

IR 35

If you are a Contractor who trades through a Limited Company you must be aware of the IR35 rules as this could affect your tax efficiency and prevent you from taking dividends, our IR35 guide explains the background to IR35 and how it can affect you.

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

IR35 Rules: IR35 was introduced in April 2000, as a piece of tax avoidance legislation – to prevent contractors setting up their own limited companies (in order to benefit from significant national insurance and tax savings), who, were it not for their limited company, would be considered an employee of their end client for whom they undertake work directly.

There is a great deal of uncertainty surrounding IR35, in attempting to determine employment status and there are many factors to consider. If HMRC were to 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.

The interpretation of IR35, and the defining of status, is reliant on case law and as a result, 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 HMRC will look at both the written contract between your limited company and the agency/or client along with your actual working practices, i.e. the way the work is performed on a daily basis. In the event of an IR35 enquiry your working practices will always tend to carry more weight than the written terms themselves. If you have a compliant contract in place it is crucial that your actual working arrangements mirror the written terms.

There are a number of key areas that must be considered in order to determine IR35 status, however the three most important tests are; Personal Service / Substitution, Control and Mutuality of Obligation.

The right to provide a Substitute 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 a helper to provide the service. An employee would provide his services personally. 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.

Contractors who are able to exercise their right to provide a substitute would significantly improve the prospects of successfully defending an IR35 enquiry, as a guide HMRC actually attribute 20 points to the provision of a substitute which would put most contractors at low risk on HMRC's Business Entity Tests.

Mutuality of Obligation A self-employed person will do the work he is being contracted to do and will finish without any 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. Additionally in the case of *McManus v Griffiths*, Mr Justice Lightman said in relation to a three-month notice period in that case “I do not think it is indicative of either (employment or self-employment). I regard the provision as neutral.

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.

Control The degree of control exercised by the client over the services to be completed, as well as how, when, and where the work is undertaken 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.

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.

Implications If your contract work is caught by the IR35 rules, you will receive most of your income in the form of a “deemed payment”, net of a standard “5% allowance” to cover admin expenses (no receipts required). You will also be able to claim other contractor expenses on top of the 5% allowance such as insurance cover, pension contributions, subsistence when working away from home and travelling purely for business purposes. To calculate the “deemed payment” you need to :

- 1) Calculate the total income received by your company over the tax year which falls under IR35 rules
- 2) Deduct 5% admin expenses from the total
- 3) Add any other Benefits in kind received
- 4) Deduct any other expenses as per the above
- 5) Deduct the total amount of Employers NIC paid during the year
- 6) Deduct the total amount of salary drawn during the year
- 7) Whatever is left is known as the “deemed payment”. If this is greater than zero you must pay further tax and NIC’s on this amount.

Summary There are many other factors which would be taken into account when looking at IR35 status, such as, whether or not you provide your own equipment, the intention of the parties, financial risk, and basis of payment, whether or not you provide your services exclusively, and business-like trading.

All of these factors would help HMRC to draw up a ‘hypothetical’ picture of your relationship with the end client, ultimately to establish whether or not you are a disguised employee.

The above IR35 rules guide is intended to give you an overview of how it works but we would always suggest speaking with a specialist.