trowers & hamlins

thinking Business

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Contents

Investing in innovation 4

Succession planning 2.0 8

Getting it right on ESG 10

Protecting value on the high street 12

New era of data standards 16

IR35 compliance update 18

Welcome to the fifth UK edition of Thinking Business, a Trowers & Hamlins publication in which we share our latest insights and thinking with readers as we seek to support growth and development in our clients' businesses.

In this edition, we focus on the theme of Protecting Assets, considering some of the many ways in which UK businesses – currently faced with a great deal of uncertainty on a number of fronts – can safeguard their human, financial and physical resources in order to position for sustainable future growth.

In the UK, with a new government in place, ongoing uncertainty around the Brexit process and with the threat of an economic slowdown looming not only in this country but worldwide, companies face a period of unprecedented change. Embracing that change will be critical to future success but proceeding with caution is advisable at a time when so many variables are in play.

This publication looks at just a few of the ways in which businesses can transition to a new reality without losing sight of current priorities, considering opportunities for transformation that matter to our clients, including:

- Protecting innovation by investing in research and development;
- Protecting the future of a business through succession planning;
- Protecting value in the retail landscape;
- Protecting business impact exposure by looking at ESG credentials from the perspective of lenders;
- Protecting data standards in a new era of data ethics; and,
- Protecting the workforce through compliance with new rules relating to IR35.

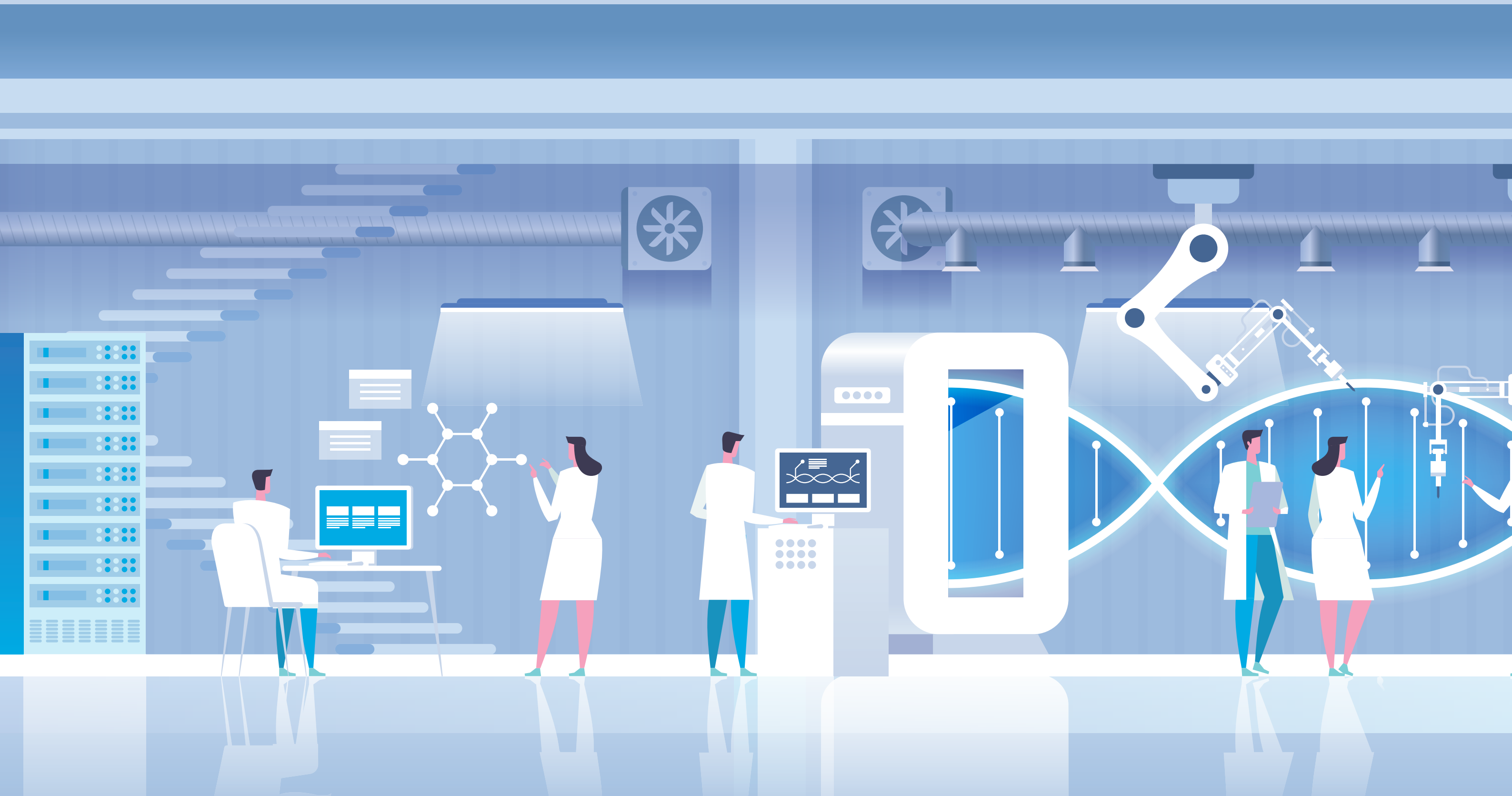
We hope you'll find these articles an enjoyable and thought-provoking read and that you'll find plenty to interest you over the course of the following pages.

Should you wish to discuss anything in more detail, or ask any questions, please do get in touch with your usual Trowers & Hamlins contact, or feel free to email any of us directly at thinkingbusiness@trowers.com. You can also follow us on Twitter @Trowers.

FEBRUARY 2020

INVESTING IN INNOVATION

With concern mounting about a downturn in investment by UK businesses as a result of the Brexit uncertainty that characterised 2019 and looks set to continue into at least early 2020, attention has turned to the various ways in which the UK tax regime can support and incentivise innovation.



The tax regime offers a number of carrots in the form of both tax credits and tax reliefs to encourage businesses to continue to invest in research and development, many of which are widely available and currently under-utilised.

The three main tax incentives for R&D in the UK are research and development tax relief, research and development capital allowances, and the patent box. The first, R&D tax relief, seeks to make R&D easier for small companies by offering relief on corporation tax that can reduce a company's tax bill or even result in a payable tax credit. Not available to individuals or partnerships, the relief defines R&D as a project that seeks to achieve an advance in overall knowledge or capability in a field of science or technology, with quite detailed guidance available from HMRC on what qualifies.

There are two schemes through which R&D relief is calculated, with the scheme for small and medium-sized companies allowing a company to get 230% relief on qualifying R&D costs and allowing loss-making companies to – in certain circumstances – surrender their losses in return for a payable tax credit. The alternative scheme for larger businesses with more than 500 staff or turnover above €100m is the Research and Development Expenditure Credit, makes a taxable credit available at 11% of R&D expenditure, with that tax credit fully payable for loss-making companies.

Nathan Williams, tax partner at Trowers & Hamlins, says:

For SMEs, that means that if you are employing individuals to develop a piece of software or a new vaccine, then you can claim a relief equivalent to 230% of the expenditure you are incurring.

(although this may change in the forthcoming March Budget). There does have to be an element of future exploitation and expanding knowledge, rather than just reinventing the wheel."

Guidelines from HMRC say that qualifying projects can include creating new processes, products or services, making appreciable improvements to existing ones and even using science and technology to duplicate existing processes, products and services in a new way. But pure product development in itself does not qualify, and HMRC recommend getting them involved early when judging whether projects and activities will qualify.

"We see this as a benefit but it's very complex and has been abused in the past," says Williams. "There are a considerable amount of pitfalls. HMRC will look for and request evidence of innovation, so you will need to demonstrate how you are expanding knowledge with what you are doing and incurring that expenditure. It's a hard-won relief but there are opportunities there for companies that qualify."

Research and development capital allowances provide for a deduction on capital expenditure on R&D, on assets used for R&D purposes, or on providing facilities for carrying out R&D.

Meanwhile, the patent box was introduced in the UK in 2013 as a tax incentive for businesses that are generating income through the exploitation of patents, by reducing the tax paid on that income to an effective corporation tax rate of 10%. "Again, the devil is in the detail," says Williams. "The scheme hasn't been as successful as HMRC thought it would be in terms of attracting that base of exploitation and creation of patents in the UK."

A company can qualify for the patent box scheme if it is liable for corporation tax, makes a profit from exploiting patented inventions, owns or exclusively licenses the patents and has undertaken qualifying development on them. That means the company must have made a significant contribution either to the creation or development of the patented invention, or to a product incorporating the patented invention.

Williams says:

People with patents will typically be aware of the patent box and have it on their radar. When it comes to R&D tax credits, however, small businesses and technology start-ups are not always aware of what is qualifying expenditure and what isn't.

"What is sometimes missed is the opportunity to claim cash back from HMRC in surrendering a loss, which can be valuable in those first few years that are particularly cost heavy."

One other aspect to keep in mind, particularly when looking to raise investment, is the Enterprise Investment Scheme (EIS) which offers tax incentives for individual investors seeking to invest in companies. The EIS has a category of 'knowledge intensive companies' (KICs) which allows companies undertaking research, development or innovation to raise EIS investment more flexibly than non-KIC companies.

In addition to funding and investing in R&D, it is also imperative that companies put innovation at the heart of their business strategies, and particularly micro-innovations, which are small but highly effective changes that drive forward company growth. If R&D is the work that is done to increase knowledge and create new applications, then innovation is the implementation of those processes or practices. Most companies recognise weaknesses in their ecosystems that can benefit from innovation but many focus on large-scale advances rather than smaller, everyday improvements and practical ideas.

"It is often said that companies need to prioritise innovation at board level," says Tim Nye, corporate partner at Trowers & Hamlins. "The business strategy needs to put the customer front and centre and encourage innovation at every level, which often means building a no-fault and no-mistakes culture. Not every idea is going to work and in order to bring ideas to the fore, people need to feel free to fail and not expect to be criticised."

While tax credits will apply to the initial R&D, the intangible costs of implementing change must also be taken into account.

That means embracing the implementation of change from the top down and championing innovation from the C-suite. “Creating and developing cross-departmental teams can be very effective,” says Nye. “That can bring out new ideas by putting together different concepts, encouraging people to think outside existing silos and integrate in order to come up with new suggestions.”

One final consideration for companies investing in R&D is the need to think at the beginning about how inventions will be protected and who will own any resulting intellectual property. This is a particular issue where R&D is conducted in partnership with another organisation that might become a competitor in the future, or when partnering with a university to undertake commercial research.

Caroline Hayward, an IP partner at Towers & Hamlins, says: “If there is any form of collaboration, you need to think very carefully at the outset about what rights you actually need and want.

Often, we see R&D agreements that are thrown together and provide for joint IP ownership, and that is actually very restrictive and does not mean both parties can do whatever they want.”

Applying for patents is an expensive process but has to be done to secure protections, so thought should be given to who will apply for the patent, as well as to what licensing rights will apply.

“You have to really think ahead when you embark on R&D,” says Hayward, “and assume that the R&D is going to be very successful and then think about what you want to do with the results. Are you happy to only sell the product in Europe and allow someone else to sell it in the US, for example? The key message is to think all of that through at the very outset.”

The most recent figures available show that the UK spent £34.8bn on R&D in 2017, up £1.6bn on the year before, with R&D representing 1.69% of GDP, well below the European Union figure of 2.07%. The UK ranked 11th of all EU countries for R&D expenditure as a percentage of GDP in 2017, and the government’s industrial strategy includes a target to significantly increase that investment to 2.4% of GDP by 2027.

SUCCESSION PLANNING 2.0

When Julian Richer, the founder of music and TV retail chain Richer Sounds, started to think about succession planning for when he leaves the business, he decided he wanted to hand over control to the company's staff. Richer, who recently turned 60 and started the company when he was 19, is the latest convert to employee ownership and will transfer 60% of his shares into an employee ownership trust for the benefit of the chain's 500-plus employees.

The company will pay Richer an initial £9.2m for the stake, of which £3.5m will be given back to staff, who will receive a £1,000 windfall for every year they have worked for the business. The Richer Sounds Trust will operate according to a set of principles set out by Richer to ensure it continues to follow the direction he has set over the past 40 years, and a Colleagues' Advisory Council will be set up to represent the interests of employees.

Richer, who has no children, joins a growing number of UK businesses transitioning to employee ownership, and, with annual sales of nearly £200m, is one of the biggest recent converts. The UK's largest and oldest employee-owned business is the John Lewis Partnership, and the Employee Ownership Association says more than 350 businesses have now adopted the model.

The UK government introduced the employee ownership trust (EOT) in 2015 in an attempt to encourage more companies to follow the example of John Lewis. If you own a trading company, you can now sell some or all your shares to an EOT for full market value without incurring any capital gains tax liability.

Alison Chivers, corporate partner at Trowers & Hamlins, says clients are increasingly interested in exploring the employee ownership route. "I had one client that was trying to sell their business to an investor. The deal was going a lot more slowly than they would have liked and they had doubts about the deliverability of the buyer's offer, so they started looking at viable alternatives including an EOT," she says.

This growing interest is a trend recognised by the manifestos of the Labour and Liberal Democrat parties before the recent election. They both put forward new law setting out different types of employee ownership.

Melanie List, a senior associate in the tax team, adds:

I have seen it coming up where you have a family business and the owners maybe don't have children, they are getting older and living comfortably, so they don't know what to do in terms of transferring ownership.

"They often don't want to sell to an outsider and want the business kept in the same form, and they want to look after the employees and avoid redundancies. They are essentially treating employees as family and are happy to be paid out on a deferred basis."

When selling to an EOT, the purchase price is agreed and is generally left outstanding as a debt owed by the EOT to the selling shareholders. As the company continues to generate profits over time, those are contributed to the EOT and then used to pay back the purchase price to the original shareholders.

"The deferred consideration can go way out into the future," says List. "There is often a long lead-in time to these deals and they are horses for courses; they may not suit everyone. If you're a founder that wants your money out immediately, it's not necessarily going to be the route you want to go down."

There is plenty of evidence to suggest that the benefits of employee ownership are widespread, including enhanced employee engagement, which increases productivity and reduces staff turnover. The Employee Ownership Association also says that employee owned companies have an excellent record of sustainability because employee co-owners are so committed to making sure the business does well, which can be particularly valuable during periods of economic downturn or recession.

Chivers says:

Employee ownership models can be really great examples of ethical business practices and sustainable capitalism, values which have had the spotlight shone on them in recent years and are increasingly playing a bigger role in business."

Other examples of recent converts to employee ownership include Aardman, the Bristol-based animation studio behind Wallace & Gromit, and Riverford, the organic vegetable box company.

For those business owners looking to incentivise their employees and foster increased employee engagement, but without exiting or undertaking a full sale to an EOT, consideration may instead be given to implementing a share option scheme. These share option schemes can take many forms, but for some time now the most straightforward and (potentially) tax efficient scheme has been an EMI (Enterprise Management Incentive) Scheme. The EMI was introduced in 2000 and, according to HMRC, 84% of the 13,330 companies that operated employee share schemes in the UK in 2017-18 operated an EMI scheme, making it the most popular share scheme by some distance.

List says: "The EMI is potentially a very tax efficient way to get shares into the hands of employees. It allows companies to grant options over shares, so the employees don't get shares now but are granted an option to get shares in the future if certain targets are met. If they stay with the company until it achieves an exit, or leave as a 'good leaver', then they can get cash-out. That's a really popular way to motivate and retain staff."

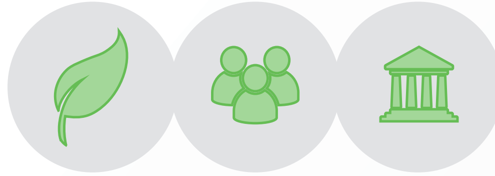
While there is an element of political risk associated with any arrangements that have favourable tax treatments, as future governments could change the arrangements, there are signs that EOTs are growing in popularity as the benefits of employee ownership are more widely recognised.

Chivers concludes: "If you're a founder and you're looking to exit your business, then you might typically be looking to either sell to a trade buyer or find an investor to do a management buyout.

But increasingly, people are thinking about the possibility and the benefits of employee ownership, and we are seeing more and more high-profile examples.

"You have to have a desire to benefit your workforce and a belief in the sustainability of the business long-term once you leave, but if you're not looking to get paid out on day one, then it is can be a good way to incentivise your staff and is worth considering as one of your potential exit options."

GETTING IT RIGHT ON ESG



With the environment rapidly moving up the agenda for all business stakeholders, lenders are the latest constituency to increase their focus on a company's ESG credentials when looking to make loans.

Where businesses have fallen foul of the increasingly high standards expected in terms of environmental, social and corporate governance (ESG) responsibilities, the banks that have financed their activities are now coming in for criticism, putting further pressure on financial institutions to take up the mantle as arbiters of good corporate behaviour.

Katharine Lewis, banking and finance partner at Towers & Hamlins, says it is not just public opinion that is demanding banks check out the ESG policies of companies before they lend to them. "It is also a response to regulatory pressure," she says. "Mark Carney, the governor of the Bank of England, has been at the forefront of discussions around the world about the risk to the economy posed by the climate crisis, and central banks have recognised the risk of the climate crisis to macroeconomic and financial stability."

She adds, "A taskforce has been set up to ensure that banks and their businesses are doing the right things. The Bank of England has also said that in its next round of financial system stress tests it will stress test banks against "different climate pathways including the usual catastrophic business as usual test" and the transition to net zero by 2050. So banks are feeling pressure both downward from global regulators and upward from other stakeholders, so this is an issue they are having to take seriously."

The result is that banks are developing products and offering specific types of loans to companies that are looking to finance projects that are designed to address ESG challenges, like energy efficiency, for example. They are also offering positive incentive loans for companies that are prepared to commit to certain green or sustainability linked targets.

Lewis says:

"We are now seeing a set of green loan principles being applied, which are very much focused on how the borrower is going to be using the proceeds of the loan.

"They have to demonstrate they will be using the money for certain types of projects that have an environmental benefit, and if so, there is no guaranteed upside in terms of pricing, but lenders will often reduce the margin for the bit of the loan being used for a particular type of project."

Likewise, there are sustainability linked loans on offer that can be used for any purpose, including general working capital, but include certain targets that the borrower has to meet in relation to ESG, like perhaps employing a certain number of people out of long-term unemployment, for example. "There," says Lewis, "the margin is reduced if the targets are met but will go back up again if there is a failure to meet them."

Lenders are increasingly factoring ESG criteria into their overall credit risk assessments, so they are looking for clear evidence that a business is taking its governance and stewardship responsibilities seriously, and taking a considered approach to reporting on its social impact, before they will lend.

Globally, green bond and loan issuance exceeded $200bn in 2019, with the market quadrupling in size since 2015. "This is still a very small part of the market, but it is growing rapidly," says Lewis. "It is now very easy to access green finance and it can apply to all the different types of loan that a business might like to borrow, including green revolving credit facilities. Banks in the UK are very much looking to make sure that the green products they are offering meet the needs of all the different types of customers that they are supporting."

HSBC, for example, has committed to providing $100bn in sustainable financing and investment to clients by 2025 and has already provided green loans valuing £600m to UK businesses as part of a pilot. In July 2019 it unveiled a new range of green finance offerings including a green loan, the UK's first green revolving credit facility, and a green hire purchase, lease and asset loan.

However, the market is very much still developing when it comes to clear definitions of what can and cannot be defined as 'green'.

Amanda Stubbs, partner in the planning and environment team at Trowers & Hamlins, says: "One of the problems for the banks is that in order to make these loans and decide on lending strategies, they need a set of criteria to assess the green credentials of a business. That is a really interesting area into which the banks are going to have to drill down further as this evolves."

Rebecca McKay, a partner in the pensions practice, says: "There are so many elements to this and it is an incredibly complex area for banks and investors to assess. Just because a business is good on its environmental credentials, it could be really bad on governance and social impact. If companies want to attract banking interest on the back of ESG then they really need to be able to project what they are doing in a meaningful and coherent way."

It is not just banks that are having to address the issue. As of October, 2019, new rules for UK pension funds mean trustees must outline their approach and demonstrate how they take account of financially material factors including ESG and the climate crisis considerations when making investment decisions.

Pressure is also being placed directly on large UK companies. The government published its Green Finance Strategy in July this year and the Financial Reporting Council made it clear that the boards of UK companies should now address, and where relevant report on, the effects of the climate crisis.

Companies should also reflect the current or future impacts of the climate crisis on their financial position," it said.

Expectations are also increasingly moving beyond just the environmental agenda. McKay says: "A lot of companies are aware of environmental issues because that is the most high-profile area. But social impact and governance are going to become more important too, so don't forget about those when you are looking at your ESG profile – you need to look at it holistically across the board."

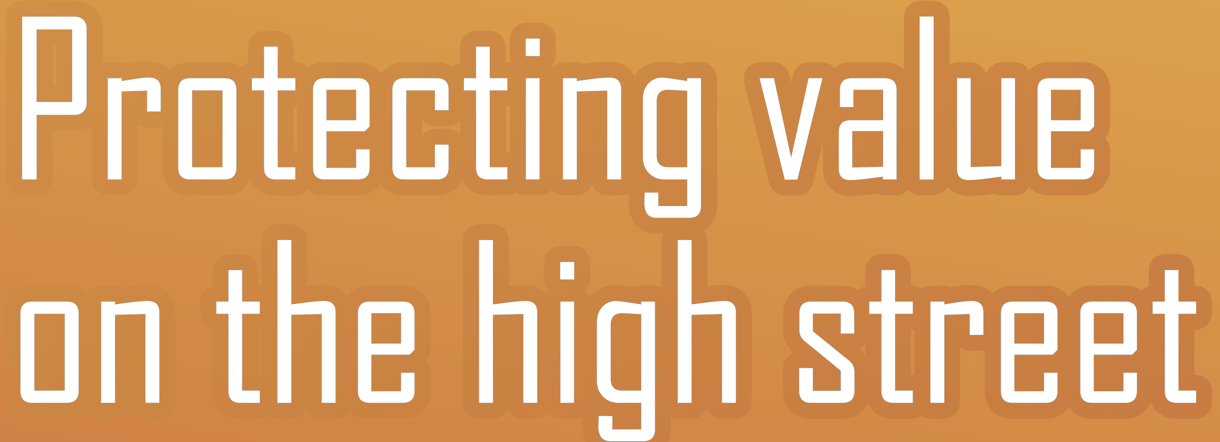
Lewis concludes:

If you are going to a bank and wanting to borrow a green loan or a sustainability linked loan, you have got to have done your homework. You will need to have a framework in place and have had that verified professionally by a third party so that you can demonstrate that what you are saying you are doing is genuinely going to have a positive impact.

"You will also need to agree to report back to lenders on a regular basis in an open and transparent way."

As lenders and investors continue to heighten their interest in ESG metrics when assessing company characteristics, it makes sense for borrowers to up their game.

Protecting value on the high street



The retail industry in the UK is changing, as is the face of the British high street. There is no doubt that traditional retailers are under pressure, largely because of the rise of online shopping, but also because of other challenges like declining footfall, increasing business rates and pressures on consumer incomes.

But there is much to suggest that it is not the death of the high street or the retail market that we are witnessing, but rather a change of focus and an evolution. There is plenty that can be done to protect value, both in terms of regenerating high streets and protecting retail brands online.

"With the rise of internet shopping, retailers need to find a way to become a destination for other reasons," says Julien Allen, a commercial property partner at Trowers & Hamlins.

This is where retail and leisure differ – leisure has an advantage because it cannot be done online. You can't go out for a meal or a drink or get your nails done without visiting a physical space."

He adds: "From a real estate perspective, the changing face of retail has resulted in a growth of logistics demand to cope with distribution, through things like warehousing. And there has also been a growth in out-of-town shopping destinations where the shopping experience goes hand in hand with the leisure experience, though investors are paying less attention to those opportunities today than they have in the recent past."

For retailers, the challenge is to find ways to build their online shopping businesses that complement, rather than alienate, their store networks. Many are doing this. According to a report by Savills, the real estate agency, in 2018 as much as 30% of non-store sales actually went through a store, either because of the use of click and collect, or because things were brought online following a browse in store. This 'shop window' element is increasingly evident as aspirational brands like Apple and Nespresso open large physical stores even though they are well aware that many of their customers will buy online.

Savills points to two examples of retailers that are embracing the multi-channel approach. Next, the fashion retailer, has signed a partnership with online retailer Amazon that allows customers to collect parcels from its stores, while John Lewis fulfils half its online orders through collections in store. Savills data shows 39% of customers in the UK bought an additional item when they were collecting their click and collect order in 2018, and John Lewis reports 44% of its customers make an additional purchase worth an average of £18 when they click and collect.

"We have also seen an enormous growth in aspirational eating on the high street in the last decade. This became a bubble as too many casual dining restaurants didn't get their offerings or price points quite right and have been squeezed by cannier competitors." says Allen.

The younger generation goes out for meals much more than the generation before, and so we have seen a lot of different types of restaurants opening up. That destination feeling is still very much there.

FASHION
STORE

"That said, the high street looks very different now, with a combination of big conglomerate chains and small local boutiques."

One of the biggest stories in retail over the past two years has been the increased use of the company voluntary arrangement (CVA) insolvency technique by high street brands and large multiple retailer chains. CVAs allow businesses in financial difficulty to renegotiate their debts with creditors and, in the case of retailers, have been used to press landlords for rent reductions by seeking their support in a turnaround.

"What we ought to be talking about is more flexible, short-term leases and pop-up shops," says Allen. "I think we will see more of that coming in. We are also seeing developers putting retail into mixed-use schemes alongside residential, which creates a clientele and also diminishes the risk."

Meanwhile, for retailers that are moving more and more of their sales online, there are further challenges associated with brand protection on the internet. Caroline Hayward is a partner specialising in all aspects of intellectual property law at Trowers & Hamlins, and she says:

"The main point really is that if you move a business online, you are obviously absolutely dependent on the IP rights relating to that platform."

Many retailers will outsource responsibility for running their website to a third-party marketing agency, who will be in charge of maintaining the domain name and delivering the online strategy. Serious problems can arise if the relationship with that agency breaks down, and there have been cases of agencies holding retailers to ransom because it is the agency, rather than the retailer, that actually owns a valuable domain name.

"Those problems can be easily avoided if stores look at their contracts properly in the first place and properly register trade marks to cover everything they need," says Hayward. "The contracts should state that the store will own all domain names, all IP rights relating to the website, and that they can clearly take over if the contract with the agency comes to an end."

She says that such agency contracts are often signed off at a low level within the business and fail to get adequate attention at the outset: "You need to ensure you have all the IP rights you need if the day comes when you don't want to use the agency anymore," she adds.

There is another challenge that arises in relation to the use of other people's trade marks as Google search terms. This was the subject of a long-running dispute between florist Interflora and retailer Marks & Spencer, because M&S advertises its flower delivery service via the internet and uses Google AdWords so that when an online shopper searches for 'interflora', an M&S advert for flower delivery pops up. Interflora sued on the basis that the advertising infringed its trade mark, but was unsuccessful. "The courts have developed various criteria about where the line is drawn in terms of using other people's trade marks to increase your online presence," says Hayward.

There are also trade mark issues that arise where companies with the same name, potentially doing very different things and on opposite sides of the world, run into each other online. And finally, the more business that a brand conducts online, the more vulnerable it becomes to attack from disgruntled customers seeking to malign its brand.

""All of these cases are highly fact dependent and generally come down to existing trade marks," says Hayward. "They can present real commercial problems for online retailers, and by the time the problem has arisen, it is often too late.

The key is to get proper advice on all contracts with people that run your online presence and do your advertising, and to register trade marks comprehensively and promptly.

"Getting a registered trade mark is much cheaper than sorting out issues once a problem has arisen."

Retail is an industry undergoing transformational change on all fronts, where it pays to invest in registered brand protection, which can be then be deployed across all trade channels.

A NEW ERA OF DATA STANDARDS

More than 18 months on from the advent of the EU-wide General Data Protection Regulation (GDPR), organisations are not only getting far more sophisticated in their handling of data but are also increasingly embarking on much more advanced data strategies.

As companies get more adept at handling large volumes of data in a compliant manner, a new challenge has reared its head, and that is the challenge of data ethics. This highlights the difference between what companies CAN do with data, versus what they SHOULD do.

Riccardo Abbate, partner in the corporate department at Trowers & Hamlins, explains: “The term data ethics, which is now being used a lot, is really a flag to say you have got to think about a lot more than just the mechanical aspects of processing personal data. As well as thinking about where and how personal data is stored, and who has access to it, you now also need to think about the underlying core of data protection legislation, which is purpose.”

He adds, “Data protection legislation is not written in a prescriptive way but is instead underpinned by principles. As well as looking at the physicality of data, it is saying you must process personal data lawfully and fairly, and that you must only collect it for a legitimate purpose.

With ever-increasing advances in computer power and capabilities, it is becoming more challenging for people to not be blinded by the practical aspects and make sure they keep sight of those ethical angles.”

One of the changes of emphasis that came with the introduction of GDPR and the UK’s Data Protection Act 2018 was a suggestion that organisations should be asking themselves periodically about the purposes for which they are collecting, storing and processing personal data. On a practical level, that requires much greater understanding and coordination between the members of a business that are responsible for compliance and the people at the coalface developing software and other processes that rely on data.

“That’s the challenge,” says Abbate, “making sure that the software people, the sales people and everyone else across the organisation understands and really appreciates what is actually going on. All too often there is a disconnect and people on the front line are doing things for the benefit of the business without keeping compliance in mind.”

The way that data is used is increasingly throwing up its own ethical issues too, as algorithms, artificial intelligence and machine learning take more and more responsibility for corporate decision-making. There have been a number of high-profile incidents of computers delivering outcomes that would fall foul of equality legislation, for example, with tech giant Apple one of the culprits. The algorithms behind its credit card business Apple Card hit the headlines for awarding men better credit scores than women, even within married couples where the pair shared all their bank accounts, credit cards and assets.

While computers cannot discriminate off their own bat, they can produce decisions that are racist, sexist or in some other way discriminatory if the bank of data that they are analysing, or the programmers that made the initial inputs, are already biased, even unintentionally.

Abbate says:

What’s happening is that algorithms are processing data in a purely statistical way, but there needs to be an additional layer of scrutiny beyond the raw processing to say that while the data might say

X, we have to draw our own conclusions and potentially come up with the answer Y."

Decisions on data ethics are impacting more and more areas of our daily lives. In the US, artificial intelligence is being used to reduce some of the burden on the criminal courts, including making decisions on custodial sentences. In the UK, the Serious Fraud Office has started using a document review service backed by artificial intelligence to analyse documents in large cases, piloting it on the high-profile Rolls-Royce bribery case. Capable of processing half a million documents a day, the system operated 2,000 times faster than a human lawyer, according to the SFO.

Mark Kenkre, partner in commercial litigation at Trowers & Hamlins, says: "The Law Society is now looking at situations where you rely on algorithms to analyse documents and asking whether that increases the potential for missing something that could be critical to a case. If there's a risk of someone going to prison for a long time, is AI really good enough? Or could it be better?"

There are also further complexities when it comes to the use of employee data, where it is increasingly possible to track the movements of staff throughout the working day and collate data on their habits and preferences. There is a growing business in the field of worktech, which can be used to monitor time use and attendance, to identify signs of fatigue, manage the allocation of overtime or spotlight incidents of stress.

Christopher Recker, an associate in commercial litigation, says:

"Organisations need to be embracing the fact that all this technology is out there, whether it is worktech, regtech, wearable tech or fintech.

"But the question that has to be asked when it is being used to produce enormous amounts of data is why? Why are you creating all of that data?"

Emma Burrows, partner in the Employment and Pensions team says, "If you are collating information on your staff's exercise habits or eating habits and you haven't told them that is happening, the implications are potentially very serious. That data may be very valuable for identifying signs of stress or spotting challenges at home, and that may well be beneficial to the employee, but if you are surreptitiously generating or analysing that information the impact could be hugely damaging. It could give rise to employment challenges, because an employee who is being monitored may well have claims for constructive dismissal and discrimination, and reputational issues, when the modern workplace puts emphasis on employees' flexibility and autonomy. On balance, harvesting that data may not be seen as beneficial."

One key way to avoid failings is to return to the point about everyone in the organisation fully understanding what an ethical data policy looks like.

"Organisations must continuously challenge themselves to ensure they truly understand the purpose for which they are generating and using personal data," says Abbate. "The really key thing is to make sure the people actually developing the software and working with the client development teams are aware of what the law has to say on data protection. It is not so much at board level, where senior management of course has to understand this, but getting everyone in the business to break down internal silos and work together to make sure the products that are being developed are compliant."

He adds: "The laws continue to evolve and GDPR demonstrates that everyone is now really serious about data protection. We now see the Information Commissioner's Office showing they mean business and using their new powers to impose large fines and that's the big message – the supervisory authorities are now coming in with fines that are commensurate with the powers they have been given."

A failure to understand the ethics behind data privacy rules could be very serious indeed.

IR35 COMPLIANCE UPDATE

As a recap, the intermediaries legislation (more commonly known as 'IR35') applies where an individual worker provides services to an end client through an intermediary, such as a personal service company (PSC), in circumstances where the individual would otherwise be regarded for tax purposes as an employee or an office-holder of the client.

The basic premise behind IR35 is to ensure that the worker's income tax and NICs liability is broadly equivalent to that of an employee and to impose a PAYE and NICs obligation on the intermediary (ie the PSC). Sounds simple enough, but in reality and even ignoring the proposed changes due in April 2020, the IR35 regime is problematic as it is often unclear whether arrangements are within or outside the IR35 regime resulting in uncertainty for taxpayers.

As a number of high profile TV presenters (such as Lorraine Kelly) have come to discover, there is a significant risk of HMRC investigation and potential dispute, which can be invasive, burdensome and costly.

Given this backdrop, the proposed changes to the IR35 rules to introduce them to the private sector have not gone down well with those operating in the sectors where engagement via PSCs is prevalent (such as the banking, IT/tech, media, construction and healthcare sectors). Lobbying of Government resulted in the pre-general election announcement by the Chancellor that the IR35 rule changes would be reviewed. In January, this review was confirmed by HM Treasury but the tone was very much of ensuring a smooth transition of the changes rather than them being abolished or altered. So as Nathan Williams, Tax Partner at Trowers & Hamlins says, "at best, we might be looking at a delay as to when the new rules are brought in".

Assessing whether IR35 applies isn't always straightforward. Someone who is genuinely self-employed will not fall within IR35, but it's this which isn't always easy to determine. Both the contract in place, and the reality of the situation, will be relevant, because HMRC and the Tax Tribunals will look behind the contract. The documentation therefore can't simply be a tick box exercise.

In the spring of 2019, the television presenter Lorraine Kelly defeated HMRC when she successfully appealed a tax bill of £1.2 million, arguing that she was not an employee of ITV. Kelly was hired by ITV via a limited company (effectively her PSC) and was not on the payroll. However, HMRC argued she was effectively an employee of ITV (ie a deemed employee under the IR35 rules) with the PSC therefore liable to account for PAYE income tax and NICs on her earnings, rather than the significantly lower rates of corporation tax payable by the PSC if she were self-employed.

Kelly won the case by proving that she had more control over the work she performed than if she were an employee: one of the key factors in determining employment status.

It is currently planned that as of April 2020, companies in the private sector that engage individuals as consultants or contractors will have to take responsibility for deciding whether the individual should be deemed an employee for tax purposes. And if they fail to get it right, under the changes it is the client that will be obligated to account for the employment taxes, rather than the PSC. "It is this change in passing the tax risks to the end client instead of the PSC that has caused most concern, together with the tax compliance burdens that come with it", says Williams. The changes bring the private sector in line with the public sector, where public sector bodies have had to take responsibility for IR35 compliance of contractors since 2017.

At the moment, in the private sector it is the PSC's responsibility to establish whether the arrangements represent an employment relationship for tax purposes. The PSC pays corporation tax instead of income tax where it determines that the IR35 rules do not apply.

It is currently planned that as of April 2020, the complexity of the rules and their application will remain but with the difficulty of determining the employment status now resting with the private sector client. "What we saw in the public sector was a lot of clients saying they didn't want to take any risks so they made the decision upfront to treat off-payroll contractors as employees for tax purposes going forward," says Williams.

“For an individual, that means becoming subject to tax at source, which results in a cashflow disadvantage and higher tax costs, neither of which are balanced against any corresponding increase in the individual’s employment rights.”

Some commentators say that it is this inconsistency that results in unfairness for the individual: they are taxed as an employee but have little legal standing as an employee.

In some industries, the challenges of assessing the compliance risk across a workforce can be daunting. “We are dealing with clients in the construction industry where there are layers upon layers of sub-contractors, with multiple supply chains, so the individuals that are providing services via personal service companies may not even be aware of the end client,” says Williams. “The client has to inform the individual of the status determination they have made (and this will have to flow down the labour chain), and whether they are deemed employed or not, so it is all becoming much more complicated than it used to be”. This is arguably borne out by the recent announcements of some of the big high street banks to move all contractors on to payroll so that they avoid having to deal with the IR35 process.

The advice for businesses in the private sector that engage workers via PSCs or other intermediaries is to start preparing for the changes now, if not already commenced. That means conducting a thorough assessment of the contractor population and the scale of the impact of any changes, and then assessing whether the individuals concerned should be deemed employees for tax purposes and so fall within IR35.

The next step is to review contracts to ensure that they are fit for purpose, ensuring contracts for those who fall outside of IR35 genuinely reflect the self-employed relationship, or updating contracts where IR35 applies. Where there are contractors that need to move onto PAYE, employers will need to be mindful of increased costs to the business as well as potential cashflow implications for those workers. For tax purposes, it only matters whether someone is self-employed or a deemed employee. For employment purposes there are three types of employment status: employees, who have the whole host of rights; workers, who have some rights; and the truly self-employed. Where contractors are moved onto PAYE, it is possible that they will assert they are employees in the general sense.

Imogen Reseigh, senior associate in the employment practice at Trowers & Hamlins, says:

“We are suggesting to clients that they effectively audit their workforce, ascertaining what contracts they have in place as well as how those contractors are operating in practice.

“It’s important that businesses really get to grips with the implications of IR35 applying and who this will affect.”

She adds: “The test for whether or not someone is an employee for tax purposes and so falls within IR35 is not exactly the same for whether or not they are an employee (or a worker) for employment purposes. So, it is possible to put all contractors onto payroll without making them employees, but you might find contractors that fall within IR35 asking to be considered employees and you should also consider if they are (or are workers) in reality.”

One group that will be particularly challenged by the new IR35 reforms is non-executive directors, who often provide consulting services to the companies on whose boards they sit, and to others. They therefore provide consulting services and are impacted by the IR35 rules, while their fees for carrying out the role of director are subject to income tax and national insurance.

“In the NED sector it’s very common for people to be engaged via personal service companies,” says Williams. “You then have a challenge of how you remunerate a director via payroll for some part of their role and via that company for their consulting work. You are not necessarily going to be tax compliant unless you split out what you provide as a director and what you provide as an external adviser, and even then, your client company may not want to run the risk of tax non-compliance following the IR35 changes.”

The complexities are evident and this is an issue that many companies are going to have to get to grips with quickly to be ready for April 2020. “We have known for some time that IR35 would likely be extended to the private sector, and if organisations are not preparing already they should start doing so imminently” says Reseigh. “Some organisations will have lots of contractors engaged in different parts of the business, on different contracts. Getting ready for IR35 is a process that will involve various parts of the business, for example HR, finance and internal communications teams. Organisations will need to put processes in place for making IR35 determinations and dealing with disputes. IR35 requires each part of the business to be aligned and preparing together”.

All businesses, with the exception of small companies (as defined by reference to the Companies Act 2006), are going to have to take responsibility for assessing if off-payroll contractors should be on the payroll or risk substantial tax liabilities and penalties for non-compliance. Now is the time for anyone impacted to get ready for the change that is coming.

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