

The Inland Revenue's IR35 regulation could lumber independent IT consultants with the burden of paying tax as an employee without being able to enjoy the benefits. Know your rights and don't let yourself be bullied says Simon Easterman

A taxing problem

Benjamin Franklin's assertion "nothing can be said to be certain except death and taxes" is the only saying about taxation to have ever gained much common currency, probably because no one likes to discuss the subject very much. However, the quote is actually quite misleading. There are grey areas in the tax regulations that make divining your status a difficult and daunting task. One culprit is IR35.

A relatively recent regulation, IR35 is designed to stop employees avoiding income tax by posing as freelance contractors. However many believe it has been used to deny genuine contractors the tax relief that they deserve by setting up a limited company through which to market their skills.

The saying 'only the little people pay taxes' rings far truer because IR35 applies only to smaller consulting firms with one or two workers and not to larger agencies. Unfortunately, such companies don't have the benefit of big financial and legal departments to navigate the shifting sands of employment status and individual contractors often end up

paying more tax than they should. Luckily a few organisations seek to help these smaller firms.

There are people who do their best to avoid paying income tax by exploiting a loophole that IR35 seeks to close. They do this by setting up a paper company to act as an intermediary between their employer (the client) and themselves (the individual). The client pays the individual's wages in full to the intermediary, without any of the customary income tax or national insurance contributions that an employee's salary would yield to the Inland Revenue.

The intermediary can then apportion the money on a range of 'expenses' or reward untaxed dividends to the individual, paying only a small amount directly to the individual as taxable income.

After Armanigate

A notable instance of this mode of tax evasion was alleged against John Birt in 1993, when the *Independent on Sunday* revealed that the then director general of the BBC was being paid as a freelancer

through his paper company, John Birt Productions Limited. It was alleged that he was saving £30,000 a year in taxes by doing this and also claiming large expenses against the intermediary including £3,666 on clothes, which led to the case being known as Armanigate.

The scandal, which almost cost Birt his job, had put this particular tax loophole on the agenda. Six years later Gordon Brown included IR35 in his 1999 Budget, saying, "Avoidance of Paye and National Insurance contributions by setting up an intermediary service company should be tackled in the interests of fairness."

The regulation applies only to individuals who own at least five percent of the intermediary company or more than 60 percent if it is a partnership. Application of IR35 depends on determining the status of the individual as either a self-employed contractor or an employee - an apparently clear-cut situation that is really a grey area of fine distinctions. This can lead to drawn-out wrangles between the Inland Revenue and the individual.

Resistance seems futile

The PCG (Professional Contractor's Group), which was originally set up in reaction to IR35, has consistently fought to clarify the definition of a freelance contractor. The ill-defined nature of the status judgements, based for the large part on legal precedents that often go back over a century, has created periods of uncertainty among small consultancies which were uncertain how to comply with the regulation.

According to PCG external affairs director Ian Durant, "The old case history refers to a master-and-servant relationship that no longer exists." It is also extremely difficult to navigate without professional legal knowledge, which most contractors neither possess nor feel they can afford to pay for.

Status judgements depend on around eight broad areas which can be broken down into roughly 100 sub-points. Some of these points are more important than others, to the extent that the final decision of a judgement can hinge on them. For example, Durant describes the right to substitution - that is, the freedom for a contractor to send an equally qualified operative to carry out work in his place - as something of a 'silver bullet' upon which many cases have been decided.

The more important of these points will form central aspects of the contract between the intermediary and the client. This is of course vital

to an individual's situation and in the course of an investigation the contract and its relation to the work situation will be paramount. However, getting a contract checked and approved can be an expensive and fraught business.

Roger Tilbury, the director and sole consultant of Roger Tilbury Consulting Limited, paid his legal advisor to look over the contract he had drawn up for freelance computer consultancy work he was carrying out for Ford Motors. Though his advisor was quite happy with the contract, Mr Tilbury thought he would submit it to the Inland Revenue to be sure it was within the regulations.

Battle stations

What Mr Tilbury got for his good intentions was two years of investigation and legal battles. By taking things this far the IR displayed such a level of brinkmanship that it appeared as if they planned to face down Mr Tilbury and his accountants in order to win the case.

Despite continually coming up against brick walls in their search for evidence from Ford and being made aware of precedents that stood in Mr Tilbury's favour, the IR would not let the case go. At one point in the final hearing the special commissioner was so incredulous at the arguments presented to him that he told an Inland Revenue officer, "If we continue down that route we shall stray beyond the bounds of reality."

Sound advice

The relentless, pushy attitude displayed by the IR in this instance is well known to tax advisor and former Revenue inspector Ray MacMahon. "We did a lot of these jobs because we knew we could get a result," he says, "[The Revenue] always try to put you on the back foot and then press the advantage."

Many contractors fall for these tactics, daunted by the legal complexities of status judgements and the spectre of the IR fighting its position. Ian Durant estimates that "about 60 percent of the contracting world is too frightened of the grey area of Inland Revenue, so they just pay up". However, this leaves them in the invidious position of having to cough up full Paye income tax payments without any of the benefits of full employment such as pension contributions, sick pay or training.

Yet of the 170 PCG members who have been investigated by the Inland Revenue, only one has been forced to abandon their freelance status. The message from all the people we talked to is clear - unless you are a tax expert, you need help to be sure the Inland Revenue won't bully you in to paying more than you should.

"You have to get them round the table and negotiate the position," says Ray MacMahon, "if you're looking at two hours of intense argument, you have to know what the Revenue will throw at you." ☒