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Personal Service Companies

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

The proposals targeted 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 was a limited company, the worker was able to take money out in the form of dividends instead of salary. Dividends are not liable to NICs so the worker would pay less in NICs than either a conventional employee or a self-employed person.

Scope of the Rules

The 'IR35' rules apply where a worker provides services under a contract which would have been a contract of employment if the worker had been working direct for the client (*relevant contract*). There is no statutory definition of employment or self employment, so case law still applies in deciding employment status (see our title *Employed or Self Employed?*)

A company is not within the provisions if the worker (together with his close family) does not control more than 5% of the dividends unless he or she receives payments or benefits which are not taxable under Schedule E.

A partnership is within the provisions if the worker (together with his close family) is entitled to 60% or more of the partnership profits, or where most of the partnership profits come from work for a single client, or where a partner's profit share is based on his income from relevant engagements.

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 return P35 by 19 May. It is evident that there is very little time to process the calculations, and HM Revenue & Customs have indicated that they will not penalise the use of provisional payments and calculations in order to meet the deadlines.

The deductions cover expenses that would normally be available to direct employees, contributions to approved pension schemes and the actual salary and employers NIC plus the employer's NIC on the deemed salary. Also allowed is a 5% flat rate deduction to cover the company's running costs. The example on the next page 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.

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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 subject to the new proposals 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.

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.

Under the IR35 rules, at the end of the tax year E Ltd has to calculate the amount of PAYE and NICs due on Mr E's 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.

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Item	Relevant Engagements £	Other Engagements £	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	(404)		(404)
Pension contributions	(2,000)		(2,000)
Flat Rate 5% expenses	(1,000)		
Shortfall	6,096		
Apportioned as:			
Deemed Payment	**5,357**		(5,357)
Employers NICs on this	**739**		(739)
Corporation Tax Profit			**6,000**

Please note that from 6 April 2007, legislation created Managed Services Companies (MSCs) as a special type of Personal Service Companies. Please see our separate factsheet for details of the more rigorous rules that apply to MSCs.