

Q&A



‘Intermediaries
Legislation’, commonly
known as IR35

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What is IR35?

The 'Intermediaries Legislation' is commonly known as IR35 because that was the number of an Inland Revenue Press Release issued on 9 March 1999 that announced it.

Entitled 'Countering Avoidance in the Provision of Personal Services', the aim of the legislation was to eliminate the avoidance of tax and NIC through the use of intermediaries, such as service companies or partnerships where an individual worker would otherwise be liable.

It came into effect in April 2000 throughout the UK.



Why was IR35 introduced and by who?

Before the days of IR35, the most common way of operating as a contractor was as a self-employed individual.

In the late 1980s the Inland Revenue (now HMRC) introduced a new rule, making any recruitment company which engaged self-employed workers liable for any unpaid tax if they failed to deduct full PAYE prior to paying the contractor.

This rule resulted in:

- recruitment companies refusing to work directly with contractors, because of the high potential tax risks and costs involved
- contractors setting themselves up through their own limited companies. For example, personal service companies (PSCs), as this meant recruitment companies could hire the contractor without holding any liability for unpaid taxes
- increased popularity of PSCs amongst contractors, particularly as it created new opportunities for the workers to reduce their exposure to tax by both supplying their services to an 'end-user client' through an intermediary (usually a PSC) and paying themselves in dividends, avoiding paying employee income tax and national insurance contributions.

To counter this perceived tax avoidance, the government announced in the March 1999 Budget that it would introduce provisions to allow the tax authorities to look through (ignore) a contractual relationship, where services were provided through an intermediary such as a PSC, but the underlying relationship between the worker and the client had the characteristics of employment.

IR35 was born in 2000 to tackle the misuse of PSCs for tax avoidance purposes.

What were the original effects of IR35 for workers and for employers?

The original IR35 legislation required the intermediary (e.g. the PSC) to determine whether or not the worker would have been a deemed employee of the end-user client, if the intermediary had not existed. If the worker would have been a deemed employee, the intermediary had to:

- operate payroll
- make deductions for income tax
- make deductions for employee's national insurance contributions
- pay employer's national insurance contributions on the fees received for the services.

Income tax

The law details when IR35 applies for income tax. In broad terms, this is where:

- an individual personally performs services for a client (or is obliged to do so)
- those services are provided under arrangements involving an intermediary
- the circumstances are such that, if the arrangements had been directly between the individual and the client, the individual would have been regarded as employed by the client for income tax purposes.

The law indicates that the contractual terms forming part of these arrangements are one of the circumstances that should be taken into account.

All third parties standing between the worker and the client constitute intermediaries, but there will only be a 'relevant engagement' involving that intermediary (with the resulting income tax consequences) if certain conditions in relation to intermediaries are met.

National Insurance Contributions (NIC)

In contrast, for NIC, the regulations define at some length what an intermediary is and provide that third parties standing between the worker and the client will only be intermediaries if certain conditions are met. Despite the differences in approach, the intention appears to be the same.

The key provision specifies, in broad terms, that the Regulations apply if the same three conditions are met:

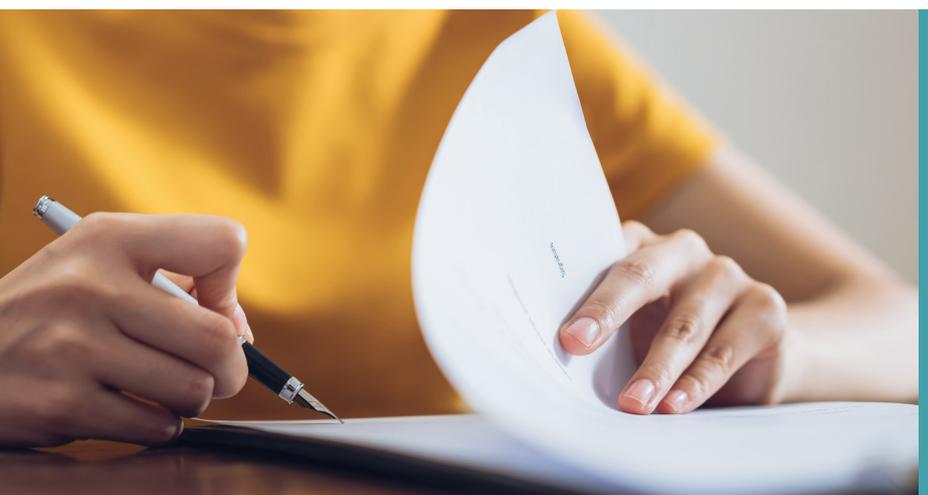


- an individual personally performs services for a client (or is obliged to do so);
- those services are provided under arrangements involving an “intermediary”;
- the circumstances are such that if the arrangements had been made directly between the individual and the client, the individual would have been regarded as employed by the client “in employed earner’s employment” for NIC purposes.

If the regulations apply, then the worker and the intermediary are treated as employee and employer for NIC purposes.

Although, in most cases, NIC contributions will be due under these regulations only where the income falls within IR 35 for tax purposes, this will not always be the case because the NIC regulations are more widely drafted.

In summary, if the original IR35 applies, the sums received by the intermediary are, in effect, treated as employment payments by the intermediary to the worker for tax and NICs purposes and will be subject to PAYE. But this is calculated at the end of the year on the deemed income, after allowing a 5% deduction to cover general expenses (unless there is supervision, direction or control, in which case PAYE must be accounted for monthly on actual payments made throughout the year).



What significant changes have there been?

The dividend tax regime was changed in April 2016, effectively wiping out the tax advantage for contractors, who thereafter paid roughly the same amount of tax as an employee when considering the corporation tax and dividend taxes combined.

For the Treasury, the issue remained that the clients (i.e. the fee payers) do not pay employers’ NIC of 13.8% when hiring the self-employed, perpetuating large scale revenue losses.

HMRC believe that 9 out of 10 of the ‘outside IR35’ decisions made by intermediaries are incorrect, losing the government millions of pounds in tax revenue per year. So the government introduced the off-payroll working rules in 2017 for the public sector; these make the hirer/end client (instead of the intermediary) responsible for making the IR35 decision and, more importantly, taking the financial tax risk if HMRC argue that they were wrong to classify an assignment as outside IR35.

Following a 12-week consultation published in May 2018, the government announced at the autumn Budget 2018 that it would extend the public sector reform to all engagements with medium and large-sized organisations (small companies are exempt, as discussed below) in the private sector as from April 2020. However, the application has been delayed by government to April 2021 due to the Covid-19 pandemic.

What changes are now proposed and why are they being made?

There can be numerous agencies or other intermediaries in the contractual chain, but, for the purposes of the off-payroll working rules, the party that operates PAYE/NIC is treated as the employer for tax purposes.

The effect of the new rules is that, from April 2021, the burden of making a determination of employment status will fall on medium and large 'end-user clients', who then need to notify their contracting party and the worker of that status determination.

The final party in the chain before the PSC must:

- operate payroll
- make deductions for income tax and employee's national insurance contributions
- pay employer's national insurance contributions on the fees paid for the services.

The hiring organisation will determine the IR35 status of an engagement and be required to provide the contractor with a Status Determination Statement (SDS).

The SDS will inform the contractor of the status decision and the reasons behind it. The SDS will also be passed down the supply chain i.e. to the agency (if there is one).

If the client decides IR35 does apply, the contractor business will be taxed at source, through the Real Time Information (RTI) system, exactly like an employee.

The tax will be deducted by the 'fee payer' – which is whoever pays the contractor's company. If the contractor contracts directly with the client, the client is the fee-payer. If contract is with an agency, then the agency would be responsible for operating the PAYE. It is also likely a payroll, or umbrella, company will enter the supply chain as the fee-payer, if the engagement has been deemed 'inside IR35'.

The fee-payer will be liable for tax on any payments made after 5th April 2020. It is not about when the work is done, it is about when the payment is made. If you are paid in mid-April for work you did in March, and the client decides IR35 applies, tax will be deducted from that payment.



What about small businesses?

Where an end-user client in the private sector qualifies as 'small', they will be exempt from the off-payroll working rules, but the original IR35 legislation will continue to apply, and the obligation remains with the PSC/intermediary to make an assessment of employment status and to operate payroll if appropriate.

To qualify as small, the client must meet at least two of the following three criteria, having no more than:

- 50 employees
- £10.2m turnover
- £5.1m on the balance sheet.

A 5% allowance is currently available to those who apply the off-payroll working rules, to reflect the costs of administering them. Because responsibility is shifting from the PSC to the hirer, this allowance will be removed for those engagements with medium and large-sized organisations. It will continue to be available for engagements with small organisations.

To summarise, the off-payroll working rules apply differently depending on the status of the end client:

End client type	Who assesses the worker's employment status?	Who deducts PAYE/ NIC?	When from
Public sector	End Client	Fee payer	6 April 2017
Large or medium-sized private sector	End Client	Fee payer	6 April 2021
Large or medium private sector (IR35)	PSC	PSC	Until 5 April 2021
Small private sector (IR35)	PSC	PSC	Ongoing

What are the key risks for workers?

Although contractors caught by this measure will have to pay tax like an employee, their employment status will not automatically change, so they will not necessarily receive the rights and benefits that go with employment, such as pension contributions, holiday pay and unfair dismissal rights.

This was clarified in a fact sheet that government issued in January 2020 on the position of contractor rights:

“Where the rules apply, it is important to note that, unless you have a direct employment contract, you will not be classed as a direct employee of the hiring organisation you provide your services to. This means that you will not be entitled to statutory payments or employment rights from them.”

While the tax liabilities and the risks of penalties generally shift to the end-client after April 2021, in the case of small clients, the contractor retains the tax liability and the responsibility to make the IR35 assessment.

Given the increased potential liabilities for clients (discussed below), the clients may be more likely to take a risk averse approach and decide to apply IR35 if there is any doubt whatsoever (and there is usually an element of doubt when it comes to IR35). This is known as ‘blanket determination’, which would mean that workers may need to pay increased income taxes and NICs through the PAYE.

However, clients are advised not to adopt this approach as the legislation requires them to take ‘reasonable care’ when determining status, and blanket determinations will generally fail that test.



What are the main risks for employers?

Lack of expertise for applying IR35

According to the Association of Independent Professionals and the Self-Employed (IPSE), one of the biggest risks faced by the private sector end-clients that are deemed employers under the new regime is that clients may not be able to determine accurately whether IR35 will apply to the intermediary because the IR35 rules are so complex.

Clients will have much more responsibility for gathering information. Currently, in the public sector, clients have to provide a determination to the party with which they contract at the start of the contract. The new proposals go beyond this and require clients to:

- inform the entity with which they contract
- inform the individual contractor of their determination
- if requested, provide them with the reasons for it
- share the status determination and reasons with all relevant parties in the contractual chain to ensure they have sufficient information to allow them to comply with their obligations under the rules.

Increased risks of tax liabilities

In case of wrongful IR35 determination, the clients may be liable for any unpaid income tax and class 1 employee national insurance contributions due on deemed payments of employment income. Over a three-year period, the employer's gross tax risk for an average contractor earning £100,000 pa, including national insurance, apprenticeship levy, interest and moderate penalties, is well over £100,000.

In addition, if HMRC were unable to collect the outstanding liability from a party further down the chain, for example because it ceased to exist, the government proposes that liability will transfer back up to the first party or agency in the chain and if HMRC could not recover from them, ultimately to the client.

This all means that the due diligence being performed by the client on the whole of the supply chain will be much more significant in order to ensure that they will not be left with liability. This also leads to a related risk in relation to any data privacy issues arising from this new process of operationalising IR35.

What are good sources of information, if I need more?

For more detailed information on IR35 and new off-payroll working rules:

- [Association of Independent Professionals and the Self-Employed \(IPSE\)](#)
- [Lexis Nexis for employment taxes guidance](#)
- [House of Commons Library – Briefing Paper ‘Personal service companies and IR35’ for a historical analysis of the IR35 legislation](#)
- HMRC guidance on IR35 [here](#) and [here](#).



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