

IR35 – Are You Inside or Outside?

A simple guide to contractor and employee classification

Prepared by: Lieu Vo **Tax year:** 2025-26

If you work through your own limited company as a contractor, you need to know about IR35. It could mean the difference between keeping more of what you earn, or paying significantly more tax. This guide explains it simply, with real examples.

What Is IR35?

IR35 is a tax rule introduced by HMRC to stop people working as “disguised employees.” The idea is simple: if you work through a limited company but your day-to-day working life looks like an employee’s, HMRC wants you to pay tax like one.

Example

Sarah is a software developer. She set up a limited company and contracts for a bank five days a week, 9-5, using the bank’s laptop, sitting at a bank desk, and attending the bank’s staff meetings. She calls herself a contractor, but HMRC says she looks like an employee. IR35 applies.

Example

James is also a software developer with a limited company. He works for three different clients at the same time, sets his own hours, uses his own equipment, and can send a colleague to cover if he is unavailable. He is genuinely self-employed. IR35 does not apply.

Why Does It Matter?

The tax difference is significant. Outside IR35, a contractor can take a small salary from their company and the rest as dividends, taxed at a lower rate. Inside IR35, all the income is treated as employment income, meaning full Income Tax and National Insurance apply.

Scenario	Outside IR35	Inside IR35
Contract income	£80,000	£80,000
Effective tax + NICs	Approx. £22,000	Approx. £34,000
Take-home (approx.)	£58,000	£46,000

Figures are illustrative. Actual amounts depend on individual circumstances.

The Three Key Tests

There is no single rule that decides IR35 status. HMRC looks at the whole picture, but three factors matter most:

1. Substitution – Can someone else do your work?

If you can send a substitute (a qualified replacement) to do the work and the client cannot insist on you personally, this strongly suggests you are a genuine contractor.

Example

Tom's contract says he can send a substitute. When he is ill for two weeks, he arranges for a colleague to complete the project. The client accepts this without objection. This is a genuine right of substitution – strong evidence of being outside IR35.

2. Control – Who decides how you work?

If the client tells you exactly what to do, when to do it, and how to do it – that looks like employment. A real contractor is hired to deliver an outcome and decides how to achieve it.

Example

Emma is a marketing consultant. The client tells her the campaign goal and deadline. Emma decides her own approach, works from home in her own hours, and invoices for the completed project. Low control, pointing outside IR35.

Example

Dan is a graphic designer contracted to a large agency. He must be at the office 9-5, attend daily briefings, and follow the creative director's instructions on every task. High control, pointing inside IR35.

3. Mutuality of Obligation – Is there an expectation of ongoing work?

In a genuine contractor relationship, once a project ends, there is no obligation for the client to offer more work, and no obligation for you to accept it. If there is an unspoken expectation that work will just keep coming, that starts to look like employment.

Example

Lisa finishes her 3-month contract. The client has no obligation to renew, and Lisa has no obligation to stay. She moves on to another client. Clear break. No mutuality of obligation.

Other Factors HMRC Looks At

Beyond the three main tests, HMRC also considers:

Factor	Looks like employment	Looks like self-employment
Equipment	Client provides laptop, phone, desk	You use your own tools
Integration	You have a company email, appear on the org chart	You are clearly an external supplier
Financial risk	You get paid regardless of outcome	You fix mistakes at your own cost
Exclusivity	You cannot work for anyone else	You have multiple clients
Holiday / sick pay	Client pays you when you are off	No work, no pay

Who Decides Your IR35 Status?

It depends on the size of the client you are working for:

Client type	Who decides	What they must do
Small private company (turnover under £15m)	You (the contractor)	Assess your own status and keep records
Medium or large company	The end client (hirer)	Issue a written Status Determination Statement (SDS)
Public sector (NHS, councils, etc.)	The end client	Issue a written SDS

A "small" company must meet at least 2 of: turnover under £15m, balance sheet under £7.5m, fewer than 50 employees. Thresholds were raised from £10.2m / £5.1m in April 2025.

A **Status Determination Statement (SDS)** is a written document from the client that says whether your contract is inside or outside IR35, and explains why. You are entitled to receive one, and you can challenge it if you disagree.

Example

Mike receives an SDS saying his contract is inside IR35. He disagrees – he works from home, uses his own equipment, and has three other clients. He formally challenges the SDS. The client has 45 days to respond with a revised decision or reasons. If they do not respond, the liability shifts back to the client.

What Happens If You Are Inside IR35?

If your contract is inside IR35, tax is deducted before you receive payment, similar to being on payroll. Your limited company still exists and still invoices the client, but the income is treated as employment income.

- Income Tax is deducted at source via PAYE
- Employee National Insurance (8%) is deducted
- Employer National Insurance (15%) is charged on top, reducing what reaches you
- You cannot take dividends from this income at the lower dividend tax rate
- Expense claims become much more restricted

Example

Claire's contract is inside IR35. Her company invoices £10,000 per month. After PAYE, employee NICs, and employer NICs (now 15% from April 2025), she receives approximately £6,600, compared to around £8,200 if the contract were outside IR35. The difference is real and significant.

After you receive the money, do you owe more tax?

This is one of the most common questions contractors ask. The short answer: **it depends on your total income**, but there are specific traps that catch people out.

How the money flows

Step 1	You invoice the client (e.g. £10,000)
Step 2	Fee-payer deducts Employer NIC (15%), which comes off the gross value first
Step 3	Remaining amount is treated as a gross deemed salary – fee-payer deducts Income Tax and Employee NIC via PAYE
Step 4	Net amount arrives in your company's bank account
Step 5	You pay yourself a salary from the company equal to the deemed gross – no further PAYE is due because it was already settled at step 3

When you generally do not owe more personal tax

If PAYE was deducted at the correct rate and your total income stays within the basic rate band (under £50,270), you should not owe significant additional personal tax. The deemed salary mechanism is designed so that the PAYE already paid settles the liability.

When you will owe more, via Self-Assessment

- **Higher rate tax:** If your total income across all sources exceeds £50,270 but PAYE was only deducted at the basic rate, HMRC will collect the difference through your Self-Assessment return
- **Student loan repayments:** Inside IR35 income counts toward your income threshold, so repayments may be triggered or increased
- **High Income Child Benefit Charge:** If total income exceeds £60,000, you may need to repay some or all Child Benefit
- **Personal Savings Allowance and Dividend Allowance:** These are reduced for higher-rate taxpayers, so additional tax may be due on interest or dividends from other sources

The company profit trap (the most common mistake)

If the net amount sits in your company and you do not pay yourself the full deemed salary, the retained profit is subject to Corporation Tax (19–25%). When you later extract it as dividends, dividend tax applies on top. This creates double taxation on money that was already partly taxed via PAYE.

The clean approach: pay yourself a salary equal to the deemed gross salary. Since PAYE was already settled by the fee-payer, no further Income Tax or NIC is due on that payment. The company should retain little or no profit from an inside IR35 engagement.

Example

David's agency deducts PAYE and NICs on a £8,000 deemed salary each month. His company receives £5,100 net. He pays himself £5,100 as salary. No further PAYE is owed on that amount. At year end, he files Self-Assessment showing the deemed employment income. His total income is £96,000, so he owes higher rate tax on the portion above £50,270 that was only taxed at the basic rate. His accountant calculates the top-up: approximately £2,800 additional tax due in January.

You must still file a Self-Assessment return each year even if all tax was deducted via PAYE. Inside IR35 income is reported as deemed employment income on your return.

Tax Implications in Detail

Outside IR35 – how your tax works

When outside IR35, your limited company receives the contract income. You typically pay yourself a small salary (up to the personal allowance or secondary NIC threshold) and take the remaining profit as dividends. This is more tax-efficient because:

- Salary up to £12,570 is free of Income Tax (personal allowance)
- Dividends benefit from a £500 tax-free allowance, then are taxed at 8.75% (basic rate), 33.75% (higher rate), or 39.35% (additional rate)
- Your company pays Corporation Tax on profits at 19% (small profits rate) or 25% (main rate above £250,000)
- You can deduct genuine business expenses through the company before paying any tax

Inside IR35 – how your tax works

When inside IR35, the fee-payer (your client or agency) must deduct tax before paying your company. The income is treated as if you were employed directly:

- Income Tax is deducted via PAYE at 20%, 40%, or 45% depending on your total income
- Employee National Insurance at 8% (on earnings between £12,570 and £50,270) and 2% above
- Employer National Insurance at 15% is charged on top of your invoice, coming out of the gross contract value before it reaches you
- You cannot pay yourself dividends from this income at dividend rates
- The 5% expenses allowance was abolished in April 2021. General running costs can no longer be offset against an inside IR35 engagement

Example

Alex invoices £10,000 per month on an inside IR35 contract. Employer NICs of 15% (£1,304) are deducted first, leaving £8,696 as the deemed salary. After Income Tax (40% higher rate) and Employee NICs (8%), Alex receives approximately £4,900 in hand, compared to around £8,200 on an equivalent outside IR35 contract.

What If You Have Both at the Same Time?

It is entirely possible, and fairly common, to have multiple contracts running simultaneously with different IR35 statuses. Each contract is assessed independently. You could be outside IR35 for one client and inside IR35 for another at the same time.

How the tax works when you have both

Outside IR35 contract	Inside IR35 contract
Income stays in your company	Tax deducted at source by fee-payer
You pay yourself salary + dividends	Treated as employment income (PAYE)
More tax-efficient structuring available	No dividend option on this income
You report via Self-Assessment	Fee-payer handles PAYE; you still need Self-Assessment

Key points to manage carefully:

- Keep clear records separating inside and outside IR35 income; HMRC may review both
- Your total income across all sources determines which tax bands apply. A large inside IR35 contract may push your outside IR35 dividends into the higher rate band
- You still need to file a Self-Assessment return each year regardless of mix
- Do not mix inside IR35 income with outside IR35 company profits. They are treated differently and must be accounted for separately

Example

Rachel has two contracts. Contract A (£60,000/year) is outside IR35 – she takes a £12,570 salary and the rest as dividends. Contract B (£30,000/year) is inside IR35 – the agency deducts PAYE and NICs before paying her company. When completing Self-Assessment, Rachel includes the inside IR35 deemed employment income alongside her dividends. Because her total income exceeds £50,270, some dividends fall into the higher rate band at 33.75% rather than 8.75%. Her accountant plans her salary and dividend timing accordingly.

How to Protect Yourself Outside IR35

If your contract is outside IR35, make sure your working practices actually match:

- **Do not use a client email address.** Use your own company email
- **Do not appear on the client's org chart** as a member of staff
- **Work for more than one client** where possible
- **Exercise your substitution right.** Even once, in writing, helps
- **Keep records.** Save invoices, emails, and project briefs that show you work independently
- **Review your contract before signing.** The wording matters
- **Avoid being treated like an employee.** No staff parties on the payroll, no company perks

IR35 status is assessed contract by contract. Even a new contract with the same client can have a different status.

Common Mistakes to Avoid

Mistake	Why it is a problem
Assuming "outside" without checking	HMRC can investigate years later and raise large tax bills with interest
Relying on the contract alone	HMRC looks at the reality of the working arrangement, not just the written terms
Never substituting	A substitution clause that is never used may be seen as window dressing
Working at one client for years	Long-term single-client engagements attract HMRC scrutiny
Ignoring an SDS	You only have a limited window to challenge – missing it means accepting the decision
Not keeping records	Without evidence, it is your word against HMRC's

How Lieu Vo Can Help

IR35 is one of those areas where a small amount of advice early on can save a large tax bill later. Lieu Vo can help with:

- Reviewing your contract and working practices against the IR35 tests
- Giving a written opinion on whether your engagement looks inside or outside
- Helping you challenge an SDS you believe is wrong
- Advising on how to structure your working arrangements to reduce IR35 risk
- Answering specific questions about a new contract before you sign

To discuss your situation, get in touch using the details below.

Name	Lieu Vo
Email	your@email.com
Phone	[+44 XXXX XXXXXX]

This guide is for general information and reflects UK tax law as at April 2025. It does not constitute formal tax advice. Please seek specific advice for your own situation.