

E-Nuff is not enough

ANNE REDSTON considers the possible effects of the decision in *Cable & Wireless v Muscat*.

EVER SINCE 1999, IR35 has been the target of hostilities and may now have been dealt a mortal blow by the recent decision of the Court of Appeal in *Cable & Wireless v Muscat* [2005] EWCA Civ 220. This article explores that decision and its relevance for personal service companies and their clients.

Where a client contracts with a service company, and that company provides the services of the worker to the client, established employment law has almost invariably held that the interposition of the company prevents the individual being employed by the client (see for example *Winter v Westward Television* [1977] EAT/589 and *Hewlett Packard v O'Murphy* [2001] EAT/612).

The courts have, however, recently begun to explore the interesting question as to whether the existence of the chain of written contracts necessarily precludes the existence of an unwritten or notional contract of employment directly between the worker and the client.

In *Franks v Reuters Ltd and First Employment Ltd* [2003] IRLR 423, the Court of Appeal held that 'dealings between parties over a period of years, as distinct from weeks or months typical of temporary or casual work, are capable of generating an implied contractual relationship'.

This was followed by *Dacas v (1) Brook Street Bureau (UK) Ltd (2) Wandsworth London Borough Council* [2004] EWCA Civ 217. Mrs Dacas was a cleaner paid by the employment agency, Brook Street Bureau, to work for their client, Wandsworth Borough Council ('Wandsworth').

In the Court of Appeal, Mummery J said he thought there was a real possibility that Mrs Dacas had been employed by Wandsworth, and Sedley J went further and said Wandsworth had almost certainly been her employer. Mummery J said that 'although there was no express contract between the applicant and the end-user in this case, that absence does not preclude the implication of a contract between them. That depends on the evidence, which includes, but may not be confined to, the contractual documents'.

The court thus recognised that there could be a notional contract between the worker and the client, despite the existence of a chain of parallel written contracts, and that this notional contract could be effective in creating employment rights.

Muscat at the EAT

But in both *Franks* and *Dacas*, the individuals did not have service companies. In February 2005, the EAT in *Cable & Wireless v Muscat* [2005] 0661/04/LA, a case where Mr Muscat was engaged to work for Cable and Wireless (C&W) via his service company, said that:

'We are unable to accept that the *Dacas* decision can be distinguished on its facts. The fact that in the present case Mr Muscat did not contract directly with Abraxas, but E-Nuff, his service company did, is a distinction without any difference.'

The EAT concluded that Mr Muscat was an employee of his end-client. C&W appealed.

Mr Muscat's working arrangements

Before looking at the grounds of appeal, it is important to consider the facts of *Muscat*, so that the extent of its application to other cases can be assessed.

During 2001, Mr Muscat was employed as a telecommunications specialist by a company called Exodus Internet Ltd (EIL). In September 2001, EIL wished to reduce the number of its employees in order to facilitate a potential buyout, but it still wished to retain Mr Muscat's services. Mr Muscat was told that he would have to become a 'contractor' and provide his services through a limited company.

On 15 October 2001, EIL dismissed Mr Muscat, and re-engaged him the following day. Mr Muscat set up a service company called E-Nuff Comms Ltd (E-Nuff). The EAT tells us that the cost of the incorporation was borne by EIL.

The court recognised that there could be a notional contract between the worker and the client, despite the existence of parallel written contracts.

E-Nuff billed EIL for Mr Muscat's services. The sum paid to E-Nuff was increased, as compared to the amounts Mr Muscat had received personally, to take account of the fact that E-Nuff was now responsible for the tax and NICs.

There was no written agreement between E-Nuff and EIL. Instead there was a contract between Mr Muscat, as an independent contractor, and EIL. This contract included the following clauses:

'Contractor may not assign, delegate or subcontract neither this Agreement nor any of its rights, duties or obligations under this Agreement without the express written consent of Exodus. Any purported assignment or delegation in violation of this provision shall be void at the option of Exodus. Contractor's obligations are personal to Contractor, and Contractor acknowledges that Exodus has entered into this Agreement in reliance on Contractor's ability and agreement to perform its obligations accurately, competently and completely. Exodus reserves the right to assign its rights and obligations hereunder, as it

deems appropriate ... This Agreement constitutes the entire agreement between the parties with respect to the rendering of the Services.'

Despite this, the EAT appears to have accepted that the terms of this contract 'became the terms as between E-Nuff and EIL as well, as if the name of E-Nuff was substituted for that of Mr Muscat in the document' (paragraph 7 of the EAT judgment).

In February 2002, EIL was taken over by C&W. The takeover was complete by the end of April 2002. Mr Muscat continued to work as before, although he now worked under the direction of C&W management. C&W supplied Mr Muscat with a mobile telephone and a laptop computer; they paid his mobile telephone bills and Mr Muscat arranged his annual leave with C&W. Within the C&W departmental structure, Mr Muscat was described as an employee and was assigned an employee number. All the equipment that he used was paid for by C&W.

“ *Contracting via a service company, as compared to contracting directly as an individual, was 'a distinction without any difference'.* ”

E-Nuff continued to submit invoices for Mr Muscat's services but C&W did not pay them. In August 2002, Mr Muscat was told that C&W did not deal with contractors direct and that he must deal with them through an agency, Abraxas PLC (Abraxas).

On 13 August 2002, E-Nuff entered a 'Contract for Services' with Abraxas by which E-Nuff agreed (in part retrospectively) to provide services to C&W for the period 26 April to 31 August 2002. That contract included the following clause:

'This Contract for Services together with the works schedule and any attachments shall constitute the entire contract between the company (Abraxas) and the consultancy (E-Nuff) and shall govern the assignment undertaken by the consultancy. No verbal or other written contract shall be valid.'

The contract also included a clause allowing substitution, provided that the substitutes were suitably qualified and the client was prepared to accept them. However, at no time did he (or E-Nuff) seek to provide a substitute.

After the 'contract for services' had been signed, Abraxas paid E-Nuff's monthly invoices. In late November 2002, C&W informed Mr Muscat that it would not require his services further. In fact, he continued to work for C&W until 31 December 2002. During the period from August to December, the only role undertaken by Abraxas was the payment of the invoices.

We do not know whether E-Nuff treated Mr Muscat as inside or outside IR35. There are only two clues – the ET recorded that the accountant who set up E-Nuff advised Mr Muscat 'that he should pay himself a salary with tax to

be paid under Schedule E'. This suggests that he believed Mr Muscat to be within IR35. If so, did this treatment change when E-Nuff signed the Abraxas contract with its substitution clause?

Court of Appeal

One of the interesting factors is what elements of the EAT decision C&W decided to appeal.

First, and most surprisingly, C&W accepted that contracting via a service company, as compared to contracting directly as an individual, was 'a distinction without any difference'.

Secondly, C&W also did not challenge, either here or at the EAT, the earlier findings of the ET that Mr Muscat remained employed by EIL after 15 October 2001. In other words, they accepted that his status had not changed on the date his services began to be provided by E-Nuff Limited.

Thirdly, C&W did not dispute the finding of the ET that on the transfer of EIL's business to C&W, Mr Muscat became the employee of C&W.

What C&W did argue is that Mr Muscat's status changed when the contract was signed between Abraxas and E-Nuff, and relied upon the fact that it contained a clause (quoted above) stating that it constituted the entire contract between Abraxas and E-Nuff, and that 'no verbal or other written contract was valid'.

However, on this point the Court of Appeal upheld the view of the lower courts that these contracts were not the whole picture.

What if ...?

Would the decision have been different if there had been a proper agreement between E-Nuff and EIL from inception, instead of an agreement with an independent contractor? It would appear not, as the ET accepted that the terms of that contract 'became the terms as between E-Nuff and EIL' and at no point did the courts comment that failure to have established formal contractual relations between E-Nuff and EIL at inception was a relevant point.

Secondly, would C&W have succeeded at the Court of Appeal had they argued that the existence of E-Nuff prevented Mr Muscat from being an employee?

The EAT clearly did not think so. Having said that the existence of the service company was 'a distinction without a difference' it went on to say that 'this is so, even were it not to be the case that the Employment Tribunal found that at all times prior to the agreements entered into on 13 August 2002, Mr Muscat was in point of law an employee of EIL and then Cable & Wireless'.

In other words, the existence of the service company was simply to be disregarded, even if the hypothetical contract had been one of self employment.

It is, in the writer's view, very likely that if the Court of Appeal judges had disagreed with this, and thought that the role of the service company was an essential ingredient in coming to the correct decision, that they would have said so. In *Dacas*, the judges went so far as to ask Wandsworth to attend the court, even though Mrs Dacas had dropped the case against them; two of the judges then expressed the view that she had very probably been employed by Wandsworth, notwithstanding that this had

not been part of Brook Street's defence. This intervention was much more significant than that which would have been required in *Muscat* to reinstate the existence of the service company as a key issue.

Thirdly, could C&W have made more of the terms included in the Abraxas/E-Nuff contract, given that these included a right of substitution? Should they have argued that, although there may be an implied contract, the terms of that contract made it one of self employment?

The Court of Appeal decision shows that they did not use these arguments; see paragraph 11 of the judgment. It is difficult to know what would have happened if they had, but a reading of both the Employment Appeal Tribunal and Court of Appeal cases suggests that they would not have been successful, probably because it was considered that the written terms did not reflect the reality of the hypothetical contract.

IR35 skewed?

If an individual is working via a service company, the IR35 legislation requires that company to consider whether the relationship between the individual and the client would have been one of employment, had the service company not existed. As Mr Justice Burton said in *R v CIR (oao Professional Contractors Group Ltd)* [2001] STC 629, 'the Revenue must bear in mind that under IR35 they are not considering an actual contract between the service company and the client, but imagining or constructing a notional contract which does not in fact exist'.

This view has been repeatedly endorsed by the courts; see for example Mr Justice Park in the Court of Appeal case of *Usetech v Young* [2004] STC 1671.

These IR35 decisions thus follow the precedents of earlier employment law cases, in holding that the existence of the service company prevented a claim for employment rights directly from the client, and thus required the construction of a notional contract for IR35 purposes.

But it is clear from *Muscat* that the position has changed. If there is a notional contract between the individual and the client, and this contract is one of employment, then this is not a fiction – it is a genuine implied contract between the parties and the individual will be an employee of the client.

The implications for IR35 are radical. This legislation is only relevant where 'the services are provided not under a contract directly between the client and the worker' (ITEPA 2003, s 49(1)(b)). Thus where the client is the employer under an implied contract, IR35 cannot apply. Instead, the client will have the normal PAYE and NIC obligations of an employer.

Comparing the IR35 and Muscat notional contracts

C&W argued that the content of the notional contract should be limited to the terms of the written contracts, which made it clear that Mr Muscat was not an employee of C&W. The judges disagreed, they said that:

'The written contract between Mr Muscat/E-Nuff and Abraxas should be examined in order to see whether it affects the relationship between C&W and

Mr Muscat and weighs against the existence of an implied contract of employment between them. In our view, it does not.'

This echoed the findings of the EAT that:

'Although the construction of the contractual documents was important, it was not necessarily determinative of the contract of service questions, as contractual documents do not always cover all the contractual territory or exhaust all the contractual possibilities ... The relevant evidence included, but was not necessarily confined to, the contractual documents.'

The Court of Appeal did not reject the contractual documents entirely, stating (at paragraph 42) that:

'Examination of that written contract is also useful as a means of determining the precise terms of the implied contract of employment, for example the hours of work, remuneration and notice periods.'

This approach is very similar to the requirement of IR35 that, in constructing the notional contract, it is necessary to consider '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' (ITEPA 2003, s 49(4)).

While 'having regard to' the contracts, the courts in IR35 cases also take into account the conduct of the parties and other external evidence.

However, while 'having regard to' the contracts, the courts in IR35 cases have also been concerned to take into account the conduct of the parties and other external evidence, exactly as is set out in the extracts above.

The key question

The key question is whether all those who fail IR35 are employees of their clients. It seems to the author more likely than not that the majority of those who fail IR35 will, following *Muscat*, be found to have implied contracts of employment with their clients. This is because there are few factors in this judgment which allow the position of Mr Muscat to be distinguished from that of other contractors.

Some may argue that most cases can be distinguished from *Muscat* because Mr Muscat was previously employed by EIL and then re-engaged via the service company. It is difficult to say how significant this factor was. However, in the final paragraph of the judgment, Lady Justice Smith indicated that it might not be of any importance at all. She said, in reviewing how the decision might be applied in the future:

'No doubt, if ETs apply their minds to the possibility of an implied contract between the worker and end-

user, there will be some cases in which they find that relationship, as in this present case. There will no doubt also be many cases in the future in which ETs will conclude that a worker in the triangular relationship is not an employee of the end-user. That may be because they find that he or she is an independent contractor. It may be that the ET will conclude, on the particular facts of the case, that the worker was employed by the agency. Another possibility is that the worker may be found to have had a series of short employment contracts with different end-users, but no continuing contract of employment such as will support employment rights. All will depend on the facts of the individual case. We find it hard to imagine a case in which a worker will be found to have no recognised status at all, either as an employee of someone or as a self-employed independent contractor. But that question must await another day.

“ It may be the case that future judges will distinguish between the *Muscat* situation and that of other contractors, and that this ‘necessary’ test is not met.

The fact that Lady Justice Smith considered that a contractor with a succession of short contracts could nevertheless have these classified as employments indicates that Mr Muscat’s previous employment by his client may be of minor significance.

This comment also suggests that the view of the Court of Appeal has moved on since their view in *Franks* (quoted



at the beginning of this article) that the existence of an implied contractual relationship is restricted to ‘dealings between parties over a period of years, as distinct from weeks or months typical of temporary or casual work’.

There is, however, one possible difference between IR35 and the *Muscat* principle. In IR35, the service company’s existence is automatically ignored, and a notional contract is deemed to exist. In *Muscat*, the court accepted that a contract can only be implied if it is ‘necessary’ to do so. Lady Justice Smith cited with approval Mummery J’s words in *Dacas* that:

‘Depending on the evidence in the case, a contract of service may be implied – that is, deduced – as a necessary inference [my italics] from the conduct of the parties and from the circumstances surrounding the parties and the work done.’

She added, in relation to the present case:

‘It was necessary to infer the continuing existence of the employment contract in order to give business reality to the relationship and arrangements between Mr Muscat and C&W. There was no other possible explanation for what they were doing. Also, it was necessary to infer the existence of an employment contract in order to establish the enforceable obligations that one would expect to see in these circumstances.’

It may be the case that future judges will distinguish between the *Muscat* situation and that of other contractors, and hold that this ‘necessary’ test is not met, particularly where there has been no prior employment relationship. But that is far from certain.

What next?

When contacted after the Court of Appeal decision, HMRC said that they will consider the *Muscat* judgment very carefully and that they cannot, at the present time, comment on its possible implications. They nevertheless noted that ‘businesses will wish to take professional advice about the contracts they might have and the implications of the judgement for them’.

The implications of the *Muscat* case may differ depending upon which party we are considering.

Clients

Clients should, without delay, examine their relationships with limited company contractors to see if the individuals have implied contracts of employment. A change in the working relationship so that any notional contract is one of self employment should both protect the client from future employment rights claims and the service company from IR35.

Agencies

Agencies are vulnerable to the *Muscat* ruling because many of their contracts with clients transfer the costs of any adverse status ruling to them. For example, in this case the contract with Abraxas said that ‘in the event that any person should seek to establish any liability or obligation upon the company [i.e. the client] on the grounds that any individual engaged

on the assignment is an employee of the company, the consultancy [i.e., the agency] shall upon demand indemnify the company and keep it indemnified in respect of any such liability or obligation and any related costs, expenses or other losses, which the company shall incur’.

Contractors

It is likely that many contractors will try to make retrospective claims for employment rights from their clients. What is less clear is the tax and NIC position. The following questions come to mind:

- Will HMRC pursue clients for PAYE and NICs relating to prior periods? In the recent (and much criticised) case of *Demibourne Ltd v Revenue and Customs Commissioners* [2005] SpC 486 (*Taxation*, 22 September 2005), the Special Commissioner held that because the PAYE regulations were based on the principle that the employer was responsible for accounting for tax, the Revenue had an obligation to collect this from the employer, and could not use its discretion to collect it from another party (in *Demibourne* this other party was the individual, but the same point could be made in relation to service companies).
- Alternatively, could HMRC hold that the service companies acted as agents for the true employers, the clients?
- What will happen if the service companies pursue HMRC for refunds under the ‘error or mistake’ provisions?

- Will HMRC rely on ‘prevailing practice’ to leave the past as it lies?
- How do the National Insurance contribution rules apply to this situation?

Exploration of these interesting points is, however, beyond the scope of this article.

Conclusion

Muscat is a ground-breaking case which has changed the employment law landscape. But it is clearly not the last word. Future cases will clarify its scope, and it is likely that its application to IR35 will also be tested.

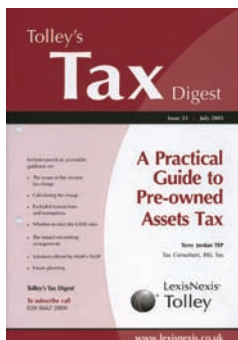
It also remains to be seen whether the Government will take action to ensure that, where a service company is used, the tax and National Insurance contributions liability remains with that company. This was clearly the intention of the legislation, see the IR Press Release which was dated 23 September 1999.

Alternatively will HMRC take the easier route (for them) of collecting the tax and National Insurance contributions from the client? It is hoped that we will soon receive substantive comments on this point. ■

Anne Redston is Chair of Personal Taxes at the Chartered Institute of Taxation (CIOT) and a Visiting Professor in Law at King’s College London. The views expressed are her own and not necessarily those of Kings or the CIOT. Anne can be contacted by email via the CIOT at technical@ciot.org.uk.

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