

Are you at risk from IR35?

A bit of history

In March 1999, the then Chancellor announced anti-avoidance measures to target the avoidance of tax and national insurance contributions (NIC) by individuals providing their services through an intermediary, such as a personal service company (PSC) or partnership. PSCs tend to be the main focus in this area, so this Briefing will concentrate on companies rather than partnerships. The proposals were announced in a press release and the rules have become widely known as 'IR35' simply because that was the number of the press release!

The rules have applied since April 2000 and, broadly, target those who would be employees of their clients if no intermediary, such as a company and /or agency, was interposed between the individual and the paying client. The rules have attracted considerable opposition over the years, particularly from the IT sector, as many individuals have no commercial option other than to operate through their own company.

A refresher

The tax advantages of using a PSC mainly arise from the extraction of the net taxable profits of the company by way of a dividend. This avoids any NIC which would generally be due if that profit was extracted by way of remuneration or bonus. The intention of IR35 is to instead tax most of the income of the company as if it were a salary of the person doing the work.

The rules apply if, had the individual sold his/her services directly rather than through a company (or partnership), he/she would have been classed as employed rather than self-employed.

For example, an individual operating through a PSC but with only one customer for whom he/she effectively works full time may well be caught by the rules. On the other hand, an individual providing similar services to many customers is far less likely to be affected.

The broad effect of the legislation is to charge the income of the company to income tax and NIC at personal tax rates rather than corporate tax rates.

Employment v self-employment

One of the major issues under the rules is to establish whether particular relationships or

contracts are caught. This is because the dividing line between employment and self-employment has always been a fine one.

A variety of 'status' factors will be considered but, overall, it is the reality of the relationship that matters.

HMRC will consider the following status factors when deciding whether a contract is caught under the rules.	
Mutuality of obligation	will the customer offer work and the worker accept it as part of an ongoing understanding?
Control	does the customer have control over tasks undertaken/ hours worked etc?
Equipment	does the customer provide all of the necessary equipment?
Substitution	can the individual send a substitute if he cannot do the job himself?
Financial risk	does the individual's company (or partnership) bear financial risk?
Basis of payment	is the company (or partnership) paid a fixed sum for a particular job?
Benefits	is the individual entitled to sick pay, holiday pay, expenses etc?
Intention	have the customer and the worker agreed there is no intention of an employment relationship?
Personal factors	does the individual work for a number of different customers and does the company (or partnership) obtain new work in a businesslike way?

The history of employment versus self-employment is long and complex but it is fair to say that in more recent cases, greater emphasis has been placed on some of the above tests compared to others. A genuine right of substitution and the degree to which the services are heavily controlled by the payer are critical tests.



A recent case

A recent case illustrates the considerations and consequences of being wrong!

The taxpayer was employed by his own company, albeit that there was no written employment contract, which then contracted to provide his services via an agency to the payer. The dispute spanned the tax years 2000/01 to 2007/08, with HMRC claiming a total of £91,443.48 in tax, £61,268.35 in NIC, and interest of £48,048.46!

Having looked at the contract for some of the later years, the Tribunal reached the following conclusions in relation to the status factors:

Substitution - 'We stop short of saying that the substitution clause in this case was a complete "sham". We accept that if the (company) had notified (the agency) and indirectly (the payer), that (the taxpayer) was going to be unwell, or absent, for a long period for some reason, but that the (company) had managed to engage a suitable substitute, and that substitute passed (the payer's) interview test with flying colours, then it is indeed

possible that the (company) could have continued to bill for the services of the replacement.

That, however, is the extent of the reality of the substitution clause. It is perfectly obvious that, as with all similar contracts drafted to seek to sustain non-employee status, the clause was inserted to achieve the desired tax purpose, and it has virtually no bearing on our approach to the decision in this case.'

The reasons why it was considered to be irrelevant were:

- it was pointless to provide for an interview if the payer could not reject an offered substitute
- the only context in which substitution could be a reality is where the taxpayer was going to be absent for a long period and
- there seemed little reality to the proposition that the company might have even been able to offer a replacement where the taxpayer would be unavailable for a long period.

Control – when the taxpayer was engaged for his first single project, and even when he was re-engaged for defined projects, the control over his work was limited. However, later it became clear that the payer wanted the taxpayer's services permanently – it no longer engaged him for projects. It either offered him employment, or permanent engagement, and even if he rejected that, he was then engaged on an annual basis.

Own business – the taxpayer failed this test in that, when engaged, he had no opportunity to make more or less profit according to how efficiently he worked.

Mutuality – as far as the first few projects were concerned the Tribunal accepted that the taxpayer never knew whether the various contracts would be renewed.

Intention – the Tribunal attached little importance to the argument that the parties regarded the taxpayer as not being an employee.

Compliance

Many felt that the compliance aspects of this regime would be high. IR35 is essentially a self assessment 'tax'. This means that the onus is on the company and the individual to pay the correct amount of tax and NIC. HMRC can then enquire into the arrangements and punish where appropriate (by way of tax, interest and penalties) if the rules are not applied correctly.

In recent times, questions have appeared on both the employers' end of year return (P35) and the self assessment tax return for individuals that appear to target service companies. The tax return contains a requirement to identify income included in the return that is derived from the provision of services through a service company. Although some debate the legality of this question, HMRC have stated that this is for their risk analysis work.

In reality, for a variety of reasons HMRC enquiries into IR35 since 2000 have been few and far between but the issue was given new impetus before Budget 2012 by the arrangements entered into by the head of the student loans body.

This has prompted the Government and HMRC to revisit this area. To quote the Government:

'The Government is bringing forward a package of measures to tighten up on avoidance through the use of personal service companies and to make the existing IR35 legislation easier to understand. This will include HMRC strengthening specialist compliance teams, simplifying the way IR35 is administered, and consulting on proposals which would require office holders/controllers persons who are integral to the running of an organisation, to have PAYE and NICs deducted at source.'

A new approach

There have been two developments in recent months. Firstly, the Government proposes creating rules which would require an engaging organisation to place all controlling persons on the payroll. This provision would apply even where they might be working through a PSC for other purposes and even if the payments made by the engaging organisation were made to the PSC and not directly to the individual worker.

Secondly, HMRC have released some guidance setting out their risk-based approach to checking compliance with IR35. Key to the approach is to identify which 'risk band' a business may be in. It also gives example scenarios to illustrate when and why IR35 will apply to an engagement.

What are risk bands?

HMRC state:

'If you are in either the 'high risk' band or the 'medium risk' band, there is a risk that we will check whether IR35 applies to you. And this risk is not low. So you need to decide whether IR35 applies to any of your engagements – especially if you are in the 'high risk' band.

If you have taken the 'business entity' tests, and you are in the 'low risk' band, you need to keep evidence to support your answers.

If we check whether IR35 applies to you, please show us your evidence that you are in the 'low risk' band.

If your evidence proves to our satisfaction that IR35 does not apply to you or that you are in the 'low risk' band, we will close our IR35 review. And we will undertake not to check again whether IR35 applies to you for the next three years, provided that:

- the information you have given us is accurate
- your circumstances – and, in particular, your working arrangements – do not change in that time.

The business entity tests look at how your business works overall. But, for the purposes of calculating PAYE and NIC under IR35, you need to consider each engagement separately.'

The business entity tests

HMRC have drawn up the business entity tests to help businesses find out which risk band they are in. There are twelve tests all of which are completely voluntary. Each test asks at least

one question and a 'yes' answer scores points. The tests together with the related scores are as follows:

- Business premises (10 points) - Does your business own or rent business premises which are separate both from your home and from the end client's premises?
- PII (2 points) - Do you need professional indemnity insurance?
- Efficiency (10 points) - Has your business had the opportunity in the last 24 months to increase your business income by working more efficiently?
- Assistance (35 points) - Does your business engage any workers who bring in at least 25% of your yearly turnover?
- Advertising (2 points) - Has your business spent over £1,200 on advertising in the last 12 months?
- Previous PAYE (minus 15 points) - Has the current end client engaged you on PAYE employment terms, within the 12 months which ended on the last 31 March, with no major changes to your working arrangements?
- Business plan (1 point if the answer to both questions is yes) - Does your business have a business plan with a cash flow forecast which you update regularly? Does your business have a business bank account, identified as such by the bank, which is separate from your personal account?
- Repair at own expense (10 points) - Would your business have to bear the cost of having to put right any mistakes?
- Client risk (10 points) - Has your business been unable to recover payment for work done in the last 24 months, in excess of 10% of yearly turnover?
- Billing (2 points) - Do you invoice for work carried out before being paid and negotiate payment terms?
- Right of substitution (2 points) - Does your business have the right to send a substitute?
- Actual substitution (20 points) - Have you hired anyone in the last 24 months to do the work you have taken on?

The results

A score of less than 10 = high risk, 10 to 20 medium risk and more than 20 low risk. Each test lays out evidence to be kept to substantiate the test score.

The future

The 'new' tests are not law and it is not clear when, how or with what staff HMRC will operate this new risk-based approach but it would be foolish to pretend the guidance did not exist. A sensible starting position may be to establish how many points your business currently scores. Then consider accumulating more points to achieve a 'low risk' band, so that HMRC leave you alone. If you would like to discuss any aspect of this Briefing in more detail, please do get in touch.