



Sanderson

WHITE PAPER

DIRECT CONTRACTORS

An overview of the pitfalls and legal implications

This is the fourth in a series of white papers by Sanderson Recruitment Plc. These are written for businesses that hire professional limited company contractors to help them meet the challenges of non-permanent resourcing in 2008 and beyond.

'82% of our clients engage a proportion of their contractors directly, without going through an agency'.

Source Sanderson Recruitment Plc, 2007

Introduction

In a recent survey Sanderson Recruitment Plc found that 82% of businesses engaged a proportion of their contractor workforce directly, without going through an accredited agency.

This is a startlingly high percentage when you take into account the risks, legal implications and costs of engaging contractors¹ in this way.

Engaging contractors directly could put your organisation at risk of:

- accidental employment of these contractors
- liability for any unpaid PAYE and NIC debt, if they work through a managed service company
- paying over the odds for their services

This paper looks at the implication of recent legislation and cases including:

- Intermediaries Legislation (IR35) 2000
- Managed Service Company Legislation 2007 and the risk of transferred debt
- Muscat vs. Cable & Wireless 2006 and the risk of deemed employment of contractors
- James v London Borough of Greenwich (2008)
- Money Laundering Regulations 2007

It highlights other reasons to be wary of taking contractors directly and suggests a solution if you already have direct contractors on site.

¹In this paper, we focus on contractors, consultants, freelancers and interims, but not temporary workers. For more information on the law with regard to temporary workers contact Karen Ainsworth at Sanderson Recruitment plc. See the Glossary of Terms at the end of this paper.

“It is vital that organisations understand recent legislation and its implications, particularly if they engage directly.”

A brief history

UK organisations have always engaged freelance professionals directly. Up until the 1970s, this was the only way to take on non-permanent resource.

In the early 1970s, the IT market started to boom and agencies for IT contractors sprang up to source skills. Other professions followed suit, and agencies quickly became the most popular way to find and manage professional contract resource.

Today, despite the predominance of the agency model, many UK organisations still engage a proportion of their contract workforce directly.

There are various reasons for this: some want to avoid process; others believe that going direct is an easier and cheaper option than the agency route; most are unaware of the true cost, risk and legal implications of this approach.

In the last 7 years, there has been a significant amount of legal activity in this area. It is now more important than ever before to understand the legislation and the implications for your business, particularly if you engage directly.

Direct contractors and the law

The following is an overview of recent relevant legislation.

1. Intermediaries Legislation – IR35

The lead up to the year 2000 and the internet boom heralded an unprecedented explosion in contracting.

At the same time, the Inland Revenue brought in its Intermediaries Legislation, more commonly known as 'IR35'².

IR35 targets 'disguised employees'. The rules apply to engagements where a worker provides services under a contract between a client and a limited company; and, but for the presence of the limited company, the relationship between a client and a contractor could be seen as having the characteristics of employment.

In all such cases, where the individuals are not genuinely self-employed, then the deemed amount of tax and national insurance should be deducted under the IR35 legislation.

Organisations may wonder what this has to do with them. If you no longer want the services of a contractor and you terminate the arrangement, the contractor may wish to claim that he has been unfairly dismissed. In order to found such a claim the contractor must show that he was an employee of either the agency or you as the end client. Without the agency in the middle of the relationship, there is a risk that the contractor could seek recompense from you, the end client.

In response to IR35, contractors began to seek more cost efficient ways of running their companies. A growing number of contractors started to use the services of managed service companies (MSCs), composite companies and umbrella companies.

²IR35 comes from (i) The Social Security Contributions (Intermediaries) Regulations, pursuant to the Welfare Reform and Pensions Act (came into force 6 April 2000) and (ii) Schedule 12, Part II of The Finance Act 2000 which deals with deemed Schedule E income, PAYE and corporation tax.

“If you engage a contractor directly and that contractor runs his company through an MSC, your organisation could be liable for any unpaid tax or national insurance.”

Managed Service Company Legislation - 2007

In 2007, HMRC brought out new legislation in the Finance Bill that turned the spotlight on MSCs³.

MSCs run a limited company for and on behalf of the contractor⁴. Like other contractors, those operating through MSCs are paid by way of a combination of the national minimal wage and dividends, which minimises their tax and NIC liability.

The Government takes the view that contractors who provide services through MSCs are invariably not in business on their own account: in other words, they are not self-employed for tax purposes.

The consequences for a company being an MSC are now potentially serious.

- For the company itself, all income derived by the individual from a contract for that individual's services is deemed to be employment income and therefore PAYE tax and NICs are deducted (whether or not the contract would have fallen inside IR35)
- For those dealing with the company, there are risks that any shortfall in PAYE tax or NICs of the MSC may end up being transferred to and recovered from third parties (which can include employment businesses and clients who engage contractors directly)

Most employment businesses are outlawing MSCs, as they cannot be sure that they are tax compliant and they do not want to face the risk of transfer of debt.

If you as a client engage a contractor directly and you (knowingly) use one of these companies and the MSC or the limited company has not paid its tax correctly, there may be provision for HMRC to come after you directly for payment of NIC/tax.

³ This legislation does not apply to limited companies/personal service companies, or umbrella companies.

⁴ MSCs often have direction and control of each bank account and often give the agency a voucher in return for the referral; voucher referral schemes have now been outlawed (many agencies now see any form of payment or voucher to their consultants as a dismissible offence)

“Using an agency can help to prevent a direct relationship between your organisation and a contractor and reduce the risk of accidental employment.”

“If you engage contractors directly you need to pay very close attention to how you manage those contractors to avoid the risk of accidentally employing them.”

Muscat vs. Cable & Wireless and increased fears of accidental employment

As a result of recent legal challenges in the courts, UK organisations must pay close attention to the growing risk of accidental employment of contractors.

A degree of uncertainty was brought into the industry when on 9th March 2006 the Court of Appeal found that Mr Muscat was an employee of Cable & Wireless (C&W) under an implied and unwritten employment contract.

Mr Muscat was a well-paid professional IT contractor operating through a limited company and supplied via an employment business. The supplying agency (at the request of C&W) terminated the contract and in response Mr Muscat filed a claim of unfair dismissal, arguing he had been an employee of C&W. He was awarded all of the rights that go with employment status.

Whilst the circumstances of the Muscat case are unusual⁵ there has been real confusion and uncertainty about the employment status of professional contractors. This ruling fuelled fears that companies would witness increasing numbers of contractors claiming sickness pay, redundancy money and compensation for unfair dismissal.

There has been a modicum of certainty in the early part of February 2008 due to the ruling of James v London Borough of Greenwich. The Court of Appeal upheld the decision of the Employment Appeal Tribunal that a temp on site at Greenwich Council for several years via an employment business was not the employee of the Council under an implied contract of employment. The Court of Appeal made it clear that whatever people may think about the fairness of two tier workforces, it was not its job to create social policy but to interpret the existing law. It decided that in most cases temps and contractors supplied through an agency would not have full employment rights under existing UK law.

⁵He was originally an employee of a company that was then taken over by C&W and was then required to go contracting.

“Direct engagement costs your organisation more, takes up valuable time in contractor administration and management, and leaves your company open to employment liabilities and other legal responsibilities.”

Clients and agencies alike may now breathe a sigh of relief but businesses should not become complacent about this decision and should still be looking to minimise the risk of accidental employment of contractors by bringing in measures that clearly differentiate “between employed and self-employed status”.

If you engage contractors directly you will still need to pay close attention to how you manage these contractors in order not to expose your organisation to the risk of disguised employment.

Using an agency can help to prevent a direct relationship between your organisation and the contractor and can help to reduce the risk of disguised employment: your organisation is at greater risk if you engage contractors directly.

Take steps to ascertain the status of your contractors and be mindful of how they are treated: you could put your organisation at risk of accidentally employing them or becoming liable for unpaid tax and NICs, in the eyes of the law.

There are things you can do: for example, you can ensure that you engage contractors on deliverable-based or project-based contracts. You can find out more about the steps you can take in Sanderson’s free paper ‘Innovations in Contractor Supply – how to get the best out of your contractors and reduce the risk of accidental employment’⁶.

⁶For Sanderson Recruitment Plc’s free whitepaper ‘Innovations in Contractor Supply – how to get the best out of your contractors and reduce the risks of accidental employment’, see www.sandersonplc.com or contact Sanderson on 0117 9706666.

Other pitfalls of direct engagement

Engaging contractors directly, without going through an agency is a high-risk strategy. This is not just because of recent legislation.

Direct engagement costs your organisation more, takes up valuable time in contractor administration and management, and leaves your company open to employment liabilities and other legal responsibilities.

We have listed below four reasons why organisations should consider very carefully whether to take on contractors directly without going through an agency.

“Organisations spend on average 8.3% more on direct contractors than those supplied via an agency.” Sanderson Recruitment Plc, 2007

1. Direct contractors cost more

Direct contractors cost your organisation more money. Many hiring managers believe that if they engage a contractor themselves they will save their organisation money by avoiding agency fees. In reality, the true cost of direct contractors is far higher than agency supplied resource.

Recent research by Sanderson Recruitment Plc found that organisations that engaged direct paid on average 8.3%⁷ more (this equates to an average of £32.10 per day for each direct contractor). This figure includes the agency margin, thus the discrepancy in pay rates is even greater.

One reason for this is that agencies are skilled and experienced in rate negotiation on behalf of their clients. As they regularly analyse and benchmark market rates, they are aware of market averages and will negotiate hard to keep contractor rates in line. Organisations can be responsible for artificially inflating the market rate for a skill or job role by not managing pay rates effectively.

This is a serious issue for corporations with large numbers of direct contractors, as you can see from the following case study.

Direct contractors cost more: a case study

Sanderson conducted an audit within the business change department of a FTSE 250 customer. The customer had 33 contractors on site, 12 of which they engaged direct: they sourced these contractors through referrals from their staff and from other contractors alike.

On analysis, the average daily charge rate of agency-supplied resource was £562.88 (exc.VAT). The average daily charge rate of the 12 direct contractors was £610.41 (exc.VAT).

The client asked Sanderson to take on these contractors. By benchmarking against market rate and realigning the pay rates of these direct contractors, Sanderson generated over £70,000 of cost savings. They also standardised all contracts, ensuring full compliance with customer standards and processes.

⁷This is based on analysis of the rates paid to 249 managed contractors against the averaged daily rates of 1298 agency-sourced contractors.

2. With direct contractors you have less protection from employment liabilities and other legal responsibilities

Engaging contractors via an agency⁸ can help to reduce risk for your organisation. If a contractor is supplied by a third party/agency your organisation has the security of knowing that liability rests with the agency if things go wrong.

When placing a contractor with a client, agency responsibilities include the following.

- a. **Contracts.** An agency ensures that a robust commercial contract is in place and signed before any contractor starts on site. This includes areas such as confidentiality, intellectual property rights and termination clauses.
- b. **Insurances and indemnities.** The agency also makes sure that all relevant insurances and indemnities are in place. These can include employers liability professional indemnity, and public liability insurance.
- c. **Checking.** In some businesses there is a legal requirement for all those on site to be CRB checked or credit checked. The agency is responsible for carrying out such checks and ensuring any paperwork is returned before start. Consideration also needs to be given to the Money Laundering Regulations 2007; additionally, in financial services companies, it is common for credit checks to be completed pre-start in order to meet FSA guidelines.

⁸When selecting an agency, companies should look for agencies that are members of REC or ATSCo – this gives them confidence that the agency takes regulations and legislation seriously, and does not just pay lip service to them.

- d. **Correct engagement vehicle**⁹ (limited company, umbrella company, sole-trader). The agency will ensure that the engagement vehicle, contractual terms and associated documentation are appropriate and legally correct for the company and for the contractor.

If you engage directly, your organisation will need to carry out all these tasks for each and every contractor you engage in order to protect your interests.

3. Direct contractors can be an administrative burden

Contractor administration is a time-consuming process. Using an agency can free up hiring managers (and other departments such as procurement) to focus on their work.

An agency will deal with the management of the contractor and all related paperwork. This usually covers recruitment, resourcing, contracts, extensions, terminations, renewals and payment.

It also covers the heavily administrative checking and vetting process. Checks can include eligibility/right to work in the UK, reference checking and customer specific checks such as CRB check, additional reference checking, criminal declaration, proceeds of crime, and credit checking. They can also include specific confidentiality and non-disclosure agreements.

The agency ensures that all relevant checks are carried out and paperwork is signed and returned before start. The agency is responsible for regular auditing of this process.

When you engage a contractor directly someone in your organisation has to take on all of these tasks.

4. Contractors prefer working through an agency

Contractors usually have greater confidence working through an agency: the agency understands their objectives, puts in place appropriate commercial terms and pays them regularly.

An agency understands the issues that contractors face and can advise and manage issue resolution and disputes effectively. This serves to protect the vital customer-contractor professional relationship.

⁹See our Glossary of Terms at the end of this paper.

“All non-permanent resource, whether through an agency or direct, should be subject to a standardized clearance process.”

What to do if you have direct contractors on site

Many UK organisations already have direct contractors on site, some in very large numbers.

The question is, if you have gone down this route, how do you control and mitigate the risks associated with direct contractors? What do you need to do to protect your organisation?

A four-point plan to mitigate risk

1. The starting point has to be **education**. You and your hiring managers need to fully understand the implications of engaging contractors directly. You must then put into place a standard process across the business to protect your organisation and the contractors themselves.
2. You will need to conduct a complete **audit** of your contractor population to find out where you have supply that is direct or non-compliant. In a large organisation, this is no mean task. For each contractor you need to assess:
 - how they were supplied;
 - their terms and conditions;
 - rates and costs;
 - how long they have been on site and the length of their contract.
3. When you have a full picture, it is important to build up a risk profile across the business. Some contractors will present little risk, others much higher. **A full risk assessment** across your contractor population will show you the areas you need to address first.

“The primary objective must be to reduce risk and standardise the process, for the benefit of the business, your suppliers and your contractors.

The bi-product of this will be long-term cost savings and short-term cost reduction and better processes for your organisation.”

4. Then you can design a **new process** to mitigate risk. We believe that all non-permanent resource, whether they have come through an agency, a consultancy or direct, should be subject to a standardised ‘clearance process’ before they start on site. Before start you must be clear how they have been supplied and what engagement vehicle they are using (e.g. limited company, umbrella company, sole trader¹⁰ etc.) and you must be sure that they have the following in place:
 - appropriate levels of checking and vetting;
 - insurances;
 - standard terms of business.

Only when you are sure these are in place should the contractors start on site. In this way, you can minimise your risk, keep your costs down and gain control of the process.

¹⁰See our Glossary of Terms at the end of this paper.

Conclusion

Engaging contractors directly, without going through an agency, can put your organisation at risk. In light of recent legislation:

- your company could be at risk of accidentally employing a contractor
- your company could be liable for a contractor's unpaid PAYE and NIC debt

On top of this:

- direct contractors cost you more
- they can be a heavy administrative burden
- they could leave you open to employment liabilities and other legal risks

These days, direct contracting is not even popular with contractors themselves.

Using an agency to supply and manage your contractors can significantly reduce the risks for your organisation. It can also cut costs and free up your managers.

If you already have direct contractors on site, as many UK organisations do, there are things you can do to mitigate your risks. We advise a full audit and risk assessment and the implementation of a new 'clearance process' for all non-permanent resource before start. This will ensure that you reduce the risk and cost to your organisation.

Other whitepapers by Sanderson Recruitment Plc

This paper is written for senior decision makers and hiring managers in both large and small UK organisations. We hope it helps to inform strategic decisions on contractor resourcing.

Contact us for other free papers and legal updates or visit our website www.sandersonplc.com. Other papers of interest include the following.

- ***The Candidate Attraction Minefield*** – an overview of the options available to attract talent in today's competitive marketplace.
- ***Innovations in Contractor Supply*** – how to get the best out of your contractors and reduce the risk of accidental employment.
- An Introduction to the new Age Regulations 2006

About the author

Karen Ainsworth is Head of Legal Services for Sanderson Recruitment plc. Karen acts in an advisory capacity to Sanderson and its clients, offering practical advice and guidance on legislation that affects the recruitment of permanent and contract resource.

Sanderson Recruitment plc is a specialist recruitment consultancy providing professional resource in IT, Human Resources and Finance to organisations across the UK.

Operating since 1975, Sanderson is now the largest independent specialist recruitment business in the country.

Sanderson is leading the drive to improve quality in the contractor marketplace, advising and educating clients on all aspects of contractor engagement and supply.

For further assistance

For more information and a free assessment of your contractor engagement methods, please contact Karen Ainsworth at Sanderson Recruitment on 0117 9706666 or email: karen@sandersonplc.com.

Glossary of Terms

Glossary of terms for non-permanent resource:

- ***Consultant:*** an individual offering expert or professional advice in a field. this person may be a director of a limited company or an employee of a consultancy, utilised on site at an organisation.
- ***Contractor:*** person or business which performs services for another person or entity under a contract between them. This person is often a director of a limited company with the term 'limited company contractor' often being used.
- ***Freelancer:*** not a term that has a particular legal definition, rather more of a generic term for an individual who is not employed. This encompasses contractors, consultants and interims. Tends to refer to people that are offering a specific skill or technique.
- ***Interim:*** not a term that has a particular legal definition, rather more of a generic term for an individual who is not employed. This encompasses contractors, consultants and freelancers. Tends to refer to management roles, e.g. business management, change management, HR management.
- ***Temporary Worker:*** someone who provides services to a client, on the payroll of an employment business (note that different industries refer to a temporary position in different ways and the definition used here is for the purpose of this white paper).

Glossary of methods of contractor engagement:

- ***Composite Company:*** a set up of artificial companies with numerous directors, all of whom operate through the same company to avoid IR35 legislation through sophisticated tax loopholes.
- ***Limited Company*** (also known as a Personal Service Company 'PSC'): a business that is incorporated and where an individual owns and runs their own limited company, usually as a director and being the major shareholder.
- ***Limited Liability Partnership ('LLP')***: a limited liability partnership shares the features of limited liability companies and unincorporated partnerships. Limited liability partnerships enjoy the protections of limited liability that exist in English company law and are subject to lower taxation rates than companies.
- ***Managed Service Company ('MSC')***: the individual's limited company is totally outsourced and managed by third parties; typically the individual does not have access to their own business bank account [see section 61B of the Finance Bill 2007, which will insert.

- **Managed Service Company provider ("MSCP"):** the MSCP is not a managed service company, but is an entity with which a managed service company must be involved (as defined in the Finance Bill) so as to become a managed service company for the purposes of the legislation.
- **Sole Trader:** a business organisation that is not incorporated and only has one owner (e.g. an individual working for themselves that is solely responsible for their affairs).
- **Umbrella Company:** the contractor essentially become an employee of the umbrella company, paid as a PAYE employee (less the umbrella fee).