

ALERT

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The Infamous IR35 – A Tax Change For The IT Sector

For many years, it has been a recognised practice in the UK IT industry that individual contractors frequently choose to work for clients through service companies rather than as individuals. This has traditionally had significant tax advantages. The Government has recently imposed severe restrictions on this practice which have caused an outcry from the small business community. The sweeping implications of the new regulations (known as "IR35") for the IT sector should not be underestimated - particularly as this is the sector at which the new regulations are most explicitly aimed.

IT consultants need to ensure that they understand their tax position. Companies which use external consultants operating through service companies also need to check that their contractual arrangements are clear and that they are insulated from tax or employee responsibility for such consultants.

Who Or What Does IR35 Cover?

IR35 achieves the Inland Revenue's desire to remove opportunities for the avoidance of schedule E tax and national insurance contributions by "intermediaries", such as service companies or partnerships, where a worker would otherwise have been an employee of the user client (or where income would have been received from an office held by the worker). The regulations were first published in the Inland Revenue's 1999 Budget press release numbered IR35, from which the regulations derived their nickname. The regulations finally came into force on 6th April 2000.

In summary, the new rules apply where a worker performs services for a business client under arrangements involving third party intermediaries in circumstances where the worker would have been treated as an employee (for tax and national insurance contribution purposes) if the worker had entered into an arrangement with that client directly.

What Happens?

Where the regulations apply to the performance of a worker's services, the Inland Revenue will deem remuneration received by the worker as "hidden wages" which should be subject to schedule E income tax and national insurance contributions ("NICs") in the same way as for other employees.

Accordingly, if the worker is not subject to such tax and NICs, and if the intermediary does not fall into one of

the permitted exceptions (such as a small shareholder - under 5% - in a company or a partner who enjoys only a minority of the profits earned by the partnership or where the worker provides services for a number of clients), then at the end of each tax year (or earlier in appropriate circumstances) the Revenue will calculate the worker's notional salary and send a bill for the relevant statutory charges. For these purposes, the intermediary will be treated as the worker's employer.

In estimating the size of the bill, the Revenue will deem the payment which should have been paid as salary as **the aggregate amount received for arrangements of the type covered by the Regulations less specific allowed deductions**. These deductions include a blanket 5% to cover the costs of overheads and running the intermediary, any expenses incurred by the intermediary that the individual could, if employed, have claimed against income tax (and the same applies for capital allowances), any contributions paid by the intermediary to an approved pension scheme, NICs actually paid as well as any salary on which schedule E tax and NICs have been paid. If more than one intermediary is involved on a particular engagement and one defaults on payment, the others will be liable for the whole bill.

A Slightly Softer Blow

Bad as this may appear, the original proposals were, most industry commentators agree, worse. The most important changes thrashed out between the March '99 and September '99 drafts (the latter being the basis of the current legislation) were a revisiting of the categories of workers to whom or which the rules apply (see below) and - most importantly - recognition that the **intermediary**, not the **client**, should be responsible for ensuring the new rules are followed. The idea of a certification scheme, under which the client would need to check the intermediary's status, has been abandoned for the present. Intermediaries will be responsible for applying PAYE and NICs on earnings from relevant engagements. Failure to account for these will be result in the normal penalty provisions for employers.

Which Workers Are Covered?

The Revenue has reverted to the existing tests (largely derived from UK employment case law), rather than the alternative test proposed in March 1999, to establish the boundaries between employment and self-employment. Effectively, case law makes it clear that in reaching a

decision in this regard all relevant circumstances, and the overall effect of a given arrangement, should be considered.

The Revenue has provided guidance on the point, both in the *Inland Revenue Tax Bulletin Issue 45* and by reference to *Inland Revenue Issue 56: Employed or self-employed?* Subject to the overall proviso that each case must be looked at on its individual facts, points which may be relevant in reaching a decision may include: whether the worker is obliged to perform the services personally, whether the worker provides his or her own equipment to carry out the services, whether the worker has any degree of financial risk in the arrangement, the basis on which the worker is paid and whether he or she has the chance to profit from the way they manage a given arrangement, the length of the engagement, whether the engagement may be terminated on an agreed period of notice and whether the worker enjoys employee-style benefits. Other factors which may be considered (but which will also not of themselves be conclusive) will be the intention of the parties and whether an employee has become “part and parcel” of the organisation.

Who Needs To Worry?

Primary responsibility for ensuring compliance with the regulations currently rests with the intermediary. Normally this will be the service company set up by the IT consultant precisely with a view to insulating him or her from statutory charges in ways which the new regulations seek to prevent. The regulations will also cover some partnerships (such as husband and wife ventures) and some individuals. A spokesperson for the Revenue has clarified: “It is the tax-payer’s responsibility to be aware of the legislation” and therefore, presumably, to come clean on his or her arrangements.

For now, the client user is off the hook so far as primary responsibility is concerned, although the Revenue will have wide powers to check payments made to service companies and raise queries about the arrangements made between the client and its service providers, as well as its arrangements with intermediaries.

Further, if the Revenue finds the cost and resources required to police the regulations through the intermediaries too onerous, there remains a risk that it will revert to its original idea of placing responsibility with the client, whether by reintroducing the idea of a certification scheme or otherwise.

Finally, and potentially most importantly, in situations where the Revenue elects to treat consultants as employees for the purposes of IR35, it seems inevitable that those individuals will, in turn, treat themselves as employees for the purposes of invoking rights (for instance against being unfairly dismissed, or on the transfer of an undertaking) under relevant UK employ-

ment legislation. Whilst the client will argue that liability for such claims rests with the intermediary, a careful look at indemnity arrangements between intermediary and client will be essential.

What Should Be Done?

Both clients and intermediaries should carry out a thorough audit of their respective workforces and carefully review the contractual arrangements in place which relate to the provision of services by non employees. In most cases a degree of rethinking - and subsequent redrafting of service contracts - will be necessary and, where appropriate, changes to a worker’s status engineered and formalised.

Comment

The introduction of IR35 reflects the UK government’s wish to reduce anomalies in the labour force - a throw back to its much publicised “fairness at work” programme (much of which was encompassed in the Employment Relations Act 1999) - as well as to increase its own revenues. Other examples of this approach include the adoption of the national minimum wage and the latest moves to reduce the difficulties which temporary workers face in accepting a permanent position as a result of onerous terms which have become standard in agency/client contracts.

How far the Revenue has the will, or the resources, to enforce the new regulations remains to be seen, but in any case it seems likely that the spotlight will initially be focused on high profile users and intermediaries, where a large number of potentially infringing arrangements may be exposed, rather than on small trading companies. In other words, this is not an area which many companies which currently contract for the provision of services, and particularly IT services, can afford to ignore.

About Shaw Pittman

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