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No substitute for Dragonfly

If you provide services through an intermediary company and think you are protected from the so-called IR35 rules, you may need to look at your arrangements again. A recent decision in the High Court has made it easier for HM Revenue & Customs (HMRC) to ignore a 'substitution clause' in a contract if, in practice, substitution would not happen.

Although there are many factors to consider, a strong indication that an engagement is not akin to employment is a contractual right for the intermediary to send a different individual to do the work. Until the Dragonfly Consulting Ltd case, many people thought that the presence of a substitution clause was nearly conclusive in taking income outside IR35. The court made it clear that

other elements are significant, in particular, the extent to which the client would allow substitution in reality. In the Dragonfly case, the client company wanted the services of the particular individual, a skilled IT system tester, and the manager said substitution would not happen in practice.

A complication in this case was that Dragonfly provided services through an agency, so there were two contracts. The 'lower contract' between Dragonfly and the agency contained a substitution clause, but the contract between the agency and the client did not. This 'upper contract' is usually outside the control of the worker, who often is unaware of its terms. Coupled with the need to find out what the client would allow in practice, this makes it very difficult for the

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“ ... Dragonfly provided services through an agency, so there were two contracts ... ”

worker to decide up front whether income falls within IR35. And it is difficult to argue against a ruling by HMRC that it does.

If the ultimate client wants the services of a particular individual, it now appears to be very difficult to put in place

contracts that take the arrangement outside IR35. This leaves the worker having to suffer the full tax and NICs equivalent to an employee without the protection that employment legislation would provide if he or she were employed directly by the client

or even by the agency.

If an arrangement is otherwise indicative of self-employment, then the lack of a clear substitution right is unlikely to be decisive. If you would like to discuss this issue with us, please get in touch.

The credit crunch fallout

The credit crunch started in the US, but first hit the UK over a year ago with the Northern Rock crisis and has grown in seriousness ever since. The sea change in the world's financial structure is affecting more and more people's lives.

Bank deposits The collapse of three Icelandic banks has served as this generation's reminder that even in the world of bank deposits, the rules of risk and reward still apply. The Icelandic banks were regular 'chart toppers' in the interest league tables, but it now appears that the marginal extra rate was there for a good reason.

On this occasion, individual depositors were lucky in that the government was willing to fill the gaps left by the Financial Services Compensation Scheme (FSCS), notably for deposits above £50,000.

Mortgages US sub-prime mortgages – property loans to risky borrowers – have been blamed by many commentators as one of the main causes of the crisis. Once those mortgages started to default, the effect was felt throughout the world because of the way in which the loans had been repackaged and sold to a wide range of institutions. The backwash in the UK has seen banks and building societies adopt much more cautious lending policies. In some areas of the mortgage market – notably buy-to-let – there has been an over 70% contraction in the number of mortgage offerings.

If your solution to a cash shortage in the past has been to remortgage, you may now need to rethink your options.

House prices By October 2008, house prices were falling at an annual rate of 15%

according to the Halifax. That drop exceeds the entire fall of the early 1990s and looks likely to continue. The Halifax notes that the current ratio of house prices to earnings is 4.92, which is still almost a quarter above the long-term average of 4.0. This view is echoed in data from the Nationwide.

The decline in house prices is a reminder that relying on residential property – be it your home or a buy-to-let – as your only retirement/savings fund can be a dangerous strategy.

Pensions For personal pensions, smaller funds will normally mean lower pensions, although annuity rates have been rising. Higher contributions may therefore be required to restore benefits to the original target levels.

If you need help in managing your financial situation, please let us know.

“ ... answering the question might result in HMRC opening an enquiry ... ”

Tax returns controversy for service companies

A new question on the 2007/08 tax returns has caused controversy because of the ambiguous wording of HM Revenue & Customs' (HMRC) explanatory notes and because it appears designed to highlight taxpayers for enquiry. People who provide services 'through a service company' are asked to state the total amount of income derived from doing so, even though this income – generally employment remuneration and dividends – is reported elsewhere in the tax return.

The term 'service company' is much wider than companies caught by the IR35 rules. For the tax return question, services are provided through a service company where the shareholders provide intellectual or manual services to the company's clients and

more than half the company's income (before deducting expenses) is derived from their work. If more than half the company's income consists of charges to cover materials or work done by employees, you need not answer the question.

The ambiguity in HMRC's explanatory notes resulted in HMRC issuing a revised explanation in September. This says that you need not keep any additional records to determine whether more than half the company's income is derived from services performed by the shareholders, but that 'best judgement' may be used.

It is hard to escape the fact that answering the question might result in HMRC opening an enquiry to determine whether the company falls within the IR35

rules, although HMRC's limited resources will mean that only a small percentage of tax returns will be questioned. If it is clear that the company's engagements are outside IR35, such an enquiry would have no consequences apart from being a nuisance.

Not answering the question may also result in an enquiry if HMRC thinks you should have done so. You may also leave yourself open to an enquiry after the normal time limit of one year after HMRC receives your tax return, because it may argue that you have not provided enough information for it to be sure that your tax return is correct.

If you are concerned that you may fall within IR35, you should get in touch with us now.

Trading disclosure regulations

New regulations came into force on 1 October 2008 covering the information companies have to disclose.

You now have to respond within five working days if someone who deals with your company asks for the address of your

registered office or any other place where your business records are kept, and the type of company records you keep there.

You also have to display your company's registration number and registered office address on

your electronic and paper documents, including emails, invoices, receipts, order forms and websites. If you include the name of a director on letters, other than as the signatory, remember to include all directors' names.

“ ... The new rules mean that employers no longer have to seek a mandate from self-employed workers ... ”

New rules on PAYE liability

Employers may benefit from yet another change to the rules for collecting tax where HM Revenue & Customs (HMRC) recategorises a self-employed worker as an employee.

Recategorisation for past tax years normally results in the employer having to pay over to HMRC the income tax and national insurance contributions (NICs) that should have been paid for the worker under PAYE. Until 2006, HMRC generally accepted that the worker's self-employed income tax covered the employer's PAYE liability.

After the Demibourne case in the Court of Appeal, HMRC realised that it could not refuse a

subsequent claim by the worker for repayment of the self-employed tax, but it would then be too late to reopen the settlement with the employer. That would leave HMRC out of pocket. Since then, the employer has had to pay the full PAYE amount, unless the worker signed a mandate authorising HMRC to set any repayments of self-assessed tax against the employer's PAYE liability.

A change in the legislation has now introduced a formal procedure under which HMRC will set the worker's self-employment tax against the employer's liability, subject to some conditions. First of all, there has to be a 'trigger event'.

This can be an HMRC notice to the employer that tax is due on the payment, or a written agreement from the employer that they are liable to pay the tax, or receipt by HMRC of the mandate from the employee.

Further conditions are that the first trigger event for the liability occurs after 5 April 2008 and that the employer has not paid the tax. The new rules mean that employers no longer have to seek a mandate from self-employed workers.

Recategorisation often follows an HMRC compliance check. If you are subject to such a check, please get in touch with us right away, so that we can help you.

Stamp duty land tax change

If you are buying a residential property between 3 September 2008 and 2 September 2009 inclusive, you can benefit from a temporary increase in the stamp duty exemption threshold to £175,000. The relevant date is normally on completion and there will be no leeway for transactions before or after this period. Everyone is entitled to the exemption, but the property must be solely residential. Mixed use property, such as a shop with a flat above, does not qualify, unless it is being converted to residential use.

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