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## Use of Consultants and Interims – End of Project Evaluation

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### 1. Executive summary

LBHF had a process for recruiting consultants and interims through personal service companies (PSC's) which was not fit for purpose and was given nil assurance opinion in an Internal Audit report in June 2011. A robust new procedure was developed and implemented in August 2011.

A review of all off payroll engagements entered into between August 2010 and August 2011 was also carried out by the Council at its own initiative. The review identified that LBHF managers were not applying and did not understand the process for determining employment status. Additional guidance about employment status was developed and incorporated into the new procedure. Training and briefing to the HR and Payroll teams and to departmental management teams was delivered. The revised procedure came into full operation in January 2012.

In early 2012 the scope of the review was extended to schools. Guidance specifically aimed at schools and new contract templates were developed and published to all schools. Scrutinies of engagements were carried out face to face in just under half the borough's schools.

Because the Council had identified a total of 94 people who had been incorrectly treated for tax and National Insurance Contributions (NIC's) purposes as self-employed, a voluntary disclosure was made to HMRC. After detailed exchanges of information and a series of meetings a final liability of £357k including penalties and interest over a six year period from 2006 - 2012<sup>1</sup> has been agreed. Given a worst case scenario of £640k, this represents the best outcome which the Council could have achieved. HMRC have complimented the Council on the effectiveness and efficiency with which it has managed its voluntary disclosure<sup>2</sup> and that has led to a nil penalty for most of the liability.

An Internal Audit follow up report published in March 2013 has confirmed that all the recommendations made in its June report have been implemented and no further action is required.

The Council has successfully concluded a difficult and sensitive issue and in doing so learned important lessons and played an important part in clearing up the distinction between independent contractors and people who should be treated as employees. In order to ensure that LBHF maintains its position, this report concludes with three recommendations:

- Management teams should be informed that the voluntary disclosure to HMRC has been successfully concluded and reminded of the importance of complying with Council procedure;
- A full internal audit of the operation of the new process including employment status should be commissioned; and

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<sup>1</sup> This is the period over which HMRC can go back to claim unpaid tax with penalties and interest. This report does not intend to suggest that this is when the issues identified first began to arise.

<sup>2</sup> Agreed minute of a meeting between LBHF and HMRC in August 2012

- HM Treasury has published an action note about the tax arrangements of public appointees. LBHF already applies most of the guidance given, but it should consider a recommendation to seek formal assurance from contractors that income tax and national insurance obligations are being met.

## **2. Introduction**

This report summarises the outcomes from a project which began in June 2011 as a result of an Internal Audit report which identified serious weaknesses in the procurement by the Council of consultants and interims engaged through PSC's.

What began as an exercise to put in place a commercial value for money procedure for buying in additional external resources, however, developed into a comprehensive review of all engagements with consultants and interims whether through personal service companies or as independent self-employed contractors.

The review identified gaps in the Council's approach to employment status and led to a recommendation that it make a voluntary disclosure to HMRC. At the same time the council reviewed its new procedure for recruiting additional resources and added detailed guidance on the determination of employment status.

In early 2012, having identified similar concerns in their approach to bringing in additional resources, the Council extended the scope of its review to schools. Visits were made to just under half the borough's schools, individual engagements were reviewed and comprehensive guidance prepared and distributed.

Following extensive discussions and negotiations with HMRC, LBHF has confirmed a tax and NIC's liability of £483k, a 15% penalty for the tax years 2006 – 2007 and 2007 – 2008 of just over £6k and a nil penalty for the years 2008 – 2009, 2009 – 2010, 2010 – 2011 and 2011 - 2012. Set off will reduce the liability by just under £150k. Interest will add approximately £18k. The total liability will, therefore be approximately £356k.

## **3. Recruiting additional external resources into the council**

The Council's process for the procurement of consultants and interims was not fit for purpose. It suffered from a high level of non-compliance and left significant control gaps. An Internal Audit report on the engagement of consultants and interims through PSC's published in June 2011 gave a nil assurance opinion.

In July 2011 a robust new procedure for the recruitment of additional resources which addressed the recommendations made in the Internal Audit report was approved by the Executive Management Team of LBHF. The procedure put in place:

- A single point of control in Human Resources, which became the gatekeeper for the recruitment of such additional resources;
- A requirement that requests for additional resources were approved by Executive Directors based on a clear business case;
- Measures for ensuring value for money; and
- Steps to ensure proper contractual arrangements and effective due diligence checks in relation to such things as professional indemnity insurance.

A standard contract template was also developed for both personal service companies and sole traders.

The new procedure was implemented in August 2011.

#### **4. A comprehensive review of all engagements with consultants and interims**

At its own initiative, the Council also decided to review all its existing engagements with consultants and interims, including those engaged as independent self-employed contractors. The review began in August 2011 and covered the preceding year. A total of 215 engagements with people not operating through PSC's were examined. Initially a view was formed that about 30 of these contractors had been incorrectly treated as self-employed for tax NIC's purposes.

Conversations with hiring departments confirmed that the existing process for determining employment status was not being applied and was not sufficiently well understood by managers. With this in mind PwC were commissioned to carry out a review of the new procedure. They recommended a number of revisions:

- The inclusion of additional tax guidance;
- The development of a robust employment status test; and
- The use of process flow charts to help people navigate through the procedure.

PwC confirmed that, subject to their recommendations being implemented and providing that the procedure was communicated to the right staff and applied in practice, it was robust, fit for purpose, would meet the expectations of HMRC and would minimise the risk of any further tax or NIC's non-compliance.

Revisions were made to the procedure for recruiting additional resources addressing each of these points. A revised procedure was approved by the H&F Business Board in January 2012. Training in the procedure and the determination of employment status was provided to the HR and Payroll teams and briefings were given to the management teams of each of the Council's departments. At the same time action was taken to put in place more appropriate contractual arrangements with those engaged. Some of the contractors were offered contracts of employment and some were converted into suppliers.

#### **5. Recruiting additional external resources into schools**

A significant number of the independent self-employed contractors identified by LBHF during the course of its review were found to have been engaged by schools. A total of 59 people, who were being paid without deduction of tax and National Insurance Contributions, were working in schools in the borough. The majority of these engagements were low value and were intended to provide additional teaching or enrichment activity, such, for example as guitar lessons or tennis coaching.

Schools now enjoy considerable freedom to engage with and pay people who are not employees and LBHF was not in a position to deal with them as it had its own managers by developing and implementing a new procedure.

Visits were arranged to the majority of the schools which had recruited additional resources. Heads and School Business Managers were given an in depth briefing about employment status and its implications and individual engagements were

reviewed. Recommendations for change were confirmed in writing and in the majority of cases engagements were converted into contracts of employment. A revised zero hours contract was developed reflecting the specific needs of schools for a flexible “on and off” arrangement when dealing with things like sports coaching and music teaching.

Comprehensive tailored guidance was also developed and circulated to all the borough’s schools in early 2012. This has been supplemented by briefings at, for example, the School Business Managers’ forum.

## **6. Voluntary disclosure to HMRC**

The identification of a number of people who had been incorrectly treated as self-employed for tax and National Insurance contributions purposes led to a recommendation that LBHF consider making a voluntary disclosure to HMRC.

Following a tendering process, Deloitte LLP were invited to carry out a more detailed review of individual cases and make a recommendation with respect to the need for a voluntary disclosure. Work on the review began on 24<sup>th</sup> January 2012. It was quickly established that a voluntary disclosure would be necessary and on 21<sup>st</sup> February HMRC were notified that the Council was considering this step.

When the review by Deloitte LLP had been completed a total of 52 people had been identified who had been incorrectly treated as self-employed between August 2010 and August 2011. In addition there were still a number of “unknowns” for whom there was insufficient information on which to make an employment status decision<sup>3</sup>. The report prepared by Deloitte to support the voluntary disclosure, made in April 2012, included a calculation of the Council’s potential liability based on two key assumptions. First, that HMRC would accept an argument limiting the disclosure to two tax years. Secondly, that only a proportion of those who were unknowns would be included in the liability calculation.

At a meeting with HMRC on 24<sup>th</sup> March it was agreed that HMRC would accept the two years presented in the Deloitte report as the basis for the disclosure rather than requiring LBHF to carry out a full review of every year for the past six years, but would require retrospection for each of those named. It was also agreed that the “unknowns” would have to be dealt with case by case on their merits. HMRC would not accept the idea of applying proportions as a means of determining LBHF’s liability. That ultimately brought the total number of people incorrectly treated as self-employed to 94.

The decision was made to make a payment on account to HMRC. This step has the effect of preventing the accumulation of further interest on any subsequent liability. A first payment of £175k was made on 10<sup>th</sup> July 2012 and a second of £125k on 19<sup>th</sup> November 2012.

Over the course of the summer and autumn, the Council exchanged case by case calculations with HMRC and agreed a final tax liability of £263k and a final NIC’s liability of £220k – a total of £483k. HMRC also agreed to apply its procedure for setting off tax already paid through their self-assessment returns by the individuals with whom LBHF had contracted. This has resulted in a reduction of the liability by

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<sup>3</sup> A number of people had stopped working for the council at the time that the review took place in March 2011 and we were either unable to contact them or speak with those responsible for hiring them. Letters were sent, but the majority of these went unanswered.

£150k to £333k. We have also been involved in detailed negotiations with respect to penalties. The period of the voluntary disclosure spanned two different penalty regimes. For the years up to 2008 a 15% penalty has been recommended by HMRC. That amounts to just over £6k and is half the maximum penalty that could have been imposed. For the subsequent years a nil penalty has been recommended. This reflects the fact that we were successful in establishing that the disclosure was unprompted as well as our openness with information and access to records and the assistance we provided to HMRC in working out the size of the error. The maximum penalty would have been 15%.

That leaves only the calculation of interest, which is charged on the amount of tax and NIC's after the application of set off. The greatest amount of interest that could be charged, assuming an average rate of interest over six years of 5.5%, would be £18k. HMRC do not charge interest on a compound basis.

The Council's final liability will therefore be as follows:

- Tax and NIC's liability      £333k
- Penalties                        £ 6k
- Interest                         £ 18k
- **Total**                         **£357k**

The best case scenario which was reported to the Audit Pensions and Standards Committee in September 2012 was £350k. The worst case was £640k.

## 7. Internal Audit follow up

The Internal Audit report which led to the instigation of this project was issued in June 2011 with a nil assurance opinion.

In accordance with procedures agreed with the Council, a follow up audit of the recommendations made in the report was undertaken in February 2013. All recommendations were found to have been implemented in full. An extract from the Internal Audit report is given in Table 1.

**Table 1: Follow Up Report from Internal Audit March 2013**

	<b>Recommendation</b>	<b>Priority</b>	<b>Assessment</b>	<b>Further Action Required</b>
1	Corporate policy on appointment of Personal Service Companies	1	Implemented	No
2	Demonstrating compliance with the Council's financial regulations	1	Implemented	No
3	Appointment of individuals operating as PSC's	1	Implemented	No
4	Retention and monitoring of agreements	1	Implemented	No
5	Due diligence	2	Implemented	No
6	Records of PSC's engaged by the Council	2	Implemented	No
7	Performance monitoring	2	Implemented	No

## 7. Project costs and benefits

The total expenditure on the project is given in the Table 2 below.

In terms of tangible benefits, the investment of time and effort resulted in a reduction of the liability from a worst case of £558k to £483k. A gain of £75k with a concomitant reduction in interest (£4k).

**Table 2: Project expenditure**

<b>Item</b>	<b>Amount</b>
PwC - process reviews and recommendations	£26,000
Deloitte LLP – individual case reviews and advice on voluntary disclosure	£27,269
Interim manager – project management, research, reporting and liaison with consultants and HMRC (162 days)	£76,950
LBHF staff time – confirming calculations, reviewing reports, agreeing recommendations and attending meetings	£19,212
<b>Total</b>	<b>£149,431</b>

LBHF might also have expected to face a penalty of between £145k (had HMRC not been persuaded to accept that this was an unprompted disclosure) and £72k had HMRC not been encouraged by the way in which the process was managed to reduce the penalty for the last four years of the disclosure to nil.

In terms of intangible benefits, LBHF and the schools for which the Council is the employer now have a fit for purpose procedure for recruiting additional resources and a clear understanding of the issues at stake when taking on people other than as employees. Provided that the new procedure continues to be applied in practice, LBHF will meet the expectations of HMRC and minimise the risk of any future non-compliance and the reputational damage to which such non-compliance may give rise.

LBHF has also been able over the last 18 months to build a more positive and engaged relationship with HMRC and is exploring with it the possibility of cooperating on the development of more comprehensive guidance for employers.

## 8. Conclusion

LBHF and the schools for which it is the employer now have a robust, fit for purpose process for approving the business case for engaging a contractor, for recruiting and selecting and contracting with him or her, for carrying out all the necessary due diligence checks, for managing contractor performance and for determining employment status before engagements begin. That process will minimise the risk of any noncompliance with HMRC requirements. It also gives the council an increased assurance that the procurement, deployment and management of consultants and interims will be a response to a clearly defined business need and that it will be effectively controlled and monitored.

Contracts are in place with all of those engaged through personal service companies, or who have been supplied as contractors by agencies, and all the necessary due diligence checks have been carried out.

The Council has successfully completed a detailed voluntary disclosure to HMRC. HMRC has complimented the council on the effectiveness and efficiency of its approach and has recognised that it has done everything that it could have done to resolve the matter. As a result of the Council's management of the process with HMRC we have been able significantly to reduce its liability and to achieve a nil penalty for four out of the six years covered by the disclosure.

Although with the benefit of hindsight the Council might ask how the issues which emerged in 2011 came about, we must also recognise that:

- From the late 90's there has been a rapid rise in the number of personal service companies (over 3.5 million companies in the UK employ only one person). This has been prompted in part by policies encouraging the creation of a more flexible and competitive workforce, in part by changes in tax regulations and in part by recession. The rapid rise has outstripped the development of the understanding of and processes for engaging with this resource;
- Employment status is a complex and difficult area about which there was only limited guidance. A very large number of local authorities were and remain the same position as LBHF. Indeed many have come to the Council for advice, guidance and copies of its procedure and templates. In 2012 the Council was invited to give a presentation about its experience and approach to the London Councils' HR Directors Forum;
- The Council is a far leaner organisation than it was and that means that there will be times when it has to buy in specialist expertise and skills. Engaging people as consultants and interims is a cost effective and flexible way of responding to a fast changing environment. This is not uncommon in either the public or the private sectors; and
- There is no suggestion that anyone has acted other than in good faith or that the people engaged by the Council did not manage their own tax affairs entirely properly.

The Council has successfully concluded a difficult and sensitive issue and in doing so learned important lessons and played an important part in clearing up the distinction between independent contractors and people who should be treated as employees. In order to ensure that LBHF maintains its position, this report concludes with three recommendations:

- Management teams should be informed that the voluntary disclosure to HMRC has been successfully concluded and reminded of the importance of complying with the procedure for the recruitment of additional resources;
- A full internal audit of the operation of the new process including employment status should be commissioned to identify any remaining control gaps; and
- HM Treasury has published an action note about the tax arrangements of public appointees. LBHF already applies most of the guidance given, but it should consider a recommendation to seek formal assurance from contractors with off payroll arrangements lasting more than six months and costing over £220 per day that income tax and national insurance

obligations are being met. This would require an amendment to the existing contract template.

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