

What is IR35?

This guide can be used to help you determine how compliant your contractual agreement is. *This document is intended for guidance purposes only and should not be used in place of a professional contract assessment.*

HM Revenue and Customs introduced the 'intermediaries legislation', commonly known as IR35, in April 2000. The legislation is intended to combat the abuse by an individual who would be treated as an employee were it not for the fact they provide their services via their own personal service company (PSC). Working in this manner enables an individual to make substantial tax and NIC savings. If the Revenue investigate a contract and decide that it is 'caught' by IR35 they will calculate a deemed payment, treating all income received as salary and demanding all tax and national insurance contributions on payments originally paid out as dividends.

Obviously there are a huge amount of contractors who are genuinely independent and they face the same struggle to prove this fact to the Revenue. Therefore it is vital that all contractors working through their own companies are fully aware of the legislation and do everything possible to ensure that they remain legitimately outside of IR35. The interpretation of IR35, and the defining of status, is reliant on case law – as such, the determining factors surrounding IR35 change over time and certain issues become more prominent following each significant case.

To determine whether you are caught by IR35 the Revenue will look at both the written contract between your limited company and the agency and the actual working practices, i.e. the way the work is performed on a daily basis. There are a number of key areas that must be considered and incorporated if you are to remain compliant. They are as follows:

- **Personal Service/Substitution**
- **Control**
- **Mutuality of Obligations**
- **Provision of Equipment**
- **Financial Risk**
- **Basis of Payment**
- **Exclusive Service**
- **Part and Parcel of the Organisation**
- **Intention of the Parties**
- **Business-like trading**

Personal Service and Substitution

A self employed contractor enters into a contract to provide a service rather than personal skills and should be able to provide a substitute or engage helper to provide the service. An employee would provide his services personally. The case of *Chaplin v Australian Mutual Provident* (1978) held that:

"...the power of unlimited delegation is almost conclusive against the contract being a contract of service."

The right of substitution is one of the strongest tests of self employment as shown in the case of *Echo and Express Publications v Tanton* (1999).

Although the majority of contractors may never exercise it, the right to substitute someone else to undertake the work must be a genuine one. The substitute must be answerable to, and paid by, the company who originally undertook to complete the contract.

The client may retain the right to veto a substitution on reasonable grounds, however this should be limited to factors such as the qualifications/experience of the proposed substitute or security issues.

EXAMPLE OF A COMPLIANT SUBSTITUTION CLAUSE

The Supplier shall provide the services using suitably qualified personnel of their own choosing. The Supplier reserves the right to substitute any personnel, provided the Client is reasonably satisfied that any proposed substitute possess the necessary skills and qualifications for the satisfactory completion of the services. The Supplier will remain liable for the services completed by substitute personnel and will bear any costs

A contract without an explicit right of substitution will almost always fail a contract assessment. Attempted substitution clauses that contain the following will also cause a contract to fail assessment:

- If the Client is given sole discretion over a proposed substitution. In order for a subs clause to be valid, the client may only be able to reject a proposed substitute on reasonable grounds. Reasonable grounds would relate to the suitability of the proposed substitute, or security issues.
- If the Contractor is required to give anything more than reasonable notice of a proposed substitution – anything longer than 7 days can be seen as unreasonable (although more flexibility can be given to those with clients with particular security risks, such as the MOD)
- If the Client requires to “interview” a proposed substitute.
- Rights to *subcontract* do not constitute a right of substitution.

Control

The degree of control exercised by the client over the services to be completed, as well as how, when, and where the individual does the work is highly important.

A self employed individual may agree to perform a particular task at a specific time and place, but it is unlikely that he will be subject to any right of control by the client. An employee on the other hand, is likely to be told where and when the tasks should be undertaken. This is shown in the case of *Morren v Swinton and Pendlebury Borough Council* (1965).

This being said, for control to be relevant, it must be much more than merely monitoring or checking work. Unless a contractor is “tied hand and foot” to the client, then the detrimental level of control is not present [*Chaplin v Australian Mutual Provident*].

Control over what the contractor does will be clear, as he will be constantly advised by a manager or supervisor as to the work to be done. Where a client can move the contractor from job to job due to the changing priorities, there will be a right of control over what is to be done – this is a strong indicator of employment. [*Stagecraft Ltd v Minister of National Insurance* (1965)]

Control over where the contractor does the work may be in the contract. A contract of service will usually provide the client with the right to require a contractor to work at a specific place. Where the tasks are to be undertaken at the client’s premises and the work to be integrated into the client’s premises, there is likely to be control. It is acknowledged, however, that certain services can, in reality, only be carried out at the client’s premises therefore this factor may be neutral.

Control over when the contractor does the work is obvious; an employee would be required to work set hours. A self employed contractor would be expected to arrange his hours to suit the task and his own convenience.

Control over how the tasks are completed can be difficult. In the case of *Morren v Swinton Borough Council*, it was said:

“Clearly superintendence and control cannot be the decisive test when one is dealing with a professional man or man of some particular skill and experience. Instances of that have been

given in the form of a master of a ship, an engine driver or a professional architect or, as in this case, a consulting engineer. In such cases, there can be no question of the employer telling him how to do the work, therefore the absence of control and direction in that sense can be of little, if any, use as a test.”

However, in reality, contractors with specialist skills and expertise will be likely to work with clients who have their own knowledge of these specialist areas. As such it is important that contractors retain a reasonable degree of autonomy over their working methods.

It should be remembered that the control need not be exercised directly, but that it can be delegated as was the case in *Global Planet v The Secretary of State for Social Security*.

EXAMPLE OF A GOOD CONTROL CLAUSE

The Client shall have no right to, nor shall seek to, exercise any direction, control, or supervision over the Supplier in the provision of the services. The Supplier shall endeavor to co-operate with the Client's reasonable requests within the scope of the services, however it is acknowledged that the Supplier shall have autonomy over their working methods.

The Supplier may at any time and without giving the client prior notification, make any changes to the specified service which are necessary to comply with any applicable safety or other statutory requirements, or make any changes to the specified service which do not materially affect the nature or quality of the specified service.

The services shall be provided at such locations, and during such hours, as the Supplier deems appropriate for the satisfactory provision of the services.

If a contract remains silent on the issue of control, this is would not cause the contract to fail outright, however closer attention should be paid to other key issues. Contracts that contain any combination of the following are likely to fail assessments:

- The client is given control over the working methods.
- The contractor is required to follow client instructions and direction in the same way an employee would.
- The contract must be carried out a times and locations as directed by the client (although some contractors will have mitigating circumstances making this aspect of control less problematic).
- The contract specifies that the contractor will have a 'line manager'

Mutuality of Obligation

An employer will try to make sure that his employees have a continuous supply of work and will also expect the employees to carry out the work when he requires. A self employed person will do the work he is being contracted to do and will finish with no expectation of further work.

When work is regularly given and accepted over a period of time, HMRC may take the view that employee status has been created by custom and habit.

Although mutuality of obligation is a key determining factor surrounding IR35, it is worth noting that HMRC's lack of understanding and misinterpretation makes it difficult to mount a successful defence on this test alone. Currently, much focus is being placed on non-mutuality of obligations *during* the contractual term and, as such, it is important that a contractor has the right to walk away from a contract early, if they so choose. Also see **Right of Dismissal**.

If no clear end date is included in the agreement, and there is no explicit non-mutuality of obligations clause, the contract will likely fail an assessment. If there is no end date, it may be appropriate for certain contracts to terminate upon the completion of the

services – this would be acceptable in cases where the contract is based on clear deliverables.

Provision of Equipment

Whether equipment and other facilities are provided by the individual can be important. An employee will have all the necessary major items of equipment and facilities provided by its employer. The self employed will generally provide their own equipment [Ready Mixed Concrete (South East) v The Ministry of Pensions and National Insurance (1968)].

The more essential the equipment is to the work, the more important this factor becomes, i.e. a milk man who does not own his own float will not normally be accepted as self employed.

HMRC will also take into account investments in skill, i.e. training.

If a contract contains clauses that stipulate the client will purchase any training or equipment (other than particularly specialized equipment) on behalf of the supplier is likely to fail an assessment.

Financial Risk

If the individual concerned is really in business on his own account is the most relevant test of all. A self employed individual, is responsible for how his business is run. Unlike an employee, he provides his own equipment, hires his own helpers, takes a financial risk, takes responsibility for investment in management and has the opportunity of profiting from sound management in the performance of his task.

HMRC will look at the risk being taken by the contractor as it is not usual for an individual to be classed as self employed if he takes a financial risk.

Method of Payment

How an individual is paid may be a factor as to whether he is employed or self employed. Payment in terms of a hourly, weekly or monthly rate is associated with employment, whereas a self employed individual will negotiate a rate for a job, invoice for the work done, and bear his own expenses and overheads.

It should be remembered that HMRC's Employment Status Manual states that as self employed professionals such as lawyers and accountants are be paid by the hour or the day, this test can be inconclusive.

Exclusive Services and Length of Engagement

When an individual works exclusively for one client, there is a presumption that he is an employee, as it usual for a self employed person to work for more than one person. HMRC do not see this as important; there view seems to be that most employees are not restricted to working for one employer. Contractors must have the right, however, to take on additional clients on a concurrent basis.

In Tax Bulletin 28, HMRC do concede that 'long periods working for one client may be typical of employment, but are not conclusive'. The article then goes on to say that 'regularly working for the same client may indicate that there is a single and continuing contract of employment [Nethermore (St Neots) Ltd v Gardiner (1984)]'. See also **Mutuality of Obligation**.

If a contract explicitly states that the supplier is not able to supply their services to other clients is likely to fail assessment. It is acceptable, however, for clauses to be included that prevent the contractor from working with the clients direct competitors, or if any other conflict of interests is created.

Part and Parcel of the Organisation

Contractors must not be 'part and parcel' of the client's business as if they were one of their employees. They should not be on any internal lists of employees or have business cards showing their client's name and, crucially, must not be entitled to any benefits offered to the client's own staff, i.e. bonuses, pensions, and use of facilities such as a gym.

Any clauses that stipulate that a contractor will be subject to performance reviews or disciplinary action (as would be expected of employees) would cause a contract to fail an assessment.

Right of Dismissal

It is not normally the case that a self employed person could be dismissed other than if he was in breach of the terms of his contract. An employee would have the right to be given statutory notice of the termination of his employment. HMRC see notice periods as being indicative of employment however reasonable notice periods are considered defensible.

If a contractor is not able to terminate their contract early, or has a notice period in excess of one month, the contract will fall inside IR35.

Intention of the Two Parties

A self employed person works under a 'contract for services' and an employee under a 'contract of service'.

The contract does not need to be in writing - an oral or implied contract is legally binding if the parties intend it. The terms of the contract can be collected from the circumstances surrounding the engagement.

Where there is a written contract, HMRC may look through the contract to find the facts of the case. While often important in deciding an individual's status, the terms of the contract are not a conclusive element.

This is seen as a 'tie breaker' issue – if a contractor's status is unclear after consideration of the other issues surrounding IR35, the intended relationship of the parties can be used to determine the outcome of an enquiry.

Business-like Trading

Other matters such as VAT registration, business insurances, health and safety requirements, licences, advertising, etc. should be taken into account and help to demonstrate being in business on your own account. A limited company contractor should have all the normal trappings of a legitimate business in place.