IR35 Legislation Explained

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Introduced in April 2000, IR35 legislation aims to eliminate the avoidance of tax and national insurance contributions through the use of intermediaries, including personal services companies (most notably contractors and freelancers) and partnerships, in circumstances in which an individual worker would otherwise:

- For tax purposes, be regarded as an employee of the client; and
- For national insurance contributions purposes, be regarded as employed in employed earner's employment by the client.

What is IR35?

As we touched upon briefly in our 'How to Start a Limited Company' guide, IR35 legislation was put into place to determine whether you, as a limited company (and in most cases, a contractor or freelancer), could otherwise be deemed as an employee of your client under any other circumstances. Simply put, it aims to answer the question: Are you an employee 'disguised' behind your limited company?

The reason for this legislation coming into force was mostly due to the government believing that, in certain circumstances, some contractors had been providing their services to clients via means of a limited company or a partnership with the sole purpose of such arrangement allowing them to avoid paying tax and national insurance contributions, as corporate tax and NICs on limited companies and partnerships is significantly lower than the equivalent levied at an individual.

Now, thanks to IR35, the tax advantages of forming a limited company or partnership rest entirely on your individual contracts falling outside of IR35, therefore a proper understanding of the legislation is crucial.

How to Determine Your IR35 Status

There are a number of things you're going to have to think about when trying to determine what HMRC would consider your IR35 status to be, though the one cautionary piece of advice you'll do well to remember above all else is that HMRC review absolutely everything in order to establish your status.

The overriding theme HMRC will be looking for in determining your status is whether you, as a contractor or freelancer operating your own limited company or partnership, have the same level of risk, responsibility, control, and liability that other directors of limited companies have upon their shoulders in the same role; as these four considerations, above everything else, can help draw a clear line between a legitimate company director and a faux employee.

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How to Determine Your IR35 Status

To determine whether you would fall inside or outside of IR35 under each of these factors (risk, responsibility, control, and liability), consider the following with regard to your own company dealings:

Your Control

How much control do you have over your provision of services? Your control in this area will by no means be black and white, of course, but to show appropriate control in this area would be to put you in charge of what, where, when, and how your services are performed.

For example, if you've been told by a client to paint a wall at midday on Tuesday, in this situation you have no control over the provision of your services, and have more in common with a standard employee than a hired contractor. On the other hand, if you've been hired by a client to paint a wall at midday on Tuesday, and you tell them you're busy Tuesday, but can make the same time on Wednesday, you have displayed a level of control over your provision of services appropriate to a contractor or freelancer, but inappropriate to an employee.

The key here is you're the one who holds the cards. Of course, if you don't allow your client some level of control you're unlikely to be hired by them at all, but that should be the only negative consequence of you exerting this control.

Your Financial Risk

To fall outside IR35, and therefore avoid all the taxes and penalties that come with it, it's absolutely crucial that you, as your company director, have appropriate financial risk in your company.

Generally employees risk no financial loss through being employed, whereas company directors most certainly do; with this risk of financial loss being offset by the rewards that running and growing a limited company can bring.

Your Working Obligations and Right of Dismissal

Another key indicator to HMRC as to whether or not you're a legitimate company director is what working obligations you have with your clients, and whether either of you has the right to dismiss the other at a moment's notice.

HMRC argue that a fixed notice period in a working relationship with a client is akin to fixed employment terms. They believe the same to be true if you're obliged to take all and any work a client gives you, and they are obliged to provide you with this work.

Your Working Equipment

Another easy, though not foolproof, way in which HMRC can determine your IR35 status is by looking at your equipment.

If your working equipment is provided for you, such as a laptop for a freelance writer, or buckets of paint and a ladder for a painter, HMRC have good grounds to say you fall inside IR35, as purchasing your own equipment – assets in your company – requires you to take a financial risk, a risk employees very rarely take, but company directors invariably do.

Your Employee Benefits

This is an obvious one, but you'll be wise not to overlook it. In order for you to be determined as a legitimate company director, you must receive no forms of employee benefits from any of your clients. Your clients can't pay for you to attend any training courses, receive any sick pay, or indeed come to the office Christmas party, as you're not a member of staff.

Substitution Clauses

Though by no means a strong indicator on its own unless it has actually taken place, you'll move HMRC towards agreeing you should be outside of IR35 by placing in all of your contracts a clause stating that you have the right to send a substitute in your place.

The key here is indicating that your company has the right to do this, not whether or not you've ever done it. If you write into your contracts that all work will be provided by you, with nobody substituting for you at any point, this could have a negative effect on your case.

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The Tax Implications

If HMRC do decide that you fall inside IR35, the tax implications can be extraordinarily negative from your point of view. This is known as a 'relevant engagement' and in this instance the concept of 'deemed salary' is introduced, meaning any income earned from that particular contract will be liable to tax and national insurance contributions.

In this situation your expenses will also be vastly reduced, as HMRC deem you not to be taking the same levels of financial risk that other directors of limited companies take on.

The exact tax implications will vary by company, though on top of having to now pay tax and NICs at a standard rate, there's every chance HMRC will pursue you for previously unpaid tax and NICs due to you having paid yourself a lower salary in exchange for company dividends; and there's also every chance they will do all they can to levy a penalty against you.

Reviewing Your Contracts

It should be again noted that when working to determine your IR35 status HMRC review absolutely everything, meaning though reviewing your contracts is crucial, just as important is looking into your working practices to ensure they match up with that you've already said to be true.

With that said, reviewing your contracts is the best place to start in making sure you're kept outside of IR35.

Do You Need Advice on IR35?

To have your contracts reviewed by a professional accountancy firm and receive advice and suggestions surrounding how to reword your contracts and rethink your working practices so to avoid IR35, contact Tax Agility today on **020 8780 2349** to arrange a complimentary, no obligation meeting.