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IR35 Latest News

IR 35 Consultation Group

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What is the Current Position on IR35?

As the IT market is now operating under the effects of IR35 it is a logical time to review the legislation, consider how it affects companies and examine the way forward. Much has been written about the likely **effects of IR35** on the UK IT Industry; a significant proportion is inaccurate.

The Legislation

There is no legislation actually called IR35 (it was the name of the press release), but the changes it introduced have been in effect from 6th April 2000. The Welfare Reform and Pensions Bill passed through both the House of Commons and the House of Lords in 1999, setting the rules for collection of additional National Insurance, and the Finance Act 2000 has now mirrored that legislation with regard to taxation. The Finance Act was finally approved on the 28th July 2000 (This legislation is now contained in the Finance Act 2000, Section 60 and Schedule 12).

There has been talk of **legal challenges** both in the UK and Europe, however, there is little chance of success for either of these approaches. The Legislation in the UK is designed to counter what the Inland Revenue see as a loophole in taxation, and has the backing of the current Labour Government – and their sizeable majority in the House of Commons. The challenge in the UK would require an overturning of primary legislation that has been introduced by the party elected at the will of the country. Europe has been pressuring the UK to adopt IR35 type legislation for some time as they felt that the existing system was tantamount to unfair competition in the European marketplace. It is unlikely that the European Courts will rule against something they have wanted for some time.

“IR35 Proof Contracts”

This appears to be the most used phrase in the UK IT industry today and is generally followed by the words – “where can I get one?”

Despite many rumours to the contrary there is no such thing as an IR35-proof contract. IR35 looks at the **engagement** itself and as such it is the engagement that is being tested, not just the wording on the contract. It is true, however, that wherever the relationship on site is one where the criteria for falling outside IR35 are met, the contract must be written in such a way as to match that engagement.

An "IR35 proof contract" may be tested by the IR in a series of ways. Even if the engagement, as described in the contract is deemed to be outside the scope of IR35 by the IR Contract Testing Unit there can still be problems. The letter from the Inland Revenue confirming that the engagement is "IR35 Exempt" stipulates that if the terms of the actual engagement differ in practice from those defined in the contract then the assessment will be ignored for the purposes of calculating tax and National Insurance liability and the Contractor will be liable to pay all IR35 monies. (i.e. a false contract will get you in trouble) - here is the text from a recent IR assessment letter:

"I have reviewed the contract between XXX [Agency] and YYY Ltd and am of the opinion that had it been a contract between XXX and [Contractor] it would be considered to be a contract for services. As such, the contract will not be subject to the "intermediaries" legislation.

*My opinion assumes that the terms stated reflect the true arrangements. If the contract is not fully acted upon in practice or there are other oral or implied conditions which have not been presented to me, my **opinion may be modified**. As part of its normal compliance activities, the Revenue reserves the right to check that the working arrangements are as stated."*

Many Contractors may have received information from the press, other Contractors, Internet sites and agencies stating that there are **model contracts** approved by the Inland Revenue, but again this is not accurate. Every contract is assessed individually and it is the nature of the actual engagement in conjunction with the contract that determines the status.

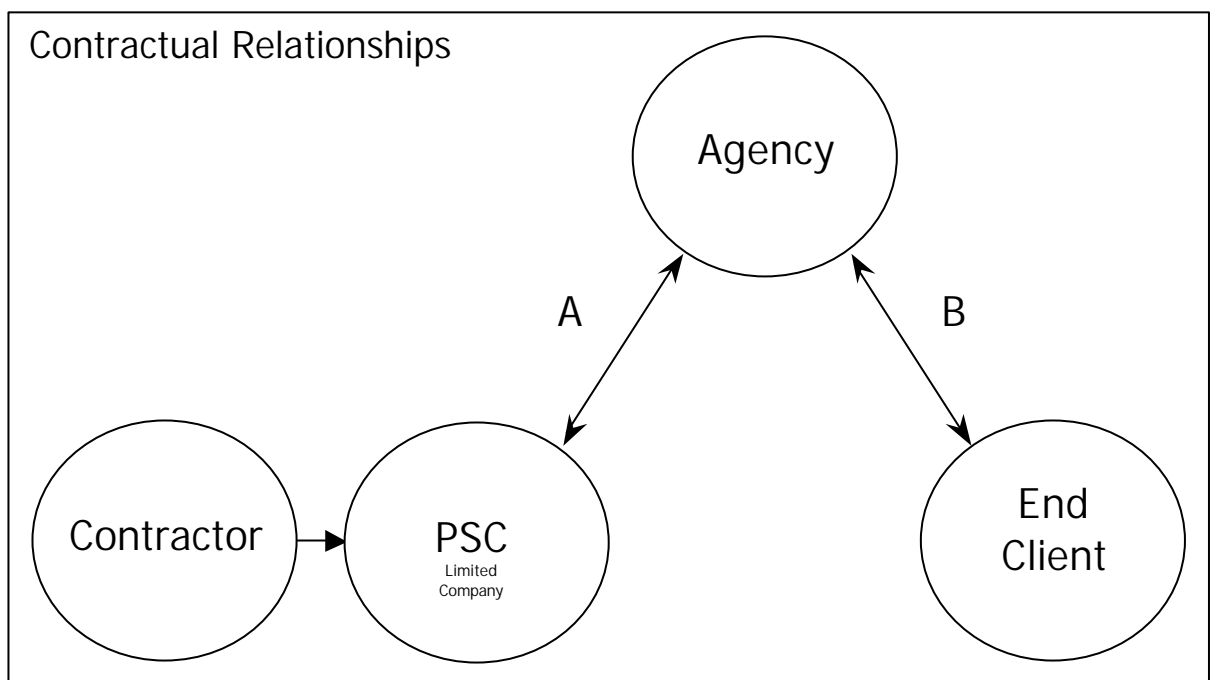
On the Inland Revenue Website this is covered by a recent FAQ answer: -

43.I hear that the Revenue have approved a model contract - how could this happen if each case is decided on its merits?

The Inland Revenue has not approved a model contract.

Contractual Relationships

Where an **agency** is involved in the placement of a Contractor the relationships considered for IR35 are multi-directional. Although the contractor is doing the work there exists a series of contractual links between the various parties. All parts of these relationships are important in the assessment of the engagement.



1. A Contractor who works through a Limited Company is actually an employee of that company and should have a contract of employment with it – even if the Contractor is the only employee of that company. (see diagram on previous page)
2. The **Personal Service Company (PSC)** i.e. the Limited Company is contracted by the Agency to provide an individual with the necessary skills to fulfil the requirements of the end-client. (A). Agencies do not take upon themselves responsibility for the project.
3. The Agency enters into a mirroring contract with the End-Client (B) to form a genuine business to business relationship.

There are sections of the industry offering Contractors “IR35 Proof” Contracts that relate to their relationship with the Contractor only (A). For a non-IR35 relationship to exist it is imperative that the End-Client has been involved in the decision to operate in that way. Should the Inland Revenue wish to verify the status of any relationship they will contact the End-Client directly and ask a series of questions to determine the accuracy of any information or contracts provided by the Contractor. If an End-Client has not been involved in the process and agreed to an IR35 proof way of working (which is usually very different from an hourly paid method of working) then it is likely that the Contractor will be found to have been operating under an IR35 Contract and will become liable to pay the full IR35 tax and National Insurance. Furthermore there will have been an attempt by the Contractor/Agency to disguise the true nature of the relationship and as such they may have entered into a “**corporate collusion**” to avoid paying what the IR deem to be fair and reasonable tax and National Insurance.

Some organisations have seen “IR35 Proof Contracts” as an opportunity to win new business irrespective of the true relationship that exists for the engagement. Contractors should ensure that they work with Agencies who only enter into fully mirroring contracts; otherwise, they face a significant risk of action by the Inland Revenue. The Inland Revenue have updated their website to confirm that they will be looking at all parts of the relationship and have recently issued a series of press releases confirming their approach.

The Website IR FAQ item is as follows:

47. You can't look at a contract between an agency and a client if the worker is not party to it.

*The legislation says that the IR35 rules apply if the circumstances are such that, if the worker had contracted directly with the client, the relationship would have been one of employment. Those circumstances include all the agreements which define that relationship: contracts signed by the **client** are just as important as contracts signed by the worker or the intermediary.*

*In particular, a **right of substitution** will only be effective if both the worker and the intermediary have agreed to it, and the Inland Revenue will need to see evidence of this. The Revenue can require the production of the contract by the client or agency if necessary to establish the facts*

End Client Concerns - Direct Contractors

A number of end-clients are worried that in entering into direct contracts they will become liable for **employee type rights** if that engagement would have fallen under IR35. The tests used to determine that status of the Contractor are exactly the same. This can pose a significant risk for end-clients and removes a large part of the benefit of using Contractors in the first place.

Where a Contractor works direct to the end-client through an intermediary (their own Limited Company), but is the only employee of that company, the Limited Company has already been found to be insufficient to distance the End-Client from the Contractor and a direct employee type relationship has been deemed to exist.

End-Clients who enter into contracts that do not match the true nature of the relationship, either in a direct relationship or via an agency, may in fact be liable to action if they are deemed to have assisted the Contractor to avoid paying the correct IR35 tax and National Insurance amounts. This type of corporate collusion could render the End-Client liable to significant financial **penalty**. End-Clients should discuss the contract relationships with the agencies they use and it is strongly recommended that they only work with those agencies who specifically require **back to back contracts**.

End-Clients can obtain full details of these issues from Iain Sutherland, Brian Keegan or Sebastian Moore on 0845 20 20 360

Inland Revenue closes tax net on consultants

Employment agencies operating in IT, engineering and other key sectors are to be required to disclose details of payments to clients as part of an Inland Revenue drive to close the tax net.

Around 300 agencies are about to receive a letter from the Inland Revenue requiring them to list payments to limited companies for work on behalf of their clients.

Payments now being made by the agencies will have to be disclosed to the Inland Revenue after the end of the current tax year, which ends in April 2001.

These payments will then be matched against the returns of the consultants who work through these agencies, many of whom are employees of their own personal service companies (PSC). They can pay themselves or partners' salaries at below the PAYE level and make the rest up



Consultants: £4,000 tax hike out of dividends, which are exempt from National Insurance contributions.

Forms to be sent out to consultants in April will include a box asking them whether they rate themselves as a PSC or not.

Matching the two sets of returns will help the Inland Revenue to identify those consultants who are mistakenly or deliberately claiming tax advantages to which, under IR35, they are no longer entitled.

The Inland Revenue estimates that the average consultant will pay about £4,000 a year more in tax by switching from a personal service company to the IR35 PAYE/NIC scheme.

The tax collection agency said: "Closing this particular loophole will save the Exchequer £350m in lost revenue."

But the Confederation of British Industry and the Professional Contractors Association said the measure should be withdrawn from the Finance Bill currently going through Parliament as "poorly targeted and unworkable".

Recent IR Press Coverage - Professional Recruiter July 2000

Full Disclosure

The Inland Revenue have issued notice to the IT Recruitment industry that they will require full disclosure from them regarding payments made to Contractors working through Personal Service Companies (PSCs i.e. Limited Companies). This measure will enable the Inland Revenue to match the Tax and National Insurance payments made by Contractors with the gross sums paid to their companies. Where there appears to be a significant variance between the projected and the actual payments this could lead to further investigation and, ultimately, costly legal bills. Underpayments are recoverable from the Contractor up to six years after the date of underpayment if the mistake is accidental and indefinitely if there is a deliberate attempt to misdirect the decision of the Inland Revenue.

3 sixty group have worked with a number of Contractors who have submitted their contracts to the Inland Revenue for testing. There has been a marked change in approach recently, with the IR requesting copies of both the PSC↔Agency and Agency↔End-Client contracts. Furthermore, the Inland Revenue have asked for details of contacts at the end-client so that they can interview them to verify the correctness of the relationship portrayed in the contract.

Should an End-Client give false information to assist the Contractor in avoiding the effects of IR35 and the Inland Revenue subsequently discover the reality of the relationship, there could be significant penalties.

Payment For deliverables

There are a small number of end clients who are prepared to pay their Contractors on the basis of delivery rather than hours worked. The key features of these contracts – which allow them to remain outside IR35, are:

- a. Payment on delivery of items (Genuine Financial Risk) – this may include stage payments for specified modules of the project
- b. No paid overtime (Genuine Financial Risk)
- c. Contractor agrees to stay at own cost if they fail to deliver on time (Genuine Financial Risk)
- d. Contractor agrees to return to site at own cost to put work right if it is faulty/goes wrong after they leave site (Genuine Financial Risk)
- e. Contractor takes out Professional Indemnity Insurance (Insurance against real risk)
- f. End-Client agrees to a genuine right of substitution. (Control of Cost etc.)
- g. Contractor negotiates “variations” for additional work or enters into additional simultaneous contracts
- h. Contract must be fully back to back with the End-Client contract

Many End-Clients have pointed out that the administration cost of moving to a project deliverable type contract outweighs many of the benefits they gain from an hourly paid Contractor. They identify particularly the cost of checking/testing the produced deliverables before payment and have pointed out that they would almost certainly need to employ more technical staff to carry out this function.

Contractors are generally selected because they are expert in their field and it would require a tester with similar levels of skill to verify the quality of the final output from that Contractor. The current system of payment on hours worked is generally administered by a human resources team who are happy to pay workers on the basis of hours they attend, but would probably not feel happy to verify that a highly skilled Contractor had completed a piece of work to the necessary skill and standard and sign to that effect.

As mentioned elsewhere in this update, the risk for an End-Client who agrees to a contract that is not an accurate description of the actual mode of working could be significant.

Sole Traders

Queries have been raised with the Inland Revenue as to whether IR35 applies to Contractors operating directly to End-Client as a sole trader. The IR have again clarified this on their website.

“The legislation extends ‘intermediaries’ to include not only companies and partnerships but also individuals. Does this mean that a ‘sole trader’ will be able to contract directly with a client without having to be treated as an employee?”

Nothing in the legislation will affect the law as it currently applies to individuals who have contracts directly with clients: it only affects cases where there is an intermediary involved in the contract, such as a limited company, partnership or other third party. The normal employment status tests will apply to determine whether or not an individual is an employee of the client.”

This might appear to offer a lifeline to those Contractors keen to avoid the impact of IR35, however, many End-Clients are not keen to accept **direct** relationships for a number of reasons. Direct contracts that would have failed the IR35 tests (Schedule D/E tests) may inadvertently render the End-Client liable for a range of employee type liabilities.

Double Taxation under IR35

There have been a series of articles written over the last few months talking about concerns that the rushed nature of IR35 has produced unworkable legislation. The Inland Revenue have accepted that there may be some problems in applying the new rules. One such item occurs where a Contractor has a year-end date that does not fall on 31st March as this leads to a potential double taxation situation.

For example, let us take a company with an accounting year-end of 31st December 2000. If no deemed salary were calculated from 6th April 2000 to 31st December 2000, the client would not get Corporation Tax relief on the deemed salary. So effectively, the company would pay tax once for corporation tax and then the director would pay again for personal tax. The relief on corporation tax would be delayed until the next year.

To avoid this scenario, 3 sixty group run the salary at the company's individual year-end and at 31st March (the financial year end), for all our clients. This prevents any double taxation issue

Professional Indemnity Insurance

For those wishing to demonstrate a genuine IR35 status the possession of Professional Indemnity cover can help to prove this status. A Contractor who deems themselves to be operating with a significant risk element is expected by the IR to protect against that risk in a reasonable manner. Hence the Contractor should consider taking out PI cover. This has in the past been prohibitively expensive (approximately £2500 pa) and therefore most Contractors did not take out PI insurance.

Through negotiation, 3 sixty group have now obtained the most competitive PI rates available. Rates now range from £200 to £800 per year depending on personal circumstances. We have a fast track application process and cover is available immediately.

For further details please contact Jonathan Stow on 0845 20 20 360

Case Law

There is no doubt that there will be a considerable delay before new case law is produced as a result of IR35. Contractors are only required to account for monies due under IR35 at the end of the financial year and there can be no attempts by the IR to challenge any approach adopted by a Contractor until that point. The Inland Revenue will endeavour to claim additional monies from those they feel are avoiding paying the correct tax and National Insurance and will begin proceedings at that time. With the normal run of case law events it is unlikely that any final decision would be reached for at least three years and more likely five years plus, however, there is no doubt that test cases will occur.

Contract Testing & IR35 Calculator

Those contractors wishing to do self-tests on their contracts/engagements can use the self tester available on the 3 sixty group website. The IR35 section of the website receives approximately 1100 hits per day with most visitors using either the Contract Tester or the IR35 Calculator. These are available free of charge and provide a valuable insight into the real impact of IR35. These resources are available at www.360-group.com/ir35

For further information please call Iain Sutherland or Brian Keegan on 0845 20 20 360 or visit the website at www.360-group.com and register for updates.

IR35 Update - Executive Summary

September 2000

1	The Legislation	The IR35 legislation has now been approved by Parliament The Welfare Reform and Pensions Bill – Approved 1999 Finance Act 2000 Approved 2000
1	IR35 Proof Contracts	The IR is testing the engagement – not just the contract. Use of “IR35 Proof Contracts” can lead to significant penalty Action: Carry out check on current contracts/contracts supplied by agencies who supply Contractors
2	Contractual Relationships	Action: Check that you understand the various links and why they matter
3	End-Client Concerns – Direct Contractors	End Client are becoming increasingly aware that Direct Contractors can pose significant liability with regard to employment rights Action: Carry out check on exiting arrangements/liabilities
4	Full Disclosure	The Inland Revenue have confirmed that they will be requiring full disclosure of contracts between Contractor↔Agency and Agency↔End Client Action: This will quickly identify those sectors of the industry entering into contracts that do not reflect the actual engagement – due diligence warning!
5	Payment for Deliverable	Deliverable contracts are possible but do not appear to be popular with end-clients Contractor Action: Verify that you actually want to work on a deliverable contract – the loss of overtime pay etc may exceed the benefit of IR35 “genuine contract” status End-Client Action: Verify that your procedures can actually cope with verification of delivery prior to adoption of delivery based contracts – The Inland Revenue can ask for details to confirm the accuracy of the contract
5	Sole Traders	Use of sole trader legislation to avoid IR35 can lead to extended employment liability for end-clients End Client Action: Carry out check on exiting arrangements/liabilities – assess risks before extending liabilities
6	Double Taxation under IR35	The rushed nature of the introduction of the legislation has produces some potential errors in accounting procedures Action: Carry out check on your Accountants procedures
6	Professional Indemnity Insurance	3 sixty group can offer industry leading rates for PI cover Contractor Action: Verify if your contract requires PI cover and ask for a quote
6	Case Law	Case Law will take some time to appear – but there will be cases brought about in order to verify the legislation and to set precedent The Inland Revenue appear very confident of victory
6	IR35 Contract Testing & IR35 Calculator	Verify the accurate impact on rates and check the status of contracts – free web resources available at www.360-group.com/ir35

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For further details or to arrange a meeting – contact Iain Sutherland, Brian Keegan or Sebastian Moore on 0845 20 20 360