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## **Guide to IR35**



IR35 is considered to be the main piece of legislation affecting contractors and freelancers as its implications affect the way in which they are paid and the amount of tax they pay. The purpose of this guide is to explain its rationale, scope and implications and to provide readers with an understanding of the current developments in this area.

## Example

An employee would leave his employment on a Friday afternoon and return to work the following Monday to do the same job but not as an employee of the original employer. Instead he would be employed by an intermediary (a personal service company of which he would be a controlling shareholder/director) through which his services would be supplied to the original employer. The intermediary would invoice the original employer for these services and would receive a gross payment.

Through coming to the above arrangement the original employer would avoid paying Class 1 NIC at 13.8% and the (former) employee could arrange his payments between salary and dividends in order to minimise his tax and NI liabilities. The government, therefore, introduced anti-avoidance legislation, known as IR35, in April 2000 with the purpose of countering this problem.

## Scope

The IR35 legislation applies to individuals who provide their services through an intermediary (usually a personal service company) where the income received for performing the services would have been treated as employment income had the individual contracted directly with the customer (without the intermediary). The tests used in deciding if somebody is employed or self employed are therefore be used in deciding whether an engagement is caught or exempt from the IR35 legislation.

There is no straightforward way to determine whether a IR35 should apply to a worker as there is no distinction between a contract of service (employee) and a contract for service (self employed) in statute – we therefore rely on common law principles (past judgements) to establish the factors which are relevant.

These factors are applied to both the contract under which the services are provided as well as the working practises of the contractor. The main areas looked at include, but are not limited to:

## Direction and control

The amount of direction and control by the end client must be considered. It is not necessary to prove that the person carrying out the work is doing so under very detailed supervision because even professional persons can be operating under a general and overall framework of control from the end client.

- What is done – if a client can move the contractor to different areas of higher priorities then this will be an indicator of employment.
- When it is done – control over when the work is done may be an indicator of employment.
- Where it is done – when the contractor is required to work at the client's premises this can be an indicator of control, although if the work can only be done at the client premises, this may not be a factor.
- How it is done – this is a strong indicator of employment; it permits the client to prescribe the way in which the work is to be carried out. However, the absence of this level of control does not necessarily indicate self-employment, it is unusual for someone of a particular skill to be told how to do their work, but this does not make them self-employed.

**Contract pointer** – ideally the contract should clearly state that the client has no right to direction, control, supervision etc. The contract can state that the client can make sensible requests but the contractor has no obligation to agree to them.

## Right of substitution

Personal service is an essential element of a contract of employment. A person who has the freedom to choose whether to do the task themselves or hire somebody else to do it (on a reasonably unfettered basis) for them, is probably self employed.

**Contract pointer** – a right of substitution written into all contracts in the chain is probably essential. The contract should state that the contractor is responsible for the completion of the services but should enable a right to use a suitably qualified person to provide the service if necessary. A clause to allow the client to be reasonably satisfied that the substitute has sufficient skills, is acceptable.

## Mutuality of obligation

Mutuality of Obligation would normally appear in all contracts, i.e. an obligation on each party to provide something.

The internal guides for HMRC staff suggest that they ignore this test when considering the IR35 status of a contract. This is quite a complex test but a Judge was critical of the HMRC's instruction to ignore it. This tests if any obligation exists between the client and the contractor. The expectation for continuous work to be provided to a person and the expectation for all work provided to be completed characterises an employment relationship. If therefore there is a clause contained in a contract setting out an obligation for the client to offer further work and for the contractor to accept it, there would be a mutuality of obligation in the contract and it would be caught by the IR35 legislation. 'Rolling contracts' or indeed contracts that are continually renewed could therefore fail this test.

If the client simply pays the contractor or agency for services then it may be that MOO does not exist and so this is not an "employment" situation.

**Contract pointer** – A self-employed person will have no expectation of further work at the end of a contract therefore, a clear end date is desirable. An exception would be if the contract was for a specific, clearly defined task.

## Provision of equipment

A contractor engaged to undertake a specific piece of work using their own tools and equipment will be a pointer to self-employment. If the contractor is provided with basic equipment this would be a pointer to employment.

**Contract pointer** – the contract should not state that the client will provide basic equipment or cover training costs. The client provision of specialised equipment is acceptable.

## Financial risk

An individual who risks their own money, such as buying assets, bearing running costs and paying for overheads, will be self-employed. The risk of not being paid for an invoice would not qualify; this would be viewed as bad luck. Financial risk could also take the form of quoting a fixed price for a job, with the consequent risk of bearing the additional costs if the job overruns.

**Contract pointer** – working for a fixed price, agreeing to correct defective work (at your cost), providing your own insurance cover will support a case for self-employment.

## Basis of payment

Employees tend to be paid by fixed rates, paid weekly, monthly etc. and may also be paid for overtime. Self-employed contractors tend to be paid a fixed sum for a particular job.

**Contract pointer** – if you cannot charge a fixed price, try to issue your own invoice rather than relying on timesheets, steer away from using terms such as "overtime" and try to get any expenses included in the rate. If you must charge for expenses, include on the invoice and do not use the client's claim forms.

## Length of engagement

Long periods working for one client may be typical of an employment but not conclusive. Regular working for the same client may also indicate that there is a single and continuing contract of employment.

A period of notice in the contract is more typical of employment contracts, so an absence of a notice period would point towards self-employment. If a period of notice is present, it should only be for a reasonable period.

**Contract pointer** – ensure that the contract does not contain any clauses that prevent you from working for other clients at the same time. The contract should be able to be terminated early with a notice period of no more than one month.

## Business set up

To show if a person carries out business on their own account, it is necessary to take account of all aspects of the business from an overall view. If the business looks like a real business this will strengthen your case.

**Contract pointer** – aspects that would help towards showing that you are a genuine business include, having business insurance, equipment, more than one client at a time, business telephone, stationery, other sources of income etc.

## Part and parcel of the organisation

The contractor should not be seen to be an integrated part of the organisation as this can weaken the case for self-employment status. The contractor should not use any benefits provided to the client's employees such as subsidised canteens, gyms, Christmas parties etc.

**Contract pointer** – the contract should not cover areas seen in employment contracts such as reviews and disciplinary procedures.

For an initial assessment please refer to our free online IR35 Test on our website, look for IR35 Calculator under "Tools".

The above contractual indicators would not be examined in isolation and so the existence of a single indicator would not be conclusive. In addition to this, the actual working practices would be examined along with the contract under which the person is engaged – it is therefore important that the actual working practices of the contractor are reflected in the contract. More and more we are seeing the contract being overlooked by Inspectors and reliance being placed on the working practices themselves to determine the IR35 status.

It is highly recommended that each contract is reviewed to ensure that the obligations of IR35 do not apply.

## What happens if the contract is caught by IR35?

If, after a review of the contract and working practices, the engagement falls within the scope of IR35, HMRC sets out specific rules on how to calculate the tax that will be payable. You are required to pay the majority of your income (less a few qualifying deductions) as salary – this is referred to as their IR35 'deemed salary'. This is calculated as follows:



	£
Turnover (net) from relevant engagements (cash basis)	A
Less: 5% of the amount of (A) to cover other unspecified expenses*	( B )
<b>Income (A - B)</b>	C
Less: Qualifying Expenses**	( D )
Less: Employer contributions to a registered Pension Scheme	( E )
Less: Salary paid to the worker	( F )
Less: Employer's Class 1 NICs paid on salary	( G )
<b>Total Deductions (D+ E + F + G)</b>	( H )
<b>Amount to be apportioned between deemed payment and employer's NICs (C-H)</b>	I
Employer's NICs on the deemed payment (I * 13.8/113.8)	( J )
<b>Deemed Payment/Gross Salary (I-J)</b>	K

The above 5% allowance is the amount of profit that the company would make assuming that the company incurs only qualifying expenses.

\*The 5% deduction is not available if your client operates in the public sector.

\*\* Qualifying expenses should meet the wholly, exclusively and necessarily test

## Qualifying expenses

The following expenses are qualifying deductions in calculating an employee's deemed IR35 salary:

- Travel, Mileage, Accommodation and Subsistence costs covered under Section 339 ITEPA 2003;
- Childcare;
- Employer contributions to an approved pension scheme;
- Employer National Insurance contributions;
- Approved professional subscriptions;
- Professional indemnity insurance.

Any other expenses incurred by the company will not be offset against the salary but will still be an allowable deduction from the profits made by the company which are subject to corporation tax. If, therefore, the company was to incur non-qualifying expenses greater than the 5% allowance – the company would make a loss for the year.

## Non-compliance

If an engagement is found by HMRC to have fallen within the scope of IR35 and the payments have not been treated in the above manner, HMRC would put this right by performing the above calculations on the income received by the intermediary in the relevant years. This would mean that the individual becomes liable to additional tax and NI – penalties and interest may also be charged on the additional tax/NI due as a result of the check.

The determination of penalties is dictated by whether the individual under investigation has taken reasonable care to prepare returns etc appropriately. It follows that if a contractor was found to be caught by the legislation and had used a professional to have their contract reviewed then the penalty levied on the contractor should be significantly lower than if the individual did not use a specialist to review the contract under investigation.

## Developments and case law

Since its introduction, IR35 has been a controversial piece of legislation among contractors and tax practitioners alike – this is largely due to the high costs of administration and the low revenues that it brings to the exchequer. The factors in determining the status of a particular engagement for IR35 is subjective and difficult to prove and as a result of this HMRC have not won many cases where they have challenged this.

The Agency Workers Regulations (AWR) that came into force in October 2011, further affected contractors that are caught by IR35 and their clients. The AWR rules state that temporary workers engaged for 12 weeks or more should be given the same basic rights and access to facilities as their permanently employed counterparts. This legislation therefore provided an incentive for businesses that make use of contractors to ensure that the engagements are not caught by IR35 as contractors who are seen to be 'in business on their own account' (generally outside the scope of IR35) will not be affected by the AWR rules and the engager will not be legally obliged to provide these additional rights.

### Dragonfly limited

Dragonfly is the most well know IR35 case, which concluded with an unsuccessful High Court Appeal by the contractor in September 2008 resulting in a £99,000 tax bill and a review of the HMRC guidance on IR35. The main factors affecting the court's decision against Dragonfly were:

- The contractor (John Bessel) had a succession of contracts with the AA over a number of years (suggesting the existence of a mutuality of obligation), when contracts were extended they were modified to be more IR35 friendly – indicating that the clauses existed specifically for the purpose of avoiding IR35;
- Dragonfly was found to have only a 'limited' right of substitution as any substitute for Bessel would have to be first approved by the AA;
- The work carried out by Dragonfly was subject to the supervision and quality control procedures of the AA, Bessel himself also had regular appraisals by the AA.

### MBF design services limited

This case went through the courts in 2010 and the contractor has succeeded with the case. The ruling in this case is a sign of the courts taking a more pragmatic approach in the determination of the IR35 status of a contract, which tested the reality of the relationship between the contractor and the client and is thus a very significant ruling for contractors. The key factors in this case which make it so relevant are:

- The absence in reality of a right of substitution was not inconsistent with being engaged as a professional man whose personal expertise was valued;
- The fact that design work was checked and approved was considered a necessity given that the contract involved the design/building of aircraft – the safety of which were subject to the approval of external authorities;
- The fact that the contractor was required to work at the client's site was not a conclusive indicator of employment – again the reality of the situation was that due to the nature of the work undertaken by the contractor, it would have been impossible to carry out the relevant services in any other location than at the client's own premises.

## ECR consulting ltd

This case concluded in May 2011 after a 4 year debate with HMRC and represents another important victory for freelancers. HMRC sought additional tax and NICs for the tax years 2002/03 to 2004/05 totalling approximately £44,500. HMRC's argument for IR35 to apply to ECR Consulting was similar to their other cases and rested on what HMRC perceived to be a fettered substitution clause, a lack of control and a high level of integration between the client and the worker. In the judge's summary of the decision, it was stated that the contract was considered to be a contract for services for the following reasons:

- the client negotiated for the best price at the time of entering into a contract, at the time of the first contract this was £600 per day, at the time of the second contract this was reduced to £350 per day – the judge concluded that it would not be possible to control an employees in such a manner;
- despite the contractor having submitted invoices for 37.5 hours per week, the judge did not believe this to reflect the reality of the situation as records showed that the hours worked varied from week to week and that the payment was therefore consistent with the contract being at an agreed price;
- ECR was considered to be a genuine business and therefore not a target of the IR35 legislation – the judge made the following statement on this "ECR is in business on its own account. Elaine produced to the Tribunal copy business cards and company stationery. ECR operates from a dedicated business area at her home. It has company domain and website. ECR advertises its services and is a member of the PCG. It has retained reserves and invested in development and has over the years taken on fixed price work for a variety of clients."

## Marlen ltd

This is another recent case which has gone to tribunal and resulted in another victory for the contractor. The judgement was conclusive stating "We have considered two factors – mutuality of obligation and control. These are the two factors which make up the irreducible minimum required to demonstrate a contract of employment...It is our conclusion that there is no mutuality of obligation and the degree of control which would have been needed to establish a contract of employment just did not exist."

## What we can learn from these IR35 cases?

In each of the above cases, HMRC have challenged the IR35 status of each contractor based on substitution, control, mutuality of obligation and the working practises in each situation– it therefore appears that these are the most important factors used to determine a workers employment status. The distinguishing thing about Dragonfly is that the contractor repeatedly amended his contract to bring it into line with IR35 legislation however there was no corresponding change the working practices and as such HMRC looked through the contract changes – we therefore strongly recommend that any changes that need to be made to contracts are made prior to the contractor beginning work and that the contractor's working practises are aligned to the contract.

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