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### > IR35 – The “Disguised Employment” Tax Legislation

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#### Background

Prior to the introduction of the IR35 legislation in the UK (so-called because of the Inland Revenue (now HMRC) budget press release number 35 in March 1999) it had been common practice for individual contractors to supply their services to end users (their clients) through an intermediary, typically, a personal service company, managed service company or a partnership.

Personal service companies were usually controlled by the contractor who was the sole shareholder and director of the company, or run as family businesses with the spouse or civil partner and/or children holding shares in the company. Although contractors were shareholders of the managed service companies, these companies were typically controlled and operated by a management service company scheme provider.

Under such an arrangement, the intermediary service company hired out the individual worker to an end-user client sometimes via an employment agency (particularly in the case of managed service companies) in exchange for the payment of a fee to the intermediary.

Although the contractors' relationship with their clients was often such that had they been paid directly they would have been employees of the client, under this arrangement, the worker could pay themselves primarily by way of dividends from the intermediary company (which are not liable to national insurance contributions (“NICs”)) with little or no salary. In the case of managed service companies, the scheme provider handled payments between the employment agency and the service company, deducted a fee for its services and arranged payment for the worker. Whilst corporation tax is payable on profits of a company after expenses, the arrangement would still usually result in a significant income tax and NIC saving to the worker.

Since 6 April 2016, it has, however, become less tax efficient than before with HMRC abolishing the notional 10% tax credit on dividends and potentially making it more expensive for contractors to pay themselves this way.

### Pre and Post April 2000

The IR35 legislation was introduced to enable HMRC to deal with those situations where the sole purpose of an individual's intermediary arrangements was to avoid liability for income tax and NICs. The IR35 legislation allows HMRC to look behind the intermediary and ignore the legal relationships to determine how the worker should be taxed. In particular, post-April 2000, if a worker would, in the absence of the intermediary arrangement be regarded as an employee of the client for tax purposes and/or be regarded as employed in "employed earner's employment" by the client, then the worker will (if certain other conditions are met) be subject to tax and NICs which should be deducted under the PAYE system by the intermediary service company.

The government's basic rationale for introducing these rules is that it is arguably fair that people doing the same job as salaried employees should be paying the same amount of tax.

### The legislation

The legislation enacting the principles behind IR35 was introduced by way of the Social Security Contributions (Intermediaries) Regulations 2000 which addresses the position in relation to national insurance contributions and in respect of income tax in two tranches: the Social Security Contributions (Intermediaries) Regulations 2000 ("**Regulations**") address the position in relation to NICs, while Schedule 12 to the Finance Act 2000 dealt with the position in relation to income tax. Schedule 12 has since been replaced by equivalent provisions in Chapter 8 of Part 2 of the Income Tax (Earnings and Pensions) Act 2003 ("**ITEPA 2003**").

### National insurance contributions

#### Do the Regulations apply?

The Regulations will apply if the three following conditions are met:

- An individual personally performs services for a client (or is obliged to do so).
- Those services are provided under arrangements involving an "intermediary".
- The circumstances are such that if the arrangements had been made directly between the individual and the client, the individual would have been regarded as employed by the client "in employed earner's employment" for NICs purposes and NICs are due.

#### Definition of intermediary

Regulation 5 sets out at some length what constitutes an intermediary. In general terms, an intermediary is any legal person that meets the three following conditions:

- Of which the individual supplying the services to the client is a member.
- From which the individual receives (or is entitled to receive) a payment or benefit which is not chargeable to tax as employment income under ITEPA 2003.
- Whose relationship with the worker satisfies certain conditions, which differ depending on what type of legal person the intermediary is.

Where an intermediary is a company, the conditions referred to above are that the intermediary is not an associated company of the client and the worker has to have a material interest (i.e. a right to control more than 5% of the ordinary share capital of the company) of the intermediary.

## Income Tax

As above, the relevant legislation is in Chapter 8 of Part 2 of ITEPA. The provisions of Chapter 8 are similar in effect to the Regulations. Slightly confusingly, however, the approach taken to determine whether income tax is payable in respect of a particular arrangement is different to that taken in the Regulations. Under ITEPA 2003 it is necessary to ask two questions:

- Does Chapter 8 apply in principle to the arrangement?
- If so, is there a "relevant engagement"?

### Does ITEPA 2003 apply?

Section 49 of ITEPA 2003 details when Chapter 8 applies. In broad terms, this is where:

- An individual personally performs services for a client (or is obliged to do so).
- Those services are provided under arrangements involving an "intermediary".
- The circumstances are such that if the arrangements had been directly between the individual and the client, the individual would have been regarded as "employed" by the client for income tax purposes. Section 49(4) of ITEPA 2003 indicates that the contractual terms forming part of these arrangements are one of the circumstances that should be taken into account in determining whether ITEPA 2003 applies.

### Is there a relevant engagement?

Section 50 of ITEPA 2003 provides that there will be a relevant engagement if:

- Chapter 8 applies in principle.
- The individual (or an "associate" of the individual) receives (or is entitled to receive) a payment or benefit which is not employment income.
- Certain conditions in relation to the intermediary (which differ depending on what the intermediary is) are satisfied.

Where the intermediary is a company, the conditions are that the client and the intermediary are not both under the control of the worker and one of the following is met:

- The worker has a "material interest" in the intermediary.
- The payment or benefit received by the worker from the intermediary can "reasonably be taken to represent" payment for the services provided by the worker to the end user client.

Material interest is in turn defined and encompasses, amongst other things, ownership or the right to control more than 5% of the ordinary share capital of the company.

### Relevant engagements: consequences

If a worker is treated as having undertaken one or more relevant engagements, the worker is treated as employed by the intermediary and the "relevant engagements" undertaken by the worker are treated as if they were undertaken in the course of employment. In other words, the worker and the intermediary are treated as employee and employer for income tax purposes.

### Employment status

As can be seen from the above, most of the questions that need to be answered in order to determine whether an arrangement will be caught by the IR35 legislation (i.e. whether there is personal service and whether an intermediary is used) are set out in detail in the legislation and/or are relatively straightforward.

However, determining a worker's employment status is less straightforward. In both the Regulations and ITEPA 2003, one of the key questions is whether the worker would (for tax or NICs purposes) have been an employee of the client if they had been working directly for it. If the answer is no, then the intermediary and the worker will not be caught by the IR35 rules.

Whilst the IR35 rules only apply to an individual's status for tax purposes, the question of whether an individual worker is an employee or some other form of worker has ramifications far beyond questions relating to tax/NICs. In particular, employees benefit from a far more extensive range of statutory rights than other workers.

HMRC includes guidance on the factors that it considers to be the most important in determining an individual's employment status. Whilst the guidance stresses that the factors it lists are not exhaustive, and that the overall picture must be looked at, it identifies the following factors as being the most important:

- **Personal service.** In order for the worker to be an employee, they must be obliged to provide their services personally. If the worker is entitled to provide a substitute to do the work, this may point away from an employment relationship. However, the absence of a right of substitution will not necessarily make the situation one of employment.
- **Mutuality of obligation.** The HMRC guidance states that as a minimum, in an employment relationship there must be an obligation on the part of the worker to provide his or her work or skill and the obligation on the part of the engager to pay the worker for that service.
- **Right of control.** The employee must be subject to a certain degree of control by the engager, although control need not be exercised in practice. It is, according to HMRC, the **right** of control that matters. This control may take the form of the way in which a worker performs their services, what tasks have to be performed and when and where they must be performed.
- **Provision of own equipment.** A self-employed contractor would generally provide whatever equipment is needed to do the job. In contrast, where a worker is provided with the necessary equipment and materials that would point to employment.

- **Financial risk.** Individuals who risk their own money (for example, incurring significant amounts of expenditure on training in order to obtain the skills needed, which are used in subsequent engagements) are less likely to be employees. Self-employed workers may also be required to rectify unsatisfactory work in their own time for no additional reward.

### Practical considerations

#### Reducing the risk of IR35 applying

What emerges from both the HMRC guidance and the cases is that both the contracts in place, and the reality of the situation, will be relevant to whether a particular arrangement is caught by IR35. In other words, whilst it is important that the contracts are drafted in such a way as to reduce the risk of IR35 applying (for example by including a right of substitution), it is also important that the practical reality is in accordance with those terms (for example, it will clearly help if the right of substitution has been exercised).

In arrangements involving an intermediary there are likely to be two key contracts:

- A contract between the intermediary and the client; and
- A contract between the intermediary and the worker.

#### Contract with the client

Of the two contracts, the one that is likely to get more attention in any HMRC investigation (and which is therefore the most important) is the contract between the intermediary and the client. In order to limit the risk of an arrangement falling foul of either the Regulations or ITEPA 2003, some or all of the following should be considered.

- **Include a right of substitution** within the contract. This should be drafted so that it is as wide-ranging as possible (although in some circumstances a limited right of substitution may suffice), and should not be subject to an excessively-wide veto on the part of the client. If the right is actually exercised in practice this will help to demonstrate that there is no requirement of personal service.
  - **Avoid an obligation to provide and accept work.** Recent case law has demonstrated that it would including a notice period will point towards a conclusion that there is mutuality of obligation, so this should be avoided if possible.
  - The intermediary should be **subject to as little control as possible**. For example, the intermediary should, if possible, be free to set their own hours and place of work and to determine how the work is done.
  - Contracts should, if possible, be structured by reference to **completion of a project or piece of work, rather than by duration**. Similarly, payment should be structured by reference to completion of a project, rather than time worked. If possible, some element of financial risk and reward (other than payment of fees) should be incorporated into the contract. For example, penalties/bonuses can be included for early/late completion of work. It may also be helpful to require the worker to maintain insurance in respect of claims arising out of services provided by them,
  - The worker **should not be integrated into the client company more than is absolutely necessary**. For example, the worker should not be held out as a member of the company, should not be subject to its policies and procedures, and should not be entitled to participate in employee-type benefits.
- If possible, **require the intermediary to provide its own equipment**, rather than providing this to them.
- Although not determinative, it is still helpful **to state in the contract that the relationship is not intended to be one of employment**.

Of course, all of the above points need to be weighed against the commercial requirements of the contract in question. However, if the situation does require, for example, an obligation of personal service, then it should be appreciated that this may bring some IR35 risk with it.

#### Contract with the worker

Although less important than the contract with the client, it is still important to put an employment contract in place between the worker and the service company. The key consideration with the employment contract is to ensure that it is not linked too closely to one particular client. Therefore, the worker should be obliged to provide services to whatever clients the intermediary requires. Clearly, if the worker is only obliged to provide services to one client, this will point towards IR35 applying.

The contract should also avoid linking the amount of salary, and in particular benefits, to the client the worker is providing services to. Rather, the worker should get such salary and benefits as the intermediary determines.

The contract should also specify that the worker will be subject to the control and direction of the intermediary (rather than the client to which it is providing services). Therefore, for example, the contract should provide that any disciplinary and grievance matters will be dealt with by the intermediary.

In short, the contract should, as far as possible, look like a standard employment contract with the intermediary as employer.



## Consequences if IR35 does apply

### Tax/NIC consequences

As is indicated above, if IR35 applies, the sums received by the intermediary are, in effect, treated as employment payments by the intermediary to the worker for tax and NICs purposes and will therefore be subject to PAYE. However, this is calculated at the end of the year on the deemed income, after allowing a 5% deduction to cover general expenses (unless there is supervision, direction or control, in which case PAYE must be accounted for monthly on actual payments made throughout the year).

In other words, if IR35 applies, the relevant tax and NICs consequences fall on the intermediary, not on the client. HMRC may also charge interest and penalties to the intermediary on overdue tax/NICs. If an intermediary wishes to challenge a finding by HMRC that IR35 applies, it may appeal to the Special Commissioners.

### Impact on employment status

Finally, it should be noted that whilst the question at the centre of the IR35 legislation is whether the worker would have been an employee of the client if they had been working directly for it (rather than for the intermediary), this will not, in itself, affect the employment status of the worker. Therefore, it would be possible for HMRC to conclude that the IR35 legislation applied (with the resulting tax and NICs consequences for the intermediary), but for an employment tribunal to conclude that a worker was not employed by the client. Equally, however, it should be borne in mind that the tests used to determine status in both jurisdictions are largely the same. Therefore, the fact that HMRC has reached a certain conclusion on IR35 may give some indication as to what an employment tribunal would decide on the employment status question.

## IR35 changes in April 2017

Up until now, the responsibility for deciding whether they were genuinely self-employed or disguised employees lay with the individual worker. However, in the public sector only at this stage, the responsibility for determining self-employment status is being shifted to the end-user client with effect from 6 April 2017. If the public sector client decides that IR35 should apply to the engagement, payment to the contractor's company will be taxed at source as if they were an employee. Organisations that fail to do this or incorrectly assess IR35 status can be subject to fines.

In his first Autumn Statement in November 2016, Chancellor of the Exchequer Philip Hammond said:

*"Following consultation, the government will reform the off-payroll working rules in the public sector from April 2017 by moving responsibility for operating them, and paying the correct tax, to the body paying the worker's company."*

*The government believes public sector bodies have a duty to ensure that those who work for them pay the right amount of tax.*

*This reform will help to tackle the high levels of non-compliance with the current rules and means that those working in a similar way to employees in the public sector will pay the same taxes as employees."*

HMRC believes that the changes *"will make the engager responsible for paying and accounting for the taxes rather than just checking they have been paid"*.

On 27 January 2017, HMRC published, for technical consultation, draft regulations as part of the reforms to the off-payroll working rules for public sector engagements that will take effect on 6 April 2017. The regulations make provision for NICs, and will be known as the Social Security (Miscellaneous Amendments) Regulations 2017.

Draft legislation for the Finance Bill 2017 was published on 5 December 2016 to take effect as amendments to the Income Tax (Earnings and Pensions) Act 2003 (ITEPA 2003), to ensure that responsibility for operating the off-payroll working rules, and deducting income tax, will move to the relevant public sector body, agency or other third party paying a worker's personal service company or intermediary.

Questions that remain unanswered at this stage whether HMRC will retrospectively investigate engagements that have now been determined to be inside IR35. There is nothing in the legislation which prevents HMRC from doing this but whether they will or not is unknown.

Secondly, although the government has made it clear that it has no current plans to widen the scope of this change outside of the public sector, public sector bodies might well put pressure on the government to introduce it in the private sector if they have difficulty filling positions. This could result in a significant change to the IR35 landscape with risk-adverse clients deciding to apply IR35 if there is any doubt whatsoever. Accordingly, intermediary arrangements could become much less common in the future.

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