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CUK Insider's Guide to IR35

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What is IR35?

In brief:

New legislation, introduced in April 2000, affects anyone who is working via an intermediary, such as a company or partnership. IR35 will only apply if the individual is working for a client under circumstances that if it were not for the imposition of the Limited company or Partnership (known as the "intermediary") would be one of employment. (The Inland Revenue argues that in these cases the individual is "a disguised employee".) Anyone working via an intermediary will be caught by new rules if they fail the 'IR35 test'. This test determines whether the person would be an employee if they were contracting directly with the 'client', rather than using this intermediary. If their terms and conditions or working practices are of employment then they will be caught by IR35 legislation.

IR35 Legislation

The IR35 legislation is designed to increase both the Tax and National Insurance (NIC) to the Inland Revenue from the service industry, which on the whole has found it more tax efficient to distribute income as dividends, usually subject to the payment of a small salary. To this end, it introduces the concept of "deemed salary" which will be taxed and subject to NIC as if it has been paid as a salary.

The Government's concern is that small limited companies are being used to disguise employment, so this is the test which has been applied: -

Where the employee is provided by his/her Company to an ultimate client on terms which would normally constitute an employment with that client, this is called a relevant engagement and the IR35 rules apply.

How will I know if I am caught by IR35?

The test is to determine from the outset whether or not the worker is effectively an employee. The overall picture will be made up by how the contractor operates on a day to day basis – the reality of which must be reflected by the contract. The Revenue will often challenge any contracts and try to discredit them. Some common arguments are:

- The contract is not a “live” or “working contract”;
- The contract has been “bought off the shelf” or has been copied from another contract and does not therefore reflect actual terms;
- As the Revenue were not part of the process in preparing the contract, they do not accept it; and
- The contract has not been submitted to the Revenue to confirm the contract is one of self-employment.

The Revenue's opinion may be that the contract is not a true reflection of the work carried out (see ‘Deemed Employment’).

Remaining outside of IR35 is determined by the working practices of the individual. Many people try a “tick” approach. For example if 8 pointers are towards self-employment and only 6 towards employment, then the individual must be self-employed. This is a popular and incorrect basis. In one judgement the judge specifically stated that using a points system would not be acceptable in determining status.

Factors to Consider

The IR will consider the whole picture but some factors can be:

- What is the client's business?
- Is there any form of contract?
- Is the contractor at financial risk in the project?
- Is the contractor working exclusively only for one client?
- Does the contractor work with their own materials on site?
- Does the contractor have to rectify work at their own expense?
- Can he or she provide substitutes to carry out the work in place of themselves?
- Is the contractor "part and parcel" of the client's organisation?
- Is the contract project based with deliverables and milestones?
- The intention of the parties
- The length of the contract
- Terms of contract – e.g. does the contractor have a notice period, the hours of work, where and how is the work carried out?
- The pay structure e.g. holiday pay, is the worker paid by the job/project or a fixed wage at a fixed time (as an employee would be);
- Are any benefits provided similar to employees (company car/van, sick pay bonuses etc.) and
- Has any Government Department (Inland Revenue/Contributions Agency) ever provided a written status ruling in the past?

Each case is individual, so all factors must be considered to arrive at the correct status decision. It is worth noting that the Inland Revenue questionnaire to determine status is over 80 questions in length as they will consider as many factors as possible. Do not leave the decision to the Inland Revenue or it could be a costly exercise once additional Tax, NIC, interest and penalties are added.

The Revenue's view on the 'painting a picture' is this:

“In order to decide whether a person carries on business on his own account it is necessary to consider many different aspects of that person's work activity. This is not a mechanical exercise of running through items on a checklist to see whether they are present in, or absent from, a given situation. The object of the exercise is to paint a picture from the accumulation of detail. The overall effect can only be appreciated by standing back from the detailed picture which has been painted, by viewing it from a distance and by making an informed, considered, qualitative appreciation of the whole. It is a matter of evaluation of the overall effect, which is not necessarily the same as the sum total of the individual details. Not all details are of equal weight or importance in any given situation. The details may also vary in importance from one situation to another. The process involves painting a picture in each individual case.”

So how much will it cost me if I fail IR35?

That really depends on how much your contract rate is. Generally speaking the cost to you will be the additional National Insurance contributions that are payable on the deemed salary. To calculate exactly how this would affect you, we have IR35 calculators on the members' page of CUK. The Revenue will also consider charging additional interest and penalties.

How do I know whether I pass or fail IR35?

This is dependant on your contract itself, and the working practices you have. The easiest way to find out is to ask one of the expert providers for an opinion on your contract. The Revenue do offer a form of IR35 contract opinion service, but almost all experts advise against using this service, at least without their professional guidance first.

The rest of this guide explains some aspects of IR35 in more detail.

Relevant engagements

Introduction

Where the Company provides the services of a member of staff to a client (either through an agency arrangement or otherwise) and the terms are such that, without the intermediary the individual would be an employee of that client, the new IR35 tax treatment is applied. It is important to remember, therefore, that it is a test of employment as regards the eventual client that is considered. We are not then saying that the individual is an employee of the client, just that in these circumstances the "relevant engagement" rules will apply.

Income from such work arising from a relevant engagement will be taxed according to the new rules. Clearly, therefore, the planning considerations will depend on the correct classification of the engagement by the Company, so that the new treatment is adopted when appropriate. It is best to assess the contract from the outset, not some years later when the Revenue are inspecting the client's business records.

Deemed employment or self-employment

As deemed employment will trigger the IR35 rules, it is vitally important to consider what the Revenue will treat as being employed.

The entire IR35 site is available at <http://www.inlandrevenue.gov.uk/ir35/index.htm>

It would be unwise indeed to pin all hopes on a contract effectively bought "off the shelf" described as a self employed engagement (or IR35 proof contract). The parties to the contract must behave in such a way as to make it clear that the contract does indeed summarise their working relationship. If the Contractor and client have a different interpretation of the written or oral contract, it will give the Revenue the impression the contract isn't "live" and allow them to discredit the contract.

Internal Inland Revenue guidance on contracts includes: " The terms of a contract can be written, oral or implied, or a combination of all three." In establishing the terms of engagement the officers enquiring into status are instructed to obtain copies of any contract in existence, and then review the following for additional evidence: -

- Other documentation such as handbooks, procedures manuals and franchise agreements. These may give more information about the terms of the engagement and may also identify the conditions under which the worker is expected to operate;

- Evidence to support oral and implied terms, which might be at variance with the written contract. SE541 warns that the written contract may not have been implemented and that the true contract is made by oral or implied terms. These are identified from verbal agreements at the beginning of the contract and also from working practices on a day-to-day basis. Guidance highlights “the prevailing practices or conventions of the particular trade or organisation.”

Thus, where the parties to a contract do not behave in the way described by the agreement, it is normal for the courts (if called upon to make a ruling) to regard the subsequent behaviour as a variation in the terms of the contract, and therefore view the case based upon the working relationship, rather than being bound by a contract which bears little resemblance to reality. This is why the Revenue will challenge written contracts and will identify the working practices based on their questionnaire. Where the Inland Revenue inspects the client's records, it is not unusual for the Inland Revenue to later decide to interview any “consultants” who they believe may be disguised employees. This can highlight differences between the client and the contractor's interpretation on the terms of the contract. Where there are a number of differences it can give the impression the contract isn't a live contract and can be discredited by the Inland Revenue.

Expenses available for deduction

General

In the calculation of the "deemed salary" certain expenses will be deducted from the income arising from relevant engagements. The most important of these is the deduction for travelling expenses. To be clear, the following expenses have been mentioned by the Inland Revenue in various consultations and Frequently Asked Questions (FAQ) publications: -

- Travelling and other expenses deductible under Section 198 of the Income and Corporation Taxes Act 1988 (Business travel not private or home to work travel);
- Employer contributions to approved pension schemes, which attract tax relief in the normal way;
- Gross salary paid plus any employer NIC on both the salary paid and any deemed payments;
- 5% of the gross income from relevant engagements to cover running costs;
- Any other expenses which do not fall within S198 ICTA 1988, but have another statutory route for deduction, such as payment of professional indemnity insurance.

Does working at the client's site affect IR35?

It is fair to say that the majority of contractors work at the client's site and usually for fixed hours. The Revenue often argue that these are factors of control and therefore pointers toward being inside IR35.

They contend this on the basis of a case called Ready Mixed Concrete (South East) Ltd v Minister of Pensions and National Insurance. When considering what constituted control, MacKenna J said:

“Control includes the power of deciding the thing to be done, the way in which it shall be done, the means to be employed in doing it, the time when and the place where it shall be done.”

On the face of it then, the fact that the work is done on site means a pointer toward being inside IR35. However, the contractor would argue of course that the work has to be done on the client's site because for example that is where the equipment is.

In the Revenue's internal guidance manuals (ESM1019) the following advice is given to the Inspectors when considering this issue:

“However, you should be careful about making a judgement concerning status where the *nature of the work* dictates where it should be carried out. In such cases, this factor is not likely to be of any significance in determining status.”

This important paragraph is often ignored by the Revenue in status disputes, but is a powerful tool in overcoming their control arguments. (The Revenue questionnaire has 15 questions alone on Control).

Turning now to the fixed hours. Again the Revenue would have you believe that working say 9-5 is a strong pointer toward being inside IR35. This can be true, but very much depends on why you have to adhere to those hours. For example are there security issues which dictate when you can be on site, is the building closed outside these hours? For most contractors we believe one of these two factors would apply.

This being the case is it really a factor of employment?

Again, the Revenue often argue strongly that it is, but buried in ESM1021 we have the following paragraph:

“For example, if working on large sites where access is limited to normal working hours, the worker is not going to be able to work as and when he or she pleases. In such circumstances the limitations put on when the work can be carried out tells us nothing about the status of the individual and other factors will have to be considered.”

The paragraphs extracted above, taken directly from the Revenue's own Status Manuals quite clearly indicate that working on the client's site, for fixed hours can play no part in determining whether a contractor is inside IR35. (However, the Revenue still has over 65 other questions on which to base their decision.)

Does the right of substitution defeat IR35?

There has been a lot of debate recently over substitution clauses in agency contracts, and whether they do indeed defeat IR35. In this article I will sum up the Revenue's thinking toward the subject, quoting directly from their employment status manuals.

Is the right genuine?

ESM1055 says:

“The right to provide a substitute is a strong pointer towards self-employment. However, a right to send a substitute must be genuine for it to be taken into account in deciding employment status. Where the true agreement between the parties is that the worker must undertake the work personally but a written contractual term allowing substitution exists the written clause will be ignored as a ‘sham’.”

It is important to point out at this point that it is the contract with the agent (i.e. the one the contractor signed) that is pertinent here.

How then does the Revenue contend successfully that the right is a sham? To quote:

“The Commissioners and Courts will accept a written contractual clause unless they have evidence that it does not represent the true agreement between the parties. This means that if we (the Revenue) are to dispute such a clause the onus is on us to demonstrate that it is a sham (or has been varied by an agreement subsequent to the contract being signed).”

“Disproving a claimed right of substitution can be difficult. Unless there is reason to doubt a claimed right of substitution it may normally be accepted at face value. If the claim later turns out to be untrue we will normally be able to rectify the matter later. Enquiries are more likely to be appropriate where other alleged terms are found to be false or a claimed right of substitution does not seem to make sense in relation to the contract. For example, an engager is unlikely to want to accept a substitute where the work involves a complex task worked on a team basis and is likely to take some time to complete and where ongoing work relies on a knowledge of the whole system being worked on (for example, in some computer programming situations). “

We now get to exactly how the Revenue will want to challenge these claimed rights of substitution. Bearing in mind the above it would be wise, if your contract purports to allow substitution, to figure out exactly how in practice you would be able to substitute. Not necessarily names, but a simple outline to show how it could be feasible were the need to arise. This will then counter any objection the Revenue may have based on the above. Consideration should also be made of additional training time and costs. If a substitute is to be used, they will need time “to come up to speed” on the contract which could mean deadlines are missed imposing financial penalties on the contractor.

Do you have to send a substitute, or do you just need to have the right?

The Revenue says:

“As explained above it is the right of substitution that is important. The fact that substitution has not actually occurred during a contract is not necessarily relevant. Workers with such a right are of course entirely free to carry out the work themselves if they wish. We may want to consider claims that there is a right of substitution critically if substitution does not occur over a long period of time. However, we should not automatically assume, in such cases, that this means that there is no real right of substitution.”

This is clear cut and unambiguous. You do not need to actually invoke the right. The right is enough in itself.

Is the right of substitution a guarantee I will pass IR35?

As “one pointer” to self-employment it will certainly help in the majority of cases, but no one clause will prove self-employment or employment. It is worth noting that ESM1057 says:

“If, exceptionally, you decide a right of substitution is genuine but there are other terms that appear wholly inconsistent with self-employment, Personal Tax (Technical) can provide advice. Such cases will be exceptional (for example, membership of the employer's pension scheme and a common intention for employment expressed in the contract – but the employer alleges the worker is self-employed because of the right of substitution). Submissions should not be made simply because control exists alongside a right of substitution.

In other words there would need to be exceptional circumstances to contend employment where a right of substitution exists. It would be advantageous if the rest of the working contract emphasised that it was a genuine contract for services and not a contract of services.

It is important to point out that the need for personal service (i.e. a lack of the right of substitution) does NOT mean you fail IR35. There are many other factors to be considered. However if you have a genuine right, it is fair to say that this will be a major pointer to self-employment and will help in any dispute with the Inland Revenue.

Where can I find out more?

Our IR35 section gives far more detail, together with expert articles, summary and the latest case law development.

Our thanks go to Ray McMahon for his 'insider knowledge' in the guide. Ray is an ex Tax Inspector and works with CUK to give our members advice on what the IR look for.