CHARTERED ACCOUNTANTS

KEY GUIDE

Working through personal service companies

When the IR35 tax avoidance rules apply

Last year the IR35 rules applying to public sector engagements were reformed, and the results were very unpopular. Following an announcement in the November 2017 Budget, these reforms could soon be extended to the private sector, making it essential for contractors to be clear about their employment status.

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 take effect 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 if 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. To start making this decision you need to ask yourself the following questions:

- 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 number 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 (indicating employment) or have you agreed to work for a fixed price regardless of how long the contract takes (indicating self-employment)?
- Do you generally work for one client at a time, rather than having multiple simultaneous contracts? Having many different clients 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.

Planning point

There are several questions you should ask yourself when deciding if you are effectively working on an employed or 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

- 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, your employer must deduct income tax and NICs from your pay under PAYE. You can only be paid gross if you are genuinely self-employed.

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 in recent years, this approach can still be beneficial when compared to being taxed as an employee. However, the tax increases have removed much of the tax advantage of operating via a personal service company.

Other tax savings are possible because:

- Companies can deduct more expenses than employees.
- Higher rates of income tax can be avoided by retaining profits within the company.
- Dividends can be shared with a spouse.

Planning point

Carefully review the terms of each new contract before acceptance. It is not just 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.

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 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 already have been subject to PAYE. Only employer NICs actually paid are taken into account, so the annual allowance of £3,000 will be deducted from the employer NICs, should this be available. Note, however, that 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 your deemed salary. 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. This means you must include it on your tax return, which might result in other income being taxed at higher rates than would otherwise be the case.

Detail	Deadline
Deemed salary	Treated as paid on 5 April – the end of the tax year.
Submitting details to HM Revenue & Customs (HMRC) under the real-time reporting requirements.	5 April – the end of the tax year.
Payment of the company's NICs, your NICs and the PAYE on the deemed salary to HMRC.	22 April for the previous tax year (19 April if you do not pay electronically).

Planning point

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

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.

How to avoid the double charge to tax

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

- The deemed salary could 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. It could simply be retained in your company without any further tax implications.

Example – Income caught under the IR35 rules

During 2018/19, 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 2019, and during 2018/19 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 £2,494 (with Peter as the company's sole employee, the employment allowance is not available).

- The income subject to the IR35 rules is £75,000.

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- The actual gross salary of £25,000, taxable benefits of £1,500 and associated employer's NICs of £2,494 are deducted from this figure.
- The pension contributions of £3,600 can also be deducted.
- A 5% flat rate expense allowance of £3,750 (£75,000 at 5%) is given.
- The remaining balance is £38,656 (£75,000 – £25,000 – £1,500 – £2,494 – £3,600 – £3,750).
- The balance of £38,656 is inclusive of employer's NICs at 13.8%, so the NICs on this amount are £4,688 (£38,656 x 13.8/113.8).
- Peter's deemed gross salary, treated as paid on 5 April 2019, will be £33,968 (£38,656 – £4,688), and this will be subject to PAYE and employee NICs. Details must be reported to HMRC by 5 April 2019, and the PAYE and NICs (both employee and employer's) will be payable by 22 April 2019 (19 April 2019 if not paid electronically).
- Peter Smith Ltd will deduct the deemed salary of £33,968 and the associated NICs of £4,688 when calculating its taxable profits for the year ended 5 April 2019.
- Peter could have avoided the implications of IR35 by taking additional gross salary of £33,968 during 2018/19.

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.

Planning 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, this will need careful planning throughout the year.

Example – IR35 timing issues

Assume that Peter's company instead has a 31 March year end. The deemed salary of £33,968 treated as paid on 5 April 2019 will now fall into the year ended 31 March 2020. For the year ended 31 March 2019, 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 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 more complicated.

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 within the scope of the IR35 rules.
- Offshore companies do not escape the IR35 rules, 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.
- A company paid by an employment agency, rather than directly by the client, does not escape the operation of the IR35 rules.
- Although this guide deals with companies, the IR35 rules apply equally to partnerships used as an intermediary between a business and the client.

Tax planning and pitfalls

The employment contract

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.

Signs of employment

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.

Planning 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 will not result in timing issues. Although there is scope for changing a year end retrospectively, such a change is not always possible.

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 nor should you be eating in the client's staff canteen.

Written confirmation

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.

CEST tool

You can check the IR35 status of an existing or future engagement using HMRC's check employment status for tax service (CEST) – www.gov.uk/guidance/check-employment-status-for-tax – and HMRC will stand by the result provided the information submitted is accurate.

Unfortunately, more complex cases are likely to give the result, "We're unable to determine the tax status of this engagement", which is not exactly reassuring.

Where the outcome of the status check is unclear, HMRC does offer a contract

review service. However, this 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.

Insurance

Where there is any risk of being caught under the IR35 rules, one way 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 that any extra tax liabilities and NICs will be covered if the decision goes against you.

If IR35 cannot be avoided

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

Recent IR35 cases

As a warning of how costly it can be to get IR35 wrong, HMRC won its first IR35 case in nine years against a BBC presenter in February 2018, landing the presenter's company with a tax bill of nearly £420,000. It didn't help that the presenter had a seven-year contract with the BBC and was required to work for them 225 days each year.

Planning point

If you are working through an employment agency, 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.

However, three other recent decisions have gone the way of taxpayers. These decisions have done nothing to clarify the complex IR35 rules, but have highlighted the shortcomings of HMRC's CEST tool. One common thread running throughout the decisions is that none of the clients, despite HMRC's assertions to the contrary, were considered to be controlled by the client in the same manner that employees were.

Public sector engagements

The government has reformed the way IR35 applies to public sector engagements. The change has moved 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 also lies with the public sector body. HMRC's CEST tool should, in theory, make the decision-making as simple as possible and provide certainty. However, as already mentioned, the CEST tool struggles with more complex cases, and there are reports of public sector bodies ignoring the results. It is no surprise that public sector bodies prefer to take a risk-adverse approach and IR35 status may even be set even before a contract is advertised.

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 is not available where IR35 applies to public sector engagements.

Even though a public sector contractor can be taxed as an employee, their employment status does not change and they do not receive the rights and benefits that go with employment. Not surprisingly, the change has been extremely unpopular, with many affected businesses deciding to either no longer work in the public sector or to increase fees to cover the additional tax cost. One survey has indicated that nearly 80% of government IT projects are suffering delays due to contractors leaving over the IR35 tax reform.

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.

Extension to the private sector

The government has launched a consultation to examine whether the public sector reforms should be extended to the private sector.

The timing of the consultation means potential changes could be introduced from April 2019, although, given the complexity of the issues involved, a later date is more likely.

With the prospect of further IR35 reform, it is more important than ever to maintain dialogue between contractors and clients regarding IR35 status and working arrangements.

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 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.

Planning point

If you are working through an employment agency, 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.

This publication is for general information 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 20 June 2018.

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