



**Safehands
Accounting
Ltd**



KEY GUIDE

Working through personal service companies



When the tax avoidance rules apply

The personal service company tax avoidance rules prevent you from saving income tax and national insurance contributions (NICs) by interposing a limited company between you and your 'employer' (or client). The rules (known as the 'IR35 rules' after the number of the press release in which they were first announced) were introduced in April 2000, and only come into play where you would be treated as an employee if you worked directly for the client under the same terms.

When are you treated as an employee?

The rules are applied on a per contract basis, so for each contract (or engagement) that you undertake, you need to decide whether you are effectively working on an employed or on a self-employed basis – IR35 will not apply if you are working on a self-employed basis. The following questions are a basic starting point in making this decision:

- Do you have to do the work yourself or can you hire someone to do the work for you or engage helpers at your own expense? The requirement for you to provide a suitably qualified or skilled substitute in your absence is a strong indicator of self-employment, although less so if the client has the right to reject your substitute, if substitution does not actually take place or if the substitute is paid by the client.
- Can the client tell you at any time what to do, when to work or how to do the work? This would be an indicator of employment.
- Do you work a set amount of hours, or a given number of hours each week or month? This indicates employment.
- Do you work at the client's premises? This indicates employment.
- Are you paid by the hour, week, or month (indicates employment) or have you agreed to work for a fixed price regardless of how long the contract takes (indicates self-employment)?
- Do you generally work for one client at a time, rather than having a number of contracts? If you have many different clients then this is a good indicator of self-employment.
- Can you make a loss on the contract? For example, you might quote a fixed contract price and therefore take a risk that the job overruns or that you have to correct unsatisfactory work in your own time and at your own expense. This is a strong indicator of self-employment.
- Do you provide the main items of equipment for you to do the job – not just the small tools that many employees provide for themselves? If, for example, you work exclusively from home and use your own computer equipment, then this is a strong indicator of self-employment.



Action point

There are a number of questions you should ask yourself when deciding whether you are effectively working on an employed or on a self-employed basis.

Company qualifying conditions

IR35 only applies if your company meets certain conditions:

- You or your family controls more than 5% of the company's ordinary share capital, or
- You or your family is entitled to receive more than 5% of any dividends paid by the company.

For these conditions, 'family' includes an unmarried partner.

Why the IR35 rules were introduced

If you work on terms that amount to employment, then your employer must deduct income tax and NICs from your pay under PAYE. Only if you are genuinely self-employed can you be paid gross.

Prior to the introduction of the IR35 rules, someone could circumvent these tax requirements by setting up an intermediary company that would contract with the client to provide services. The client could then pay the company gross, with the profits being withdrawn from the company mainly by way of dividends which are not subject to NICs. Despite the tax cost of withdrawing profits by way of dividends substantially increasing from 6 April 2016 (the rate of tax on dividends, in excess of a tax-free allowance of £5,000, has increased by 7.5% compared to the rates for 2015/16), this approach can still be beneficial when compared to being taxed as an employee. However, the tax increase has removed much of the tax advantage of operating via a personal service company.

- Companies have greater scope for deducting expenses compared to employees.
- Higher rates of income tax can be avoided by retaining profits within the company.
- Dividends can be shared with a spouse.



Action point

Carefully review the terms of each new contract before acceptance. However, it is not a matter of adding up the various factors pointing towards either employment or self-employment, but the overall nature of the contract that must be considered. Not all the factors carry equal weight, and their importance may vary from one contract to another.

How the rules work

You can still work through a company, and the company can receive gross payments from the client. There are no IR35 implications where profits are then withdrawn as remuneration, but the rules prevent any tax saving either through paying dividends or by leaving money in the company. This is done by imposing PAYE on all the income that your company receives in respect of contracts caught by IR35, subject to certain deductions. The deductions are:

- Your actual gross salary, any taxable benefits, plus the related employer NICs. The salary and benefits will have already been subject to PAYE. Only employer NICs actually paid are taken into account, so the relevant figure will be after deducting the annual £3,000 employment allowance should this be available. However, the employment allowance is not available if you, as a director, are the company's sole employee.
- The company's contributions to an approved pension scheme.
- A flat rate expense allowance (calculated as 5% of income) to cover administrative costs. You can also claim for direct costs such as computer costs, subsistence, training and payments to sub-contractors. Although you can claim for business travel, any deduction is likely to be somewhat limited given that business travel does not include home to client travel and subsistence.

The balance of the IR35 income remaining after the permitted deductions is deemed to be your salary. It is treated as paid on 5 April at the end of the tax year, and this is also the deadline for submitting details to HM Revenue & Customs (HMRC) under the real time reporting requirements. The company's NICs, your NICs and the PAYE on the deemed salary have to be paid to HMRC by 22 April following the tax year (or the 19th if you do not pay electronically). The £3,000 employment allowance cannot be claimed in respect of NICs payable on a deemed salary.

You have to make the calculation based on the tax year, regardless of your company's accounting date.

The gross amount of deemed salary is treated as your employment income for all tax purposes. You will therefore have to include it on your tax return, which might result in other income being taxed at higher rates than would otherwise be the case.

Your company's tax position

Your company will pay corporation tax on its profits in the usual way – with one difference. In calculating taxable profits, the company can deduct the deemed salary and associated employer NICs. The deduction is made in the accounting period in which the deemed payment date falls. If your company's accounting date is not 5 April (or 30 April), this can result in taxable profits in some periods with losses being made in other periods.



Action point

Make sure that your company records are up to date because the reporting and tax payment requirements permit very little leeway.

How to avoid the double charge to tax

If the deemed salary is subsequently taken as salary in a later tax year, then this will result in a double charge to tax because the actual salary then taken will itself be subject to PAYE and NICs. There are two ways of avoiding this double charge:

- The deemed salary could instead be paid as a dividend. A claim can then be made to reduce the dividend by the amount of the deemed salary – effectively making the dividend exempt from tax. The deemed salary is treated as relevant earnings for pension purposes, so this approach will not preclude investment in pensions schemes.
- You could pay yourself sufficient actual salary to avoid the IR35 charge arising in the first place. The problem with this approach is establishing the exact amount that needs to be taken before 5 April, and invariably some amount of income will still be subject to IR35.

There is of course no requirement to withdraw the deemed salary, and it could simply be retained in your company without any further tax implications.

Example – Income caught under the IR35 rules

During 2016/17, Peter will receive income of £75,000 under a contract caught under the IR35 rules. Peter works through a personal service company, Peter Smith Ltd, and he is the sole shareholder and director. There are no other employees. The company prepares accounts to 5 April 2017, and during 2016/17 Peter will draw a gross salary of £25,000 that will be subject to PAYE. He will also have taxable benefits worth £1,500, and the company will pay pension contributions of £3,600 on his behalf. Employer's NICs in respect of the salary and benefits will be £2,538 (with Peter as the company's sole employee, the employment allowance is not available).

- The income subject to the IR35 rules is £75,000.
- The actual gross salary of £25,000, taxable benefits of £1,500 and associated employer's NICs of £2,538 are deducted from this figure.
- The pension contributions of £3,600 can also be deducted.

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- A 5% flat rate expense allowance of £3,750 (£75,000 at 5%) is given.
- The remaining balance is £38,612 (£75,000 – £25,000 – £1,500 – £2,538 – £3,600 – £3,750).
- Employer's NICs on this amount are £4,682 (£38,612 x 13.8/113.8).
- Peter's deemed gross salary, treated as paid on 5 April 2017, will be £33,930 (£38,612 – £4,682), and this will be subject to PAYE and employee NICs. Details must be reported to HMRC by 5 April 2017, and the PAYE and NICs (both employee and employer's) will be payable by 22 April 2017 (19th if not paid electronically).
- Peter Smith Ltd will deduct the deemed salary of £33,930 and the associated NICs of £4,682 when calculating its taxable profits for the year ended 5 April 2017.
- Peter could have avoided the implications of IR35 by taking additional gross salary of £35,930 during 2016/17.

Timing issues

The deemed salary under the IR35 rules is treated as paid on 5 April, and this is the date that your company can claim it as a deduction when calculating its corporation tax liability. However, many companies will have a 31 March year end to tie in with the financial year, and such a year end will result in complex timing problems.



Action point

Consider how you will withdraw income from your company. If you are going to take sufficient salary to eliminate all, or most, of the IR35 charge, then this will need careful planning throughout the tax year.

Example – IR35 timing issues

Continuing with the previous example, assume that Peter's company instead has a 31 March year end. The deemed salary of £35,687 that is treated as paid on 5 April 2016 will now fall into the year ended 31 March 2017. For the year ended

31 March 2016, the company will only be able to deduct the actual salary of £25,000 and the other expenses paid during the year – meaning a large corporation tax bill in addition to the tax and NICs payable on the deemed salary.

An accounting date of 5 April (or maybe 30 April) avoids this problem.

Another issue is that IR35 only applies to client payments that have actually been received during the tax year, whereas for accounting and corporation tax purposes your company's income will be calculated on an accruals basis – that is, including income invoiced before the year end but not paid until later. Although this works in your favour because it means unpaid income is not included when calculating the deemed salary, it does make your record keeping that much more complicated.

Business entity tests

HMRC introduced some voluntary business entity tests (BETs) three years ago with the aim of giving businesses some idea of where they stood risk-wise in relation to IR35. However, the tests were heavily criticised, and HMRC withdrew them from 6 April 2015. There are no plans for any type of replacement.

The BETs consisted of 12 weighted questions and scores, with a low score indicating a high risk of being subject to an HMRC IR35 enquiry. The problem was that many of the BETs were not particularly realistic.

HMRC no longer takes the BETs into account if they open an IR35 enquiry. However, if you have previously managed to use the BETs to close an enquiry, HMRC will not open another enquiry for a further three years provided there is no change in your circumstances.

Some other points

The scope of the personal service company rules has been extended several times.

- Domestic services provided to an individual rather than a business, such as nannies and butlers, are within the rules – originally they were excluded.
- Office holders are also within the scope of the IR35 rules.
- You cannot escape the IR35 rules merely by setting up an offshore company, and the rules apply regardless of where your client is based. However, if you are working full-time overseas you may be treated as non-UK resident, and if that is the case your employment income will not be subject to UK tax.
- The fact that your company is paid by an employment agency, rather than directly by the client, does not affect the operation of the IR35 rules.
- Although this guide deals with companies, the IR35 rules apply equally where a partnership is used as an intermediary between yourself and the client.



Action point

If you have recently started working through a company and there is any chance whatsoever of IR35 applying, then ensure that your company's year end is not going to result in timing issues. Although there is scope for changing a year end retrospectively, such a change is not always possible.

Tax planning and pitfalls

IR35 planning generally means having an IR35 friendly contract that establishes a self-employed relationship. However, your actual day-to-day working practices must match those stated in the contract, e.g. there is little point having a substitution clause if it is never made use of. Under no circumstances should the contract mention you personally by name – the contract must be solely with your company. The contract will not be IR35 friendly if it prohibits you from taking on other work at the same time.

Be careful of your client asking you to stop working on your current assignment and to start working on something else. This suggests client control, and is a strong indicator of employment.

Similarly, be wary of completing any tasks requested by the client that are not covered in the contract. Also, be careful when it comes to being named on the client's organisation chart, having a client email address or network privileges, and having the client's business cards.

Taking time off for holidays and sick leave should be managed carefully, so that it does not seem as if you are asking the client's permission. And although it might be tempting, the client should not be paying for your training and nor should you be eating in the client's staff canteen.

It is good practice to have written confirmation of your actual working arrangements from each client. With such confirmation of arrangements, it is more likely that any HMRC IR35 enquiry can be quickly concluded. Typically, the client will be asked to

confirm that you are able to provide a substitute, that you do not work under the direct control and supervision of the client, and that your services are provided in the style of a self-employed consultant.

HMRC offer a contract review service, but it only covers existing contracts, a considerable amount of information has to be submitted, and there is always the risk that a review could lead to an enquiry.

Where there is any risk of being caught under the IR35 rules, then one way in which you can protect yourself is by taking out IR35 insurance. Policies vary, so make sure your costs are covered should any case go to appeal and also that any extra tax liabilities and NICs will be covered if the decision goes against you.

And if it looks like it is impossible to avoid the implications of IR35, then maybe you should consider actually working for the client as an employee – you may receive lower pay, but you will be entitled to all of the associated employment rights.

The future – public sector engagements

Following a review of the IR35 rules, the government is going to reform the way in which IR35 applies to public sector engagements from 6 April 2017. The change will move the liability to pay the correct employment taxes from the personal service company to the public sector body or employment agency.

The responsibility for deciding whether IR35 applies will lie with the public sector body or agency, and HMRC will introduce a new online employment status service to make the decision making as simple as possible and to provide certainty. If a contract falls under IR35, then the public sector body or agency will effectively treat you as an employee (despite the use of an intermediary company), apply PAYE and NICs to payments made to you, and report details to HMRC under the real time reporting requirements. The flat rate 5% expense allowance will not be available where IR35 applies to public sector engagements. This change is extremely unpopular, with many affected businesses planning either to no longer work in the public sector or to increase fees to cover the additional tax cost.

The public sector definition covers government departments, legislative bodies, the armed forces, local government, the NHS, schools and further and higher education institutions, the police and various other public bodies and publically owned companies.

Fortunately, the rules are to remain as they currently are if you work in the private sector, although a future similar change is a distinct possibility.

How we can help

We can help you to decide whether your engagement falls within the personal service company rules, or help you to ensure that it does not.

We can advise you whether and when to make actual salary payments. At the end of



Action point

If you are working through an employment agency, then you must make sure that any contract between the agency and the client is the same as the contract between your company and the agency.

the tax year we can calculate what tax and NICs you might have to pay on any deemed salary, help you to pay these on time and complete all necessary tax forms. We can also steer you through the more complex areas, such as overseas issues.

Our aim is to relieve you of all your tax worries, so that you can concentrate on doing your job.

This publication is for general information only and is not intended to be advice to any specific person. You are recommended to seek competent professional advice before taking or refraining from taking any action on the basis of the contents of this publication. This publication represents our understanding of law and HM Revenue & Customs practice as at 11 January 2017.



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