



IR35...

Have HMRC lost their way?



Four times in the last six months taxpayers have been forced by HMRC to take their IR35 cases to a First Tier Tribunal and four times HMRC have lost resoundingly; each time against IR35 Specialists, Accountax. The cases were **MBF Design Services Ltd** (decision handed down in January); **ECR Consulting Ltd** (May); **Marlen Ltd** (June); **Primary Path Ltd** (July).

Each started as a low-key Employer Compliance Visit with no mention of IR35 being made and seemingly no real cause for alarm; yet it took between five and almost eight years to settle each case. There was a certain consistency about the early stages: once contracts were called for, the inevitable detailed questionnaire followed and after an average of two years of further correspondence, HMRC came off the fence and issued determinations for unpaid income tax and National Insurance Contributions. The amounts at stake ranged from £25,000 to £63,000, so every one of the freelancers had an awful lot at stake!

The cases followed a very similar format which we will outline here before looking in more detail at the factors which led all four Tribunal Judges to the conclusion that IR35 did not apply.

In each of the Tribunal decisions, the Judge laid down the parties to the engagement and in all four there was one End Client, one or more Agency, the company (the 'Intermediary' of which all four were the sole fee earners) and the individuals referred to as the 'Worker'. The Judges then determined the purpose of the Tribunal, as in Marlen:

"The issue to be determined by the Tribunal is whether, had the arrangements taken the form of a contract between Mr Hughes and JCB, Mr Hughes would have been regarded as employed by, i.e. an employee of, JCB."

And the starting point for each Tribunal was the same, as identified by the Tribunal Judge in ECR:

"We are bound by the High Court's decisions but not those of the Tribunal, although we are bound to consider them. In Ready Mixed Concrete (South East) Ltd v Minister of Pensions and National Insurance [1968] MacKenna J listed three conditions for a contract of service to exist:

(1) The servant agrees that, in consideration of a wage or other remuneration, he will provide his own work and skill in the performance of some service for his master

(2) He agrees, expressly or impliedly, that in the performance of that service he will be subject to the other's control in a sufficient degree to make the other master

The provisions of the contract are consistent with its being a contract of service.

These conditions are fundamental to the creation of a contract of services and if any one of them cannot be met then the contract is not a contract of service.”

As readers will be aware, these three conditions are often expressed by reference to whether a contract denies *personal service/substitution, control and mutuality of obligations*. These, of course, are the primary and key factors for determining status, but in all Tribunal cases, the Judges will also consider the ‘in business’ factors and whether the contractor was taking financial risk.

However, it has become clear that some comments which have circulated following some of these judgements seem to be turning these tests on their head and focussing on the ‘in business factors’ and financial risk as being the primary considerations. The starting point in all status cases has to be, as MacKenna made clear over 40 years ago, whether the contract – hypothetical or otherwise – is indicative of a contract of employment; because by definition, if it isn’t, it must be a contract for services.

We will consider what the Judges said about the three key tests:

Personal service/Substitution

In the first case to be decided, MBF Design Services, it was determined that it was highly unlikely that Mark Fitzpatrick (the Worker) would have been able to send a substitute to work at Airbus (the Client), but the Judge Malachy Cornwall-Kelly noted two important points: firstly, the contract between Airbus and the agency did not require specific individuals but resources to undertake the work; secondly, that his inability to send a substitute was *“not inconsistent with his having been engaged as a professional man whose personal expertise was valued as might be that of an architect or surgeon. Against the background of MBF’s well-established existence and its history of engagements with various end-users, Mr Fitzpatrick’s status as a freelance specialist in his area is entirely credible.”*

In ECR, Judge David Porter believed that the fact that VDS (the Client) were content to leave the choice of operative to the agency and so he could not accept that the work was personal to Elaine Richardson (the worker). In fact he noted that given VDS was prepared to engage Elaine on a contract without ever having met her, he was satisfied that if Elaine had been unable to attend through illness or had been unsatisfactory, VDS would have returned to the agency under the substitution clause for them to supply another contractor with sufficient skills, qualifications and experience. Nevertheless, it was also helpful that Elaine could confirm that she could have sent other people to do the work as she knew of at least six others who were suitably qualified.

Similar comments were echoed in Primary Path where Mr Sadler noted that the End Client: *“GSK (GlaxoSmithKline) required the services of an independent contractor to add particular skills to its existing employee team and to give flexibility in staffing the project – independent contractors were hired usually for the short term and for a particular project, that is, for situations where GSK did not require the continuing services of an employee.”* No doubt many freelancers would recognise these traits in their own work.

In Marlen, Lady Mitting was less enthusiastic, but took a similar view when she said:

“On balance it would seem to us that Mr Hughes’ personal services were not required. JCB (the client) wanted a job doing and they wanted it done by a skilled and properly qualified and competent designer. If it was not Mr Hughes, no doubt DDC (the agency) could have provided another. However, so ambiguous was the evidence and so untested the proposition that we do not feel this is a factor to which we can attribute much if any weight.”



Judge Sadler also seemed to agree with HMRC's point that the right to substitute did not determine that the hypothetical contract to be one for services, and only on balance did he feel the existence of a substitution clause tilted the matter away from employment. This was despite noting that Phil Winfield had used substitutes in previous engagements and had himself been a substitute, which established that the practice of substitution could feature in the type of business in which Phil Winfield was engaged and so gave credence to the inclusion of substitution clauses in engagement contracts. The Judge accepted that both Upper and Lower contracts at least provided a framework for GSK to consider a substitute.

It was interesting that all four Judges placed greater weight on the substitution clauses in the Upper Contracts between client and agency than they did on the Lower Contract between the agency and the contractor's company.

Control

In both MBF and ECR, the system of peer review was not deemed to be a form of control and in ECR the Judge noted that Elaine Richardson largely worked the hours that she wished and this showed that control was not being exercised. He said *"VDS has no control over how the work is done nor when the services are to be performed save for obvious opening times of the offices and the fact that the work had to be carried out there."*

HMRC often argue that being tied to the site and the client's working hours is an indicator of control, but in MBF the Judge took issue:

"Mr Fitzpatrick's design work had normally to be performed on site and with Airbus's equipment because there was no other sensible way to do it, given the nature of the overall project of building an aircraft; there are many other examples of an independent contractor's work being done on the client's site and with the client's equipment for the same sort of reasons: an electrician repairing a wiring circuit, a plumber adapting a drainage system, an engineer checking a safety installation of an oil rig and so on. In the context, we do not see on-site working as a conclusive indicator of employment."

In other words the client may have control over 'when' and 'where' the work is performed - and presumably the client usually decides what is to be done – but critically it is 'how' the work is done which determines where control lies.

Lady Mitting concluded similarly, but with a caveat:

"In summary therefore we look at "the thing to be done" and "the way in which it shall be done" we find that management dictated what had to be done, but the way in which he did it was very much down to Mr Hughes, but having said that we believe that this would have been no different from the way in which similarly qualified senior engineers worked."

In Primary Path, Mr Sadler observed that Phil Winfield had *"a particular specialisation in database software in relation to medical, pharmaceutical and healthcare sectors"* and further that *"Mr Winfield had a unique skill set which GSK required specifically and only for the project in question"*. He also commented that GSK had no employees with specialism in the area in which Phil Winfield was operating.

In discussing the Judges comments regarding control in Primary Path, we return to the importance of the terms flowing from the Upper through to the Lower Contract and this was the case regarding control: *"the contract between GSK and Spring contains a provision as to the relationship of the parties which specifies that Contingent Workers are not employees or subcontractors of GSK and that GSK has no right to control the manner, means or method by which Spring provides the Services under the contract, save*



that GSK is entitled to direct where and when the services are to be performed. There is a corresponding provision in the Spring/Appellant contract, reserving to the Appellant (Primary Path) the right to determine the manner, means and methods required to ensure its services are performed to GSK's satisfaction and reserving to GSK the right to direct the Appellant as to where and when such services are to be performed."

All the Tribunals decided that control over how the work was done did not lie with the client and most came to the same conclusion as the Judge in Primary Path:

"The level of control or supervision did not go beyond that which one would expect in the hiring of an independent contractor".

Mutuality of Obligations

As mentioned above, this concerns whether the engagement includes the expectation that work will be offered and accepted. As far as HMRC are concerned, mutuality exists if work is provided and a fee received a point which was completely refuted in ECR. When presented with the argument that this would be enough to ensure that the irreducible minimum of mutual obligation existed in the hypothetical contract, the Judge said:

"We cannot accept that. As indicated earlier we believe that VDS was unconcerned as to who the contractor should be, they were merely interested in obtaining a necessary skill for the shortest period of time as cheaply as possible. We do not accept that there was any mutuality of obligation."

In both ECR and MBF, the Judges noted that there were occasions where the computer systems had failed and from MBF *"the employees of the company would try and find something to do and make themselves look busy. By contrast contractors ... found themselves stood down and unpaid until the problem was remedied."*

In both these cases, the contractors also turned down work and in Primary Path Judge Sadler also believed that Phil Winfield had been paid only for the hours worked and had the project ceased temporarily or otherwise, he would not have been able to demand further work or payment, nor was there any intention of GSK to offer further work; this was indicative of a contract for services.

Related to this point, HMRC had argued that hourly rates were indicative of employment to which the Judge took issue, believing that for someone of Phil Winfield's skill and expertise a monthly salary in an employment contract would be more appropriate. He felt hourly rates were a feature of the charging structure of both professional firms and skilled tradesmen and if they pointed in any direction – it was away from employment.

This is an interesting interpretation of hourly pay and at odds with many who believed that hourly rates meant that a contractor could never incur financial risk.

In business factors and financial risk

We have already noted the Judges comments in MBF that *"Mr Fitzpatrick's status as a freelance specialist in his area is entirely credible."* And in the three other cases there were similar comments including one which will no doubt please all members of the Professional Contractors Group (PCG) whose tax investigations insurance policy supported the three PCG members who were under enquiry:

"ECR is in business on its own account. Miss Richardson produced to the Tribunal copy business cards and



company stationery. ECR operates from a dedicated business area at her home. It has company domain and website. ECR advertises its services and is a member of the PCG. It has retained reserves and invested in development and has over the years taken on fixed price work for a variety of clients."

Finally a self fulfilling prophecy: a PCG member because she was in business and in business because she was a member of the PCG!

The Judge had also been advised in HMRC's submission about the precedent in *Hall v Lorimer (1992)* of painting a picture from the facts presented and he concluded: *"In 'painting the picture' it is clear to us that ECR is a genuine business and therefore not a target of the IR35 legislation."*

In Marlen, Lady Mitting summed up: *"In both these instances (when contracts were terminated early), Mr Hughes lost income and it was a risk which he bore and accepted as a contractor but would not have been borne by an employee."* And *"Looking overall at financial risk, there is evidence that Mr Hughes carried some financial risk, albeit not great and this would if anything point towards a contract for services rather than employment"*

Finally, in Primary Path, the Judge concluded that the in business factors were "compelling" and that Primary Path had demonstrated that it was in business on its own account and that the services which it performed – including those under scrutiny by the Tribunal – were performed in the course of that business.

Some have seized on these in business/financial risk factors and determined that these are the most important. Whilst it is important to demonstrate that one is operating in a business-like fashion and having a designated office space, office equipment, business insurances etc are all relevant, no IR35 status case has ever been won on the basis of these factors alone.

In conclusion

Tribunal cases (and status enquiries in general) are won on the three key issues – personal service/control/mutuality. Technically if any one of these factors does not exist, then the contract cannot be one of employment, as noted in Marlen:

"We pause here to review our findings so far. We have considered two factors – mutuality of obligation and control. These are the two factors that make up the irreducible minimum required to demonstrate a contract of employment to demonstrate a contract of employment....It is our conclusion that there is no mutuality of obligation and the degree of control needed to establish a contract of employment just did not exist. The appeal therefore should succeed on this basis, but for the sake of completeness we go on to examine the remaining aspects of Mr Hughes working activities, thus enabling us at the conclusion to stand back and take an overview of the entire relationship."

This must have made awfully painful reading for HMRC. In a sporting context it would be like the batting side in a one-day cricket match reaching the other's total with ten overs to spare but batting on to see just by how much they could humiliate the opposition...

What will also be hard for HMRC to take is that in all four cases, it was evident that none of the conditions existed to create a hypothetical contract of employment and indeed the ancillary factors of financial risk and being in business also pointed towards a contract for services. These were resounding victories for all four freelancers and perhaps best left again to Lady Mitting to sum up:

"We did not find one single aspect which was consistent with a contract of employment. On the contrary however we did find certain aspects which in our view were compelling indicators that our hypothetical contract would have been one for services".



So where does HMRC go from here? Matt Boddington of Accountax was clear in his assessment following Primary Path that HMRC were unlikely to change their tactics – no doubt HMRC will find contractors who do not have the benefit of an Abbey Tax insurance policy to call upon and may be tempted to look for a settlement rather than commit to five figure sums in professional fees without any guarantee of success.

Certainly HMRC will need to improve their case selection and case conduct. Based on the minutes of the first meeting of the IR35 Forum held in May much emphasis will be placed on ‘customer segmentation’, although we will not be privy to how HMRC risk assess their enquiry cases. Whilst none of HMRC’s many initiatives have targeted the freelance sector specifically, it is unlikely that freelancers will escape unscathed, nor can this run of defeats continue if HMRC are to police IR35 better as required by the Chancellor in the March Budget.

In the meantime, we will just have to wait and see if HMRC can recover from these four resounding defeats.

If you would like to discuss this update in more detail, please contact us by calling 0870 166 6270 or email marketing@abbeytax.co.uk.

