

A large, stylized logo consisting of a pink lowercase "f" and a light blue lowercase "w" is positioned in the background. The text "IR35 Guide" is overlaid on this logo in a blue, sans-serif font.

# IR35 Guide

## IR35 Guide

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.

a) What is done – if a client can move the contractor to different areas of higher priorities then this will be an indicator of employment.

b) When it is done – control over when the work is done may be an indicator of employment.

c) 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.

d) 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.

## 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.

## 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.

## 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.

## 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.

## 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.

## 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.

## 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.

## 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.

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.

## 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
5% Allowance (5% of A)		(B)
		C
Qualifying Expenses	D	
Pension Contributions	E	
D + E		(F)
C – F		G
Employers NI ((G-7072) x 13.8 / 113.8)		(H)
		I

### Gross Salary (G – H)

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

### 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 336 ITEPA 2003;
- Childcare;
- Employer contributions to an approved pension scheme;
- Employer National Insurance contributions;
- Approved professional subscriptions;
- Professional indemnity insurance.
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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

## Umbrella Company Option?

Whilst the overall tax paid on an IR35 caught contract will be higher, it is still more tax efficient to operate through a limited company, rather than an umbrella company, the reasons for this include:

- Ability to benefit from the VAT Flat Rate Scheme, typical annual savings are £1,300
- Lower administration fees, typical annual savings are £360 but can be over £1,000
- 5% of the income is not subject to PAYE and NIC, typical annual savings are £2,500
- Expenses prohibited by umbrella's such as mobile phone and internet can be claimed.
- One less company handling your money, after a series of umbrella companies becoming bankrupt this can be perhaps the most compelling reason.

# freshwater Service Summary

## Set Up

- Form a Limited company at Companies House.
- Register your company for PAYE.
- Register your company for VAT.
- Register your company for Corporation Tax.
- Register your company for the VAT Flat Rate Scheme.

## Monthly

- Operate your payroll with payslips for each employee.
- Calculate and issue a profit statement for your company.

## Quarterly

- Calculation & advice of VAT returns & payments.
- Calculation & advice of PAYE payments.

## Annually

- Issue and file P14's/P60 & P35 with HMRC.
- Issue and file P11d & P11d(b) with HMRC.
- Calculate and advise of Class 1A NIC payments.
- Prepare & file annual accounts with HMRC.
- Prepare & file Corporation Tax return (CT600) with HMRC.
- Prepare accounts for Companies House.
- Prepare Companies House Annual Return (AR01).
- Personal Tax Return for one person

## Ongoing

- Dedicated Chartered Accountant including their direct phone number & email address.
- Unlimited telephone & email support.
- Produce dividend vouchers and board minutes.
- Deal with any general HMRC correspondence and queries.
- Advise Companies House of company changes.
- Deal with change of address for the company and director.
- Mortgage and tenancy references.
- If you decide to cease using our services, your only commitment is to give us one month's notice.
- If you choose to move to another accountant, we do not make a charge for the transfer.

## Your obligations to us:

- Send us copies of your invoices.
- Send us your expense claim form.
- Send us a copy of your company bank statements.
- Respond to letters and emails from us.
- Pay our fees each month.