

HM

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KEY GUIDE

Working through personal service companies

Introduction

THREE DIFFERENT TAX TREATMENTS

If you work as a contractor, there are three different possible tax treatments which could apply to your engagements depending on your circumstances. For contracts not subject to the IR35 rules, whether working in the private or public sector, you will be in a position to withdraw profits on a very advantageous tax basis. However, if working in the private sector and a contract is caught under the IR35 rules, much of this tax advantage is lost. If working in the public sector and caught under IR35, then the public sector body or agency will effectively treat you as an employee, despite the use of your intermediary company.

From 6 April 2020, the government is planning to extend the public sector tax treatment to the private sector, although this will be subject to a small organisation exemption. Early in January, the Treasury announced that the latest changes will be reviewed prior to implementation, although there is some uncertainty over whether there is now sufficient time to make any major changes.

Contents



EMPLOYMENT STATUS

Key indicators to identify your employment status under IR35



TAX PLANNING AND PITFALLS

How to make sure you calculate your tax correctly under an IR35 engagement



HOW THE RULES WORK

What the rules mean for your earnings and contracts



PUBLIC AND PRIVATE SECTOR ENGAGEMENTS

Who is responsible for paying employment taxes and what that means



What is meant by IR35?

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 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.

TAX ADVANTAGES IF NOT SUBJECT TO IR35

Payments made to your company by the client will be made gross. You can then withdraw the profits from your company mainly by way of dividends, which are not subject to NICs. Even though the tax cost of withdrawing profits by way of dividends has substantially increased 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.

WHEN DO THE IR35 RULES APPLY?

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 make this decision start by asking 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, but 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, this is a strong indicator of self-employment.

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.

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.

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.

The CEST tool has, however, been criticised for providing inaccurate results. In response, HMRC has recently revamped

it, with round 30 questions updated or added so that there should now be a more accurate determination of a person's employment status.

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.

HOW THE IR35 RULES WORK FOR PRIVATE SECTOR ENGAGEMENTS

You 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 (expected to increase to £4,000 from April 2020) 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:

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- 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.

| 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 following the tax year (19 April 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. 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.

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.

Planning 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 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 a pension scheme.
- 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 2019/20, Peter receives an 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 2020, and during 2019/20 Peter draws a gross salary of £25,000 that is subject to PAYE. He also has taxable benefits worth £1,500, and the company pays pension contributions of £3,600 on his behalf. Employer's NICs in respect of the salary and benefits are £2,466 (with Peter as the company's sole employee, the employment allowance is not available).

continued on page 6



- 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 £2,466 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 £38,684 (£75,000 - £25,000 - £1,500 - £2,466 - £3,600 - £3,750).
- The balance of £38,684 is inclusive of employer's NICs at 13.8%, so the NICs on this amount are £4,691 (£38,684 x 13.8/113.8).
- Peter's deemed gross salary, treated as paid on 5 April 2020, will be £33,993 (£38,684 - £4,691), and this will be subject to PAYE and employee NICs. Details must be reported to HMRC by 5 April 2020, and the PAYE and NICs (both employee and employer's) will be payable by 22 April 2020 (19 April 2020 if not paid electronically).
- Peter Smith Ltd will deduct the deemed salary of £33,993 and the associated NICs of £4,691 when calculating its taxable profits for the year ended 5 April 2020.
- Peter could have avoided the implications of IR35 by taking additional gross salary of £33,993 during 2019/20.

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.

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.



EXAMPLE IR35 timing issues

Assume that Peter's company instead has a 31 March year end. The deemed salary of £33,993 treated as paid on 5 April 2020 will now fall into the year ended 31 March 2021. For the year ended 31 March 2020, 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.

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.

- 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.

Planning point

If you have recently started working through a company and there is any chance whatsoever of the IR35 private sector rules 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.

HOW THE IR35 RULES WORK FOR 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. The CEST tool has previously struggled with more complex cases, so it remains to be seen whether the recent revamp improves the situation.

The public sector reform has been extremely unpopular, with many affected businesses deciding to either no longer work in this sector or to increase fees to cover the additional tax cost.

Tax treatment

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.

Lack of employment rights

Even though a public sector contractor can be taxed as an employee, their employment status does not automatically change so that they become entitled to the rights and benefits that go with employment, such as holiday pay.

Public sector definition

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 publicly owned companies.

CHANGES FROM 6 APRIL 2020

Subject to the recently announced last minute review, the government intends to extend the public sector reform to engagements with medium and large-sized organisations in the private sector from 6 April 2020 and has already published draft legislation.

As for the public sector, the client will be responsible for determining IR35 status, with responsibility for paying the correct employment taxes moving from the personal service company to the business or employment agency engaging the contractor.

It will therefore be more important than ever for you to maintain dialogue with your clients regarding IR35 status and working arrangements.

Small organisations

The changes will not apply where services are supplied to small organisations, with the determination of 'small' based on the Companies Act definition. This will generally mean satisfying at least two of the following requirements:

- an annual turnover of not more than £10.2 million;
- a balance sheet total of not more than £5.1 million; or
- not more than 50 employees.

If contracting with a small organisation, you will continue to be responsible for determining IR35 status and will still receive gross payments from the client if IR35 treatment applies.

Will it be worthwhile retaining your company?

If all of your engagements are going to be subject to the new rules, you will have to decide whether it is worthwhile retaining your company given the ongoing costs involved. One option is joining what is known as an umbrella company. There will be no change to your tax treatment, but the umbrella company will take care of administration, such as dealing with HMRC and Companies House, and payroll. Your clients may even insist on the use of an umbrella company.

Planning point

With the changes coming in from 6 April 2020, you need to be careful that HMRC do not try to backdate an IR35 ruling if the same contract is currently treated as outside IR35. One possibility would be to move to a new contract now and treat this as within IR35, hopefully preventing any further backdating.

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.

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.

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. HMRC has lost some more recent cases, however, including one in November 2019.

**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.

We can help you plan ahead to establish the impact of the planned extension of IR35 reforms on your business. Our aim is to relieve you of all your tax worries so that you can concentrate on doing your job.



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