Personal service companies

The IR35 legislation seeks to tackle the avoidance of tax and national insurance contributions (NICs) through the use of intermediaries such as service companies or partnerships.

The rules target circumstances where a worker would be treated as an employee of the client, if it were not for the existence of the intermediary. Where this is a limited company, the worker can take money out in the form of dividends instead of salary. Dividends are not liable to NICs so the worker would therefore pay less in NICs than either a conventional employee or a self-employed person.

Scope of the rules

The IR35 rules apply to income earned in respect of work done under contracts which would have been contracts of employment if the worker had been working direct for the client (relevant engagements). They do not introduce any statutory definition of employment or self-employment, so the existing case law will still apply to decide employment status (see: Employed or Self Employed?). The rules catch those employed in a domestic situation - eg nannies - as well as workers in the wider business sense.

Workers with up to 5% share in the intermediary (taking into account the holdings of family and domestic partners) are not subject to the rules, unless they receive payments or benefits which are not taxable under Schedule E.

Calculations

If you are caught by the IR35 rules, you are treated as receiving a notional salary on the last day of the tax year (5 April) equal to the company's gross income from relevant engagements less certain specified deductions. You will have to pay over PAYE and NICs on this notional salary by 19 April and include it on the year end final FPS return by 5 April. It is evident that there is very little time to process the calculations, and HMRC have indicated that they will not penalise the use of provisional payments and calculations in order to meet the deadlines. A provisional payment must be finalised by 31 January following to avoid penalties.

The deductions cover expenses that would normally be available to direct employees, contributions to registered pension schemes and the actual salary and employers NIC plus the employer's NIC on the deemed salary. A 5% flat rate deduction is allowed to cover the company's running costs. The example below illustrates some of the main features of the computation of the deemed payment.

Apportionment

Where a company has relevant engagements and other business which does not fall within the new rules, allowable expenses will have to be apportioned. Likewise, if a payment for a relevant engagement covers more than one worker, the payment can be apportioned between them on a 'just and reasonable' basis.

Other taxes

Corporation Tax is computed in the normal way, including the deemed salary and associated employers' NICs as allowable expenses. VAT operates regardless of any IR35 adjustments.

Dividends and other payments

Nothing in the legislation prevents a service company from paying money to the worker or others in the form of dividends, or retaining cash in the company. It will simply mean that an extra payment of PAYE tax and NICs will be calculated on 5 April. Dividends which are reclassified as deemed salary are relieved from tax so the PAYE takes priority, thus preventing double taxation of the payment.

Amending contracts

Workers who think they may be caught by IR35 should consider their position carefully, and should seriously think about renegotiating contracts so that they are no longer relevant engagements. Particular items to cover are:

- Getting away from payment at hourly rates
- Ensuring that the client will accept a capable substitute worker
- Creating freedom in the way the work is carried out

It is, of course, essential that the contracts should actually operate within the scope of the written terms.

You should also be aware that if you find work through an agency, that the contract between the agency and their client (your ultimate client) will affect your status for IR35 purposes. Cases have been lost where the contract with the agency satisfies the requirements to be outside IR35, but the contract between the agency and the end user client does not. It is also possible that verbal evidence given by the end user client could undermine terms in your contract which put you outside IR35.

Example

Mr E works through a service company, E Ltd, in which he owns all the shares. The company receives £20,000 during the year for contracts which fall within the IR35 rules (relevant engagements), and £10,000 for contracts which are outside the IR35 rules. E Ltd pays Mr E a salary of £10,000 in the year, in accordance with the normal PAYE rules. E Ltd also pays pension contributions of £2000 to a registered scheme. £500 of travel costs relate to the relevant engagements. The company has £5,000 of other business expenses, all allowable for corporation tax purposes.

At the end of the tax year E Ltd has to calculate the amount of PAYE and NICs due on Mr E's relevant earnings. If they have not actually paid enough PAYE and NICs during the year, then further PAYE and NICs will be payable on a 'deemed payment' on the last day of the tax year.

Item	**Relevant Contracts**	**Other Contracts**	**For Corporation Tax**
	£	£	£
Income	20,000	10,000	30,000
Less : Expenses	(500)	(5,000)	(5,500)
Salary paid in year	(10,000)		(10,000)
Employers NICs on this	(217)		(217)
Pension contributions	(2,000)		(2,000)
Flat rate 5% expenses	(1,000)		
Balance	**6,283**		**12,283**
Treated as:			
Deemed payment	5,521		(5,521)

Employers NICs on this	**762**	(762)
Corporation tax profit		**6,000**

Off-payroll working in the public sector

Contractors working through their own limited companies for the public sector can no longer decide whether they are caught by IR35 or not, as the public sector employer (or the agency) is required to put the payments to the company through the payroll and account for PAYE and NIC (employee contributions) on them. The agency is liable for the employer rate of NIC on the payments.

This results in a number of complications for the adviser to the company.

VAT

The company will receive part payment of invoices issued, because tax and NICs have been deducted. However, these are calculated on the net of VAT amount of the invoice, and the VAT is paid in full. It is important that when making VAT returns the full amount ogf the VAT is accounted for, and that the deductions are not treated as a 'bad debt' for VAT purposes. This would cause an underpayment of VAT, with penalties a likely consequence.

The worker's tax return

At the end of each tax year the worker will be provided with a form P60 by the party making the payments. This income (the gross amount of any deemed payment) plus the relevant tax deducted must be shown on the worker's self-assessment return as employment income, naming the payer as the employer.

The company

Any income received by the company which has been subject to PAYE is not liable to corporation tax, and so will be deducted in arriving at the taxable profits. If all of the company's income relates to public sector contracts classed as deemed employments, this means that the corporation tax profits will be nil. If there are expenses in the company, these may not be used to create a corporation tax loss - they are just met out of post taxed income.

Detailed guidance is available from HMRC - search for "off-payroll working".