

IR35 – BASIC PRINCIPLES

IR35 is the generic name given to anti avoidance legislation introduced by the Government to counter “abuse” of PSCs. The name stems from a press release issued in the April 1999 budget, and which applied from 5 April 2000 onwards. The legislation is contained in Schedule 12 Finance Act 2000. The basic legislation states:

(1) This Schedule applies where-

(a) an individual ("the worker") personally performs, or is under an obligation personally to perform, services for the purposes of a business carried on by another person ("the client"),
(b) the services are provided not under a contract directly between the client and the worker but under arrangements involving a third party ("the intermediary"), and
(c) the circumstances are such that, if the services were provided under a contract directly between the client and the worker, the worker would be regarded for income tax purposes as an employee of the client.

(2) In sub-paragraph (1)(a) "business" includes any activity carried on-

(a) by a government or public or local authority (in the United Kingdom or elsewhere), or
(b) by a body corporate, unincorporated body or partnership.

(3) The reference in sub-paragraph (1)(b) to a "third party" includes a partnership or unincorporated body of which the worker is a member.

(4) The circumstances referred to in sub-paragraph (1)(c) include the terms on which the services are provided, having regard to the terms of the contracts forming part of the arrangements under which the services are provided.

(5) The fact that the worker holds an office with the client does not affect the application of this Schedule.

The legislation then goes on in some detail to set out the impact of this, block loopholes and prescribe remedies where the rules are not adhered to.

The legislation for National Insurance is located elsewhere but is to all intents and purposes a replica of the Schedule 12 provisions.

In essence IR35 applies where a contractor works on a contract in such a manner that he or she is a “disguised employee” – that is to say that if the PSC intermediary, and any other intermediaries, was stripped away would the contract be one of employment (IR35 fail) or one of self employment (IR35 pass).

The IR35 legislation itself may conveniently be broken down into three parts:

- The circumstances in which IR35 applies (broadly as set out above)
- The minimum salary requirement where IR35 applies
- The impact if the minimum salary is not paid

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Circumstances in which IR35 applies

IR35 applies where a contract is one of “disguised employment”. That is to say if the PSC was stripped away, along with any other intermediary, eg the agency, would the contract be one of employment or self employment?

Unfortunately there is no statutory test for employment v self employment, but there is a lot of case law and practice to assist. The case law and practice is known as the “status tests” or “badges of trade” – this whole area of tax law is known as “status” and is practised in HMRC by “status officers”.

The next section in this guide, Status Checklist, looks at status in more detail.

It should be noted that the tests used are the same ones which apply in any status decision, and therefore the same criteria apply whether you are a sole trader, partnership or limited company. The only significant difference is that if you are a sole trader the risk, i.e. liability for extra tax and NI, lies mostly with the engager, whereas under IR35 the risk for partnerships and limited companies lies with the partnership/company (and in the case of a company, with the main worker in the company, usually its director, personally as well).

IR35 applies whether an agent is involved or not (although direct contracts are more likely to pass IR35). IR35 also applies if you are not a director of your company or a major shareholder. Because the legislation has a catch all application to monies which “*can reasonably be taken to represent remuneration for services provided by the worker to the client*” (FA2000 Sch 12 S3 (1b ii)).

IR35 applies to contracts or, if it is easier to conceptualise, engagements. It does not apply to all of your income en block – i.e. each contract/engagement must be considered separately and they are not tainted by previous passes or fails. The exception to this is that a history of strong outside of IR35 contracts can cover a short weak contract which would otherwise fail.

It is the responsibility of the contractor to consider each contract as regards whether IR35 applies. Several organisations, including Garbetts, offer contract review services to help you make an informed decision. HMRC have a contract review service but industry sources – and Garbetts concur – suggest that this service is not used as it is neither comprehensive nor unbiased.

Minimum salary requirement where IR35 applies

Where a contract is caught by IR35 a minimum salary requirement is created.

The effect of this minimum salary is:

- NI (employers and employees) is due on the income whereas if it was declared as a dividend it would be NI free
- The minimum salary has to be streamed to the contractor rather than to a spouse, with a possibility of wasting spouse allowances
- Expense offsets are restricted

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The minimum salary calculation is:

1. Income from contract caught by IR35
2. Less direct contract expenses (travelling, subsistence, tools, protective clothing, etc, which relate to this contract specifically)
3. Less professional insurances (public liability, professional indemnity)
4. Less pension contributions
5. Less 5% of IR35 caught income as an allowance towards overheads/company running costs
6. = figure to which IR35 applies
7. The figure at (6) is then grossed down to take account of employers NI contributions. At 2003/04 tax rates employers NI is 12.8%, so simply put (8) is (6) divided by 121.8%. However there is a £89 p/w exemption from employers NI so this needs to be factored in where relevant.
8. The result – is such a figure that when employers NI is added on, comes back to (6).

The codification of this process into legislation is quite tortuous, and has been supplemented by various concessions and supplementary guidance notes. It becomes easier to understand with use, and any contractor who has an element of income caught by IR35 is advised to seek professional advice regarding calculating minimum salary levels.

The impact if the minimum salary is not paid

If a contract is caught by IR35 then matters are made considerably simpler by applying a minimum salary as above.

However the IR35 legislation goes into some depth about what happens where the minimum salary is not paid. The minimum salary is calculated, less any salary actually paid, and becomes a deemed salary, treated as paid on the last day of the tax year. Tax and NI is due on this under normal PAYE rules, but relief is granted against tax on dividends paid to the contractor from the IR35 income stream.

These rules are complicated and fairly indiscriminate in their application, particularly as regards how tax and NI on a deemed payment is relieved against dividends. It is strongly recommended that a realistic stance be taken on contracts IR35 status, and where IR35 applies that the minimum salary is paid as a matter of course rather than rely on these provisions.

Policing IR35

IR35 is policed by HMRC as part of their PAYE//NI compliance procedures. In the first instance IR35 status is considered as part of a PAYE inspection (known these days as employer compliance reviews). HMRC are fairly keen to not be seen to be targeting PSCs, but it is clear they have been – PSCs were a category of business which was previously fairly low risk as regards the IRs inspection programme, but the inspections have been stepped up subtly over the last 18 months or so. HMRC would claim this is co-incidence but the wording of information requests/inspection booking letters, along with odd comments dropped carelessly by IR staff, clearly suggests that IR35 is the motive behind such inspections. The IR are using low grade staff for inspections, but channelling the technical side of status consideration to regional specialists; the low grade staff are poorly trained and do not understand the basics of the law they are being asked to enforce; how this is dealt with tactically needs to be considered by any PSC facing a inspection.

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It is too early in the life span of the IR35 rules to say with certainty what happens if a wrong decision has been made on IR35 status; there simply is not enough practical experience of this in the field. However the status rules which drive IR35 (see next section) are well known and accountants such as Garbetts are used to working with them – critically they are imprecise and open to much interpretation as they are case law based rather than statute based. Therefore there is ample opportunity to argue points with HMRC, and HMRC are more than aware of this – they also know their court record on status matters is not good – so there is opportunity to negotiate.

Situations of negligence – treating a contract which is clearly caught by IR35 as being outside of IR35 – are difficult to defend.

By contrast grey areas – where most IR35 disputes will fall - can be defended, or at the very least negotiated to a compromise with the IR.

At the outset, if HMRC request a review, then the contractor should obtain professional assistance regarding HMRCs information powers, strength of contracts, avoiding obvious pitfalls and similar.

The Contract

To operate outside of IR35 successfully it is vital that the contract which you have for any engagement is “IR35 friendly” – for more information on this see the separate document “IR35 – Getting the Contract Right” elsewhere in this section of our www site.

However actual IR35 status is determined by the so called Notional Contract, which is the contract between the worker and end client if all intermediaries are removed.

The actual contractual chain is likely to be:

Worker > PSC > Agent > Client (agency based contract); or

Worker > PSC > Client (direct contract)

However for IR35 the Notional Contract needs to be considered which is:

Worker > Client

Evidence from the PSC > Agent or PSC > client contracts will be relevant but not determinative.

In any review HMRC will always try to look at the Agent > Client contract, as quite often IR35 friendly points in the PSC > Agent contract are not carried forward here. From this evidence HMRC endeavour to construct the Notional Contract; there is no legislation in place concerning the construction of Notional Contracts and robust professional advice is required to counter HMRC cherry picking clauses to suit their own needs.

It is therefore important to either have sight of the agent to end client contract, or to have a confirmation from the agent that all material points from the PSC to agent client are mirrored in the agent to end client contract.