



IR35 – ANOTHER NAIL IN THE COFFIN

“IR35” refers to a leaflet produced by HM Revenue and Customs to explain the workings of a piece of legislation that has probably produced more worry for businesses and less tax for the Treasury than most HMRC initiatives. IR35 is supposed to be under review at present, and we can only hope the outcome will be to get rid of it.

If you sell things and you are doing well, your accountant will probably advise you to form a limited company and trade through it. There are a number of advantages, not all of them to do with tax, but it is certainly true that a company can be used to reduce the tax burden on your profits, particularly in a case where you re-invest some of those profits in the business.

If you sell your services as a consultant, the same advice would apply, but for some reason HMRC think that what is ordinary tax planning for a trader in merchandise is tax avoidance for a professional selling his services. IR35 and the associated legislation is the result.

IR35 applies where a person sells his services through an “intermediary” – usually a limited company. In such a case, the contract for the work will be between the client (who wants the services of the professional) and the professional’s “service company” (a limited company of which the professional and perhaps his or her spouse own all the shares).

What IR35 says is that in such a case you have to consider an imaginary contract directly between the professional and the client. Having worked out what this contract would say if it actually existed, you then consider whether such a notional contract would mean the professional was an employee of the client and not an independent contractor. If in this imaginary world he would be an employee, IR35 kicks in to try to increase the tax payable by the company and the professional. It does this by an enormously complicated and cumbersome set of calculations which seek to reproduce the tax effect if the professional had been paid as an employee.

Provided the real contract (between the client and the service company) has been properly worded, IR35 will not apply, unless HMRC can show that in fact the business relationship between the client and the professional is not conducted according to that contract, and the “real” state of affairs is that the professional acts like an employee of the company.

The process involves looking at different factors, and the most important one in recent cases is the extent to which the client has “control” over the professional and over where, when, and how he does his work. In order to show that there is more “control” than appears in the written contract, HMRC tend to use employees of the contractor as witnesses to demonstrate that the professional was under as much “control” as they were.

A recent case (MBF Design Services Ltd) shows both how unsuccessful and how desperate HMRC are.

The case involved a design engineer whose service company (MBF) provided his services to Airbus (UK) Ltd. Among the employees of Airbus called by HMRC was a Mr Pham, about whom the Tribunal said:

“We regarded these witnesses as straightforward and honest, with the exception of Mr Pham. We did not doubt Mr Pham’s honesty, but he admitted that his witness statement had been prepared for him by HMRC and he had considerable difficulty - due apparently to a limited command of English - in reading it out; and he was hesitant and uncertain in his replies to cross-examination. We were not satisfied that Mr Pham fully understood the contents of his witness statement”.

Even using such dubious tactics, HMRC failed to convince the Tribunal that the imaginary contract between Airbus and Mr Fitzpatrick (the proprietor of MBF) was one of employment.

Don’t underestimate IR35 – but with good professional advice you should be safe, even if HMRC try to prove an “imaginary” employment contract by using imaginary evidence.

[This article by James Bailey first appeared in Tax Insider magazine \(www.taxinsider.co.uk\)](http://www.taxinsider.co.uk)