

Contractor guidance on HMRC's risk-based approach to IR35 & the business entity tests



Note that the business entity tests have been abolished, effective from April 2015. HMRC will continue to honour its commitment not to investigate for three years contractors who had previously taken the tests and secured a low risk score.

Limited company contractors can use HMRC's **business entity tests** to determine into which of three risk bands – high, medium and low – their contracting business falls. Contractors who fall into the low-risk band, and can prove it, could enjoy three years of IR35-free contracting under HMRC's new risk-based approach.

Contractors finding their businesses in the high and medium risk bands are more likely to undergo an **IR35 review by HMRC**, even though their contracts would be outside **IR35** if the legislation were to be applied in full.

However, the underlying **IR35 legislation** has not been changed. That means contractors should continue to apply the lessons learned after well over a decade of the tax law being in force. In other words, it is as important as it has ever been to maintain **IR35 best practice** on all contracts.

HMRC published new guidance in June 2014, *Intermediaries Legislation (IR35) - Working through an intermediary, such as a personal service company*, that draws together its framework for the risk-based approach using the business entity tests. The updated guidance explains how contractors can use the tests to determine which risk band they fall in.

The purpose of the business entity tests

The business entity tests form part of HMRC's risk-based approach, **introduced in May 2012**. The tests are a tool used by HMRC to identify contractors it believes are at higher risk of being inside IR35. They are not a replacement for IR35.

Encouragingly, for contractors falling into the low-risk band, the tests appear to offer a 'get out of jail free' card for three years, as HMRC has committed not to conduct IR35 reviews on such low-risk contractors.

But although **HMRC's guidance** states that contractors are not required to take the business entity tests, or to reveal the results to HMRC, it does warn that failure to do so could result in a full blown IR35 review.

Business entity tests – process and scoring

There are twelve Business entity tests which are, according to HMRC's guidance, designed to build up a picture of a contractor's business.

The idea is that contractors work through each test, answering the questions and ensuring they can evidence their answers. The results of each test will provide a certain number of points, and contractors add their points at the end to provide a final score. HMRC then allocates contractors a risk profile that depends on the overall score:

High Risk = 0 – 9 points

Medium Risk = 10 – 20 points

Low Risk = 21 points and above.

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The guidance also emphasises that taking the tests is voluntary. However, it implies that failing to take the test and deliver the results to HMRC with evidence when requested could result in an IR35 review and repeat visits by HMRC inspectors.

Contractors may also be required to take the test multiple times to ensure that changing circumstances don't also change their risk score.

The Business entity tests

The 12 questions and scores that make up HMRC's business entity tests, HMRC's guidance and the evidence required to substantiate a contractor's answers, are as follows:

Test 1: Business premises test – score = 10

Does your business own or rent business premises which are separate both from your home and from the end client's premises?

HMRC says: "For the purposes of this test, it makes no difference which of you owns or

rents the business premises – you yourself or your intermediary.”

Suitable evidence to present to HMRC could include:

Address of business premises

Lease or contract for business premises

Utility bills for business premises

Home address

Client’s address.

Test 2: Professional indemnity insurance test – score = 2

Do you need professional indemnity insurance?

Suitable evidence to present to HMRC could include:

PII policy document

PII premium note

An explanation of why PII is needed.

Test 3: Efficiency test – score = 10

Has your business had the opportunity in the last 24 months to increase your business income by working more efficiently?

HMRC says: “One way of doing this is finishing a fixed-price contract early. Say you agreed with the end client that the work would take three months and the fee would be £10,000. And say you finished in two months and received the full £10,000 at that point. You would have freed up a month to take on new business. So the answer to this question would be Yes.”

Suitable evidence to present to HMRC could include:

Clauses in the contract. Here are some examples:

The contractor receives a fixed payment on completion

The contractor ‘crystallises’ the profit when making the supply of services to the end client

The contractor’s business can provide extra workers to complete the job more quickly.

Copies of:

Costings for proposals

Tenders submitted

Letters from clients accepting offers. These would show the proposal options and related costs that you submitted for clients to approve and accept.

Test 4: Assistance test – score = 35

Does your business engage any workers who bring in at least 25% of your yearly turnover?

HMRC says:

“If the contractor’s trading vehicle is a company, these workers need to be people other than directors or shareholders of the company.

If the contractor’s trading vehicle is a partnership, these workers need to be people other than partners in the partnership.”

Suitable evidence to present to HMRC could include:

Accounting records

Details of tasks carried out

Names and payment details of workers who carried them out.

Test 5: Advertising test – score = 2

Has your business spent over £1,200 on advertising in the last 12 months?

HMRC says: "Entertainment does not count as advertising."

Suitable evidence to present to HMRC could include:

Copy of advertisement(s) placed

Copy of invoice(s).

Test 6: Previous PAYE test – score = minus 15

Has the current end client engaged you:

on PAYE employment terms

within the 12 months which ended on the last 31 March

with no major changes to your working arrangements?

HMRC says: "If you are doing the same work, the answer to this question is Yes.

Working at a different location does not count as a major change. If you were working for a company that is connected to the current end client, that counts as working for the current end client. For example, if the two companies are part of the same group."

In terms of evidence, HMRC says: "We will be able to check your employment history on our systems."

Test 7: Business Plan test – score = 1 if the answer to both parts is 'yes'

This test has two parts:

Does your business have a business plan with a cash flow forecast which you update regularly?

Does your business have a business bank account, identified as such by the bank, which is separate from your personal account?

Suitable evidence to present to HMRC could include:

Copy of business plan

Copies of updates

Statements of business bank account.

Test 8: Repair At Own Expense test – score = 4

Would your business have to bear the cost of having to put right any mistakes?

Suitable evidence to present to HMRC could include:

Clause in contract

Details of what could go wrong

Details of how the contractor would put it right

Details of the cost to a contractor's business of putting mistakes right.

Test 9: Client Risk test – score = 10

Has your business been unable to recover payment:

for work done in the last 24 months

more than 10% of yearly turnover?

Suitable evidence to present to HMRC could include:

Accounting records showing write-offs

Copies of letters and emails between a contractor's limited company and client

Copies of letters and emails about legal action for debt recovery.

Test 10: Billing test – score = 2

Do you invoice for work carried out before being paid and negotiate payment terms?

Suitable evidence to present to HMRC could include:

Copies of invoices

Copies of letters and emails about billing.

Test 11: Personal Service test – score = 2

Does your business have the right to send a substitute?

Suitable evidence to present to HMRC could include:

Clause in contract

Details of who would supply the substitute

Details of who would be responsible for the substitute's performance

Details of who would pay the substitute

Details of what level of veto the end client has.

Test 12: Substitution test – score = 20

Have you hired anyone in the last 24 months to do the work you have taken on?

HMRC says: "You could do this by sending someone to do the work in your place. You

could also do this by sub-contracting. But your business has to remain responsible for the work and for paying the person who does the work you have taken on. You can still pass this test if you had to tell your end client the name of the person who would be doing the work you took on."

Suitable evidence to present to HMRC could include:

Details of end client

Details of who was hired

Details of why the substitute was hired

Details of who was responsible for finding the substitute

Details of who was responsible for paying the substitute

Payment terms

Audit trail of payment from end client to contractor limited company and from contractor limited company to substitute.

HMRC's risk bands – medium and high

HMRC's guidance indicates that those contractors who have taken the business entity tests and are found to be in the high or medium risk bands have a correspondingly higher risk of an IR35 review.

However, the guidance published in June 2014 says that just because a contractor falls into the medium and high risk band does not mean they are inside IR35. Similarly, HMRC also says that just because a contractor is in the low risk band, it does not mean that they are outside IR35.

Because of the questions and the weighting of the scores, which largely ignore fundamental IR35 factors such as **control** and **mutuality of Obligation** to focus on **substitution**, a significant number of contractors in these bands will actually be outside IR35.

Contractors shouldn't simply roll over and accept that medium and high risk business entity test scores mean they are inside IR35. They should **seek professional assistance** from an IR35 expert and apply IR35 best practice. That way, if HMRC comes calling, contractors will have all the evidence required to close down an IR35 review before it gets off the ground.

HMRC's low risk band may result in 3 years of IR35-free contracting

Contractors who, according to their business entity test results, are in the low risk band must keep the evidence to support this status and be prepared to

supply it to HMRC on demand in the event of an IR35 review.

If a contractor is investigated and the evidence confirms their low risk status, HMRC has committed to close the IR35 review immediately and undertake not to investigate the same contractor again for three years, assuming the contractor's circumstances do not change.

These new rules appear to effectively provide contractors able to score above 20 in the business entity tests with an IR35 'get out of jail free' card valid for three years.

HMRC's risk-based approach – the process

According to its May 2012 guidance, HMRC's risk-based approach has two components:

Contractors who contact HMRC's confidential IR35 helpline and use its contract review service

Contractors targeted as a result of general compliance activity and who will be asked to prove into which risk band they fall by using the business entity tests.

Contractors who choose to use HMRC's [contract review service](#) and then pass will be provided with a certificate and unique reference number that will be valid for three years.

If contacted by an inspector seeking to conduct an IR35 review within three years, the contractor would supply their certificate and the review would be suspended whilst HMRC reviews the contractor's latest circumstances. If these have not changed significantly, the IR35 review will be closed.

However, contractors who do not use the contract review service, or whose certificate has expired and/or their circumstances have changed, and are then challenged by HMRC will have to take the business entity tests to determine into which IR35 risk band they fall.

The business entity test has not replaced IR35

Contractors should bear in mind that the business entity tests are purely a screening process to help HMRC better target limited company contractors who may be inside IR35.

The underlying legislation has not changed, so should a contractor find themselves in front of a tribunal judge, it will be the IR35 legislation and case law that will matter, not the results of the business entity tests.

Contractors are well advised to continue to invest in [investigation insurance](#), contract reviews and IR35 best practice, particularly if they do poorly in the tests and find themselves in the medium or high risk categories.

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