What is IR35? When IR35 applies to contracts explained

IR35 is tax legislation that is designed to combat tax avoidance by workers supplying their services to clients via an intermediary, such as a limited company, but who would be an employee if the intermediary was not used.

Such workers are called 'disguised employees' by Her Majesty's Revenue and Customs (HMRC). If caught by IR35, they have to pay income tax and National Insurance Contributions (NICs) as if they were employed. The financial impact of IR35 is significant. It can reduce the worker's net income by up to 25%, costing the typical limited company contractor thousands of pounds in additional income tax and NICs.

Despite having been in force since 1999, IR35 is heavily criticised by tax experts and the business community as being poorly conceived, badly implemented by HMRC and causing unnecessary costs and hardships for genuine small businesses.

If you are a genuine contractor, freelancer, interim or consultant who is in business on your own account, you should have nothing to fear from IR35. This is so long as you take the time to understand how the legislation works and apply best practice to ensure it does not apply to you, and have a defence prepared if investigated by HMRC.

What is IR35?

Introduced in 1999, IR35 is a tax law. It is properly known as the Intermediaries Legislation and came into force in April 2000 as part of the Finance Act. IR35 takes its name from the original press released published by the then Inland Revenue (now HMRC) announcing its creation.

The income tax element of the Intermediaries Legislation has subsequently been integrated into the Income Tax (Earnings and Pensions) Act 2003 (ITEPA 2003), and the NICs element into the Social Security Contributions (Intermediaries) Regulations 2000.

Why was IR35 introduced by the government?

IR35 was introduced to tackle the problem of 'disguised employment'. This is where organisations engage workers on a self-employed basis and usually through an intermediary, rather than on an employment contract, so they become disguised employees.

This can save the engaging organisation a significant amount of cash as they no longer have to pay employers' NICs, and it also means they do not have to offer any employment rights or benefits.

A common example is the 'Friday to Monday' phenomenon. That is when an employee leaves employment with their employer on a Friday only to return to the same role in the same office on the Monday, only engaged as a contractor or consultant trading through a personal services company and paying much less tax.

IR35 should have a genuine role to play in defending both workers' rights from unscrupulous employers and the Exchequer from lost tax yield. Unfortunately, the legislation in its current form falls well short of that aims.

How IR35 works – the tests of employment

Because IR35 essentially seeks to turn a legitimate one person small business into being an employee, it is underpinned by employment legislation and IR35 case law. As a result, the tests of employment evolved over decades by the UK legal system are applied,

The key IR35 case law dates back to a seminal employment law case tribunal, Ready Mixed Concrete (South East) Ltd v Minister of Pensions from 1968. More recent cases, particularly those ruled on since IR35 was introduced, can also apply.

Essentially, an HMRC inspector will disregard the written contract in force between the worker and their client, and use the actual nature of the working relationship to create a 'notional contract'.

An inspector, or a tribunal judge, will use this notional/hypothetical contract to determine whether the contract is one of employment, when IR35 applies, or one for business to business services where IR35 does not apply.

Not surprisingly, an expert knowledge of employment law is required to fully interpret these tests. Neither those independent professionals being investigated nor HMRC's tax inspectors can possibly be expected to become experts. As a result, IR35 has been incorrectly applied in numerous high profile tax cases, and contractors are left without certainty about their tax status.

Determining whether you are caught by IR35 is complex, and ideally you should seek expert IR35 advice. However, you can use ContractorCalculator's Free Online IR35 test to provide you with guidance about your IR35 status.

Control, substitution and mutuality of obligation

In short, IR35 involves applying three principles to determine employment status from the Ready Mixed Concrete case. These are known as the principal 'tests of employment':

Control: what degree of control does the client have over what, how, when and where the worker completes the work

Substitution: is personal service by the worker required, or can the worker send a substitute in their place?

Mutuality of obligation: mutuality of obligation is a concept where the employer is obliged to offer work, and the worker is obligated to accept it.

Other factors taken into account to determine whether you are caught by IR35 include the contract type, whether you are taking a financial risk, if you are 'part and parcel' of the engager's organisation, being in business on your own account and provision of equipment.

All of this evidence is taken into account, and if the balance of probabilities is that the worker is an employee then IR35 applies. So, for example, if a worker has an unfettered right to send a substitute in their place, personal service is not required and IR35 cannot possibly apply.

What to do if IR35 applies – how to calculate the deemed payment

If IR35 does apply, then the legislation makes provision for paying that extra income tax and NICs. Furthermore, another frightening aspect of IR35 is that HMRC can go back at least six years and evaluate past contracts to see if the legislation applies.

That means HMRC can demand income tax and NICs, plus penalties and interest, going back several years, resulting in tax demands reaching six figures.

When IR35 has been found to apply to an IR35 contract, then you need to calculate what is known as the deemed payment on your limited company income. This means that you deduct your Pay As You Earn (PAYE) salary, a **5% expenses allowance**, plus any pension contributions.

What is left must be treated as if it were a salary from an employer, so you calculate the additional tax due. In practice, if you are certain your **contract is caught by IR35**, then the simplest solution is to pay out all of your limited company's fees less legitimate expenses and pension contributions as a PAYE salary. Because you are paying yourself like an employee, then IR35 won't apply.

You can use ContractorCalculator's online interactive **IR35 calculator** to help work this out.

How can IR35 be avoided by contractors?

If you are a legitimate small business, then IR35 will not apply. However, that does not prevent HMRC from launching an investigation into whether it does. And that can be time consuming, costly and highly stressful.

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