

## The Background – Where IR35 Came From

Many people new to contracting will not have come across IR35, and many experienced contractors will be sick of hearing about it. IR35 is a set of rules set by the Finance Act 1999 that determine whether you are doing work which should be taxed in a similar way to a regular PAYE employee (fail IR35), or whether you should get the benefits and flexibility of being taxed as a true freelancer (pass IR35).

IR35 caused complete turmoil in the contracting sector throughout 1999 and early 2000. Up to April 2000 there had been no confusion. Contractors operating through Umbrellas or Limited Companies were free to manage income themselves. This usually included a low salary and some expenses, with the balance of income paid as dividends. Dividends were favoured to salary as they attracted no National Insurance Contributions (NIC's), and they enabled income to be distributed to other low earning individuals, such as non working spouses. In 1999, the Inland Revenue caught up with this so called manipulation of the tax system, which they regarded as avoidance and, through IR35, changed the basis of taxation for contractors trading through their own Limited Companies.

For engagements which started after April 2000 it became necessary to review their specific circumstances and decide whether IR35 applied. If IR35 was deemed to apply to the engagement (known as 'IR35 Fail') it became very difficult to pay dividends from the limited company. On the other hand, if IR35 was deemed not to apply (IR35 Pass) the company could continue operating in a similar manner as before. The process of deciding whether an engagement Passes or Fails IR35 is detailed in our [IR35 Status](#) Guide.

Immediately after the introduction of IR35, and for a few years afterwards, both the contracting market and HM Revenue and Customs (HMRC) relied heavily on the recruitment agency contract. If the contract was worded in a 'friendly' manner, with clauses that steered towards an IR35 Pass, everyone was happy. (Guidance on this can be found in our guide: [The Agency Contract](#).) At the basic level, the contractor was happy because his/her company could continue paying out dividends to shareholders; the agency was happy because the contractor was happy; and HMRC left the client alone.

Unsurprisingly, almost every recruitment agency in the land changed their contract wording and structure to assist the contractor in finding an 'IR35 Pass' position. Legal firms sprung up with the primary purpose of commenting on agency contracts. If clauses contained in the contract gave a steer towards IR35 Fail, the lawyers would recommend a change; the agency was usually happy to go with this.

Since 2003 HMRC have become more rigorous. They have increasingly starting looking beyond the contract and digging into the actual relationship between the contractor and the end-client. This approach was reinforced after the publication of the MSC legislation in 2007. Interestingly, in 2006 most of the legal firms asked only 5 questions relating to the contractor's circumstances. Now such firms are asking as many as 30 questions to enable them to get a good understanding of the working relationship and environment, in addition to assessing the contract.