

IR35 – GETTING THE CONTRACT RIGHT

Although the IR35 status tests are based on the Notional Contract between the worker and client, ignoring the PSC and Agent (if any), it's clear that whatever contract you are signing as a PSC is an important part of determining IR35 status.

In order to demonstrate that income falls outside of IR35 the contract must clearly support this. The ideal contract will have the following features:

1. Your personal name will not be mentioned (except possibly as a signatory), i.e. there will be no indication that you are expected to carry out work personally.
2. Clear indications of non personal service – a right of substitution, delegation or sub contract (which are broadly the same thing). To some extent this duplicates (1).
3. A detailed service clause not simply stating the service you are providing, eg “xxx programming” or “yyy fitting” but also outlining why you are providing those services – i.e. what project are you working on, what deliverables are your efforts meant to achieve, by when, what milestones, etc.

A clause of this nature sometimes seems daunting, and a few years ago was not common in PSC type contracts – it is now essential however. A starting point could be codifying:
 (i) what was discussed at your interview; and
 (ii) what are the key performance indicators in the job – or put another way, what, if you didn't do it, could lead to your contract being terminated.

To be adequate for IR35 purposes the service clause really needs to run to a minimum of a page – anything less than that runs the risk of not giving enough detail to show that you have been engaged for a specific task.

The above are probably essentials if the contract is to escape IR35. Below are some “nice to haves”:

4. No mention of “timesheets”. Timesheets suggest payment by the hour, that is to say a contract built around inputs, labour hours, rather than outputs, i.e. a finished task
5. An obligation to hold professional indemnity and/or public liability insurances. These are not normal for a employee, so holding them suggests something other than employment is anticipated by the contract.
6. An obligation to correct defective work in your own time and at your own cost. This suggests a responsibility for your work and to deliver an acceptable finished product in line with the responsibilities normally assumed by a self employed operative.
7. Exclusion of mutual obligations. Mutual obligations occur when, by practice or by contract, it becomes customary for someone to offer you work and you to accept it – i.e. a typical employment situation. Excluding mutual obligations makes it clear that something other than employment is anticipated.

IR35 – GETTING THE CONTRACT RIGHT – continued

8. Explicit parallel contract rights. Again, something which would be unusual, in a contract of employment, and therefore indicative of something other than employment/disguised employment.
9. An express clause saying no employment rights are created – although such a clause will not be determinative of employment status, it is of persuasive influence as regards the intentions of the parties to the contract.

The above points are not determinative – there are many other factors which could be included so long as the picture is painted of something other than employment.

Consideration must be given not only to the basic terms and conditions of the contract, but also to the personalised part of the contract, sometimes referred to as the “contract schedule”, “purchase order” or similar.

A contract cannot be forced outside of IR35 by words alone; the actual method of working must be consistent with what is in the contract, as it is this working relationship which forms the Notional Contract.

To this end it is important that evidence about the actual performance of the contract and favourable points to the contract being outside of IR35 is collected and retained. What is needed will vary depending on circumstances, but consider:

- Confirmation from the client that the substitution and non personal service clauses are recognised.
- Confirmation that the client regards the contractor as an independent resource and not in any way a member of staff.
- Confirmation from the client that benefits such as Christmas parties, staff discount schemes, etc, are not available; NB on a large site use of subsidised staff canteens is not likely to damage the IR35 status case, so do not worry too much about these.
- Confirmation from the client of the project which the contractor has been engaged to work on, milestones for the project and the tasks to be carried out. Evidence should then be retained to support that the contractor worked towards these milestones.

Sometimes a document called a “contract confirmation note” or similar is recommended – an exchange of letters between contractor and client confirming that the contract is in line with the actual working arrangements. These are a good thing, and cover the ground set out above.

Our view is that the starting point for the Notional Contract between worker and client must be a contract closely based on the contract(s) actually in place. Changes must be as minimal as possible, and should only exist where the existing contract wording contradicts the construction of a worker to client relationship – i.e. the substantive clauses of the actual contract(s) must, in their entirety, be the basis of the “notional contract” with changes merely covering updating the names of the parties and similar minor matters.

IR35 – GETTING THE CONTRACT RIGHT- CONTINUED

HMRC would probably want to start from a blank sheet when constructing the Notional Contract, but they should not be allowed to exclude favourable clauses included in the PSC to agent or PSC to client contract without reason – such a reason would be evidence that they are not recognised in practice, hence the need referred to above to gather confirmatory evidence about actual performance of the contract.

The concept of the Notional Contract is a double edged sword. On the one hand a weak written contract can be strengthened by evidence about IR35 favourable working in practice. On the other hand a strong written contract with IR35 friendly clauses which are not applied in practice, is weakened considerably when converted into a Notional Contract.

A potential area of dispute with HMRC in the event of a IR35 review is the agent to client contract (other than for direct contracts). The IR insist that these are relevant to the construction of the notional contract; our view is that this infringes basic privity of contract rules and therefore attempts to use the agent to client contract in constructing the hypothetical contract should be resisted.

However, HMRC have a right under the Taxes Management Act 1970 to request the contract, on application to the client or agent.

It is interesting to note in one of the first IR35 cases to reach public hearing before the Special Commissioners, Lime IT, the agent to client contract was not very strong, and contradicted the contractor to agent contract, but the case was won as outside of IR35 despite that. Therefore weaknesses in an agent to client contract will not necessarily render the contract caught by IR35 – the agent to client contract will influence the construction of the Notional Contract, no more.

In the event of an appeal hearing relating to IR35 the Special Commissioners (an independent tax tribunal, being the first rung in the ladder of the court system for tax appeals) have said that they will expect to have evidence about the working relationship, i.e. the Notional Contract, by the client. Their statement is at www.inlandrevenue.gov.uk/ir35/scitexpl.htm (NB the Commissioners are independent, the statement was published on HMRC www site for convenience). The document is re-produced as an appendix to this document.

A good source of draft contracts and advice on their construction is the Professional Contractors Group (www.pcg.org.uk).

IR35 – GETTING THE CONTRACT RIGHT- CONTINUED

Appendix – IR35 appeal guidance issued by the Special Commissioners

Supplement to the Explanatory Leaflet about appeals and other proceedings before the Special Commissioners.
Contents

1. What is an IR35 appeal?

An IR35 appeal is an appeal against a decision of HMRC that payments made to intermediaries such as service companies should be treated as earnings of the worker for the purposes of income tax and/or national insurance contributions.

In IR35 appeals the worker is called "the worker", the service company (or other intermediary) is called "the intermediary", and the person, firm or company to whom the worker supplies work is called "the client".

2. Why is it called an IR35 appeal?

On 9 March 1999 HMRC issued a press release called "Countering avoidance in the provision of personal services". The press release was number IR35. The legislation proposed in the press release was subsequently enacted and came into force in April 2000 and has come to be known as the IR35 legislation.

The legislation changed the treatment of payments made to intermediaries. The result is that, in certain circumstances, payments to an intermediary are treated as earnings of the worker in respect of employment. The changes apply to both income tax and national insurance contributions.

3. What legislation applies to IR35 appeals?

Section 60 and Schedule 12 of the Finance Act 2000 apply to IR35 income tax appeals.

Section 4A of the Social Security Contributions and Benefits Act 1992 and Regulation 6 of the Social Security Contributions (Intermediaries) Regulations 2000 SI 2000 No. 727 apply to IR35 national insurance contributions appeals.

4. What usually has to be decided in an IR35 appeal?

Normally it has to be assumed in an IR35 appeal that there is no intermediary. The question which then has to be decided is whether the worker should be regarded as an employee of the client.

5. Why is an IR35 income tax appeal unusual?

An IR35 income tax appeal is unusual because it is the intermediary which receives the decision from HMRC and so it is the intermediary which is the appellant in the appeal. However, the two persons most affected by the decision of HMRC are the worker and the client and neither of these are the appellant in the appeal.

6. What will I have to show?

As in almost all other appeals the burden of proof in an IR35 appeal is on the appellant. That means that it is up to the appellant to show that HMRC are wrong and that the worker should not be regarded as an employee of the client. A number of factors are relevant but none is conclusive. Some relevant factors include:

- (1) how the payments for the work are calculated; whether this is by the volume of work done or by reference to the number of hours worked;
- (2) whether the worker gets paid for sickness and holidays and what the pension arrangements are;
- (3) whether the worker's absences have to be approved in advance;
- (4) whether the client can control what, where, when and how the work is to be done;
- (5) whether the worker must do the work personally or whether he can provide a substitute;
- (6) whether the worker provides his own tools and equipment;
- (7) whether the worker is part and parcel of the client's organisation;
- (8) whether the worker occupies a post (such as General Manager or Secretary) in the client's organisation;

IR35 – GETTING THE CONTRACT RIGHT- CONTINUED

Appendix – IR35 appeal guidance issued by the Special Commissioners - continued

- (9) whether the worker has a job title in the client's organisation;
- (10) whether the worker works continuously for the client or whether the worker has a series of engagements;
- (11) whether the worker hires his own employees;
- (12) whether the client is obliged to offer work and whether the worker is obliged to do the work;
- (13) whether the worker works, or can work, for other clients;
- (14) whether, and under what conditions, the contract can be terminated by the client;
- (15) whether the worker assumes any financial risk; and
- (16) whether the worker has an opportunity to make a profit on his own account.

7. What documents will I need?

Relevant documents will include any written contract between the worker and the intermediary and any written contract between the intermediary and the client. If either of these contracts have been varied in writing then the documents about the variation will also be needed.

8. What oral evidence is likely to be needed?

Since the question to be decided is whether the worker should be regarded as an employee of the client it would be helpful for both the worker and someone from the client to give oral evidence about the factors mentioned in 6 above. Oral evidence would also be useful about: the extent to which the terms of the written contracts have been carried out: whether there has been any unwritten variation in the contracts: and whether any additional terms have been implied into the contracts.

9. How should I get evidence from the client?

You can ask someone from the client to attend at the hearing of your appeal and to give evidence on your behalf. If you wish to make sure that someone comes then you can apply in writing for a witness summons. Please read paragraph 6 of the Explanatory Memorandum which tells you how to do this.

10. Does the witness evidence have to be in writing?

It is very useful for a witness to write down his evidence before the hearing of the appeal. This means that he has time to think about what he is going to say and can check any matters like dates etc. A written document containing the oral evidence of a witness is called a witness statement. It would be useful for each witness statement to cover, as far as possible, the matters mentioned in 6 and 8 above as well as any other matter which the witness wants to mention.

11. Must the documentary and witness evidence be disclosed in advance?

It is a great help if copies of both the documentary evidence and the witness statements are sent in advance. Sometimes the Special Commissioners direct that this should be done. If HMRC agree with the contents of a witness statement it may not be necessary for the witness to attend the hearing. If no directions have been given in your appeal then it would help if both you and HMRC were to send copies of all the relevant documents and witness statements to the Clerk and to the other side fourteen days before the date of the hearing of the appeal.

Issued by
The Presiding Special Commissioner
15-19, Bedford Avenue
London WC1B 3AS