



# Corporate and business tax

# IR35 Personal Service Companies

The 'IR35' rules are designed to prevent the avoidance of tax and national insurance contributions (NICs) through the use of personal service companies and partnerships.

The rules do not stop individuals selling their services through either their own personal companies or a partnership. However, they do seek to remove any possible tax advantages from doing so.

## Summary of Approach

### Removal of tax advantages

The tax advantages mainly arise by extracting the net taxable profits of the company by way of dividend. This avoids any NICs which would generally have been due if that profit had been extracted by way of remuneration or bonus.

The intention of the rules is to tax most of the income of the company as if it were salary of the person doing the work.

### To whom does it apply?

The rules apply if, had the individual sold his/her services directly rather than through a company (or partnership), he/she would have been classed (by the Revenue) as employed rather than self-employed.

For example, an individual operating through a personal service company but with only one customer for whom he/she effectively works full-time is likely to be caught by the rules. On the other hand, an individual providing similar services to many customers is far less likely to be affected.

### Planning consequences

The main points to consider if you are caught by the legislation are:

- the broad effect of the legislation will be to charge the income of the company to NICs and income tax, at personal tax rates rather than corporate tax rates
- there may be little difference to your net income whether you operate as a company or as an individual
- to the extent you have a choice in the matter, do you want to continue to operate through a company?
- if the client requires you to continue as a limited company, can you negotiate with the client for increased fees?
- if you continue as a limited company you need to look at the future company income and expenses to ensure that you will not suffer more taxation than you need to.

The last point is considered in more detail below.

### Employment v self-employment

One of the major issues under the rules is to establish whether particular relationships or contracts are caught. This is because the dividing line between employment and self-employment has always been a fine one.

All of the factors will be considered, but overall it is the intention and reality of the relationship that matters.

The table below sets out the factors which are relevant to the decision.

The Revenue will consider the following to decide whether a contract is caught under the new rules	
Substitution	the individual can do the job himself or send a substitute?
Control	the customer has control over tasks undertaken /hours worked etc?
Equipment	the customer provides all of the necessary equipment?
Financial risk	the company (or partnership) bears financial risk?
Basis of payment	the company (or partnership) is paid a fixed sum for a particular job?
Benefits	the individual is entitled to sick pay, holiday pay, expenses etc?
Personal factors	the individual works for a number of different customers and the company (or partnership) obtains new work in a business-like way?

### Exceptions to the rules

If a company has employees who do not have 5% of the shares in their employer company, the rules will not be applied to the income that they generate for the company.

Note however that in establishing whether the 5% test is met, any shares held by 'associates' must be included.

### How the rules operate

The company operates PAYE & NICs on actual payments of salary to the individual during the year in the normal way.

If, at the end of the tax year - ie 5 April, the individual's salary from the company, including benefits in kind, amounts to less than the company's income from all of the contracts to which the rules apply, then the difference (net of allowable expenses) is deemed to have been paid to the individual as salary on 5 April and PAYE/NICs are due.



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## Allowable expenses:

- normal Schedule E expenses (eg travel)
- certain capital allowances
- employer pension contributions
- employers' NICs - both actually paid and due on any deemed salary
- 5% of the gross income to cover all other expenses.

Where salary is deemed in this way:

- appropriate deductions are allowed in arriving at corporation tax profits and
- no further tax/NICs are due if the individual subsequently withdraws the money from the company in a Revenue-approved manner (see below).

## Points to Consider from the Working of the Rules

### Income and expenses

The income included in the computation of the deemed payment on 5 April includes the actual receipts for the tax year.

The expenses are those incurred by the company between these two dates.

In order to perform the calculations, you need to have accurate information for the company's income and expenses for this period. You may need to keep separate records of the company expenses which will qualify as 'employee expenses'.

### Timing of corporation tax deduction for deemed payment

A deduction is given for the deemed payment against profits chargeable to corporation tax as if an expense was incurred on 5 April. This means that relief is given sooner where the accounting date is 5 April.

### Will the company make a taxable loss because of the legislation?

If a company's expenses are high the company may make a taxable loss. This can be relieved against other income or by carry back in the first year of the new rules, but can only be relieved by carry forward against future trading income after this.

If you consider that you may be in a similar position, you need to estimate the effect now. We can help you with the estimates if required.

One reason why the projected expenses will create a loss would be where the company pays a spouse a salary. The amount of the salary may need reviewing.

### Pension contributions

Payments made by your company into a personal pension plan will reduce the deemed payment. This can be attractive as the employer's NICs will be saved in addition to PAYE and perhaps employee's NICs.

## Other Points to Consider

### Extracting funds from the company

For income earned from contracts which are likely to be caught by the rules, the choices available to extract funds for living expenses include:

- paying a salary
- borrowing from the company and repaying the loan out of salary as 5 April approaches
- paying interim dividends.

The advantage of paying a salary is that the tax payments are spread throughout the year and not left as a large lump sum to pay on 19 April. The disadvantage is fairly obvious!

Borrowing from the company on a temporary basis may mean that no tax is paid when the loan is taken out, but it will result in tax and NICs on the notional interest on the loan. There may also be a need to make a payment to the Revenue equal to 25% of the loan under the 'loans to participators' rules.

The payment of dividends may be the most attractive route. If a deemed payment is treated as made in a tax year, but the company has already paid the same amount to you or another shareholder during the year as a dividend, you will be allowed to make a claim for the tax on the dividend to be relieved to avoid double taxation.

The company must submit a claim identifying the dividends which are to be relieved.



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## Example of payment of dividend

Mr Arthur owns 100% of the share capital of Arthur Ltd. All the income of the company is caught by the IR35 rules. Accounts are prepared to 5 April 2004. An interim dividend of £20,000 is paid on 30 September 2003. The deemed payment on 5 April 2004 is £80,000.

There is no immediate tax cost of the dividends being paid out either to the company or to the shareholder.

The company will pay tax and NI on the deemed payment of £80,000 in the normal way ie on 19 April 2004.

The company can make a claim for the £20,000 dividend not to be treated as a dividend for tax purposes in Mr Arthur's hands. Nor will it be treated as a dividend for the purposes of the new '19% regime' applying in small companies.

## Getting ready for 5 April

There is a tight deadline for the calculation of the deemed payment and paying the Revenue. The key dates are:

- the deemed payment is treated as if an actual payment had been made by the company on 5 April
- tax and NICs have to be paid to the Revenue by 19 April
- form P35 showing details of the deemed payment has to be submitted to the Revenue by 19 May.

The Revenue has announced relaxations from the strict requirements above allowing provisional figures to be calculated and submitted. However, interest on overdue tax is chargeable from 19 April if tax and NICs are underpaid on the basis of provisional figures.

It is therefore in your interests to have accurate information on the company's income and expenses on a tax year basis and, in particular, separate records of the amount of the company expenses which will qualify as 'employee expenses'.

## Partnerships

Where individuals sell their services through a partnership, the rules are applied to any income arising which would have been taxed as employment income if the partnership had not existed.

In other words, where a partnership receives payment under an 'employment contract':

- income of the partnership from all such contracts in the year (net of allowable expenses as described above) are deemed to have been paid to the individuals on 5 April as salary from a deemed employment with PAYE/ NICs due accordingly and
- any amount taxed in this way as if it were employment income is not then taxed as part of the partnership profits.

## Partnerships excluded from the rules

Many partnerships are not caught by the rules even if one or more of the partners performs work for a client which may have the qualities of an employment contract. The rules will only apply to partnerships where:

- an individual, (either alone or with one or more relatives), is entitled to 60% or more of the profits or
- all or most of the partnership's income comes from 'employment contracts' with a single customer or
- any of the partners' profit share is based on the amount of income from 'employment contracts'.

## Penalties

Where a personal service company or partnership fails to deduct and account for PAYE/NICs due under the rules, the normal penalty provisions apply.

If the company or partnership fails to pay, it will be possible for the tax and NICs due to be collected from the individual as happens in certain circumstances under existing PAYE and NIC legislation.

## How We Can Help

We can advise as to the best course of action in your own particular circumstances.

If IR35 does apply to you we can help with the necessary record keeping and calculations.