



IR35: what happens when it goes wrong?

A guide for clients

How the off-payroll rules will affect you and your business.

Contractors and freelancers operate through a private company to enjoy a better tax treatment compared to sole traders — but a more favourable tax position is actually never guaranteed because of off-payroll working rules known as IR35.

According to IR35, if a contractor or freelancer has a working relationship with a client that is more akin to regular employment, that worker has to pay income tax and National Insurance contributions on their income, rather than the more generous corporation tax.

This is called 'deemed employment', and working out whether you or your contractor are deemed employees can be difficult.

At first, the responsibility for determining employment status fell solely on the worker themselves. However, reforms in 2017 for the public sector and 2021 for the private sector shifted this burden to the client engaging a contractor's services.

According to estimates by HMRC, around 130,000 workers are likely to have been affected by the 2021 reform. It's essential that both contractors and clients understand how to comply with off-payroll working rules and what happens when it goes wrong.

Whether you're a contractor yourself or hiring someone to carry out work for you, making mistakes can lead to time-consuming tax investigations and costly penalties.

Who determines IR35 status?

These days, the client (or "deemed employer") is usually responsible for determining the worker's IR35 status. However, there are exceptions to this rule.

For example, if a contractor provides services to a small private sector client, the contractor's intermediary must determine their employment status instead. (An 'intermediary' under IR35 might be the contractor's own limited company.)

There are a number of different factors that are used to assess whether someone falls within the boundaries of IR35 or not. In short, these include:

- **Substitution:** could you send a substitute to do your work?
- **Control:** do you have autonomy over how, where and when you work?
- **Mutuality of obligation:** can you choose whether to accept work or not, and can your client choose whether they provide it?
- **Risk:** do you take on the financial risk of the arrangement?
- **Equipment:** do you provide your own equipment to do the job?
- **Payment:** are you paid once the project is complete (rather than on a regular basis)?
- **Number of clients:** are you able to have multiple clients at the same time?

These are just a few of the factors that might make a difference to your determination. Make sure to speak with a financial adviser to iron out the details of all of them.

HMRC investigations

If you determine that you fall outside the scope of IR35 but HMRC thinks off-payroll working rules could apply, they may launch an enquiry.

In this case, HMRC will send you an initial letter asking for the following information:

- the reasons you've determined IR35 does not apply to you
- a breakdown of your business income for that tax year
- copies of all your written contracts for work in that same year.

If you provide "adequate evidence" that you fall outside IR35, HMRC will close the enquiry.

However, if HMRC still believes IR35 may apply, they'll send another letter to schedule a face-to-face meeting with you. These meetings aren't compulsory, but speaking to a representative in person can help resolve the matter more swiftly.

HMRC's decision

At the end of the enquiry, HMRC will issue an opinion on whether you have complied with IR35 or not.

If you disagree with HMRC's ruling, you can object and the tax authority will take your reasoning into account before making their final decision on your case. After that, you can choose to appeal against the decision and take the matter to tribunal.

As with any tax investigation, it's important to seek professional advice as soon as possible — especially if you disagree with HMRC's verdict.

Penalties

If HMRC finds that you fall within the scope of IR35, you'll need to repay the tax you owe as well as any interest accrued on these amounts.

Depending on your case, you may also need to pay a penalty — for example, if you failed to take "reasonable care" in determining your employment status. You could also receive a more severe penalty if HMRC finds that you deliberately misled them.

If you get IR35 wrong as a client

It's vital to take reasonable care when determining a contractor's IR35 status, and you'll need to issue a status determination statement (SDS) when you make your decision.

If you incorrectly determine that a worker falls **outside IR35** but HMRC decides that they fall **inside IR35**, you may become the subject of a tax investigation, as explained above.

Some companies take a blanket approach to these rules to avoid triggering an investigation. However, it's important to look at each contract individually.

For example, if you say a genuine contractor or freelancer is inside IR35, they could end up paying more tax than they need to — which, in turn, could do damage to your business's reputation.

Handling disagreements

Unfortunately, disagreements between contractors and clients can happen. If a worker challenges your decision as a client, you should consider their reasons for disagreeing with your determination. After that, you'll need to either maintain your determination or provide a new one.

Once you've been notified of the disagreement, you'll have 45 days to respond with your decision. Until then, you should continue applying the rules in line with your original determination.

How to get IR35 right

Navigating off-payroll working rules can be complicated, but there are a few things you can do to avoid getting it wrong.

As a client, you'll need to ensure your process for determining employment status is watertight. Reviewing each contract on a case-by-case basis can make it easier to stay in line with IR35 legislation.

It's also a good idea to speak to your employees and contracted workers about off-payroll working rules to make sure they understand how to comply.

If you're a contractor, you should review your contracts and working practices from the outset, paying attention to the list of factors we mentioned earlier. For example, bringing your own computer or other equipment to the job, or not working fixed hours might help to keep you out of the boundaries of the legislation.

This can also help you build up a robust defence if HMRC does launch an enquiry.

Work with tax experts

As your accountants, we'll help you understand how off-payroll working rules affect your taxes, offering specialist advice on ways to minimise your liabilities while meeting your obligations to HMRC.

Get in touch for advice about IR35.

FOR GENERAL INFORMATION ONLY

Please note that this guide is not intended to give specific technical advice and it should not be construed as doing so. It is designed to alert clients to some of the issues. It is not intended to give exhaustive coverage of the topic.

Professional advice should always be sought before action is either taken or refrained from as a result of information contained herein.

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