

topical tips

Issue 15 Summer 2001 Using Freelancers

Using freelancers – traps for the unwary

Self employed or employed, contractor or temp? When thinking of engaging an additional person, how do you decide on the best way of doing this? If you get it wrong there can be significant unexpected tax liabilities. This Topical Tips explains the various ways of taking on the new person and the implications of each option. It also looks at some of the issues surrounding the much publicised 'IR35' provisions and how they may affect you when engaging the services of such contractors.

Methods of engagement

There are four main methods by which you may engage an individual to work for you:

- Direct employment
- Employment agency
- Self employed freelancer

• One man company

Each of these methods of engagement can result in very different consequences for both you and the individual. If an inappropriate method is chosen, for example by incorrectly treating an individual as self-employed when they should be an employee, the Inland Revenue may present you with an unexpected bill for the PAYE and national insurance that should have been accounted for.

This Topical Tips focuses primarily of the tax issues relating to engaging individuals.

Employment law is constantly developing and you must not therefore forget that significant liabilities can arise under the various employment law provisions and that these may arise despite any treatment agreed for tax purposes.

Direct employment

The simplest way of engaging an individual is to take them on as an employee, perhaps for a short fixed contract. For you this may have a number of disadvantages including:

- Employers' NIC of up to 11.9% of their salary.
- The individual gaining employment rights such as paid holidays, sick leave and redundancy rights
- Loss of flexibility

The main advantage of direct employment is that you can fully integrate the individual into your team, which will hopefully mean better quality work through higher motivation. As the employer you are responsible for paying the individual and for withholding PAYE and

National Insurance and paying it over to the Inland Revenue.

Employment agency

Indirect engagement via an employment agency that actually employs the individual offers greater flexibility as compared to direct employment, but is likely to carry a substantial cost penalty due to the employment agency's profit margin. For this reason, it is only likely to be suitable for short-term assignments or as a part of an outsourcing arrangement, for example of the IT function.

The employment agency is simply another supplier and you pay their invoices in the normal way. You have no requirement to account for PAYE or National Insurance unless exceptionally the employment agency is not based in the UK.

Self-employment

Sometimes the individual will maintain that he is a self-employed freelancer and that consequently he should be paid gross. From your point of view this seems very attractive because it means that the 11.9% employment tax (National Insurance) is avoided and you gain flexible use of that individual. From the freelancer's point of view, the picture is also very attractive: he pays a lower level of National Insurance; he can offset more expenses; and he defers the payment of the income tax. Overall a win-win situation? Not quite. Whilst both taxpayers are winners, this is at the expense of the Inland Revenue.

On becoming aware that a company is using self-employed freelancers, for example during a PAYE inspection, it is likely that the Inland Revenue will challenge their status claiming that they are really employees. If successful, the amounts that you have paid to the freelancer will be treated as his net salary and you will

then be required to pay over the tax and National Insurance that should have been deducted to arrive at that net pay. This grossing up exercise can result in a bill virtually as big as the payments that you have made to the freelancer. This liability falls entirely on you as the deemed employer.

The Inland Revenue are not always successful in recategorising freelancers, and indeed they have lost most cases that have gone before the Courts. The Inland Revenue's successes are generally where there is a freelancer working for an extended period (more than 1 month) exclusively for one company with no written contract in place. It is of course better not to be in the position where the freelancer's status is questionable. There is no definition of employment or self-employment and each individual's case will be judged on its merits. Some of the criteria for assessment are set out in the attached appendix. In considering the factors, reference will be made to any written contract. The lack of a written contract immediately puts you in a weak position. Conversely, a well-drafted contract incorporating many of the features of self-employment can immediately put you in a strong position provided that the contract reflects the reality of the arrangement.

One man service companies

A huge amount of press has been given to freelancers providing their services via their own companies, and in particular the effects of IR35.

One-man companies started to be set up in response to the risk of self-employed individuals being recategorised as an employee with the resultant potential tax liabilities for the person engaging them. Through contracting with a limited company rather than an individual this risk is largely removed and there

is no question of that individual being categorised as your employee for tax purposes.

Payment for services is made to the one-man service company which will typically pay most of the profits to the freelancer as national insurance free dividends. IR35 has been introduced in response to the perceived tax (or more specifically National Insurance) avoidance. Essentially, it deems income of the one-man company to be the salary of the freelancer and requires the one-man company to account for the PAYE and National Insurance contributions. It applies where the relationship between you and the freelancer would be treated as one of employment if the service company was ignored.

IR35 and your engagement of freelancers via their own limited companies will therefore not normally pose any tax risk to you provided that:

- The freelancer and his immediate family do not own shares in your company;
- You make all payments to the service company and not the individual;
- There is a written contract between you and the service company;
- The service company is a UK limited company.

When freelancers negotiate engagement terms with you, you will find that they will require 'IR35 friendly' contracts which maximise the chance of avoiding the deemed salary provisions of IR35. Since the basis of the test is whether in the absence of the company there would be an employment, the features that indicate that IR35 does not apply are exactly the same as those that indicate that there is a self-employment as set out in the appendix. Whilst the tax risk falls on the individual and his company where IR35 applies, there is an unquantified risk that the individual is treated

as your employee for other employment law purposes. It is therefore also important for you to ensure that a suitable IR35 friendly contract is in place to minimise these risks.

Conclusion

When approached by a freelancer, it is vital that you carefully consider their status. If they appear to fail most of the tests in the appendix they are probably an employee and should be put on the payroll. If they appear to pass most of the test they are probably not an employee and you should ensure that there is a carefully drafted written contract in place between you and the individual or his company as appropriate. Failure to address these issues at the outset could result in significant additional costs later on.

Check list

Factors indicative of self-employment

	Yes	No
1 There is a written contract for the provision of services?	<input type="checkbox"/>	<input type="checkbox"/>
2 They provide their own tools and equipment?	<input type="checkbox"/>	<input type="checkbox"/>
3 There is no obligation on you to provide work or them to accept it?	<input type="checkbox"/>	<input type="checkbox"/>
4 You do not control the way in which the individual performs the services?	<input type="checkbox"/>	<input type="checkbox"/>
5 You provide no holiday or sick pay or any other employee type benefits?	<input type="checkbox"/>	<input type="checkbox"/>
6 They are paid by task rather than a fixed weekly or hourly sum?	<input type="checkbox"/>	<input type="checkbox"/>
7 They are only paid following the issue of an invoice on the same payment terms as for other suppliers?	<input type="checkbox"/>	<input type="checkbox"/>
8 They do not work at your premises?	<input type="checkbox"/>	<input type="checkbox"/>
9 They are not an integral member of your team?	<input type="checkbox"/>	<input type="checkbox"/>
10 They have the right to send another suitably qualified person in their place (a substitute)?	<input type="checkbox"/>	<input type="checkbox"/>
11 They provide similar services to other organisations, preferably at the same time?	<input type="checkbox"/>	<input type="checkbox"/>
12 They are VAT registered?	<input type="checkbox"/>	<input type="checkbox"/>
13 They will not supervise your staff?	<input type="checkbox"/>	<input type="checkbox"/>
14 They are responsible for any remedial work?	<input type="checkbox"/>	<input type="checkbox"/>

Mainly No?

A self employment probably does not exist.

Mainly Yes?

A self employment may well exist and a properly drafted contract should be put in place.

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