

## Technical factsheet

### Treatment of off-payroll arrangements – IR35 summary

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#### **History of IR35**

The attraction of limited companies goes back a long way, ever since the law lords heard the case of *Salomon v Salomon & Co* [1897] AC 22. This was the defining case, which established the fact that a corporate personality is a separate legal person to its members. Mr Salomon was a leather merchant. In 1892 he formed a limited company with his wife, five of his children and Mr Salomon himself making up the seven shareholders (the statutory minimum in the 19th century). He sold the business to the company and used the proceeds to pay off the trade creditors. The proceeds included debentures secured on the business, which were taken by Mr Salomon.

Unfortunately, the business did not prosper as expected and Mr Salomon was forced to sell his debentures to try to save the business. This was insufficient and the company went into insolvent liquidation. The liquidator alleged that the company was a 'sham'. The Court of Appeal held that the shareholders should have been a bona fide association, not just seven members of the family in what was effectively a one-man company. The House of Lords disagreed, and one-man companies have been with us ever since.

The Finance Act 1972 was instrumental in the explosion in demand for these companies. Suspecting widespread tax evasion in the construction industry, the Treasury produced legislation requiring building contractors to deduct tax before

paying sub-contractors, unless they were dealing with a company, when the company could be paid gross.

Shortly afterwards, legislation was introduced in respect of temporary workers, so that they would be treated as employees of the agency 'employing' them, unless the agency was contracting with a limited company. Agencies in both construction and other industries preferred not to bother with numerous 'employees' starting and leaving, and it became almost impossible for an individual to find employment through an agency, other than by working through a limited company.

The attraction was increased by the Finance Act 2002, which imposed a starting rate of corporation tax of 0% (previously 10%) for companies whose profits were not more than £10,000. This continued until 2005, when it was abolished.

Against this background, the 1999 Budget Press Release IR35 proposed Intermediaries Legislation, designed to prevent individuals avoiding tax and national insurance contributions (NIC) through the use of companies. It came into effect from 6 April 2000 and continues to be known as IR35.

However, there remain advantages to trading through a limited company:

- A contractor can draw a minimum salary and pay the minimum tax and NIC, drawing profits as dividend out of post-tax profits of the company; there is no further tax on the distribution, except where the contractor has a liability to higher rate tax.
- This gives rise to a NIC saving (no NIC on dividends) and a cashflow advantage, since dividends do not attract PAYE.
- The rate of corporation tax (currently 19%) is substantially lower than the total of income tax (currently 20%/40%/45%) and NIC (currently 13.8%).
- For contractors such as IT and other professionals, there is the opportunity to work from home. This can give rise to substantial cost savings.
- Agencies engaging contractors are saved the cost of employer's NIC.

***The aim of IR35 is to seek to prevent contractors avoiding tax and NIC by treating them as employees for tax purposes. They do not, however, have the benefits due to employees under employment law, such as sickness benefit, holiday pay, maternity benefit etc.***

IR35 tests for employment are different for income tax and NIC, and may yield different results for the same purpose.

Until 2017, it was down to the worker to determine tax status – that is, whether they fell 'inside' or 'outside' IR35. If the former, they had to be taken on as employees, with the corresponding taxes and rights. If the latter, they were responsible for paying the correct (often lower, for limited companies) amount of tax to the authorities, yet had no claim to employee benefits.

As of 2017, however, the rules changed to state that it would be the hiring organisation – the *public authority* – determining a worker's tax status. This means

the organisation hiring the worker through an intermediary or personal service company is liable for any errors and attendant charges or fines, in line with Schedule 24 of the Finance Act 2007.

### **Why does employment status matter?**

There is no definition of self-employment or trade in statute and we must look to case law for guidance. From this rich source emerged the 'badges of trade'; the modern equivalents are:

- **extent and degree of control exercised by the client over the worker:** a self-employed person would probably have control of the work done: an employee would be subject to control by the employer over the time and method of working
- **right of substitution:** the self-employed may sub-contract work or bring in assistance; it is rare for an employee to have the right to appoint a substitute
- **mutuality of obligations between worker and client:** a contractor may turn down work, or work in their own time, while the client is not obliged to offer work and is not paid unless they work. An employee is obliged to be available and cannot turn down work; they are paid even if they are given no work
- **financial risk:** a contractor will quote for a job and may incur a loss or profit from work done; there is little risk for an employee, except lack of promotion, and little expectation of profit, except a bonus
- **employee rights and benefits:** not available to a contractor; available to an employee
- **part and parcel of the organisation:** a contractor may become a regular but has no additional responsibilities as a result; an employee is capable of being promoted and managing other staff
- **length of and right to terminate contract:** a contractor may have a short-term contract and no right to terminate unless the other party is in breach; an employee has an open-ended contract and can give notice according to the terms of the contract
- **mutual intention:** a contractor's stated intention may not reflect the facts; an employee contract would be persuasive

Each case must be decided on its own merits.

### **Changes from 6 April 2021**

From 6 April 2021, responsibility for making IR35 decisions will fall onto the end *client*, rather than the personal services company (PSC) or another intermediate organisation providing the worker. If you engage workers through companies or intermediaries in this way, you are the *client*.

An individual's employment status affects the amount of tax and NICs they pay, how they pay them, their employment rights and, if applicable, their employer's responsibilities.

If the status is established as an *employee*, then:

- The employer deducts tax and NIC at source from the employee's pay under the Pay As You Earn (PAYE) system
- An employee has a wide range of rights, including entitlement to:
  - statutory sick pay;
  - maternity/paternity pay and
  - holiday pay.

Where necessary, the employer's disciplinary and grievance procedures apply to an employee, as does the employer's redundancy policy.

If the status is established as *self-employed* then:

- Self-employed individuals are normally exempt from PAYE and instead report and pay tax and NIC personally through the self-assessment tax system
- A self-employed individual does not have the rights of an employee, for example they are not entitled to holiday or sick pay

If an employer incorrectly treats an employee as self-employed, it can cost the employer (or sometimes the employee) a lot of money to put things right.

An individual can have one employment status for tax and NIC purposes and a different one for employment law purposes. For example, taxi drivers in the gig economy may be self-employed for tax and NICs purposes but a 'worker' for employment law purposes and as such would be entitled to some employment rights.

*The new rules do not apply to organisations that are small and are not part of a medium/large size group.* In that case, the existing rules continue unchanged, which means that responsibility for IR35 decisions remains with the sub-contractor's company.

In this context, you will only be 'small' if you meet any **two** of the following requirements in the last financial year to end before the tax year begins (6 April 2021):

- annual turnover - not more than £10.2m
- balance sheet total - not more than £5.1m
- number of employees - not more than 50 (average per month)

This definition applies equally to LLPs and companies – whether registered, unregistered or overseas. HMRC [examples](#) can be followed if the size of the client changes in future. More details can be found [here](#).

## How to establish an individual's employment status

There is no comprehensive definition in law to say whether an individual is an employee or self-employed. An individual's employment status is established by weighing up all relevant facts and looking at the overall picture. The factors to be considered are derived from case law.

Summary of key factors to be considered:

<b>Issues</b>	<b>For employment</b>	<b>Against employment</b>
Contract	There is an employment contract	There is no employment contract
Control	The engager controls the way the work is done	The worker controls how they do the work
Substitution	The worker must do the work themselves	The worker can send someone else to do the work on terms of their own choice and pay them out of their own pocket
Losses suffered	The worker does not bear the losses nor keep the profits	The worker bears the losses and keeps the profits
Liability to correct	The worker does not correct unsatisfactory work in their own time and at their own expense	The worker corrects unsatisfactory work in their own time and at their own expense
Place of work	The engager decides where the worker must work	The worker decides where to work
Fixed salary	The worker is paid a regular salary by the engager	The worker invoices the engager for work done
Benefit in kind	The worker receives benefits in kind	The worker is only paid in cash, cheque or bank transfer
Tools and equipment	The engager provides the tools and equipment	The worker provides their own tools and equipment
Working hours	The engager lays down regular and defined working hours	The worker decides when they want to work
Liability to pay	The engager cannot withhold payment	The engager can withhold payment until the work is done as agreed
Dismissal	The engager can dismiss the worker	The engager cannot dismiss the worker or cancel the work once the work is agreed, without compensation

Single or multiple contracts	The worker works for one engager at a time or a few regular jobs	The worker has lots of engagers at the same time
Relationship	The engager and worker understand the relationship to be that of employer and employee	The engager and worker understand the worker to be self-employed
Risk	The worker does not risk their own money	The worker risks their own money in the business

- ‘worker’ refers to the person who does the work (not a ‘worker’ for employment right purposes) and
- ‘engager’ refers to the person for whom the work is done (this could be the individual’s employer or customer)

HMRC’s glossary for various key terms can be found at [ESM10002](#).

*When considering the employment status of an individual, both the written contractual terms and what happens in practice must both be considered.*

HMRC has confirmed that the [Check Employment Status for Tax](#) (CEST) output can be used as a status determination statement (SDS) – ESM10013. ESM11170 confirms that where CEST is not able to decide, further guidance and information will be provided. You can contact the HMRC helpline on **0300 123 2326**.

Organisations may face risks both in ignoring IR35, and in applying it too broadly. The best approach is one that seeks to understand different groups of self-employed or contingent workers and their working practices, to see who truly falls inside or outside IR35. Do not rely solely on HMRC’s CEST tool; you should consider mutuality of obligation in determining individual’s tax status. In a recent court case [RALC Consulting Ltd Vs HMRC TC/2017/08950](#), the first-tier tribunal held that the IT contract was not within IR35 for the lack of ‘mutuality of obligation’ and ‘control’.

Above all, communicate to all staff responsible for engaging workers – and make sure legal, procurement and HR teams stay abreast of both the law and good practice.

It would be good practice to regularly review the SDS to ensure that the working practices and contractual terms remain the same. If these change, then an updated SDS should be completed. There is no specific review period but an annual review should be sufficient to show that the compliance has been met.

If the organisations and their employment supply chains fail to apply the legislation properly then they can be liable to heavy fines as well as paying back taxes owed, with interest. What’s more, the risk of non-compliance isn’t only regulatory and financial, but reputational as well.

## How to prepare for the changes

Clients can:

1. Use the HMRC [CEST](#) online tool to get an initial decision.
2. If the outcome of the tool is that IR35 does *not* apply:
  - a. Download a copy of the result and keep it safely – HMRC may need it as evidence in any future enquiry.
  - b. Issue an SDS to the worker and to the fee-payer (whoever will pay the worker's company) – see point 4 below.
  - c. Make future payments under the contract as normal (without applying PAYE/NIC).
3. If the outcome of the tool is that IR35 *does* apply:
  - a. If you disagree with its decision, contact HMRC immediately and HMRC will arrange for an independent review of the circumstances. It may be possible to argue that the online tool is wrong.
  - b. If you agree with its decision, issue an SDS to the worker and, unless you are paying the worker's company, to the fee-payer (whoever will actually pay the worker's company) – see point 4 below.
  - c. If you will be paying the worker's company, apply PAYE/NICs to all future payments under the contract:
    - i. Enter the worker onto your payroll and deduct PAYE/NICs from the invoiced amount (exclusive of materials and VAT) as if the worker was your direct employee.
    - ii. Pay over the *net* pay (plus materials and VAT) to the worker's company.
    - iii. At the end of the tax year, if the contract is still continuing, issue a P60 to the worker.
    - iv. At the end of the contract, issue a P45 to the worker.
4. Issue an SDS to the worker and, unless you will be paying the worker's company yourself, to the fee-payer (whoever will make payments to the worker's company).
  - a. There is no standard form for the SDS – a simple letter is sufficient.
  - b. It must state the decision – either that IR35 applies or that it does not, as appropriate
  - c. It must give reasons for the decision.
  - d. If you have used the HMRC online tool or have obtained an independent review, we suggest enclosing a copy.

5. If either the worker or the fee-payer disagrees with your decision, you must reconsider the circumstances and, within 45 days, either:
  - a. confirm the original decision with reasons for doing so or
  - b. withdraw the original decision and issue a revised SDS.

*Note: there is no further right of appeal.*

6. If you subsequently start to meet the conditions to be 'small' as previously described, issue a statement to the worker and, if appropriate, to the fee-payer explaining that:
  - a. you will no longer be a 'medium or large' organisation
  - b. the original SDS is therefore withdrawn from the start of the next tax year
  - c. you will resume making payments gross (without PAYE/NICs) from the start of the next tax year.

## **Frequently asked questions**

*Who is the fee-payer?*

The fee-payer is usually a public authority or agency that pays an individual's intermediary.

*What is the exact definition of a PSC and how do we determine whether a subcontractor is a PSC or a genuine trading company?*

The rules for considering what an intermediary is for the purposes of the off-payroll rules, are set out in HMRC manual [ESM10003](#).

*If the individual was operating as a sole trader, do the IR35 rules still apply?*

No. The off-payroll working rules will *only* apply if the contractor is working through their own intermediary.

*How often should the fee-payer process the full payment submission (FPS) if payments are made to contractors weekly but the fee-payer processes monthly payroll otherwise?*

Off-payroll deductions need to be reported through an FPS *on or before the payment date*. It is up to clients and fee payers how often they choose to make payment runs. There are no plans for any concessions in this area.



*Does IR35 apply to contractors from abroad?*

Section 61R Chapter 10, Part 2 ITEPA 2003 states that where a medium or large-sized non-public sector client is based wholly overseas, so there is no UK connection immediately before the beginning of the tax year because it is not UK resident and does not have a UK permanent establishment, then the rules at Chapter 10, Part 2 ITEPA 2003 do not apply. The worker's intermediary should consider whether Chapter 8, Part 2 ITEPA 2003 applies for these engagements.

Some worked examples can be found at [ESM10026](#).

*Do I have to provide an SDS outcome to PSCs that provide infrequent services such as plumbing or decorating?*

To demonstrate reasonable care, you should consider the status of anybody engaged via an intermediary. A client must determine whether the rules apply to engagements and pass this decision on to the worker and the person it contracts with.

There is no minimum contract duration for the application of IR35 rules. Even a contract for two weeks can fall within the rules based on the terms and status determination of the contract.

Decorators and plumbers are often self-employed with no limited company or other intermediary. In this case, you would not need to supply an SDS.

*What should limited company contractors do if they are now deemed inside IR35?*

Where the engagement is found to come within the off-payroll working rules, the deemed employer will operate PAYE on the chain payment. Information on the approach the contractor should take when drawing remuneration or dividends from their limited company can be found at [ESM10030](#) with examples.

**ACCA's [Technical factsheet: accounting and tax treatment of IR35 deductions in the public sector](#) provides full details on accounting and tax treatment of IR35 deductions.**

*As this income has already been taxed it can be extracted any time tax-free.* There is no requirement for these monies to be withdrawn in the same accounting period that the work has taken place or been remunerated in. The deemed employer is the secondary contributor for NIC (Employers) purposes. Under s.141 CTA 2009, the intermediary will be given relief up to the amount of the deemed direct payment.

*If a contractor has made deductions and subsequently the deemed employment status is found to be in error, does the contractor have to refund the deductions made? Is this a statutory duty?*

Where a decision is found to be incorrect, the liability will be sought from the deemed employer in the first instance, subject to the client taking reasonable care. If an intermediary has deducted tax and NICs, and paid employer NIC, it should make a correction on an FPS or earlier year update via RTI to recover the money.

*If a person is self-employed and wishes to contract with a public body, such as a county council, does the council still have to determine whether the contract is one of self-employment or employment?*

*Can CEST be used to make this determination?*

*If the public body deems the contract as being one of employment, must the worker also receive the usual employment benefits such as holiday pay, sickness benefit and pension contributions?*

In an engagement where the client is a public sector organisation, it will be the client who must consider a status determination statement. CEST can be used to make this determination. Chapter 10 does not affect auto-enrolment. The individual does not become an employee of the deemed employer. The individual will remain employed by the intermediary. Eligibility for statutory payments arises from the contractor's intermediary and not from the client or deemed employer.

*If the client makes a genuine mistake inputting the data into CEST, has reasonable care still been met?*

If this was a one-off genuine mistake such as an entry error, this behaviour should be treated as a 'mistake despite taking reasonable care'. However, if the mistake was more widespread – for example, some hiring managers completely misunderstand something such as the reality of substitution clauses – this would be more indicative that the organisation has not taken reasonable care. Each case would be considered on its own merits. The client must take reasonable care when determining whether the worker would have been an employee if they were engaged directly. If the client fails to take reasonable care, the responsibility for the deduction of tax and NIC, and the payment of the apprenticeship levy and paying these to HMRC, will rest with it.

Guidance on using the CEST tool can be found at [ESM11000](#).

*Can a contractor (who is subject to IR35) claim any work-related expenses against PAYE deductions through self-assessment?*

The deemed direct payment calculation takes into account work-related expenses and material costs with a deduction allowed.

**The deemed direct payment** is the amount paid to the worker's intermediary that should be treated as earnings for the purposes of the off-payroll rules. To calculate deemed direct payments:

1. Work out the value of the payment to the worker's intermediary, having deducted any VAT.

2. Deduct the direct costs of materials that have, or will be, used in providing their services.
3. Deduct expenses met by the intermediary that would have been deductible from taxable earnings if the worker was employed.
4. The resulting amount is the deemed direct payment. If it is nil or negative, there is no deemed direct payment.

You then need to deduct tax and employee NIC as appropriate from the deemed direct payment. You also need to pay employer NIC.

*What happens if the contractors already working through an umbrella state that they are already on PAYE? What is the hirer's obligation in this instance?*

The off-payroll working rules apply to engagements where an individual supplies their services through an intermediary. The hirer will have no further obligations.

*Do these changes impact the construction industry?*

Yes. Where payments are subject to [PAYE under Chapter 10 \(tax\), Part 2 \(NIC\)](#), you do not need to consider the Construction Industry Scheme (CIS). IR35 supersedes CIS. If the off-payroll working rules do not apply, the party receiving the worker's services must then consider whether tax needs to be withheld on payments under the CIS rules.

If the party receiving the worker's services is small under the off-payroll working rules, then the worker's intermediary would be responsible for determining whether the off-payroll working rules apply. Where [Chapter 10, Part 2 ITEPA 2003](#) does not apply because the client is a small non-public sector organisation, the client will still be required to consider whether tax needs to be withheld on payments to the worker's intermediary under the CIS rules.

As a general guide, if the answer is "Yes" to all of the following questions, then the worker is probably an employee:

- Do they have to do the work themselves?
- Can someone tell them at any time what to do, where to carry out the work or when and how to do it?
- Can they work a set amount of hours?
- Can someone move them from task to task?
- Are they paid by the hour, week or month?
- Can they get overtime pay or bonus payment?

If the answer is "Yes" to all of the following questions, it will usually mean that the worker is self-employed:

- Can they hire someone to do the work or engage helpers at their own expense?
- Do they risk their own money?
- Do they provide the main items of equipment they need to do their job, not just the small tools that many employees provide for themselves?

- Do they agree to do a job for a fixed price regardless of how long the job may take?
- Can they decide what work to do, how and when to do the work and where to provide the services?
- Do they regularly work for a number of different people?
- Do they have to correct unsatisfactory work in their own time and at their own expense?

If contractors need help to make a decision on a subcontractor's employment status, they can use the [CEST](#) tool.

*What are the compliance checks into intermediaries post-6 April 2021?*

HMRC will only use information resulting from the new off-payroll working rules to open new compliance checks into returns for earlier years under Chapter 8, Part 2 ITEPA 2003 if there is reason to suspect fraud or criminal behaviour (see [ESM10036](#)).

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