

## **A QUICK GUIDE TO EMPLOYMENT STATUS**

*October 2005*

### **EMPLOYMENT STATUS – THE CONUNDRUM**

Employment status – is someone employed or self employed - is one of the biggest grey areas in the UK tax system, and for businesses one of the most expensive areas to get wrong in terms of higher labour costs or unexpected back tax bills.

Issues surrounding employment status affect all businesses, regardless of the sector they operate in. Even if your workers are not self employed, your competitors might be and that may be enough to give them competitive advantage.

Closely allied to this is the Construction Industry Scheme(CIS). For employers in the Construction Industry this adds extra regulation concerning status onto businesses. See [www.garbetts.com/cis](http://www.garbetts.com/cis) for assistance with the Construction Industry Scheme.

### **SOME DEFINITIONS**

*CIS – Construction Industry Tax Scheme*

*Status – whether a worker is employed or self employed*

*Engager – the business engaging a worker on an employed or self employed basis*

*Worker – the person working for the engager*

*Employed – the worker is an employee of the engager, and subject to employment rights, pay, benefits and deduction for tax/National Insurance.*

*Self Employed – the worker is an independent business in a business to business relationship with the engager, and paid a fee for their services, normally without any deduction.*

*Status tests – the tests HM Revenue & Customs use to work out whether a worker is employed or self employed*

## SO WHY IS STATUS SO IMPORTANT

It is really a matter of competitiveness and cost; in a self employment situation HM Revenue & Customs collect less. For this reason they are keen to tackle self employed status where they think there is a chance they can prove employed status. Likewise businesses are keen to demonstrate self employed status, and therefore minimise labour costs.

Let's look at some figures – suppose Jack engages Jill, for an agreed payment of £2,000 per month (£24,000 pa). What is the cost to Jack, Jill's take home pay and HM Revenue & Customs payment under an employed versus self employed scenario?

|   |                    | Employed<br>£ | Self<br>Employed<br>£ |
|---|--------------------|---------------|-----------------------|
| Jack (Engager)  | Wage cost          | 24,000        | 24,000                |
|   | National Insurance | <u>2,481</u>  | <u>-</u>              |
|   | Total              | <u>26,481</u> | <u>24,000</u>         |
| Jill (Worker)   | Wage               | 24,000        | 24,000                |
|   | Income Tax         | 4,030         | 4,030                 |
|   | National Insurance | <u>2,132</u>  | <u>1,655</u>          |
|   | Take home          | <u>17,838</u> | <u>18,316</u>         |
| Total HM Revenue & Customs payment<br>(2003-04 tax rates) |                    | <u>8,643</u>  | <u>5,684</u>          |

It can be seen that on a self employed basis the payment to HM Revenue & Customs is much less; the largest saving being on employers National Insurance.

Of course, there are many variations on this; for example Jack may decide to maintain his costs at £26,481, and pass all the savings to Jill, i.e.

|   |                    | Employed<br>£ | Self<br>Employed<br>£ |
|---|--------------------|---------------|-----------------------|
| Jack (Engager)  | Wage cost          | 24,000        | 26,481                |
|   | National Insurance | <u>2,481</u>  | <u>-</u>              |
|   | Total              | <u>26,481</u> | <u>26,481</u>         |
| Jill (Worker)   | Wage               | 24,000        | 26,481                |
|   | Income Tax         | 4,030         | 4,575                 |
|   | National Insurance | <u>2,132</u>  | <u>1,853</u>          |
|   | Take home          | <u>17,838</u> | <u>20,052</u>         |
| Total HM Revenue & Customs payment<br>(2003-04 tax rates) |                    | <u>8,643</u>  | <u>6,429</u>          |

Alternatively Jill may have some expenses which she incurs whether she is employed or self employed, but under a self employed scenario she can deduct these against her tax and NI, i.e.

|  |                    | Employed<br>£ | Self<br>Employed<br>£ |
|--|--------------------|---------------|-----------------------|
| Jack (Engager)   | Wage cost          | 24,000        | 24,000                |
|  | National Insurance | <u>2,481</u>  | <u>-</u>              |
|  | Total              | <u>26,481</u> | <u>24,000</u>         |
| Jill (Worker)<br>(£2,000 of expenses<br>deductible under<br>self employment) | Wage               | 24,000        | 24,000                |
|  | Income Tax         | 4,030         | 3,590                 |
|  | National Insurance | <u>2,132</u>  | <u>1,495</u>          |
|  | Take home          | <u>17,838</u> | <u>18,916</u>         |
| Total HM Revenue & Customs payment<br>(2003-04 tax rates)                    |                    | <u>8,643</u>  | <u>5,084</u>          |

It can be seen that under all these permutations HM Revenue & Customs lose, and in varying ways, the engager and worker win.

## FEATURES OF EMPLOYMENT AND SELF EMPLOYMENT

| <u>Employment</u>   | <u>Self Employment</u>                                    |
|---|---|
| Various employment protection rights                                | Little in the way of employment rights                    |
| Cannot easily be dismissed  | Hire and fire very easily                                 |
| Workplace health & safety protection                                | Workplace health & safety protection                      |
| Redundancy protection   | No redundancy protection                                  |
| Paid holidays   | No paid holidays  |
| (normally) Sick pay   | No sick pay   |
| Paid under deduction of PAYE<br>(National Insurance and Income Tax) | Normally paid with no tax deducted<br>(but see CIS rules) |
| Employers National Insurance incurred<br>by engager                 | No employers NI   |
| Workers NI at employment rates                                      | Workers NI at lower self employed rates                   |
| Little chance for the worker to claim<br>tax deductible expenses    | Worker can claim an assortment<br>of expenses against tax |

## STATUS TESTS

Having seen that self employment offers tax/NI savings over employment, an attraction for both engager and worker, and also has less regulation and restriction, usually an attraction for the engager, how is employment status determined, and how do you influence this?

Alas, there are no statutory tests as to whether a worker is employed or self employed, but over the years the courts have refined a series of rules known as the **status tests**. The status tests are used to reach a conclusion about employed v self employed status; no one test is determinative in its own right, but some are more important than others.

- Mutuality of obligations – mutuality of obligations points towards employment, i.e. the engager is obliged to offer the worker work and the worker is obliged to accept it – non mutuality points towards self employment. Mutuality can occur by custom and practice rather than an express contract.
- Freedom to delegate, substitute and sub-contract – contracts of employment do not have rights of delegation, substitution or sub-contract, collectively known as non-personal services rights. Where these rights are included in the contract then it is a strong indicator of self employment. A recent Court of Appeal judgement, *Express & Echo Publications v Tanton* (1999), held that where a contract allowed services to be carried out by someone other than the worker then it was a contract for services (i.e. self employment) rather than a contract of service (i.e. employment). However the case law also recognises that where the non personal service rights are a side issue, then they do not carry much weight, eg *MacFarlane v Glasgow City Council* 2001. Therefore if you are trying to prove self employed status, the non personal service rights must be wide ranging; it is acceptable for any proposed substitute or delegate to be approved by the engager, but they must actually be paid by the worker providing them.
- Control – if the worker is subject to control as to how the work is carried out then this points towards employment – if there is merely measurement against agreed outcomes/deliverables and the worker can provide the work in their own manner then this points towards self employment.
- Integration – if the worker is integrated into the engagers organisation then that indicates employment – no integration indicates self employment. Integration in this context could be work as part of a team, inclusion by name on the employers stationary or promotional literature, being on call rotas, inclusion in internal directories, ability to represent the engager to outside parties.
- Method of payment – if the worker is paid by the hour/day/week then that points to employment – being paid for a project or task points towards self employment. Equally the use of time sheet to record hours points towards employment.
- Working hours – if the worker is contracted to work set hours then that points to employment – if the worker is contracted by reference to outcomes/deliverables then that points to self employment.

- Simultaneous contracts – if the worker has only one customer/engager then that points towards employment – if the worker has a number of customers/engagers, and even better if they overlap, then this points towards self employment.
- Risk – little or no commercial risk taken indicates employment – risk indicates self employment. Risks could be responsibility for rectification of errors and mistakes or financial risk of a project overrun.
- Responsibility for losses as well as profits – if the worker is isolated against losses then that points towards employment – if there is a risk of losses then that points towards self employment. Of course with a labour only service, making a loss is difficult, but the general flavour of the contract must be for risk to sit with the worker.
- Provision of equipment – if the engagers equipment is used then that points towards employment – if the equipment is the workers then that points towards self employment. Obviously it is not practical for some very small businesses to provide large items, but PCs for working at home, hand tools, etc, point towards self employment.
- Bearing cost of correcting defective work and errors – if the worker does not bear the risks of correcting defective work and errors then this indicates employment – if the worker does bear this risk, eg by having to carry out remedial work in unpaid time or as part of a fixed price/outcome contract, then that is an indicator of self employment.
- Freedom to choose where and when the work is carried out – being tied to the engagers site and working hours indicates employment – the ability to work at home, or to set ones own hours, self employment.

By themselves none of these points are decisive, but taken together they help to paint a picture.

The important factors are generally held to be:

- Personal service
- Control
- Mutuality of obligations

## **ESTABLISHING AND MAINTAINING SELF EMPLOYED STATUS**

So, if it is desired to establish or maintain self employed status, how is this done?

First and foremost the important thing is having a self employed contract in place. This should cover most of the issues set out in the section above on status tests.

A strong contract will defeat many, perhaps most, attacks by HM Revenue & Customs. However, it is important that this contract is backed up by real practice and acknowledged by both parties to be effective. To this end it is important that both sides understand the clauses in the contract and their implementation. However the mere fact that a clause isn't implemented doesn't mean it's not valid, eg:

Suppose a contract between Bill (the engager) and Ben (the worker) had a right of substitution within it which lets Ben send someone else to carry out his work.

HM Revenue & Customs examine the contract during an inspection, and ask Bill, "What would happen if Ben sent a substitute". If Bill replies "I would accept that substitute and let him carry out the work unless he wasn't capable of doing so, in which case I would tell Ben", then all is well, even if the right is never used. However if Bill replied something like "Well, we never intended to use the clause in practice, it was just something the accountant told us to put in there" then, of course, HM Revenue & Customs will seize on this and claim the clause is invalid.

Likewise if they asked Ben "What would you do if you couldn't work one day, would you be allowed to send someone in your place?", Then if Ben answered "Yes, I would find someone else to work for me" then all is well. However if Ben answered "No, Bill has said he only wants me" then the clause may well fail.

The importance of this example is to show that not only must the contract in place be favourable to self employment, but both engager and worker must understand why it's in place and what it means in practice. However the understanding and the willingness to implement the pro self employment clauses are just as important as actual implementation.

The following are good practices to follow to preserve or establish self employed status:

- **Contract** - it is important that all self employed operatives have a contract with the engager. In the case of partnerships and limited companies the contract should be between the partnership/company and the engager, not the worker and the engager.

A suitable specimen is in the appendix - you are free to copy or use this, and we can provide blanks on request. The specimen can be altered if necessary, but we would recommend you stick to its contents as closely as possible; if you make changes it would probably be sensible to let us review them. The specimen is provided on the strict understanding that we are not employment or contractual law experts - you must seek advice from an expert in such matters if you have any concerns or queries about your rights or obligations.

It is good practice to renew contracts on a regular basis, eg every new project or every three months.

- Invoicing - it is important that self employed workers invoice the engager for the work they do and they are paid against invoices.
- Advertising – self employed workers contractors should periodically advertise their services in the local press, shop window, etc, and keep copies of the adverts.
- Business organisation – self employed workers who can demonstrate they have the trappings of a business organisation will fare better in proving self employment. Such trappings could be a business phone line, a business mobile phone, headed paper, using an accountant, sign written van, advertising, business insurance.
- Differing engagers - if self employed workers work for different engagers it will make their case stronger. This could be achieved by them sub contracting for each other, with them taking turns at "leading" on jobs. Even better, some of the different engagements should be simultaneous.
- Price work - submitting tenders for jobs and working to price, and showing evidence of this, will assist.
- Provision of loose tools and overalls.

The above points will not guarantee to protect all self employed workers status but they will tip the balance quite considerably in favour of self employment, and may well lead HM Revenue & Customs to conclude that there are easier targets to pick on.

## **WHAT IF AN HM REVENUE & CUSTOMS CHALLENGE IS LOST**

During the course of tax inspections – either routine PAYE examinations or enquiries into tax returns – HM Revenue & Customs may question whether a self employed worker is really self employed (or in theory the opposite question). This is referred to as a status challenge.

HM Revenue & Customs generally rely on fear and intimidation with these challenges, and for a properly represented business who have contracts, etc, in place with self employed workers there is little to fear. However this, like many areas of the tax system, is an area where HM Revenue & Customs will home in if there is a weakness or they feel the business may waver.

Over recent years HM Revenue & Customs have not had a lot of success in the courts with status matters, and most of the case law that exists is in favour of the engager or worker trying to prove self employed status. To this end HM Revenue & Customs will try and agree a “quick” settlement with the business/engager, and it is at this time that a firm defence is needed to present positive evidence to HM Revenue & Customs and, all being well, fend them off.

In most HM Revenue & Customs status challenges where there is a credible case, and the worker and engager have made efforts to prove self employment, then HM Revenue & Customs can be beaten.

However sometimes the evidence isn't there – contracts have not been completed, invoices haven't been received, etc, and the case is lost. Generally this means that the engager has to pick up the cost of tax and NI that should have been deducted under PAYE, on the basis of the wage paid being equivalent to take home pay.

EG - suppose Jack engages Jill, for a an agreed payment of £2,000 per month (£24,000 pa). The engagement is structured on a self employed basis, but HM Revenue & Customs re-categorise it as an employment relationship:

|   |                    | Self<br>Employed<br>£ | Re-<br>categorised<br>£ |
|---|--------------------|-----------------------|-------------------------|
| Jack (Engager)  | Wage cost          | 24,000                | 32,120                  |
|   | National Insurance | -                     | 3,521                   |
|   | <b>Total</b>       | <b>24,000</b>         | <b>35,641</b>           |
| Jill (Worker)   | Wage               | 24,000                | 32,120                  |
|   | Income Tax         | 4,030                 | 5,816                   |
|   | National Insurance | 1,655                 | 2,304                   |
|   | <b>Take home</b>   | <b>18,316</b>         | <b>24,000</b>           |
| Total HM Revenue & Customs payment<br>(2003-04 tax rates) |                    | <b>5,684</b>          | <b>11,641</b>           |

HM Revenue & Customs tax take increases to £11,641 pa, from £5,684 pa. But worse, from Jacks point of view, is that he is expected to pay it – his costs increase from £24,000 pa to £35,641 pa. Dependant on his relationship with Jill, she may re-pay him the £8,120 she was going to pay in tax and NI, but Jack probably has no legal way of forcing her to pay this. Alternatively HM Revenue & Customs may allow what Jill has already paid as an offset but, again, this is discretionary and Jack cannot rely on it.

In short; although self employed status provides savings to both engager and worker, the engager is bearing a risk if it all goes wrong. This emphasises how important it is from the engagers point of view to have contracts in place and working practices in line with those contracts.

However there is an important variation to the above where the worker is not an individual. This is covered later in the section on workers with Companies or Partnerships.

## **PLAYING SAFE AND EMPLOYING ALL WORKERS**

In light of the costs to the engager of getting it wrong, the engager may decide to directly employ all staff anyway, and have no self employed workers.

Whilst this is commendable for playing safe, it does mean that tax payments will be higher than they need be and a raft of employment protection legislation and bureaucracy will apply, maybe unnecessarily.

It is probably better for the engager to take professional advice about whether workers are employed or self employed and, if appropriate, what can be done to preserve or prove self employed status. Often some simple contracts and some small changes to working practices are all that's needed.

## WORKERS WITH COMPANIES OR PARTNERSHIPS

As seen above, where the worker is an individual the risk of extra tax and NI if HM Revenue & Customs successfully dispute the workers status is with the engager.

However if the worker operates as a partnership or limited company then the risk is with the worker. This is under a set of rules known as IR35.

IR35 is considered to be one of the worst thought out and implemented pieces of tax legislation in many years, but in essence is quite simple – it extends the existing status tests which apply between an engager and a worker to situations where the worker operates via an “intermediary” (i.e. limited company or partnership). The status tests are then applied on a hypothetical basis between the worker and the engager, and if they fail then the intermediary, or failing them, the worker, has to bear the extra Tax and NI cost; the engager is protected. In these cases the liability of the worker and the intermediary are only merged where the worker has a significant stake (as a shareholder or partner) in the intermediary.

For example, same figures as above, but Jill is operating via Jill Limited:

|   |                                | IR35 does<br>not apply<br>£ | IR35 does<br>apply<br>£ |
|---|--------------------------------|-----------------------------|-------------------------|
| Jack (Engager)  | Wage cost                      | 24,000                      | 24,000                  |
|   | National Insurance             | -                           | -                       |
|   | <b>Total</b>                   | <u>24,000</u>               | <u>24,000</u>           |
| Jill (Worker)<br>via Jill Limited                         | Wage                           | 24,000                      | 24,000                  |
|   | Income Tax                     | -                           | 3,546                   |
|   | National Insurance (employees) | -                           | 1,891                   |
|   | National Insurance (employers) | -                           | 2,198                   |
|   | Corporation Tax                | <u>2,233</u>                | -                       |
|   | <b>Take home</b>               | <u>21,768</u>               | <u>16,365</u>           |
| Total HM Revenue & Customs payment<br>(2003-04 tax rates) |                                | <u>2,233</u>                | <u>7,635</u>            |

NB assumes under the self employed scenario that Jill draws a £4,600 salary and remainder as dividend

It can be seen that Jacks costs remain the same, but Jill has a lot more tax and NI to pay and is much worse off.

## APPENDIX – MODEL CONTRACT

This is a model self employed contract. It can be altered if necessary, but we would recommend you stick to its contents as closely as possible; if you make changes it would probably be sensible to let us review them. The specimen is provided on the strict understanding that we are not employment or contractual law experts - you must seek advice from an expert in such matters if you have any concerns or queries about your rights or obligations.

If you would like an electronic copy for alteration, please let us know.

- 1) The parties to this contract are CONTRACTOR NAME of BUSINESS ADDRESS (hereinafter the Contractor), and NAME of ADDRESS [NAME could also read NAME PARTNERSHIP or NAME LIMITED] (hereinafter the Sub Contractor).
- 2) The Subcontractor will provide [type of services].
- 3) As this is a self employed contract, the Subcontractor is not entitled to sick pay, holiday pay or any form of employment protection other than work place Health and Safety.
- 4) The Subcontractor will be entitled to send a substitute or delegate at his absolute discretion to undertake the services to be provided, although the Subcontractor will be responsible for paying the substitute or delegate, and for the quality of their work. In the event of the Subcontractor being unable to carry out contracted work, and where requested by the Contractor, the Subcontractor is obliged to supply a substitute.
- 5) The Subcontractor is entitled to hire assistance at his own expense. The Subcontractor will be responsible for the cost of such assistance and the quality of the assistants work.
- 6) The Contractor will not control, nor have any right to control, in any detailed manner, how the Subcontractor is to fulfil his obligations, and the Subcontractor will use his own initiative to complete the services to be rendered. This does not prevent the Contractor from specifying the working standards to be adhered to.
- 7) The Contractor will not set hours to be worked by the Subcontractor. Performance will be reviewed periodically. The Subcontractor can choose how and when to complete the services to be rendered so long as performance is satisfactory.
- 8) The Subcontractor will be paid on a basis to be agreed between the parties and reviewed from time to time.
- 9) The Subcontractor will be able to benefit from his own efforts and sound management.
- 10) For the purposes of clarity both the Contractor and the Subcontractor consider and intend this business relationship to be one of self employment and not one of master and servant. Specifically both parties acknowledge that the Contract for Services does not give rise to a contract of employment. Both parties consider the Subcontractor to be in business on his own account.
- 11) The Subcontractor is responsible for his own tax and National Insurance.

- 12) The Subcontractor is responsible for maintaining public liability insurance.
- 13) The Subcontractor is responsible for providing his own overalls, protective clothing, hand tools and consumables.
- 14) The Subcontractor will be responsible for correcting any defective work at his own cost.
- 15) Both parties acknowledge that the Contract for Services can be terminated at any time without notice and will be periodically reviewed in any event. The Subcontractor is not under an ongoing obligation to provide services and the Contractor is not under an ongoing obligation to contract for such services.
- 16) There is no restriction on the Subcontractor working for third parties whilst this contract is in force, subject to the contract services being completed on time and to the satisfaction of the Contractor.
- 17) If the services are of a construction nature, it is intended that each CIS voucher represents a new contract.

Agreed by \_\_\_\_\_ (Sub Contractor)

Agreed by \_\_\_\_\_ (Contractor)