HMRC v RALC Consulting: the latest review of IR35

Personal tax | Large Corporate

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We review HMRC's appeal against a First-tier Tribunal's decision in an IR35 case involving an IT contractor.

Key Points

What is the issue?

Richard Alcock was an IT contractor who provided his services through a company, RALC Consulting Ltd. The company faced an IR35 challenge in relation to three contracts. The actual arrangements were entered into through an employment agency, adding a further layer of complexity to the factual analysis.

What does it mean for me?

New guidance issued by the Upper Tribunal reaffirms the position that the hypothetical contracts do not simply replicate the net effect of the actual contracts but can also take into account, for example, an individual party's subjective views as to what the contractual relationships involved.

What can I take away?

This case emphasises the need to take a careful approach to IR35 cases and, in particular, the importance of identifying the actual contractual terms between the various parties in the contractual chain and then carefully identifying the terms of the hypothetical contract or contracts between the worker and the client.

The so-called 'IR35 rules' (more strictly, the 'intermediaries' legislation') were announced just over 25 years ago with their stated aim being to prevent employment relationships (and the adverse tax consequences compared with those arising in the case of self-employment) being avoided by the mere interposition of another person (the intermediary) between the worker and the putative employer.

Under the rules, when they apply, the relationship should be taxed as an employment, notwithstanding that in law (and, in particular, under employment law) there is no actual employment relationship.

Few people will object to the aim of the legislation in those extreme cases where, as suggested back in 1999, train drivers and doctors' receptionists were engaged through their own service companies simply to avoid employer's and employee's National Insurance contributions.

However, not every situation is as clear cut as this. Indeed, it was long accepted by employment case law that there are relationships which (despite the theoretical dichotomy between employment and self-employment) could be categorised either way. In fact, it has long been accepted that in truly borderline cases, a worker's status can be definitively determined simply by the contract stating the parties' intentions so far as employment status is concerned.

One sector of workers where this 'no-man's land' problem is particularly acute is that of IT contractors. Typically, these contractors would work on projects for several months for large companies or government departments and, when the projects come to an end, look for a new project either with the same client or elsewhere.

Such work relationships could be fairly categorised as a series of short-term employments or, just as fairly, as a succession of assignments being carried out in the course of the contractor's profession. In most cases, the workers were content to be categorised as self-employed, accepting slightly higher net pay as compensation for the commensurate lack of employment rights.

Their clients, however, remained concerned that, at some later date, the workers might assert employment rights and they therefore took precautions to prevent any such claims. They did so by insisting that the workers provide their services through the medium of a limited company. That measure also provided protection for the clients from any HMRC challenge. Had the parties contracted without the use of an intermediary, HMRC would typically have turned to the putative employer for any tax and National Insurance that it considered should have been deducted at source.

When IR35 was first announced, the compliance obligation was meant to fall on the clients (in much the same way as it would absent the presence of any intermediary). However, until the reforms in 2017 and 2021, the legislation by the time it was enacted in the Finance Act 2000 ensured that it was the intermediaries (and, effectively, the workers) who bore the compliance risk.

In the first ten years following the enactment of the IR35 rules, there were a number of HMRC/Inland Revenue challenges which can be found in the case reports. All of them concerned contractors in the IT and similar sectors. Given the borderline nature of their employment status, it is perhaps unsurprising that the outcome of those cases was split almost equally between a victory for the taxpayer and a victory for HMRC (and, in the earlier cases, the former Inland Revenue). Indeed, at least from a superficial analysis of the cases, it would seem that there is a strong correlation between those taxpayers who were represented by specialists in the field (rather than by generalist practitioners) and those who prevailed before the tribunal (or,pre-2009, the Special or General Commissioners). In other words, for most such contractors, it was not unreasonable to treat their working relationships as outside the scope of IR35.

By the time we reach the 2010s, HMRC's focus seems to have broadened or at least shifted to broadcasters, with the much publicised rush of cases involving TV and radio presenters, many of which are still being litigated. However, this does not mean that IT contractors are no longer within HMRC's sights. This article looks at one such case involving an IT contractor, *HMRC v RALC Consulting Ltd* [2024] UKUT 99

(TCC).

The facts of the case

The facts can be stated quite simply. Mr Richard Alcock was the IT contractor who provided his services through a (presumably eponymous) company, RALC Consulting Ltd. The company faced an IR35 challenge in relation to three contracts: two with Accenture and one with the Department for Work and Pensions. The contracts spanned five different tax years: the first contract lasted 20 months followed by a three-month break before a further six month stint; the second contract lasted nine months; and the third contract lasted just over a year (including two Christmas periods).

As is typical with many contractors, the actual arrangements were not entered into between the intermediary and the client but through an employment agency. That does not prevent the IR35 rules from applying but adds a further layer of complexity to the factual analysis.

HMRC considered that Mr Alcock would have been an employee of the DWP and Accenture during the relevant periods and issued determinations accordingly. The company appealed against them and the matter proceeded to the First-tier Tribunal which heard the appeal in September 2019. The First-tier Tribunal, allowing the company’s appeal, concluded that the arrangements were outside the IR35 rules. HMRC appealed against that decision to the Upper Tribunal, arguing that the First-tier Tribunal had made seven errors of law in reaching its conclusion.

The Upper Tribunal’s decision

The case came before Mr Justice Jonathan Richards and Upper Tribunal Judge Ashley Greenbank.

HMRC’s first ground of appeal concerned the First-tier Tribunal’s approach to the key IR35 provision, found at Income Tax (Earnings and Pensions) Act 2003 s 49(1)(c). That provides a condition for IR35 to apply if:

> ‘the circumstances are such that … if the services were provided under a contract directly between the client and the worker, the worker would be regarded for income tax purposes as an employee of the client or the holder of an office under the client…’

In other words, one has to imagine, counter-factually, a contract existing directly between the worker and the client, and then determine whether that contract would amount to one of employment.

For the purposes of that exercise, s49(4) provides that: ‘The circumstances referred to in sub-section (1)(c) include the terms on which the services are provided, having regard to the terms of the contracts forming part of the arrangements under which the services are provided.’

The First-tier Tribunal had said that the approach to be followed was as follows:

‘The legislation requires the tribunal to do the following:

a) make findings of fact about the actual terms on which the parties contracted and any other relevant “circumstances” for the purposes of ss 49(1)(c)(i) and 49(4);

b) determine the terms of the hypothetical contracts; and

c) apply the common law tests to determine whether the hypothetical contracts would have been contracts of employment.’

It was common ground that the First-tier Tribunal’s summary of the approach was correct and, indeed, it was largely replicated in subsequent case law. It was also common ground that the question as to whether any contract amounted to an employment contract should be addressed by reference to a three-stage test as laid down in the High Court case of *Ready Mixed Concrete (South East) Ltd v Minister of Pensions and National Insurance* [1968] 2 QB 497 (albeit as supplemented by later case law).

HMRC’s complaint was that, despite the First-tier Tribunal’s own direction as to the approach it should take, the tribunal did not actually follow its own ruling. The Upper Tribunal agreed.

In particular, the First-tier Tribunal did not expressly set out the terms of the hypothetical contract (or contracts) whose status it was analysing. Although it did seem to identify some of the key terms of the contract, this was after it had already carried out some of the analysis. Allied to this, the question as to whether a contract was an employment contract (the *Ready Mixed Concrete* tests) was applied not to the hypothetical contract as a whole but to particular terms of the actual contracts in place between the various parties in the contractual chain.

On top of this, addressing HMRC's second ground of appeal, the First-tier Tribunal appears to have mis-applied the test of 'mutuality of obligations' (which is an aspect of the *Ready Mixed Concrete* analysis) by concluding that some of the facts of the case were inconsistent with the existence of an employment relationship, in breach of other binding case law.

With those two errors of law, the Upper Tribunal concluded that the First-tier Tribunal's decision could not be supported and remitted the case back to the First-tier Tribunal to be redecided by a differently constituted panel. The remaining five grounds of appeal did not need to be considered.

Commentary

Given the Upper Tribunal's concerns about the approach taken by the First-tier Tribunal, it was inevitable that HMRC's appeal would be allowed. The Upper Tribunal considered whether it should remake the decision itself, rather than remit the case back to the First-tier Tribunal. However, a particular problem that the Upper Tribunal faced was the fact that for the first two tax years under review, HMRC needed to establish that the company's failure to apply IR35 amounted to careless conduct, something on which the First-tier Tribunal made no findings.

Interestingly, I do not recall carelessness being alleged in any other IR35 case. This is because employment status is usually determined on an evaluative basis and therefore it would be rare to find cases where a taxpayer's approach is not only 'wrong' but carelessly so. There are some cases in my experience where allegations of carelessness are made simply to justify a late assessment – this might be one such case. That will, no doubt, be considered in any subsequent decision of the First-tier Tribunal.

However, the point does raise a more general concern about the impact of the IR35 rules in practice. Many work situations (and, in particular, those of contractors) are in a no man's land so far as employment status is concerned. (This point was acknowledged by the Court of Appeal back in 2001 when the proposals were challenged unsuccessfully in judicial review proceedings – *R (Professional Contractors Group & Others) v IRC* [2001] EWCA Civ 1945).)

It is therefore perhaps unfortunate that taxpayers can legitimately categorise their relationship as one of (say) self-employment – but if they find that HMRC has equally legitimately taken the contrary position, the taxpayer is then required to prove that its original categorisation was correct before a tribunal that could legitimately decide the case either way. This unfortunate scenario is exacerbated by the fact that even experienced tribunals (as evidenced by this case and many others involving IR35 challenges and employment status more generally) reach conclusions that prove to be subject to an error of law.

It is more than possible that the First-tier Tribunal's original conclusion was correct – indeed, given the history of cases involving contractors, it is not an unlikely outcome. However, what appears to be clear is that the First-tier Tribunal simply reached its conclusion by an impermissible method. Indeed, the Upper Tribunal made it clear in its decision that it was not suggesting that the First-tier Tribunal's ultimate conclusion was wrong.

As a result, the taxpayer company is back where it started, but having already had to incur the expense of a First-tier Tribunal hearing, a hearing in the Upper Tribunal and HMRC's costs in the Upper Tribunal.

If there is one consolation from this particular spin on the roundabout of IR35 litigation, the Upper Tribunal has given clearer guidance on how the hypothetical contracts should be constructed under s49(4). This new guidance reaffirms the position that the hypothetical contracts do not simply replicate the net effect of the actual contracts but can also take intoaccount, for example, an individual party's subjective views as to what the contractual relationships involved.

What to do next

This case emphasises the need to take a careful approach to IR35 cases and, in particular, the importance of identifying the actual contractual terms between the various parties in the contractual chain and then carefully identifying the terms of the hypothetical contract or contracts between the worker and the client. It is only at that stage that it will be appropriate to apply the employment status tests.

Such an exercise ought to be carried out by taxpayers and HMRC long before a case reaches the tribunal. Indeed, it would help the First-tier Tribunal if the terms of the hypothetical contract have already been agreed by the parties. Of course, any remaining dispute as to its terms can be determined by the First-tier Tribunal.