,910)