

IR35



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The introduction of IR35 for the private sector took effect from April 2021 and represented the biggest change to employment tax for decades.

Before then, businesses in the private sector were able to engage contractors using personal services companies (or other intermediaries) without having to give too much thought to the contractor's status for tax purposes. This changed for large and medium-sized private-sector businesses in April 2021 when the responsibility for determining a contractor's status and, if appropriate, operating PAYE and National Insurance contributions (NICs) switched from the personal services company to the end-user business.

What is IR35?

IR35 is a tax anti-avoidance rule designed to combat "disguised employment" in situations where an individual contractor is providing their personal services (i.e., their labour) to an end-user via their own intermediary, such as a personal services company or partnership (referred to collectively as "PSC" in this Inbrief).

IR35 applies when the contractor would be an employee (or officeholder) for tax purposes if they were hired directly by the end-user. If IR35 applies, PAYE and NICs must be operated in respect of the fees paid to the PSC.

Since April 2021, for large and medium-sized private-sector businesses, responsibility for assessing whether IR35 applies has been with the end-user. If the end-user determines that IR35 applies, the responsibility for operating PAYE and NICs will move from the PSC to the "fee payer" – that is, generally, the entity which contracts directly with and pays the PSC.

Overview of the process

The end-user is required to assess whether the contractor is employed or self-employed for tax purposes. It must take reasonable care in making that assessment and confirm its assessment together with reasons in a Status Determination Statement (SDS).

The end-user must provide the SDS to the contractor before making the first payment to them. If there is an agency in the chain (see below), the SDS must also be provided to the agency. In practice, contractors accepting a new assignment are likely to want to know in advance whether they will be assessed as within the scope of IR35.

The end-user is required to have a dispute resolution procedure to enable the contractor to challenge the assessment. A contractor is unlikely to challenge an SDS which assesses them as falling outside the scope of IR35. HMRC may review the assessment, however, so it is important that the SDS sets out in sufficient detail the basis on which the decision is made, showing that reasonable care has been taken.

If the assessment concludes that the contractor is out of scope of IR35, the PSC can continue to be paid gross. If, however, the contractor is assessed as within IR35, the fee payer is responsible for operating PAYE and deducting employee NICs on the fees it pays to the PSC (excluding VAT). The fee payer must also pay employer NICs and, where applicable, the apprenticeship levy.

If there is a UK agency in the chain

If there is a UK agency in the chain which supplies the contractor via a PSC, the agency is the "fee payer" because it is the party that contracts with and pays the PSC. As the fee payer, the agency will have the obligation to operate PAYE/NICs and pay employer NICs and, where applicable, the apprenticeship levy.

However, the end-user retains responsibility for issuing an SDS and providing a dispute resolution procedure. It must provide the SDS to the agency as well as the contractor and the agency must also be allowed to appeal against the assessment.



The obligation to operate PAYE/NICs remains with the end user if it does not meet its responsibilities, e.g., if it fails to provide an SDS before the first payment is made. In addition, HMRC has power to transfer PAYE/NICs liability from the agency to the end-user if there is no realistic prospect of recovery from the agency within a reasonable period. HMRC has confirmed in its guidance that it will generally not exercise this power if the failure to account for the PAYE/NICs is due to a genuine commercial business failure.

There are more complex rules for offshore agencies. If in doubt, please contact us for advice.

What is the wider impact of IR35?

IR35 is a tax rule. Crucially, it does not change the contractor's status for employment law purposes.

It is still legitimate for contractors to use PSCs - it is not tax evasion to do so. End-users and fee payers should bear in mind their obligation under the Criminal Finances Act 2017 to have reasonable procedures in place to prevent tax evasion and the facilitation of tax evasion by their employees and contractors while performing services for or on behalf of the end-user. If in doubt, please contact us for advice.

Which end users are affected?

Subject to anti-avoidance provisions, "small" private-sector end-users are exempt from the new rules and are not required to determine whether IR35 applies. Instead, the old rules continue to apply - the contractor/PSC remains responsible for determining whether IR35 applies and the fee payer can still pay the PSC gross.

A corporate end-user which is not part of a group will be treated as "small" in its first financial year and will remain

small until it ceases to be so. Small companies will become medium or large if they meet at least two of the following conditions for two consecutive financial years:

- ▶ annual turnover of more than £10.2 million
- ▶ balance sheet total of more than £5.1 million
- ▶ more than 50 employees

If two of these conditions are satisfied, the company must apply the IR35 rules from the start of the tax year following the accounting filing date for the second financial year. Where the small company is part of a larger group of companies, the group turnover and revenue will need to be considered - please contact us for advice.

Non-corporate end-users will be treated as "small" for a tax year if their annual turnover in the financial year ending at least nine months before the start of the relevant tax year was not more than £10.2 million.

In addition, IR35 does not apply to end-users who are based wholly overseas. In this situation, the PSC will still be paid gross and it will be for the contractor/PSC to determine whether IR35 applies and, if so, to operate PAYE/NICs. An end user is based wholly overseas if immediately prior to the start of the relevant tax year it was not resident in the UK and did not have a permanent establishment in the UK.

Which contractors are affected?

IR35 affects individual contractors using a PSC to provide their labour. Contractors will not be affected by IR35 if they supply their labour directly to the end-user without using a PSC (e.g., as a sole trader).

Contractors who are not tax resident in the UK and who are supplying their services exclusively outside the UK

are also unaffected. If they supply some services within the UK, the rules are more complex and you should contact us for advice.

IR35 is focused on the provision of *labour* rather than *services*. Fully outsourced services are therefore out of scope. For example, if a company fully outsources its IT helpdesk or catering services to a third party, it does not need to determine whether IR35 applies to any contractors working for that third-party service provider. Businesses who provide managed services rather than staff should be seeking to educate their customers about the fact that IR35 does not apply to them at all.

How to carry out the status determination

The law requires end-users to exercise "reasonable care" in making the status determination. The obligation is to assess what the contractor's status for tax purposes would have been if they had been engaged directly by the end-user without a PSC.

This involves taking account of several factors, including:

- ▶ Control and working arrangements – how much control does the end-user have over the contractor's hours and place of work? Can the end-user direct how the work is done or is it highly skilled/specialised? Can the end-user move the contractor to different projects?
- ▶ Substitution – can the contractor send a substitute? Have they ever done this? Can the end-user reject the substitute?
- ▶ Mutuality of obligation – is there a binding commitment on the contractor or end-user to provide/offer work?



- ▶ Integration into the business – how involved is the contractor in the business and its management? How would they introduce themselves to customers – as working for the end-user or for themselves?
- ▶ Carrying on business on their own account – does the contractor take any significant financial risk? Do they need to make significant investments in equipment or tools?
- ▶ Other factors – for example, does the end-user impose restrictions on what other work the contractor can do? Does the contract take up the majority of the contractor’s time? Have they previously worked for the company?

The SDS will only be valid if it includes the reasons for the determination. It must be provided to the contractor, and any agency with which the end-user contracts, before the PSC is paid.

The status determination assessment needs to be repeated if the contractor’s assignment continues for any significant period of time (we think at least every 12 months, although there is no guidance on this) or if the circumstances change.

HMRC’s CEST tool

HMRC’s [Check Employment Status for Tax](#) (CEST) is designed to assess whether a contractor would be an employee for tax purposes if they were hired directly.

CEST was revised in November 2019 following criticism that it was not fit for purpose, but it still has flaws. Specifically, it still fails to test whether there is sufficient “mutuality of obligation” in the relationship between the end-user and contractor - one of the necessary conditions of employment (HMRC’s view is that it is invariably present). CEST also fails to

produce any result in a significant minority of cases.

The end-user is not obliged to use CEST, but it highlights the main issues that HMRC are concerned about when considering status for tax purposes. It also has the advantage that, so long as the end-user enters the information correctly and keeps it up to date, HMRC is bound by the result. Note, however, that the end-user must take responsibility for using the tool. A CEST assessment that is carried out by the contractor personally is not binding on HMRC.

Given this, we consider that it is sensible to make CEST the starting point in most cases. However, end-users still bear responsibility for making a status determination, even when CEST produces no answer. Businesses therefore need an additional way to make such determinations in at least some cases.

Large businesses which are subject to the Uncertain Tax Treatments (UTT) rules may also need to think carefully before using CEST, particularly if CEST is being used to determine the status of a number of contractors operating under the same terms. The UTT rules require such business to notify HMRC if: (i) the business has interpreted the law in a way which is different from HMRC’s “known position”; and (ii) the tax/NICs advantage as a result of the businesses interpretation is expected to be more than £5m in a 12 month period. HMRC has made it clear in UTT guidance that CEST outputs indicating that a contractor is within or outside IR35 constitute HMRC’s “known position”.

The dispute resolution process

When the IR35 changes were first discussed, there were calls for HMRC to provide a procedure for verifying decisions. Instead, however, it is the end-user’s responsibility to provide a process for resolving disputes.

If a contractor or the fee payer considers that the end-user’s IR35 decision is incorrect, they may make representations before the final payment under the arrangement is made. The end-user then has 45 days to review the representations and either:

- ▶ inform the contractor (and any agency with which the end-user contracts) that their initial SDS was correct; or
- ▶ issue a new SDS, withdrawing the previous one.

The end-user must provide reasons for its decision.

Consequences if the status assessment is incorrect

If HMRC disagree with an end user’s determination that a contractor falls outside IR35, HMRC will seek arrears of PAYE, employee and employer NICs and apprenticeship levy (if applicable) together with interest and potentially penalties from the deemed employer. The deemed employer is generally the fee payer unless the end user has failed in any of its IR35 obligations, in which case the end user will be the deemed employer even if there is a UK agency in the chain.



From 6 April 2024, in calculating the deemed employer's liability for PAYE/NICs arrears, if certain conditions are satisfied, HMRC will offset: (i) any corporation tax paid by the PSC on its fees from the relevant engagement; (ii) any income tax paid by the contractor on their employment earnings or dividend income from the PSC in relation to the relevant engagement; and (iii) any employee NICs paid by the contractor on their employment earnings from the PSC in relation to the relevant engagement. Prior to the introduction of the offset mechanism, the deemed employer was liable for the full amount of the PAYE/NICs arrears and the contractor/their PSC was able to apply for a refund of the tax and NICs they had paid from HMRC. Under the offset mechanism, there is no offset of employer NICs (or apprenticeship levy if any) paid by the PSC, so the PSC should continue to apply for a refund of these amounts.

Cost impact of IR35

If IR35 applies, the fee payer needs to deduct PAYE and employee NICs from the fees paid to the PSC (excluding VAT). Although the contractor would have needed to pay tax at some point, IR35 means that they lose the cash-flow advantage associated with using a PSC. In addition, the contractor is likely to be worse off in real terms.

On top of this, if IR35 applies, the fee payer needs to pay employer NICs and apprenticeship levy costs on the fees paid to the PSC. This means an additional cost of around 14%, which cannot be passed on to the PSC. It may be possible, however - depending on the contractual terms - to enter into in a new contract with the PSC under which the fees are renegotiated to ensure the net costs do not increase.

If the end-user uses an agency to engage the contractor, the agency will be responsible for operating PAYE/NICS and the apprenticeship levy, although it is likely to negotiate reimbursement from the end-user.

Processes and documentation

The end-user needs to have robust processes and controls for identifying and recording the use of contractors, including those supplied via an agency. It will also need clear and well-communicated policies for hiring contractors which ensure that appropriate authority is given before they are appointed. In addition, the end-user should have a clear and consistent methodology for making status determinations, especially in situations where CEST does not produce a result. The end user will need to ensure that its SDS sets out the reasons for the determination. Where CEST has provided a result, attaching the CEST print-out to the SDS will be sufficient to provide the required reasons.

Contracts with PSCs should reflect the IR35 reforms. For example:

- ▶ The terms of the contract with the PSC should not contradict the basis of the status assessment made by the end-user (e.g., in relation to whether the contractor must do the work personally or can send a substitute).
- ▶ The end-user should reserve the right to deduct PAYE and NICs - immediately (if IR35 applies), in future (in case the position changes), and pending any challenge to the status assessment.
- ▶ The contract should include clear tax warranties and indemnities.

If the end-user is also the "fee payer" (i.e., there is no UK agency in the labour chain), it will also need to adapt its payroll and accounts payable systems for IR35 compliance. For contractors in scope of IR35, the payroll system will need to add the contractor to the system and operate PAYE/NICs on the fees excluding VAT, while the accounts payable system will need to pay the PSC the fees net of income tax and employee NICs plus VAT on the gross fees. The system also needs to align with the terms agreed with the PSC in relation to when invoices will be paid.

Contracts and working arrangements with agencies or other intermediaries should also reflect the IR35 position:

- ▶ Will the agency be precluded from supplying individuals via PSCs, or will they just have to notify the end-user in advance if they do so?
- ▶ Can the agency pass the full cost of operating PAYE/NICs and the apprenticeship levy back to the end-user?
- ▶ Agencies will need to supply information to help the end-user with the SDS.
- ▶ The end-user will need to communicate the outcome of the status assessment to the agency and should always make sure they do so in writing.
- ▶ Agencies will need to pass the statement to the entity with which they are contracting.



The terms and conditions of any businesses supplying staff or managed services should contain IR35 compliant terms. Different wording will be needed depending on whether the business is supplying staff or managed services. Some firms run various business models including secondment of staff, supply of staff to clients and/or managed services while using very similar or even identical terms and conditions. It is advisable for such businesses to delineate their business models, create separate terms for each model and train those who use them on when to use which terms.

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