



Wise up on IR35

With complex reforms that confuse the most experienced contractors, IR35 can prove a headache that won't go away. Our concise guide covers all the main points, giving you a simple yet comprehensive overview of this important set of regulations.

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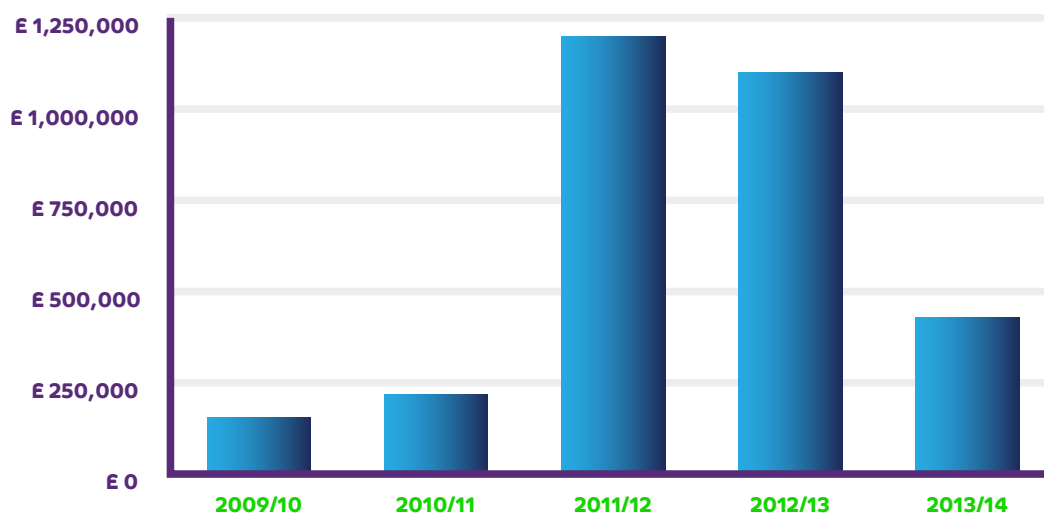
What is IR35?

IR35 is a tax law announced in 1999, which took effect from April 2000 as part of the Finance Act. Formally known as the **Intermediaries Legislation**, its name is taken from the original press release published by the then Inland Revenue (now HMRC) announcing its creation.

IR35 was introduced to tackle the problem of disguised employment. This is where long-term workers are engaged by organisations on a freelance basis, usually through an intermediary (a **limited company or personal service company**), rather than on a permanent contract of employment. A practice known as the **Friday to Monday phenomenon**, where a contractor typically leaves work on a Friday, only to return to the same role at the same desk on a Monday morning, just like a normal employee, was the principal reason for the introduction of IR35.

Such arrangements can be mutually beneficial for both the worker, who gains control over their working arrangements and financial affairs, and the organisation, which doesn't have to pay employers' NICs or offer employment rights and benefits to the worker.

Since its introduction, IR35 has been heavily criticised for its 'sledgehammer' approach. Although the legislation has a legitimate role to play in defending both workers' rights from unscrupulous employers and the HMRC from lost tax revenue, it has consistently fallen short of this aim.



Actual amounts raised by the Treasury as a result of IR35 investigations

Critics of IR35 have claimed that the legislation is badly conceived and poorly implemented by **HMRC**, often resulting in confusion and unnecessary hardship for the small business community. When working under the legislation, contractors are expected to pay the same taxes as employees, but without any of the safety, security or statutory benefits that employment brings.

In April 2017, IR35 rules changed for **public sector contractors**, making the client or agency, rather than the contractor, responsible for deciding whether a contract was 'inside' or 'outside' IR35.

IR35 Facts

- Introduced in April 2000.
- Reforms to Public Sector contracts in April 2017
- Widespread non-compliance leaves many organisations short staffed as contactors leave for private sector
- 2018 autumn budget announces that reforms will apply to the private sector in 2020
- Widespread non-compliance as business panic ban PSCs
- Post-election government conducts Off-payroll Review in response to widespread criticism, Jan 2020, concludes reforms will go ahead with a 'soft landing'
- House of Lords Finance Bill sub-committee launches inquiry into the reforms and produces compelling evidence that they have been detrimental
- Treasury confirms reforms will go ahead in March budget, but one week later announces emergency delay until 2021 due to Covid-19 outbreak
- If you are caught inside IR35 you will be deemed to be an employee and subject to full PAYE and NIC
- Applies to the individual contract, not the contractor
- HMRC can investigate previous contracts where fraud or criminal activity is suspected
- Beware: Seek professional advice to ensure you understand your risks

Inside or Outside IR35?

It's important to remember that IR35 applies to each separate contract, rather than the contractor. IR35 involves applying three main principles to determine the employment status on any given contract; these are **Control, Substitution and Mutuality of Obligation**. These principles examine the way that contractual work is carried out, in order to establish the true nature of the relationship between the hiring organisation and the worker.

Control:

What degree of control does the client have over what, how, when and where the worker completes the work?

Contractors are usually employed for their specialist skills; therefore most genuine contractors will exercise a high level of control over their work practice, retaining the main decision-making responsibility for the project they're working on. Typically, they need minimal supervision and won't be expected to conform to standard working hours at a designated place of work.



Substitution:

Is personal service by the worker required, or can the worker send a substitute in their place?

If the contractor provides a service based on a specific set of skills, then it's reasonable to assume that another person with the same skills could be used as a substitute. A contractor has the right to send such a substitute in their place and also to engage subcontractors to carry out parts of the contract if necessary. In contrast, a contract that requires the work to be carried out by a specific individual points to disguised employee status.



Mutuality of Obligation:

Is the employer obliged to offer work that the worker is obligated to accept?

Under normal employment terms there's an obligation for the employer to provide continuous work and for the employee to accept it. This obligation does not apply to contractors, who typically work fixed term contracts. Contractors who regularly work for the same client on new or 'rolling' contracts could be classified as employees under IR35.



Don't get caught out

The criteria used to determine IR35 can be somewhat vague, so it's important that contractors give a clear indication of their employment status whenever possible. In addition to the paper contract, HMRC increasingly relies on what is known as a '**notional contract**', referring to the 'notion' formed by the taxman after examining the day-to-day activities of the contractor working on a specific contract. Contractors should take the following basic steps to avoid misrepresenting themselves as employees.

Don't act like an employee:

In order to avoid falling foul of the notional contract, the contractor should avoid typical employee behaviour such as eating in the staff canteen and accessing the building with a company security pass. In addition, the contractor should not accept benefits such as sick pay or holiday pay from the client, while also ensuring that they're not listed on company literature. Whenever possible, contractors should use their own equipment to undertake the contract.



Seek professional advice:

Specialist professionals will be able to help evaluate your contract and to assist with contract negotiations to lower IR35 risk. Such reviews can also be used to demonstrate to HMRC that the contractor is taking 'reasonable care' with their tax affairs. Where an agency or client uses a generic contract, contractors can use a **confirmation of arrangements letter**, which asks the client representative to confirm the most important points about their contract and working arrangements.



Look at your contract:

A contractor should always take the time to read over their contract before signing it. Wherever possible, contracts should include a **right of substitution clause** stating the contractor's right to send a substitute in their place or to engage a subcontractor. Contracts should also cite the start and finish dates for the work to be undertaken by the contractor, which helps to clearly define their employment status.



With just four specialist IR35 compliance teams, HMRC can only tackle 250 inquiries at any one time.

If IR35 is found to apply to a contract, HMRC can evaluate previous contracts to see if the legislation applies. This means that HMRC can demand income tax and NICs, plus penalties and interest.

What to do when IR35 applies

As each contract is assessed on an individual basis, contractors should take care to seek professional advice when in doubt. HMRC also offers a [self-assessment tool](#) to help contractors decide if IR35 applies.

When IR35 has been found to apply to a contract, then you need to calculate what's known as the **deemed payment** on your limited company income. This means that you deduct your Pay As You Earn (PAYE) salary, a **5% expenses allowance**, plus any pension contributions.

The remaining amount is treated in the same way as salary paid by an employer, so you must calculate the additional tax due. The most straightforward solution is to pay out all of your limited company's fees minus legitimate expenses and pension contributions as a PAYE salary. Since you are paying yourself like an employee, then IR35 won't apply.

Another option is to join a **Compliant Umbrella Company**. The Umbrella Company becomes the contractor's employer, paying them through PAYE. Although the take home pay via the umbrella route (inside IR35) is less than the Ltd company route (outside IR35), some contractors prefer this option for peace of mind.

Most Umbrella Companies also offer the option of switching between a limited company (serviced by their associate accountants) and the umbrella payment option when a contract sits inside IR35. Providing it doesn't process payments, a limited company can be declared dormant while not in use. This can be particularly useful for contractors working in both the public and private sectors.

HMRC CEST shows that, while 54% of assessments indicate that IR35 does not apply to the contract, roughly 31% suggest that IR35 applies, with 15% proving inconclusive.

Claiming Expenses

The 5% expense allowance:

For private sector contractors operating within IR35, HMRC allows you to recoup 5% of the gross income received from caught contracts when calculating the deemed salary. This is a flat rate deduction intended to cover the administrative costs of running a business and is not an expense that can be drawn from the company. While HMRC does not specify these expenses, they could reasonably include any of the following.

- Premises costs including home as office
- Administration and secretarial support
- Accountancy and tax advice
- Costs of seeking contracts
- Printing, postage and stationery
- Employer's and Public Liability Insurance
- Training costs
- Computer equipment (if not eligible for capital allowances)
- Bank and overdraft interest
- Hire purchase payments

From April 2021 onwards, unless your client is a 'small business', if your contract is caught by IR35, then you will not be able to use the 5% allowance.

Allowable expenses:

Are those that a contractor could have claimed as deductions against their earnings if they were normal employees working for that company. Contractors incurring major costs such as international travel should ensure this is covered in their contracts as chargeable expenses. As long as the chargeable, allowable expenses are only reimbursement of actual expenditure incurred, these expenses can be paid to the contractor free of income tax and National Insurance contributions.



Travel and Subsistence (T&S):

Recent changes to travel and subsistence allowances mean that contractors working inside IR35 shouldn't claim everyday expenses such as travel, mileage, hotels and meals. If you provide your services through an intermediary, then each engagement is treated as a separate employment and each workplace will be regarded as a 'permanent' workplace. Since travel between your home and the workplace is regarded as ordinary expenditure, you will be forced to pay tax and NIC on any incorrectly claimed T&S expenses.



Pension contributions:

Contractors working under IR35 in both the private and public sector are able to continue claiming tax relief on pension contributions made by the PSC on the contractor's behalf.



IR35 in the Public Sector

From 6th April 2017, IR35 rules changed for **public sector contracts**, making the client or agency, rather than the contractor, responsible for deciding whether a contract was 'inside' or 'outside' IR35. If a contract is considered inside (caught) by IR35, the party paying the worker's company must deduct PAYE and NI at source before making payment to the PSC.

The agency effectively becomes the employer of the contractor for tax purposes only, but they will remain a PSC contractor. The contractor will be left with the net payment in their PSC, for which tax credits will apply to avoid double taxation.

Contractors caught by IR35 who work in the public sector will not be eligible for the 5% allowance if they choose to continue to use their limited company, because the hirer will be deducting tax via RTI (real time information) and the 5% rule is no longer allowed.

With your IR35 status set to 'inside', you will no longer be able to pay yourself through a combination of low salary and high **dividends**. However, those considered outside IR35 will be able to continue as normal, extracting funds from their PSC as they see fit.

The reforms have been met with considerable criticism from both the contracting industry and tax experts. There is also widespread opinion that the government's self-assessment tool, CEST, is unfit for purpose, after a number of tax tribunals proved its unreliability.

The 2017 public sector reform led to widespread non-compliance, which was not acknowledged by the government. Subsequently, many public sector contractors who were blanketed inside IR35 responded by saying that they would exit the public sector altogether, leaving organisations such as the NHS at risk.

The 2018 autumn budget confirmed that the reforms would apply in the private sector from April 2020. There was again repeated evidence of non-compliance as many businesses introduced a panic-ban on PSCs ahead of the reforms.

Roughly a quarter of locums have left the NHS since the reform, with 87% of respondents saying that the reform has drastically impeded patient care. (Independent health care professionals association)

2021 plans

The Chancellor confirmed that the reforms would go ahead in the March Budget, promising a soft landing for businesses for the first year. However, just one week later an emergency decision was announced to delay the reforms until April 2021 in light of the covid-19 outbreak. The government stated that the delay is only temporary and that it intends to introduce the reform next year.

Initially the extension will only apply to large and medium sized business, with a small business exemption. The changes will shift the responsibility for making IR35 status assessments from the worker to the end client, who must then communicate their decision to the worker. The responsibility for administering Income Tax and NICs will lie with the “fee payer” - the entity that pays the limited company, which will typically be the client or the agency.

There is some hope that the delay will give businesses more time to prepare, however many stakeholders hope the government may take the opportunity to overhaul the legislation in light of it's serious flaws. A House of Lords inquiry into the reforms continues to produce strong evidence that issues in the public sector remain unresolved and have caused widespread damage and disruption.

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