



A contractor's guide to  
**IR35**

## Introduction: What is IR35?

**The majority of limited company contractors have heard of IR35 or perhaps of its more formal title, the Intermediaries Legislation.**

## But what exactly is IR35?

**IR35 legislation was introduced on 6th April 2000 and applies to contractors who are working for a client through an intermediary. An intermediary is an entity such as a partnership or limited company (also known as a Personal Service Company 'PSC').**

Before IR35 was introduced, a worker could use an intermediary to avoid being taxed like an employee and having to pay Class 1 National Insurance (NI). By working through an intermediary, a worker could take money out of the intermediary by way of dividends instead of salary, as this does not attract PAYE and NI.

It became common practice for individuals to leave employment on, for example, a Friday evening and return on the following Monday morning as a limited company contractor. This meant that although they were carrying out exactly the same job as before, they were paying less in tax and NI than the conventional employees. HMRC perceived this as tax evasion.

The government decided that new rules were needed to close this loophole and the Intermediaries Legislation was born.

IR35 applies if you're working for a client through an intermediary (like a PSC) and in reality, you work in the same way as an employee of the client. IR35 considers the underlying nature of your working

relationship with a client. Even if you call yourself **'self-employed'** or believe you have an **'IR35-proof'** contract, you may still be caught by IR35.

IR35 will also apply if you're regarded as an **'office-holder'** of the client, which is explained in greater detail later.

We have provided a brief overview of IR35, but this eBook will go on to provide more information on its background and how it has evolved since. We also break down some of the jargon around IR35, look further when IR35 will apply and consider the consequences of getting your IR35 status wrong.



## Part 1: The history of IR35

**The Intermediaries Legislation was first proposed by the UK's Chancellor of the Exchequer, Gordon Brown, in the 1999 Budget. The legislation is more commonly known as 'IR35' following the Inland Revenue's (now HMRC) Budget press release numbered 35.**

Mr Brown outlined the government's concerns about the number of **'disguised employees'** operating through intermediary companies in the UK in a bid to avoid paying employed levels of income tax and national insurance.

A further press release on 23rd September 1999 formed the basis of the final legislation and IR35 came into force in April 2000. IR35 can be found in the Income Tax (Earnings and Pensions) Act 2003, Part 2 Chapter 8 and in the Security Contributions (Intermediaries) Regulations 2000, SI 2000/727.

## Part 2: How has IR35 evolved over the years?

**IR35 has been heavily criticised over the years and HMRC has made attempts to address these concerns.**

In May 2012, the government published a consultation document looking at the taxation of **'controlling persons'**. The government had concerns about instances where senior people, running an organisation, were using 'artificial structures' to pay minimal tax and NI.

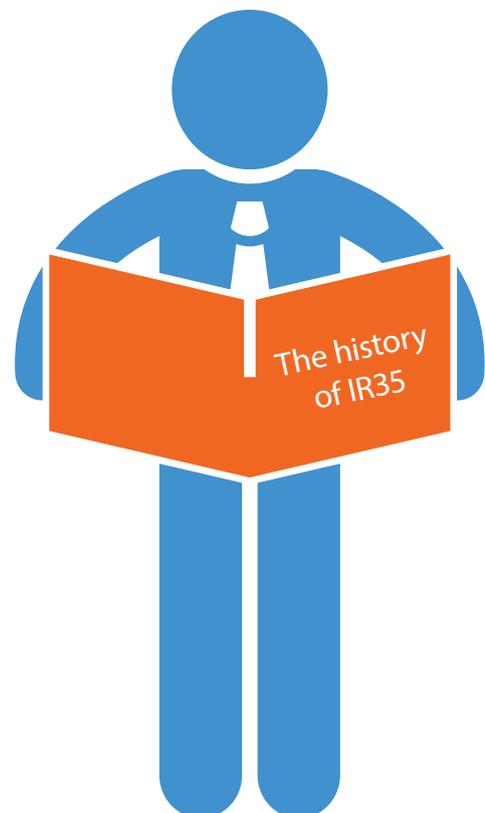
The consultation defined a senior person as a 'controlling person' and suggested that this was someone in a position to control or influence the strategic direction of a company or someone who had control over a significant proportion of the workforce and/or budget of that company.

The government decided not to introduce the so-called 'controlling persons legislation' based partly on its desire to avoid additional complexity in the tax system.

However, during 2012, HM Treasury issued guidance to the public sector on how to seek assurance about the tax arrangements of their contractors. A report published at the beginning of the year revealed that a significant proportion of contractors were not being paid through the central government payroll system.

HM Treasury said that most senior staff should be on the payroll, unless there are exceptional temporary circumstances. The public sector must now take steps to seek assurance about the tax arrangements of long term specialist contractors. HM Treasury also put sanctions in place, should public sector departments not abide by their recommendations.

Despite the government not introducing the controlling persons legislation, it did commit to a new approach to policing IR35. It strengthened the specialist teams who investigate IR35 by increasing the number and efficiency of enquiries where IR35 is the main risk. New guidance was also published and the IR35 helpline and contract review service was improved.



The Business Entity Test, introduced in May 2012, was included in the government's commitment to improve the administration of IR35. It was made up of a series of weighted questions whose answers were allocated a plus or minus score. The total score determined whether your business risk, with regards to IR35, was high, medium or low.

HMRC uses a risk based approach to check compliance with IR35. The Test indicated the likelihood of HMRC checking whether IR35 applied to you, by considering the overall business arrangement. Regardless of the outcome of the Business Entity Test, a business must still consider whether IR35 applies to each separate assignment.

The Test asked a variety of questions on a number of different topics, including business efficiency, plans for the future, whether or not a company holds insurance policies, advertising budgets and the right to substitute a worker. Businesses were also asked about their relationships with previous clients and whether or not they have had any opportunity to increase their income by improving efficiency levels at any point during the past two years.

If a PSC could provide evidence that it scored within the low risk band, HMRC would close its review and there would be no further check for 3 years (provided that the working arrangements do not change). However, if a PSC fell in the medium or high risk band, HMRC continued with its IR35 review.

In October 2014 however, HMRC announced that it was withdrawing the Business Entity Test from 6th April 2015. It concluded that the Test was seldom used and not fulfilling the intended purpose. A high proportion of small businesses fell into the high or medium risk categories.

The Test is not taken into account if HMRC opens an IR35 enquiry on or after 6th April 2015 but if you have already demonstrated a low risk band to HMRC, then HMRC will not open another IR35 enquiry within the 3 year period. It is best practice to retain evidence to demonstrate the responses given on the Business Entity Test.

In April 2013, IR35 was extended to office-holders. There is no statutory definition of an office-holder but examples include directors, executive, non-executive and nominee directors. Before 6th April 2013, IR35 generally only applied to office-holders if they would also have been regarded as an employee of the client if engaged directly.

In late 2013, the House of Lords launched a Select Committee to look specifically at PSCs and tax collection, and this included IR35. The House of Lords made a number of recommendations which included HMRC improving its guidance on IR35 and, in June 2014, HMRC replaced their IR35 FAQs with updated guidance.

In 2010, the Office of Tax Simplification (OTS) was asked to review IR35. The OTS concluded that IR35 should either be suspended with a view to abolishing the legislation or retained but with improved administration; they opted for improved administration.

The IR35 Forum was established and has already overseen a number of changes, including updated guidance and the strengthening of HMRC's specialist compliance teams. In 2015, the OTS published its final report which summarised the recommendations made to HMRC; currently, this is the outcome of the report:

- HMRC will continue to update the IR35 guidance pages on Gov.uk and raise awareness and understanding on IR35. HMRC are considering providing information on IR35 to any company start-up/registration or arranging for clear signposting to the relevant Gov.uk IR35 introductory guide.
- The abolition of the Business Entity test in April 15 which HMRC will widely publicised.
- In respect of HMRC's contract review service, HRMC are thinking about offering a qualified view (which is not guaranteed) even if they don't have all information on the circumstances; for example, HMRC are not in receipt of the contract between the agency and end client.

- During the course of an IR35 enquiry, HMRC will provide an email address for individuals to submit information and documentation to speed up the process. HMRC has also agreed to inform the individual if the end client is to be approached.

It seems that IR35 is here to stay and is relatively unscathed for the time being and with that in mind, read on to learn more on IR35 and whether you fall inside or outside IR35.

## Part 3: How do contractors tell if they are inside or outside the scope of IR35?

**In the context of IR35, you will often hear the terms 'inside IR35' or 'outside IR35.' But what does this mean? This section of the eBook will define these terms and look at when the Intermediaries Legislation most commonly applies.**

IR35 applies to all sectors and industries, as contractors working in IT, construction, finance and engineering - to name just a few - need to ensure that they are complying with the legislation.

If a contractor falls **'inside'** IR35, he must pay roughly the same tax and NI as employees. However, many contractors find it difficult to determine where they are on the IR35 scale and whether or not they fall inside or outside IR35.

When carrying out an IR35 enquiry, HMRC decide whether there is something called a **'hypothetical employment contract'** between the worker and the client. They look at a number of factors in deciding this, including the terms and conditions in place and the actual substance of the arrangements between the parties – sometimes referred to as the **'working practices.'**

HMRC may look, for example, at whether a contractor is treated the same as the client's employees - by having similar levels of responsibility, set working hours, receiving instruction and supervision; being based at a location determined by the client and being required to carry out set tasks. If this is the case, then HMRC is more than

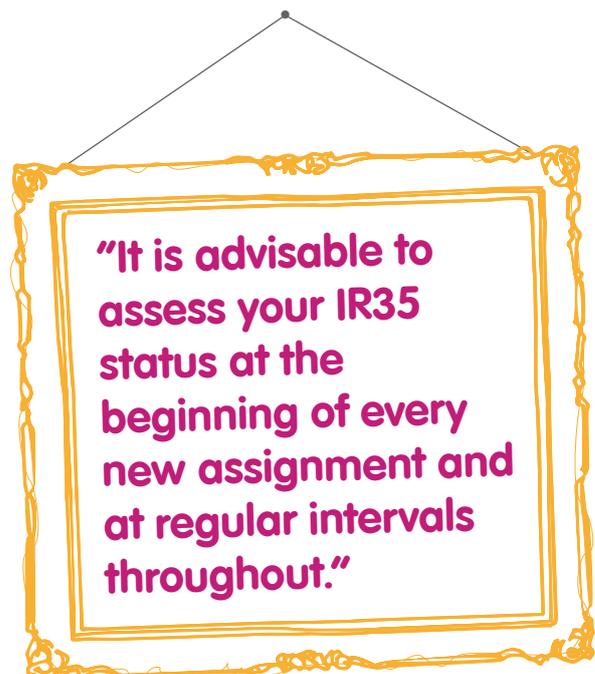
likely going to class this contractor as working inside the scope of IR35 and he will have a requirement to pay the appropriate levels of tax.

Where contractors genuinely work outside the scope of IR35, they can often work in a more tax efficient way than employment.

Contractors who fall outside the scope of IR35 can generally do the following: hire someone to do the work on their behalf or engage helpers at their own expense, risk their own money and provide equipment. Additionally, they can usually decide how, when and where to perform their services and they regularly work for different clients.

IR35 assessments weigh up all the factors, which are then balanced on their own merits. A contractor may not be classed as inside IR35 just because he can't, for example, provide equipment due to the client's security requirements.

Whether or not a contractor falls inside or outside IR35 can vary from contract to contract since IR35 depends on the individual circumstances of each assignment. HMRC will look at the contracts in place and the way in which the contractor interacts with the client. Therefore, it is advisable to assess your IR35 status at the beginning of every new assignment and at regular intervals throughout.



## Part 4: Key indicators determining IR35 status

**As outlined earlier, one of the central issues in deciding whether IR35 applies to an assignment is to establish whether or not the contractor would have been an employee of the client, if engaged directly. In order to determine this, the courts have, over the years, laid down a number of factors and tests.**

One important factor is whether or not a contractor has been engaged by a client to provide a service, rather than his personal skills. This means that a contractor outside IR35 does not generally have an obligation to provide the services to the client personally, but rather could send a suitably qualified **'substitute'** to work on the assignment in his place. On the other hand, an employee is obliged to provide his skills personally.

Another factor surrounds the concept of **'control'**. Generally speaking, this refers to being told how and when to do the work and the place where it shall be done. An employee, for example, will usually be expected to work set hours each day, work where he is told and receive instructions and guidance in how to do the work. Conversely, a contractor working outside the scope of IR35 is more likely to have the freedom to do work when, where and how he decides.

**'Mutuality of obligation'** refers to a situation where one party is obliged to provide work and the other party is obliged to accept this work. Regular employees, for example, are not only obliged to do the work given to them but also to accept it when offered at a future date. An employer is likely to keep their employees busy by moving them from task to task where necessary. There is likely to be no such obligations between clients and contractors working outside IR35.

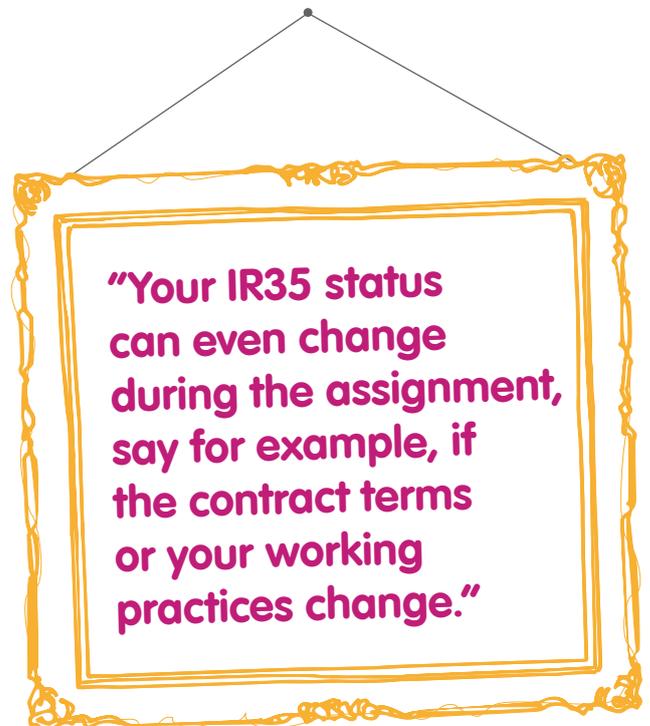
Individuals who risk their own money - for example, buying assets to do a job, paying for training to maintain and improve a skill set or accepting reduced payments for late or unsatisfactory

work - are more likely to be perceived as being in business on their own account. Employees are not usually expected to risk their own capital. Similarly, a person who can **'profit or loss'** based on the capacity to reduce overheads and organise work more effectively will more likely be regarded as falling outside IR35.

Taking the financial burden of bearing the costs of your own tools, equipment and training will help to distinguish you from the employees. It is common for employees to be provided with the equipment needed to do the job.

These are just some factors to consider, there are many more including whether or not the contractor is treated like an employee or is **'part and parcel'** of the client's organisation and, in some cases, the intention of the parties is considered.

Remember to take regular IR35 advice at the start of every assignment and at intervals during the assignment. It is possible to have assignments that fall inside the scope of IR35 and some that fall outside of it. Your IR35 status can even change during the assignment, say for example, if the contract terms or your working practices change.



## Part 5: What are the consequences of not complying with IR35?

**There are several consequences of failing to comply with IR35. If HMRC finds that a contractor has incorrectly classified IR35, they will take steps to put things right and the contractor will be obliged to pay back the correct levels of tax, NICs and any interest due.**

Following an IR35 enquiry, if HMRC also finds that a contractor has not exercised reasonable care in managing his tax affairs, he may also have to pay a penalty. The penalty is a percentage of the tax and NI due and this percentage is decided by looking at your behaviour – including whether the inaccuracies were deliberate or not.

Therefore, it's best for contractors to take regular advice on whether or not they fall within the scope of IR35 and to demonstrate that they took reasonable endeavours in making the right decision.

## How can PayStream help?

PayStream's Compliance Team offer IR35 advice in a simple and jargon-free way. We do not charge our My PSC customers anything extra for using the service and, in fact, we encourage you to use it as often as possible. Let your friends know about our service too! Your friends don't need to be using PayStream's accounting services – our IR35 review service is available to all contractors.

You can take a look at our website for more information or email us on [IR35@paystream.co.uk](mailto:IR35@paystream.co.uk) and we'll send you the details.



**Here's how to contact us:**

**T** 0161 923 0213

**F** 0161 601 7842

**E** [IR35@paystream.co.uk](mailto:IR35@paystream.co.uk)

**[www.paystream.co.uk](http://www.paystream.co.uk)**