

## Contractors encouraged to weigh up risk and reward of 'outside IR35' indemnities



Following the extension of the Off-Payroll legislation to the private sector, hiring firms and recruitment agencies are increasingly inserting indemnity clauses into contracts as a means of engaging contractors on an 'outside IR35' basis.

However, while this arrangement is providing some firms with the confidence to offer contingent workers their preferred means of engagement, contractors are warned that any 'outside IR35' contract containing an indemnity clause should be approached with great care and attention to avoid unnecessary risk.

"Businesses have historically sought commercial protection, and an indemnity clause is one way of achieving this," comments Martyn Valentine of [The Law Place](#). "It's unsurprising that companies are looking to protect against the dangers imposed by the Off-Payroll rules, but contractors accepting such clauses must make sure they aren't assuming unnecessary risk."

### What is an indemnity clause?

An indemnity is a contractual promise by one party to pay another party money in the instance of a specified event. These clauses typically protect the indemnified party against financial loss from an eventuality resulting from the indemnifying party's conduct, or from an issue over which the indemnifying party has control.

As they are designed to be flexible, indemnities are generally subject to few fixed rules, and determination over the validity of an indemnity clause will often depend largely on the drafting of the clause.

"Indemnity clauses often cover liability arising from court-issued judgments," comments Valentine. "This is partly because consideration of the clause must be made in the context of the contract as a whole, rather than in isolation."

"It's also important to note that the courts won't enforce an obligation for the indemnifying party to pay all costs suffered by the indemnified party," adds Valentine, who points towards the case of [Euro-Asian Oil SA v Credit Suisse AG \[2017\] EWHC B7 \(Comm\)](#), where the question of costs was determined in the context of the Civil Procedure Rules 1998.

### Indemnity clauses used to offset Off-Payroll risk

In response to the Off-Payroll legislation, many recruitment agencies and end-clients have reportedly been using indemnity clauses to protect themselves against tax risk resulting from an 'outside IR35' status determination.

According to the Off-Payroll legislation, the 'fee-payer' – which is the party in the supply chain directly above the contractor – assumes the liability for any unpaid tax and National Insurance Contributions (NICs) should HMRC successfully overturn an 'outside IR35' status determination. This is unless the end-client has failed to take 'reasonable care' in conducting their status assessment, in which case the client

assumes liability.

This has proven an effective deterrent against the provision of 'outside IR35' contracts for many agencies and end-clients. For others, indemnity clauses entitling them to recover from the contractor any tax loss resulting from an 'outside IR35' determination have provided a potential means of appealing all parties.

However, as Valentine highlights, many emerging clauses contain one crucial detail that contractors are advised to address: "When correctly drafted, liability should only arise from an indemnity clause once the court has made a final judgment. Where HMRC challenges an IR35 status determination under the Off-Payroll rules, the end-client and/or agency have the right to appeal via the First-tier Tribunal (FTT) and beyond. HMRC frequently makes mistakes and many contractors have successfully appealed notices of determination to the FTT.

"However, most of these clauses as they are originally drafted simply trigger the indemnity as soon as HMRC challenges the deemed status, meaning contractors could have to bear the costs regardless of whether or not they are inside IR35."

## Are 'outside IR35' indemnity clauses enforceable?

Numerous arguments have been put forward suggesting reasons why such clauses may be unenforceable, one of which is the fact that the law doesn't allow an 'innocent bystander' to accept liability for something that they haven't been involved in. However, Valentine argues that contractors don't fit the mould:

"It's not factually correct that the contractor is an innocent bystander protecting against something outside of their control. They can negotiate terms from the outset and they work the engagement in question on a day-to-day basis, so they are at least in some part responsible for the resulting outcome. The contract is ostensibly intended for the provision of commercial services and the contractor is in a position to define the services at the outset to mitigate risk of the indemnity applying in the first place."

Valentine believes arguments centred on the idea of inequality in the bargaining position are similarly flawed: "This issue was recently considered in the high-profile Uber case, but it is applicable in the context of sham clauses with regards to employment rights. Indemnifying a party against risk is another matter entirely and indemnity clauses of this nature have existed since the inception of the IR35 legislation."

"It's also true that the courts don't like to impose penalties or enforce open-ended liability. However, [section 34 of the Taxes Management Act 1970](#) stipulates that an assessment for tax liability cannot be made beyond a period of six years after the event, so no such open-ended liability exists. The indemnity clause doesn't need to restate the law."

Finally, Valentine observes that an 'outside IR35' indemnity may still be enforceable despite being at odds with the Off-Payroll legislation, which prevents fee-payers from offloading their employer's NICs liability:

"Indemnity clauses don't prevent the indemnified party from paying the tax in the first place. What they do is entitle the indemnified party to recover their own loss from the indemnifying party. So, in practice, an agency might front the cost of the tax liability, satisfying their obligations under Off-Payroll in the process, before recovering this money from the contractor via the indemnity."

Ultimately, Valentine reasserts that the enforceability of an indemnity clause hinges largely on the drafting, as per the position established in case law. But while each case is judged on its own merits, certain factors can bear more weight than others:

"There's an argument that a clause requiring a contractor to indemnify an agency or client for tax liabilities resulting from an HMRC claim - not a final judgment issued by the appellate court - is borderline unreasonable or could be challenged. But if the indemnity is triggered by a final judgment, in my view it's more likely to be seen as reasonable."

## How can contractors mitigate their risk?

Indemnity clauses could provide a welcome route to continued 'outside IR35' engagements, but contractors need to ensure that the reward is worth the risk. Whereas some will be tempted to throw caution to the wind and accept a clause as presented to them, Valentine recommends a more measured approach:

"Accepting an 'outside IR35' indemnity clause obviously leaves contractors vulnerable to HMRC's advances, while outright rejection of such a clause could cause the 'outside IR35' position to be withdrawn, resulting in the unnecessary payment of extra tax.

"Negotiating an amendment to the clause which requires the end-client and/or agency to defend the position in the event of an HMRC enquiry should offer sufficient protection to contractors without being deemed an unreasonable request. However, contractors are advised to seek competent legal advice to ensure they get this right.

"It is imperative that the contract correctly reflects self-employment. If the contractor's obligation is to supply an individual to undertake a role such as a project manager instead of providing project management services to the client, then IR35 and therefore the indemnity clause will

apply.”

Ultimately, though, an amended indemnity clause offers little protection if the deemed status isn't consistent with the working arrangement. In fact, it could make matters worse. Having required the end-client or agency to defend a position at tribunal, a resulting defeat would leave the contractor liable for court costs in addition to the tax liability. Contractors, therefore, need to be careful to ensure they aren't entering into contracts containing various IR35 pitfalls.

“We wind up in a situation similar to that created by the original IR35 legislation, whereby contractors are having to conduct their due diligence to mitigate their own tax risk,” comments Valentine. “Contractors who enlist competent legal advice to help negotiate a legitimate outside IR35 engagement will drastically reduce the likelihood of an indemnity clause being applied. In theory, this arrangement should protect the interests of all parties while enabling continued tax efficient off-payroll working.”

Published: 26 April 2021

© 2021 All rights reserved. Reproduction in whole or in part without permission is prohibited. Please see our [copyright notice](#).

200,000+ monthly unique visitors

© Copyright 2021 Byte-Vision Limited UK. All rights reserved [Copyright notice](#)