

THE BEGINNERS GUIDE TO IR35

CONTENTS

Introduction - What is IR35?

Chapter 1 - Know your status

Chapter 2 - The cost of non compliance

Chapter 3 - Selecting your operating structure

Chapter 4 - Investigations

Using this guide

You can navigate directly to a chapter by clicking on the relevant chapter on this page. You can return to the contents page at any time by clicking the link at the foot of each page.

You can search the document using the key words search facility available on PDF documents.

Need to discuss your individual situation with an expert?

Our professional members have access to our members telephone helpline that provides a range of experts to answer your questions across all of the key aspects relating to contracting.

Professional membership costs just £40.00 (+vat) per annum and you will have full access to the service for your whole membership year.

You can find out more about the helpline [here](#).

You can upgrade your membership to professional [here](#).

Please note:

This document is a general guide and does not attempt to give specific advice or guidance.

Every effort is made to ensure the accuracy of the information although we accept no liability for errors or omissions.

You should always seek professional guidance and we cannot accept any liability for reliance on this guide or actions you took or did not take as a result.

INTRODUCTION - WHAT IS IR35?

IR35 came in to effect in 2000.

Before the days of IR35 the most common way of operating as a contractor was as a self-employed individual. In the late 1980's HMRC introduced a new rule making any recruitment company engaging self-employed workers liable for any unpaid tax if they failed to deduct full PAYE prior to payment to the contractor.

Almost overnight every recruitment company refused to deal with self-employed contractors; as they saw the risks and potential costs as too great, forcing contractors to set themselves up through their own limited companies. [The recruitment companies did not hold any liability for unpaid taxes where they dealt with a limited company]

Contractors quickly became familiar with this new way of working and recognised the additional opportunities it represented in maximising their returns.

HMRC, shortly after making these changes, realised that their tax take from the market had reduced significantly as a result of contractors maximising their returns and, in an attempt to regain some of these losses, they introduced new legislation in 2000: IR35; also known as the Intermediaries Legislation.

At the time of introducing the legislation the contracting market had experienced significant growth and HMRC suggested that IR35 was being introduced to protect the workers. Their perception was that employers were forcing workers to engage through contracts as a way of avoiding many of their employers responsibilities and costs.

The idea behind IR35 was to attempt to establish the true employment status of the contractor. In simple terms; it was to examine the relationship between the contractor and the end user to establish whether it was one of 'disguised employment' or a genuine business to business relationship.

 The resulting legislation prescribes that where the relationship is considered to be similar to a traditional employee – employer it would be categorised as deemed employed for tax purposes. It was also made clear that deemed employed for tax purposes was just that – for tax purposes, and did not provide any employment rights or associated benefits to the worker. Furthermore, where a relationship was seen as that of deemed employed a special set of tax rules would be applied closing many of the traditional benefits open to those operating through their own limited company.

Contractors who were deemed employed now had to pay all their income under the traditional PAYE rules, the most tax inefficient payment structure, although they were provided with a standard 5% allowance that could be paid gross to cover the expenses incurred in running a limited company. The only other expenses allowed were those that could have been claimed by full time employees; effectively disallowing the majority of expenses contractors were claiming at that time.

This was seen by HMRC as a major disincentive to individuals who were considering setting up as contractors; as if they were caught by the IR35 rules they would have to pay tax as if they were employees without any of the benefits provided to employees such as; sick pay, holiday pay etc.

At the time of the introduction of the IR35 legislation many tax commentators reported that it was badly written, difficult to assess and almost impossible to enforce effectively. HMRC, at the time of implementing, made it clear they would look to the courts to define the exact parameters of the rules.

Since its introduction many of these claims have been proved correct as the courts have been kept busy with disputes between tax payers and HMRC over the assessment of status. Enforcement by HMRC has proved expensive and difficult with an admission recently of this fact.

However IR35 is still here and needs to be considered carefully by all contractors; the costs of getting it wrong are high!

KNOW YOUR STATUS

Accurately assessing your IR35 status is an essential part of operating as a UK contractor as it impacts on many of the decisions you have to take; such as:

- whether or not to take an assignment; if you have two assignments available, both at a similar rate, one caught by IR35 and one outside, you will more than likely take the assignment that is outside IR35 as it is more valuable to you.
- it may influence your preferred operating structure; whether to work through an umbrella or through your own limited company.
- where you operate through your own limited company it determines how you take the income from the company and the tax rules that apply.
- an incorrect assessment could result in a HMRC investigation that is both time consuming and costly.
- penalties can now be applied if you fail to demonstrate that you took reasonable care in assessing your status; these penalties could amount to 100% of any additional taxes assessed.

These areas are all covered in detail throughout the guide but for now we will just focus on knowing your status.

What information do I need to assess my status?

Many contractors mistakenly think that the contract between themselves and their recruitment company is all that is required to assess the IR35 status.



IR35 is assessed based on a 'notional contract' that looks to establish the relationship that exists between you and the end user, ignoring any contracts or relationships in between. As the name would suggest, 'notional contract', this relationship is not normally accurately represented in the contract you hold between you and your recruitment company and is not usually documented; therefore the notional contract has to be constructed. A term often used to describe the notional contract is 'working arrangements'; this looks to document the key aspects of your working relationship with your end user and therefore provides the terms of the notional contract.

If you are new to contracting; or taking a new contract with an end user you have never worked with before, you may not be able to accurately document this relationship until after you have started. In these cases you should look to establish your working arrangements as a priority; in most cases this is straightforward and can be completed in a matter of days.

If your assignment is direct with the end user you should be able to establish these as part of your initial negotiations and therefore be in a position to assess your status from outset.

Is there a template for documenting the working arrangements?

We have provided a template on our [website](#) for your convenience.

Where you use the services of a professional firm to review your status it is likely they will have their own template.

Can I assess my own status?

 It is possible to assess your own IR35 status although to do so will require you to have a detailed knowledge of the rules and case histories that have applied in this area.

If you were to assess your own status you will need to document the reasons that lead you to conclude that your assignment was outside IR35; if you assessed that you were caught by IR35 there is no need to document these conclusions. Without this documentation you could be liable for penalties if HMRC successfully challenged your assessment.

It is our advice that you use the services of a professional firm to assess your status and provide you with all the relevant documentation required to demonstrate that you took reasonable care; if required to do so. One of the advantages of using such a firm is that should HMRC seek to challenge this status assessment they are likely to act for you and be more vigorous in their defence as they gave the advice initially.

Professional Passport has a service for our members that provides both an assessment and conclusions report for all your assignments for a fixed fee per annum; regardless of how many assignments you carry out in that year. Full details are available on our [website](#) and this comes with a years free Professional Membership.

Can my recruitment company confirm my status?

 It is highly unlikely that any recruitment company would confirm your status; other than perhaps confirming where you were caught by IR35.

If a recruitment company did confirm your status then you are still potentially exposed to penalties if HMRC successfully challenged this assessment; as they are unlikely to provide you with the required conclusions report to demonstrate reasonable care.

Should I get my recruitment company to make my contract look outside IR35?

Many hours are spent with arguments between contractors and recruitment companies on the wording of contracts.

In simple terms; the contract should reflect the terms of the assignment, if it doesn't then you are perfectly correct to ask for amendments. However; asking for a series of changes that are designed to make the contract look as if it is outside IR35 and that have no regard to the actual working arrangements is a pointless exercise and a complete waste of your time.

If you are subject to a HMRC investigation the contract between you and your recruitment company is often ignored and more often than not HMRC will go direct to the end user for the confirmation of terms. Furthermore you could increase your chances of investigation where you have a perfectly worded contract; reflecting a status of outside IR35, as HMRC have seen these before and tend to be suspicious of such strongly worded contracts.

The reality is that the assessment should be made on the actual arrangements that apply not a set of manufactured circumstances.

Can my accountant or service provider confirm my status?

 Many accountants and service providers will offer an assessment of your status as part of their package to you. It is essential you clearly understand the scope of this assessment.

Where the assessment is made purely on the contract between yourself and the recruitment company this is unlikely to deliver an accurate picture. If you were subsequently successfully challenged by HMRC it is likely that you could not demonstrate that you took reasonable care in the assessment and therefore could be liable to penalties.

Where this service is offered as part of a package you should have the provider document the scope of the assessment and confirm the position if HMRC successfully challenged the assessment.

Will the end user provide me with a confirmation of the working arrangements?

This is unlikely; many end users do not full understand IR35 and can become nervous in providing these confirmations.

Once I establish my status is that it?

Unfortunately not; assessing your IR35 status is a constant process. The IR35 status is assessed on a assignment by assignment basis; therefore every new assignment, extension and renewal should have its status assessed.

It is highly likely that your status will change as you move assignments; this is normal.

The Professional Passport contract review service provides a fixed cost service for assessing all assignments, extensions and renewals in a year; regardless of how many you undertake. It also provides the required documentation to demonstrate that you took reasonable care in the assessment.

Full details are available on our website.

THE COST OF NON COMPLIANCE

If you are unlucky enough to be the subject of an IR35 investigation the true cost can be broken down in to a number of distinct categories:

- your time
- professional fees
- additional tax
- penalties

Your time

 Experience shows us that IR35 investigations are both time consuming and stressful for those involved.

An investigation can start with a seemingly simple employer compliance review. You will receive a letter from an HMRC officer that seems unthreatening and of little consequence.

Often there are specific reasons why HMRC has select a company for review; whilst some are at random this is not always the case.

During this meeting the subject will move to your IR35 status and how this is assessed; often asking for examples of the contracts relating to your assignments. This is the point that you become all too aware that you are now likely to enter a long protracted investigation.

Where you can clearly demonstrate that you have had your assignments professionally reviewed; including the assessment of working arrangements, and this is supported by a conclusions report this can help stop the case proceeding any further. If the documentation appears genuine and a true reflection of the arrangements the inspector is likely to move on; as there will be many others with much weaker positions.

It is at this time you release that the small investment you made at outset to have your assignments professionally reviewed has just paid dividends.

Professional fees

 If the initial enquiry progresses then you would be well advised to engage a specialist to represent your case, if you have not already done so. IR35 is complex and most contractors do not have the depth of knowledge to challenge a HMRC position.

Professional advisers should be engaged at the earliest opportunity as they will guide you and significantly increase your chances of success.

 Engaging these professionals can be expensive; although if they win the case for you they will be cheaper than the additional tax bill you face. You may well have taken out tax investigation cover and many of these policies will cover the cost of the professional to defend your case.

Professional Passport offers this cover to its members as we feel that the risks of an investigation are high and so this now represents excellent value for money. **Full details are available on our website.**

Additional tax

If HMRC successfully argue their case and your status is changed to within IR35 then you will be assessed for additional taxes. The amount of additional tax will depend entirely on how you have paid yourself before the investigation.

Income from assignments that fall within IR35 have to be paid in line with a set of rules known as 'deemed payment'.

HMRC would run a calculation using the deemed payment approach and this would show how much tax should have been paid on the income from that assignment. They would then subtract any taxes that had been paid and issue an assessment of tax based on the difference.

In simple terms the deemed payment is worked out as follows:

Total income from assignment
Less a standard 5% allowance
Less any allowable expenses
Now apply the PAYE rules to the net income
Employers NI
Employees NI
PAYE tax
Net income due to contractor

The employers NI, employees NI and PAYE tax is added together to produce the figure of what tax should have been paid. The actual tax paid is deducted and the difference is the amount you will be assessed for.

Typically this could result in a reduction of your net income by around 25%.

Please note:

This is a simplistic explanation for the purposes of the beginners guide; further details are available on our website and the HMRC website.

Penalties



If during the investigation you are unable to demonstrate that you took reasonable care in assessing your assignments status at outset HMRC have the ability to apply penalties of up to 100% of the additional tax assessed.

It is our understanding that they are only likely to apply the full penalty where you have been either uncooperative, unhelpful or deliberately misleading during the investigation. However it is a certainty that some level of penalty will apply.

Any penalty is likely to be substantially more than the cost of having your assignments professionally assessed from outset.

Details of our assignment assessment service can be found [here](#).

Disclosure of Deliberate Tax Avoiders

 HMRC now has the ability to publically list any tax payer who has been found deliberately understating their tax position by over £25,000.

In the case of contractors this level would be reached quickly where HMRC successfully challenge the IR35 status of assignments. Where a contractor can demonstrate taking reasonable care in assessing their assignments status it is unlikely that they would fall in to the category of “deliberately understating” and therefore should avoid any listing.

It is widely expected that this list will be used by both recruitment companies and end clients as part of their referencing procedures when engaging contractors; especially for assignments in sensitive areas such as banking, financial services, defence etc.

As a result it has become increasingly important that contractors ensure they take reasonable care, at outset, in assessing their assignments status and are able to demonstrate this in the event of an HMRC enquiry.

Details of our assignment assessment service can be found [here](#).

SELECTING YOUR OPERATING STRUCTURE

There are many factors that need to be considered in selecting the correct operating structure for you in your career as a contractor.

Typically you have three routes to choose from:

Agency PAYE

Umbrella

Limited Company

The Professional Passport website has a range of information and assessments to assist you in making the right decision and you can access these [here](#).

We have also produced a Beginners Guide to Operating Structures and you can download the PDF from [here](#).

HMRC has no issues with contractors who look to operate via an umbrella provider or through agency PAYE, as they pay full PAYE tax; they do, however, tend to want to look more closely at those operating through their own limited company. This is purely because of the potential additional tax benefits available by operating through your own limited company.

Having said that; this should not put you off setting up your own limited company, you just need to ensure you do things correctly and that it is right for you.

Umbrella marketing has always suggested that if your assignments are typically going to be caught by IR35 then you should automatically select an umbrella as your operating structure. This is not always the case; higher paid contractors, even where they are caught by IR35 and applying the deemed payment calculation, can often end up with more money in their pockets when operating through their own limited company, with no increased risk.

Many contractors operating through their own limited company will also be registered for VAT; in many cases voluntarily. You may ask why someone would want the additional administrative burden that this brings - the answer is simple - there is a simplified VAT reporting scheme known as The Flat Rate scheme and this can often provide additional benefits to contractors.

Your preferred operating structure should not be selected purely on the returns you could expect, there are many other factors that need to be considered including:

Personal organisation; if you are not well organised the additional administration that comes with operating your own limited company may not suit you.

Expectations of your contracting career; if you are new to contracting an umbrella provides a simple and fast route to get started. If you are unsure how long you will be contracting for the umbrella could provide a good home until things become clearer.

Your attitude to risk; there are many more rules and regulations to comply with when operating through your own limited company, if you are risk adverse then an umbrella may provide a good alternative.

As well as selecting your preferred operating structure you will need to decide who provides the support, advice and guidance to you.

The Professional Passport website has lists of both **umbrella and accountancy service providers** that we have audited for both compliance and customer service. If you are unsure of who to use we would strongly suggest you select a provider from these listings.

If your preferred structure is umbrella then you should consider the following when selecting your umbrella:

Financial strength; under the terms of your employment with the umbrella you are likely to have a salary based on the National Minimum Wage with additional bonus payments made whilst you are on assignment. If the umbrella got in to financial difficulty then technically your only legal right is to the National Minimum Wage salary. It is therefore important you select an umbrella provider that you feel is financially secure.

Expenses; many umbrellas operate an expenses policy based on a dispensation they have received from HMRC. In simple terms a dispensation allows a level of expenses to be claimed without the umbrella having to produce paperwork on each at year end. If you expect to have high expenses it is worth checking whether the umbrella restricts your claims to their dispensation level or whether they allow you to claim the full amount you incur.

Charges; all umbrella providers are subject to exactly the same HMRC tax rules and therefore will provide the same returns for a given set of circumstances. Many providers provide illustrations on expected returns that assume high levels of expenses; boosting the illustrated returns. The reality is that the only difference in returns you can expect will be as a result of the difference in the fees charged; although these usually only make a small difference to your net result. If a provider illustrates high returns; much higher than any other example you have, then our advice is to be cautious. It is also worth clarifying exactly what the charges are as some umbrellas charge a fixed fee, some a percentage fee and some charge based on a range of factors; make sure you are fully aware of the charges that will apply to your situation.

If you select to operate through your own limited company you have a number of options available to you:

A specialist accountancy service provider

A 'High Street Accountant'

Do it yourself

If you are new to contracting, or new to the idea of operating through your own limited company, we would always suggest using one of the specialist accountancy service providers. These providers are familiar with all the legislation applying to contractors and are likely to provide a much higher level of support and guidance in your early years. You will find a list of these specialists on our **website**.

We have also produced a Beginners Guide to Operating Structures that covers your options and the different structures available to you in more detail. You will find the guide on our website **here**.

INVESTIGATIONS



An investigation into your IR35 status will usually start with an employer compliance review but can be instigated by other routes including an aspect enquiry or a full enquiry into your company or personal tax returns. Most HMRC offices have an employer compliance team and some teams as far away as Scotland, may cover your area. It does not always follow that you will be visited by the local office.

In a typical employer compliance review you will receive a letter (or sometimes an initial telephone call) asking for an appointment and meeting to carry out a routine review of all your records e.g. payroll, expenses, sick pay calculations etc. Often there is no mention of IR35 at this stage.

You should be aware that cases selected by HMRC for an employer compliance review, have been subjected to a risk and research analysis which means that it is highly likely that HMRC has already identified an area where there is a potential tax/NIC loss.

HMRC advises that a number of reviews are selected at random but these will have to be balanced against the appropriate use of taxpayer's funds and the need to reduce the burdens on business.

It is at this point that it is recommended that you seek specialist advice from your accountant and/or a firm with experience of handling IR35 cases. Having such advice and support at the outset is often critical to a successful outcome.

You can find details of firms specialising in handling such cases on our [website](#).

Because IR35 is so complex, resolution of cases is protracted and many go on for several years. This is a stressful experience for all concerned.

IR35 cases begin with a review of the written contracts and HMRC then seek full details of the terms and conditions and working arrangements. Initially this may take the form of written questions directed at each individual contract and it is not uncommon to be asked 150 questions on each!

Don't forget they can also go back six years, so that could be a lot of questions!

HMRC will then seek confirmation of the answers given, from the end client. They may at this point give an informal opinion that IR35 applies and this is where specialist knowledge is required to enter into the technical debate based upon case law precedent.

If agreement cannot be reached on the interpretation and application of appropriate case law to the findings, HMRC will issue formal Regulation 80 determinations to collect the tax due and a Section 8 NIC decision for the NIC due. You now have the right of appeal against the determinations and the decision, and an appeal will be heard by the new Tribunals Service.

