

# Your Guide to IR35 Legislation

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## ① *An Introduction to IR35 Legislation...*

The IR35 legislation came into force in April 2000 and despite an overall lack of success, HMRC still pursue many cases each year under IR35 and as a contractor operating through your own company you ignore it at your own peril. So, what is IR35 all about...

### *What is IR35 and why was it introduced?*

IR35 was introduced because the Government believed that some contractors were providing their services through a limited company or a partnership as a means of avoiding tax and national insurance contributions (nics). The IR35 legislation effectively seeks to determine what the relationship would be if you were engaged directly by the End Client; in short it asks the question - are you an employee "disguised" behind your limited company?"

In order to understand how it works, we must consider the commonplace business relationships...

This relationship will be documented by two contracts: the one that the agency signs with the End Client to find the resources which will allow the End client to complete the project; and the contract that the Agency signs with the Contractor's Limited Company. More will be said about these elsewhere later, but the first thing to notice is that there is no contract between you, the Contractor, and the End Client.

What, however, IR35 seeks to do, is create a hypothetical contract between you, the Contractor, and the End Client to establish what the relationship would be if you were engaged directly by the End Client.

### **Would it be a Contract of Service?, i.e. employment (the master/servant relationship)**

Or

### **Would it be deemed a Contract for Services?, i.e. self employment**

**Intermediaries legislation.** How, HMRC and indeed we on this side of the profession determine the status is demonstrated below. However, we would just like to finish this section by considering what the implications are of you being "caught by", or deemed to be "inside of" IR35; i.e. your relationship with the End Client is deemed to be a 'contract of service'.

Essentially, you will be deemed to be an employee - but not of the End Client, nor of the agency, they are both off the hook - it will be your company that will have to meet the additional tax liability under the "Deemed Salary Calculation". It is impossible to quantify with any accuracy what that additional tax burden will be without knowing the specifics of each case - the turnover of your company, the amount taken by the shareholder(s) as salary, the amount distributed as a dividend - but as a very rough guide, the likely cost to you will be equivalent to the Employer's and Employee's National Insurance Contributions not paid as a result of paying dividends, plus interest and if they can, HMRC will also seek to levy a penalty. This could add at least another 25% to your tax bill.

As you can imagine, being reclassified as caught by IR35 is a painful and expensive experience; please see the Professional Expenses Insurance to find out what Freestyle Accounting have put in place to make sure you are given every opportunity to fight your case successfully and not succumb to a huge tax bill. Please read on about determining your IR35 status to understand what HMRC will be looking for.

## ② *IR35 Rules Explained – Determining Your Status*

When HMRC look at an engagement to test its status, they will be looking for two things: contract wording which shows the engagement to be between two independent parties and working practices that demonstrate this independence. It is true that where neither the terms of the engagement, nor the working practices give a clear indicator of status, HMRC will look to other factors such as the financial risk being taken by the contractor and how their business is run (e.g. expenditure associated with running a business), but the overwhelming majority of cases are determined by the working practices and the contract terms.

Let us consider both ends of the spectrum:

### *IR35 Hell*

Sadly, more often than one would like, it quickly becomes apparent by virtue of the contract wording and/or the working practices that the engagement would be classed as a contract of service (employment).

We have seen practices which indicate that the client is supervising and controlling the contractor's hours and location; work is being handed out on a task-by-task basis with little or no input by the contractor; it is evident that the client is only interested in the services of the individual and will look to the agency to find a replacement if the individual fails to deliver; the payment is by the hour with overtime available; there is a long notice period which is an indicator of employment etc.

Clearly, no amount of re-writing of the contractual terms will assist a contractor if these are the circumstances. In this scenario the contractor should be considering paying themselves under the deemed salary calculation.

## *IR35 Heaven*

In an ideal engagement, the End Client would be asking your company to take their business 'on a journey from A to B'. Deferring to your knowledge and expertise, the Client would be looking to you to map out the direction to be taken, identify the key milestones to be achieved en route, the project deliverables and what ultimately constitutes a successful project sign off. You would not only decide how the project was to be delivered, but if there were a number of locations where the work could be done (including your own offices), you would decide where and when. Furthermore, your company would be undertaking the assignment for a fixed fee and when the project was delivered on time (even if meant that in the final three weeks, you were working 18 hours a day and having to bring in outside support to do so) your company would find another engagement elsewhere.

## *IR35 Reality*

Reality, of course, lies in between (although we hope much closer to IR35 Heaven!). Apart from the obvious Health & Safety issues contained within an 18 hour day, there are other practical considerations. Rarely does a client have no knowledge of the systems, processes or procedures to be delivered and anyone who has been involved in a project will know that what is envisaged at the start is rarely the finished product - projects change, overrun and get cancelled - rarely could a contractor work for a fixed fee. On an even more practical level, nobody operates in a vacuum and so a contractor will have to engage with the client's staff at the times that they are available, the project may depend on variables not within either the End client's or the contractor's control; there may be security issues which require the work to be completed on site and so the list of variables continues.

Therefore, what both HMRC and we on this side of the fence will be considering are the three key areas of any engagement: **Control, Personal Service and Mutuality of Obligation.**

There is some belief that it is sufficient to have a well written contract to be considered as "outside of" ("not caught by") IR35, but the reality is that a well worded contract is not worth the paper it is written on unless the contract terms are supported by the working practices. Indeed, should HMRC undertake an enquiry, they will disregard the contract wording (if it is favourable to your case) and go straight to the working practices, which, wherever possible, they will seek to confirm with the End Client.

This raises an important point. The contract between the Agency and the End Client may not necessarily mirror the one that your company has signed with the Agency (despite the best intentions of the Agency to do so) and cases have been lost where the End Client has denied the operation of clauses to which the contractor has signed up in good faith. There is nothing that can be done in these circumstances - the agency contract signed with the contractor's limited company may well have a clause stating that it is not liable if the commercial reality of the contract is not borne out by the contract signed. This alone brings into sharp focus the importance of the engagement's working practices.

Despite these comments, you are going to be on the back foot if the contract wording is unhelpful because HMRC will be only too pleased to demonstrate that the written documentation proves their case (you may be the one arguing that the contract wording is to be ignored and that the working practices should be considered!)

So to the issues:

### *Control*

It is clear that we need to establish whether the End Client is controlling the work, or whether the Contractor has reasonable autonomy in the performance of the services. This will be determined by how, where, when and what is to be performed. It is unlikely that either party will fully control all of these, but if the contractor wants to be seen as being independent, they will need to have a strong degree of influence over most of these.

### *Personal Service (Substitution)*

Often referred to as "Substitution", this area of an engagement is about determining whether it is your company that has been engaged to provide the service, or whether it is you personally. It is about the right of a company to send a substitute, not whether one has been provided (although if they genuinely have, then it is difficult to see how IR35 could apply).

### *Mutuality of Obligation*

Here the issue is whether the End Client (or the agency) is obliged to offer you more work and if it is offered whether you are obliged to accept it. If the answer to both of these is "No", then there is no mutuality of obligation. Compare this with an employment contract where your employer must continue to pay you even if there is no work, or make you redundant and compensate you. Similarly, if you are asked to complete some work, you are obliged to do so (if you wish to be paid and retain your employment).

Where an engagement with a particular End client is continually extended, then it becomes harder to argue that there is no mutuality, although it is impossible to define mutuality as commencing by reference to a particular passage of time.

## *Financial Risk / Being in business on one's own account.*

We have put these under one heading because many examples of financial risk stem from being in business on one's own account and vice versa. Here are but a few:

- Marketing and training expenditure bring with them no guarantee of future business and yet are clearly investment in the business;
- The payment of various business overheads such as insurances and accountancy fees;
- The purchase of equipment and stationery.

None of these in isolation will tip the balance in favour of employment or self employment, but one can understand that where such expenditure is largely missing from a business that HMRC might not consider that the individual was truly in business on their own account.

### **3** *IR35 Contract Reviews - Why Have Your Contract Reviewed?*

As a director of a limited company, it is your duty to ensure that your company pays the correct tax, and, of course, it is your responsibility to ensure that your personal tax affairs are in order. Therefore, the onus of getting the employment status of a particular engagement that your company is undertaking also falls to you.

This clearly is not always straightforward, and it is therefore highly unfair that the decision on a complex tax matter should be left to an individual whose expertise lies outside of tax. However, those are the rules and getting that decision wrong could prove costly – not only will HMRC seek to recover the lost tax and interest, but they will also seek to levy a penalty on the basis of taxpayer negligence.

It seems extremely sensible therefore to have your contract reviewed. This gives you the peace of mind to know that if your engagement does fall outside of IR35 then you can distribute the company profits accordingly. Furthermore, you have an independent opinion which shows that you have taken reasonable care to establish the tax opinion and HMRC therefore cannot justify the levying of a financial penalty.

Freestyle Accounting clients can apply to Abbey Tax to have any of their contracts reviewed as part of the Freestyle Contractor Service.

#### *What's involved in an IR35 Contract Review?*

The review has two distinct parts: firstly, the contract wording is considered with particular attention paid to how it deals with the three key elements of substitution, control and mutuality of obligation; secondly, a questionnaire which you will be asked to complete will seek to address both the working practices of the assignment and the business practices of your company.

*Hopefully this guide has given you a little more background information on IR35 legislation and how it works.*

**Our all-inclusive *Freestyle Contractor* service includes unlimited IR35 contract reviews, so you'll always be able to have an accurate review of your current contract and can be confident of your IR35 status. Simply contact us on 0800 954 2101 or request your income illustration at the *Freestyle website* - [www.freestyleaccounting.com](http://www.freestyleaccounting.com).**



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