
Living with

*A Guide to*

# Living with IR35

**A Questions and Answers Guide to the IR35 rules impacting upon the provision of services via a Personal Services Company**

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# Contents

# The Rules and their Impact

## What is IR35?

‘IR35’ was the reference number given to an Revenue Budget Day press release (9th March 1999) which first announced the intention of the Government to introduce new rules affecting those who provide services via an intermediary, such as a personal service company.

## What is the history behind the IR35 proposals?

The 1999 Budget Day press release ‘IR35’ stated that the proposals were intended to catch ‘Friday to Monday’ workers. This means those who effectively left work on the ‘Friday’ as employees and returned to work on the following ‘Monday’ (or similar short time period) as self employed contractors operating under a more advantageous tax and NIC structure such as a limited company.

One of the main thrusts behind the proposals was to counter a perceived avoidance of NIC and PAYE. The fear was that those who set up personal service companies were opting to take out income in the form of dividends rather than salary, thus avoiding NIC. The Revenue argued that it was never the intention of the original press release to limit the impact of IR35 to just ‘Friday to Monday’ workers.

When put together with other tax losses, the Revenue came up with an overall figure for tax and NIC lost of £350 million although others have doubted the accuracy of these figures.

The Revenue did modify considerably its initial approach in September 1999 and these modifications formed the basis of what is now the Law. It also undertook a consultation process on the potential problem areas surrounding these rules and the draft guidance on the rules. Unfortunately, the actual policy decision as to whether or not to implement IR35 was not open to consultation.

## What is the impact of IR35?

The rules impact on anyone who provides relevant services through an intermediary, such as a company or a partnership. The rules, therefore, affect an individual 'worker' who has what are termed 'relevant engagements' whereby he or she provides services personally through an 'intermediary'. Anyone caught by these rules will have to perform a calculation for each tax year in which there were such engagements, which will result in additional PAYE and NI if sufficient salary has not been paid to the worker during the tax year.

If that calculation shows that there is a deemed payment due, this will be treated as if it had been paid to the worker at the end of that tax year i.e. 5 April. PAYE and NIC would apply to the 'deemed payment'. However, there are some accelerating events, which mean that calculations are done sooner than the end of the tax year, 5th April.

## Do I have to apply the rules?

Yes, if someone is within these rules. Failure to comply would result in the Revenue, upon discovery, seeking to collect any unpaid PAYE and NIC together with interest. They could also charge penalties if there is fraudulent or negligent conduct.

# Who is caught by these rules

## Who is caught by IR35?

Anyone supplying his or her services to clients through an intermediary, such as a service company or partnership, could be caught by IR35.

IR35 applies to engagements where:

a *worker* provides services under a contract between a *client* and an *intermediary*; and but for the presence of the intermediary, the income would have been a salary payment to the worker. i.e. He would have been an employee of the *client*.

This means these rules are aiming to catch those workers who the Revenue believes are effectively employees if it was not for the intermediary. This means an 'Employee' vs. 'Self Employed' test will have to be applied to see who is caught by these rules.

The rules do *not* apply if you are providing services to individuals who are not in business (e.g. services to a householder should not be affected, such as a householder engaging a plumber to fix the kitchen sink). This means it will be necessary for the intermediary to divide receipts from clients between those in business and those from individuals in a personal capacity. Only the former may be subject to IR35.

The rules do not apply where the worker only received income from an intermediary in a form that already falls within Schedule E and Class 1 NIC, as there will be no further tax to pay.

## What if the intermediary is a company?

The IR35 rules will apply to an intermediary company if both the following two tests are met:

a) the intermediary is not an associated company of the client by reason of them both being under the control of the worker (or of the worker and another person); *and*

b) *Either:*

- the worker has a material interest in the intermediary; *or*
- he receives payments or benefits directly from the intermediary which are not taxable, for income tax purposes, and can reasonably be taken to represent remuneration for services provided under a relevant engagement.

## What if the intermediary is a partnership?

The IR35 rules will apply if the intermediary is a partnership and one (or more) of the following three tests is met:

- the worker alone or with one or more relatives (spouse, partner or remoter forebear, child or remoter issue or brother or sister) is entitled to 60% or more of the partnership profits; or
- most of the profits derive from the provision of IR35 type services to a single client (or associates thereof); or
- under the profit sharing arrangements the income of any of the partners is based on the amount of income generated by the partner from the IR35 engagements

If the intermediary is a partnership but the worker is not a partner, but he or she receives a payment or benefit from the partnership that can reasonably be taken to represent remuneration for services provided by the worker to the client, then the provisions apply.

The 60% rule, mentioned above, was negotiated to allow genuine commercial arrangements to escape the remit of IR35. The 60% figure suggests effective control and where a person controls a partnership it was felt right to prove he was not caught by the rules.

**Note:** the application of the IR35 rules cannot create a loss for a partnership.

## What if the intermediary is an individual?

The rules also catch intermediaries who are individuals and make payments to workers which are not salary but which represent earnings from a relevant engagement. This is meant to be an anti-avoidance provision to prevent tax avoidance schemes being set up which use individuals as intermediaries rather than companies or partnerships.

## What are the extended rules for NIC?

Certain occupations may be treated as 'employed' under NIC legislation, but treated as self employed under PAYE legislation. This means that NIC intermediary's legislation will apply, but not the PAYE intermediary legislation.

Occupations that may be affected are those engaged:

i. in an educational capacity e.g. teachers, lecturers,
ii. as cleaners e.g. office cleaners
iii. as entertainers
iv. as non-directors in a service company.

## Employment Status

### How will employment status under these rules be determined?

The key test as to whether a ‘worker’ is within or outside of IR35 will depend on whether that worker could be regarded as employed by the client, but for the intermediary.

Trying to distinguish between employed and self-employed has a long history; status cases have been a cause of disagreement for many years, not just for taxation purposes but also for employment law purposes.

If we go back to 1968 we see cases being decided on whether the individual provided their tools for the trade.

As time has moved on, so has the complexity of the relationship between employer and worker. Therefore other tests from the traditional badges of trade have been raised in importance.

As a guide, if you can answer ‘yes’ to the following questions then you MAY be subject to IR35 legislation, as you would be considered ‘employed’ by the client:

i. Do you work set hours in a given week or month?
ii. Do you receive sick, holiday or maternity/paternity pay?
iii. Are you paid by the hour, day, week or month?
iv. Do you get paid overtime?
v. Are you told what, when, where and how to work by your client?
vi. Does the client provide all the necessary equipment/tools required for the job?
vii. Do you work for one client at a time?

As a guide, if you can answer ‘yes’ to the following questions then you MAY be classed as self-employed, and not subject to IR35:

i. Do you decide where, when and how to perform the work?
ii. Are you paid a fixed amount for the job?
iii. Is the worker at financial risk in the project i.e. Can he make a loss as well as a profit?
iv. Do you correct any mistakes at your own time and cost?
v. Do you provide all the necessary equipment/tools required for the job?
vi. Can he make more money if he does the job well?
vii. Can you hire your own workers or provide substitutes for the job instead of doing the work y yourself? And pay them yourself?
viii. Do work with more than one client at a time?

Other vital ingredients to consider in order to establish whether a person is employed or self-employed are the intention of the parties and the length of the contract.

## Dividends

### How are dividends treated under IR35?

Once the deemed payment has had PAYE and Employees NI deducted, this leaves a net amount payable to the worker. If this amount is paid as a net salary then it will again incur further liabilities of PAYE and NI. This is because it will be paid after 5th April, when the payment should have been made.

To avoid this double taxation quandary, the net deemed payment could be paid as a dividend. This ensures no further PAYE or NI liability will arise when the dividend is paid. However, all dividends should be declared on the individual's personal tax return, but this could result in an additional tax liability, so again double tax. To rectify this, a claim can be made in writing to exclude dividends totaling the net deemed amount from the personal tax return and thereby avoiding any double taxation.

The Revenue can give such relief as it believes is just and reasonable and there is no effective right of appeal.

This is a strange rule in many respects as it is the worker who is potentially subject to double taxation in these cases and yet it is the intermediary who can make a claim for relief. The other unusual aspect is the fact that it is left to the Revenue to determine if some sort of relief is appropriate. However, to date, there have been few if any complications with the omission of the net deemed amount from the personal tax return if the total net deemed amount is taken as dividends.

Does the net deemed amount have to be paid?

No. The intermediary's legislation does not require that the net deemed amount is paid to the worker. The primary purpose of the deemed payment calculation is simply to calculate and collect the additional taxes due.

However, as you have paid the extra PAYE and NI on the deemed payment, and no further tax will be due if you draw the net amount as a dividend, then why would you not pay it? If there are insufficient funds available, then payment can wait until funds are available.

There is a strict order of set off, when the net deemed payment is paid as a dividend, as follows:

a) against relevant dividends of the same tax year before those of other years
b) against relevant dividends received by the worker before those of another person; and then
c) against relevant distributions of earlier years (after 5th April 2000) before those of latter years.

## Accelerating Events

### Are there any situations when deemed payments may arise earlier than the end of the tax year?

A deemed payment is treated as being made at an earlier time than 5 April when any of the following occur:

*For a company*

a) the worker ceases to be a member of the intermediary (e.g. disposes of shares);
b) the worker ceases to hold an office in the intermediary (e.g. director); or
c) the worker ceases to be an employee of the intermediary.

*For a partnership*

a) the partnership dissolves or ceases to trade; or
b) a worker who is a partner ceases to act as such.

In these cases the deemed payment will be brought forward to the date of the triggering event. An example is found below at question 37.

### How do accelerating events work in practice?

Let us take an example. Pat is a partner in a firm that has relevant engagements relating to Pat's client. Pat leaves the firm on 8 October 2006 to join that client as an employee. His deemed payment is brought forward to 7 October 2006 and PAYE and NIC due on it must be paid by 19th November 2006 or the normal PAYE penalties and interest will apply.

By concession penalties are not due on estimated deemed calculations made by the normal due date of 19 April – but this does not apply when the payment date is accelerated. Only actual calculations (rather than estimated) are acceptable. The logic is that the volume of calculations due by 19th April makes compliance difficult but one-off early payments are less problematic.

Note, however, there is no interest charge on late payment of PAYE or NIC until after 19th April following the end of the tax year and any penalties which will result will relate to incorrect P35s which are not due until 19th May after the year end. Therefore, in reality this should not prove to be too problematic.

Advanced payments do not affect the income or expenses to be taken into account. It just advances the payment date for PAYE although any calculation is likely to be estimated and completing P45s will be interesting! It is likely that these will have to be provisional and amended later.

## Impact on Corporation Tax and Income Tax Deductions

### How will the deduction be given for IR35 payments?

A deduction is given for corporation tax and a relief for income tax for the notional payment and related employer's NIC. This is given as a deduction in calculating the intermediary's business profits.

Any deduction in calculating the profits for corporation tax will be given in the period of account in which the deemed payment is prepared.

For example, assume a company has a 31st March 2011 year-end and makes a deemed payment at 5th April 2011 following its accounting period. The deduction will not be given for the deemed until the company's year-end to 31st March 2012.

If the deduction gives rise to a trading loss for a company, it should be dealt with like any other trading loss. Except for partnerships, the IR35 legislation merely taxes a deemed salary. Apart from allowing a deduction for that deemed salary, there is no effect on the service company's corporation tax computation. Expenses that are properly allowable as a corporate deduction are still allowable even though they cannot be taken into account in calculating the deemed salary.

Where there is a loss on IR35 type engagements (which will always occur if expenses that are deductible for corporation tax but not in calculating the deemed payment exceed the 5% allowance) that loss in effect exempts an equivalent amount of non-IR35 income from corporation tax. This is because the corporation tax profit is total income, less total expenses and less the deemed payment.

### Are there any possible solutions to the timing problems for companies?

The options available to circumvent this problem are:

i. The company could change its year-end to 5th April or later, so that the notional payment date falls into the period of account.
ii. The company could calculate a deemed payment on a monthly basis and pay it as an actual salary. This is the Revenue's preferred choice but may not be practical and sensible, especially if the company is concerned about its cash flow.
iii. The company could look to calculate the notional salary immediately before the year-end and make an actual salary payment of the equivalent amount, but again, this may not be practical.

## Pensions

### What about the use of pensions?

Planning should concentrate upon minimizing the amount of income, which falls within these rules.
For example, the employer could maximise contributions to a pension for the benefit of the worker.
Of course this is subject to overall investment considerations and Revenue limits.

This not only results in a payment made for the benefit of the worker, but it saves the company Employers NIC and the contribution can be deducted from the profits in its corporation tax computation.

### What can you do to mitigate against the impact of IR35?

*Pay salary over the year*

There are advantages to paying the relevant income out over the course of the fiscal year as salary.

When salary is paid during the year, there is no risk of having taxed earnings effectively ‘trapped’ within the company and being dependent on dividends to withdraw them.

The lower the deemed Schedule E amount, the lower the risk of a large interest charge arising because of a delay in preparing the deemed Schedule E calculation.

Where monthly payments are made, PAYE and NIC will be paid in the normal way.

There are cash flow disadvantages of following this route. A deemed payment means PAYE and NIC are only due at the end of the tax year. Could you live with the situation of withdrawing a small salary during the year and accepting a large deemed payment at the end? Also a company may need the money to spend on course fees or similar expenses that are not allowable in calculating the notional salary payment or they may need the funds to acquire equipment.

The operation of PAYE coding on a Week 1 or Month 1 basis can mitigate against some of these cash flow advantages.

*Restructure your contracts*

It may be possible to re-organise work in order to fall outside of the IR35 regime e.g. by ensuring any contracts undertaken are not ‘relevant contracts’. However, it is essential (as stated earlier) that any reorganisation can stand up to scrutiny by the Revenue and truly reflects the nature of the work being undertaken.

## Impact on Specific Taxpayers

### What about couples under IR35?

The legislation states that a man and woman living together as husband and wife are treated as if they are married for the purposes of IR35.

### How are foreign intermediaries affected?

Foreign intermediaries are deemed as UK resident where:

- the worker is UK resident;
- the services are provided in UK; and
- the client or employer carries on business in UK.

The worker is not chargeable to tax in respect of a notional salary payment if (or to the extent that) he would not be taxable under Schedule E on an actual payment by the client of emoluments from an actual employment with him, by reason of any combination of:

a) the worker being resident, ordinarily resident or domiciled outside the UK;
b) the client being resident or ordinary resident outside the UK; or
c) the services in question being provided outside the UK.

Importantly it is not possible to remit a notional amount to the UK. Therefore, if the worker is non-UK domiciled and the client is non-UK resident and the services are performed outside the UK, no tax charge will arise. This is the case even if the duties of the worker's real employment with the intermediary, for example with other clients, are partly carried out in the UK. Although no tax charge will arise, this does not prevent the notional salary arising. Therefore, it would appear that the intermediary might still be able to claim a deduction for the payment.

### How are the deemed payments treated for pension purposes?

A deemed payment is treated as relevant earnings for pensions and is entered on the workers P60 at the year-end.

## Other Issues

### What is the effect on VAT?

The VAT position will not be affected by these rules.

Fees chargeable by a service company for the provision of personal services will remain subject to VAT because it is the intermediary that is contracting to provide services to its clients, which is a supply under the VAT rules. VAT will be charged on supplies and input tax would be recoverable as normal.

### Is there a chance of joint and several liabilities?

The Revenue will only apply joint and several liabilities to the intermediary and worker undertaking the relevant engagement and not third parties. i.e. if the company fails to pay to the Revenue, any taxes due under the legislation, the company, and the worker can be pursued for the unpaid tax but not a third party such as an agency.

### How does IR35 fit in with agency legislation?

These proposals do not affect the agency legislation. Where the final intermediary in the chain is an employment agency and a worker works through that agency, the law will apply in the same way as it did before.

If a worker works through a service company or partnership and contracts with a client via an agency, the agency may pay fees etc on to the service company or partnership but the service company or partnership may be obliged to deduct PAYE and NIC on any income received from relevant engagements. Whether the engagements are caught by IR35 will depend on the usual tests and will not be affected by the presence of an agency in the relationship.

## Key Dates

### When are the rules first applicable?

The rules were first applied to the tax year 2000-2001.

### When will any tax due be payable?

The PAYE and NIC on the deemed payment will normally be due on 19 April after the tax year.

### What happens if you cannot calculate the tax due on time?

If the correct amount of PAYE and NIC is not paid by 19th April on the deemed payment, then interest will accrue until the liability has been paid. One possible option is to make an advance payment to the Revenue by 19th April to reduce any interest accruing. To make an advance payment, will depend upon each situation, but if you could estimate your deemed payment and make a payment to the Revenue based on this.

The Revenue will pay interest on refunds of overpaid PAYE and/or NI, but will charge interest on underpayments of tax running from 19 April. It is, therefore, advisable to prepare as good an estimate as possible by that date.

The deemed payment needs to be included on the employees P60 at the year-end, and subsequently reported on the P35 – Employers Annual Return. As the P35 does not need to be submitted until 19th May, this should provide ample time to correctly calculate the deemed payment and submit complete returns to the Revenue.

## The Calculation

### How do I calculate the deemed payment?

The deemed payment is calculated on a cash received basis. Regardless of when the income was earned, the calculation is based on when the income was received.

### What are the steps of the calculation?

A simplified calculation is as follows:

| | | | | |
|---|---|---|---|---|
| Step 1 | Total income received net of VAT | | | x |
| | Less 5% on income | | | x |
| | | **A** | | x |
| Step 2 | Professional indemnity insurance | | x | |
| Step 3 | Pension payments | | x | |
| Step 4 | Benefits in kind | | x | |
| Step 5 | Capital allowances | | x | |
| Step 6 | Travel costs | | x | |
| Step 7 | Gross salary | | x | |
| Step 8 | Employers NIC | | x | |
| | | | | x |
| | | **B** | | x |
| Net Result - **A - B** | | | | y |
| Step 9 | If Y is positive calculate employer's NIC thereon | | | x |
| Step 10 | Deemed payment | | | x |

Issues arising from the calculation are dealt with below:

### What is the 5% expenses deduction?

The 5% expenses deduction was introduced as a means of giving an allowance for the costs associated with running an intermediary, which would not arise for a direct employee. The types of costs that are covered are items such as secretarial support, accountancy fees, training costs, in short all those costs not covered in the body of the deemed salary. Is it enough? This will depend on each individual organisation but a flat rate will produce a gain or a loss dependant upon the circumstances.

**What if relevant sums are received from someone other than an intermediary?**

In the unlikely event that amounts or benefits are received by the worker or his family from anyone other than the intermediary in respect of relevant services they are included in the calculation but without the 5% deduction.

**What pension payments are deductible?**

You can deduct payments by the intermediary to any approved pension scheme for the benefit of the worker. Any excess contributions repaid are not allowed. No deduction is allowed for pension contributions paid on behalf of someone other than the worker.

**Benefits in kind**

*The following two paragraphs will not be relevant other than to clients who receive benefits in kind. (e.g. company cars)*

Another important point under Step 7 is that only benefits provided *to* the worker *by* the intermediary are deductible (e.g. benefits provided by the client or a third party to the worker are not deductible). Therefore, the figures on the P11D need to be examined to ensure that only deductible items are identified.

Under Step 7 the intermediary is only allowed a deduction for 'any payments or other benefits received in that year by the worker from the intermediary in respect of which the worker is chargeable to income tax.

**What capital allowances are deductible?**

A deduction is available for plant and machinery used wholly, exclusively and necessarily in the performance of duties. This means capital allowances are available on expenditure incurred by the intermediary if a capital allowances claim could have been made by the worker had he been employed by the client and had incurred that expenditure.

The Revenue has noted that this is a strict test and the relief will only be given where the duties of engagement meant that the equipment had to be provided. For example, if the company purchases the equipment out of choice, no deduction will arise. Equally, if the worker is provided with equipment but chooses to use his own (such as his own computer), no relief will be due.

It may be necessary to apportion the claim for capital allowances into qualifying and non-qualifying usage. The Revenue has stated that 'apportionment is normally by reference to the actual use in the year' (Revenue website).

**What travel expenses are allowable?**

The normal rules for site-based employees apply. Travel expenses from home to the client's premises are allowable provided the contractor does not expect to spend [more than 40% of his working time or] more than

24 months at any one site. In addition accommodation, subsistence and personal incidental costs are allowable.

### What deductions can be made under Step 7 of the calculation?

One can deduct all actual pay and benefits in kind using figures from the P60 and P11D.

However, the deduction for salary is only available for salary paid in the tax year – there can be no ‘matching’ of a subsequent salary payment with a deemed salary payment. In particular the resultant net pay from the deemed salary can only be withdrawn without further tax if it is taken as a dividend.

For example, it is common in many situations for a company to protect its cash flow and not pay bonuses to directors etc. until the company accounts are prepared and the profit is clearly known. Therefore, an actual payment of a bonus may take place after the tax year-end. Assume the company is an intermediary and the worker in the company has relevant contracts under IR35. A notional payment will have to be calculated at the end of the tax year and it is subject to tax and NIC. However, if an actual bonus is paid at a later date to the director, then that will be subject to tax as well. This is, of course, double taxation. There is an entitlement to two deductions on these two events but that appears of little assistance. It is not possible to 'match' the original notional payment to relate it to the actual payment. Therefore, the only way that a worker is able to extract funds from the company in such a case is for the bonus to be made by way of a dividend.

### What NIC payments are deductible under Step 6 of the calculation?

NIC paid by the intermediary in respect of salary or benefits are deductible.

### How does the Employer’s NIC calculation on the deemed payment work?

Step 8 in the calculation, compute the Employer’s NIC on the deemed payment using the Employers NIC rate for the relevant tax year. This amount is then deducted from the ‘Net Result’ leaving the deemed payment, which will be subject to PAYE and Employee’s NI.

### How are apportionments made?

Any just and reasonable basis is acceptable to allocate amounts received where the income from a relevant engagement for services has been made to more than one worker.