



Maximum Earnings::Minimum Hassle

A Guide to IR35

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Introduction

All contractors need to address the issue of whether their company is liable to the IR35 legislation each time they start a new contract.

The legislation applies where a worker provides his services to a client through an intermediary, usually his own limited company, and where if he had worked directly for the client he would have been treated as an employee for PAYE and National Insurance purposes.

If the rules don't apply the contractor is able to set his own salary level. Income earned from contracts liable to IR35, net of allowable expenses, will have to be subjected to PAYE and National Insurance. If enough salaries have not been paid by the 5th April any balance is known as the 'deemed payment' and will be subject to PAYE and National Insurance on that date. There is no obligation to pay the deemed payment only the tax thereon.

The decision as to whether IR35 applies is therefore fundamental.

In the next section "The Test: Employment or Self-Employment" we set out the issues which help decide whether your contract is liable. At the end of this section we give details of help that is available in making the decision. In any event please feel free to call us for our advice.

If liable to IR35 we give further details including allowable deductions, ways of mitigating the liability; action points during the year and an IR35 Important Dates summary. Finally we deal with how to pay the deemed salary net of PAYE and National Insurance.

This guide is a brief summary of the legislation and highlights the major issues. Please contact us for further help and for any specific queries which you have.



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Employment or Self Employment

Where a worker is provided by an intermediary, i.e. a personal service company, the intermediary has to decide whether the new IR35 rules are triggered. If the relationship is characteristically one of employment, the income, less allowable expenses, will be treated as a salary for tax purposes. The existence of an agency in the chain is not relevant.

Each engagement is considered separately and so at the start of each contract you will have to reconsider this issue. If you have contracts that run concurrently, each one should be considered separately.

'Employment' is not defined in tax statutes and so a lot of case law has arisen to decide whether an individual is employed or self employed. One of the most important cases was Hall v Lorrimer where the Judge said:

"In order to decide whether a person carries on business on his own account it is necessary to consider many different aspects of that person's work activity. This is not a mechanical exercise of running through items on a checklist to see whether they are present in, or absent from, a given situation. The object of the exercise is to paint a picture from the accumulation of detail. The overall effect can only be appreciated by standing back from the detailed picture which has been painted, by viewing it from a distance and by making an informed, considered, qualitative appreciation of the whole. It is a matter of evaluation of the overall effect, which is not necessarily the same as the sum total of the individual details. Not all details are of equal weight or importance in any given situation. The details may also vary in importance from one situation to another.

The process involves painting a picture in each individual case"

The principal tests considered are:

- **Do you have to do the work yourself or can your company provide a substitute to carry out the work.**

The right to substitute another worker to perform the services of the contract is available only to the self-employed. However, the right of substitution must be genuine, and the person substituted or the helper must be answerable to the self-employed person and paid by him.

Where an occasional substitute is provided, but would be rejected by the client if the entire services were performed by a substitute, the Revenue are likely to challenge inferring that the occasional substitution is done under powers delegated to the individual by the client.



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Where there is no right of substitution, this is persuasive of employment but is not, in itself, a determining factor. Sometimes a self-employed person is hired personally for their particular individual talents, and no substitute would be acceptable. This does not always mean that they are an 'employee' of the client.

Where your contract does not specify that *you* personally will perform the duties, but allows for a substitute; this would be a indication of self -employment, and would therefore be a step away from IR35.

- **Financial risk and the opportunity to benefit from sound management.**

A fixed price contract would be the best evidence that you were taking financial risk; as would having to correct errors in your own time for no extra reward. Investment in training, provision of equipment, advertising, insurance, etc. would also be indicative. The risk of getting no return for these outlays would be a pointer towards self-employment.

- **Can someone control what you do?**

It is inevitable that where one party is to pay for work done by another party, there will be some element of control in the engagement. This is true even if the person performing the services is indeed self-employed. This amounts to control at a certain level, however, the control patterns indicative of employment are deeper than this:

The right to control the following aspects will be considered:

- *Where it is done*
When you are required to work on your client's premises this is strong indicator that there will be other control aspects to the engagement. If you can do the work wherever you like, this tends to indicate self-employment.
- *What is done*
The right of a client to move the worker to areas of higher priority is highly indicative of employment.
- *How it is done*
This is a very strong indicator of employment; it permits the client to prescribe the way in which the work is to be carried out. However, the absence of this level of control does not necessarily indicate self-employment. It is unusual for someone of a particular skill to be told how to do their work, but this does not make them self-employed.
- *When it is done*
The requirement to work particular hours is not such an important aspect of the control test.

Remember - it is the right of control over these aspects, which is an indicator of employment, and not the exercise of control.



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In practical terms this may present the most difficult hurdle for those attempting to clarify their status and obtain work, which would be considered to be self-employment.

In particular in the IT industry, the ultimate client usually retains a high degree of control over the work being done. This often means appointing their own manager to supervise the work of contractors, who may work alongside and on the same terms as PAYE employees of the client. In these circumstances, it may be difficult or impossible for the contractor to negotiate a contract in which the client relinquishes his rights of control over the work done in any substantial way.

- **Exclusive services**

Your contract should not restrict you to working exclusively for one client as this is a significant pointer to employment.

- **Provision of Equipment**

The provision of equipment is indicative of self-employment although, for most contractors, the equipment they provide is limited and may be inconsequential.

- **Where do you work?**

Attending the client's premises on a regular basis would tend to indicate employment, but again this is not conclusive. You may be required to attend regularly as being the only practical way to obtain access to the information/systems necessary to complete the work.

- **Do you have to work set hours?**

If yes, this would be a pointer towards employment. Usually, the self-employed determine the number of hours to be worked and when. This however, is one of the lesser tests.

- **Are you paid by the hour rather than for a completed job?**

Many self-employed are paid by the hour so this would not be conclusive.

These and other factors including the intention of the parties to the contract, dismissal rights, etc. are dealt with further in a document called 'Guidance on application of employment status rules to workers using intermediaries' on: www.inlandrevenue.gov.uk/ir35. This states the Governments view.

The revenue will look closely at repeated contracts with the same client.

Remember - it is not just the contract that is relevant. A contract may be written, verbal, implied or a combination of all three. The way you actually work and behave must reflect the terms of the written contract, otherwise it will be ignored and the actual behaviour will be treated as a variation of the written terms.



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<u>Test</u>	<u>Try to establish that :-</u>
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- **Substitutes** Your company has the right to substitute a 'suitably qualified' alternative or engage help. This must be a real and not theoretical right.

May be difficult to establish. If you can you must be responsible for the substitute and their quality of work. You must pay them.

- **Financial Risk** You need to make profit other than by doing more hours.

Fixed price contracts are the most conclusive way. Do you want this responsibility and risk?

- **Payment** You are paid a fixed price for a specified task.

Payment by the hour or day is usually indicative of employment.

- **Control** The work is not subject to control by the client. Your company has agreed to do a specific job to an agreed standard and after that it is up to you how, when and where the job is done.

This will be the most difficult test to satisfy. Go as far as you can with it.

- **Equipment** You provide equipment that is fundamental to the task.

Again difficult. Do not accept equipment provided free by a client as you will be closer to employment.

- **Other rights** You have no rights to normal employee benefits (e.g. staff canteen prices).

You will usually satisfy this. Do not accept what would otherwise be 'benefits in kind'.

- **Exclusivity** You can work for as many organisations as you wish.

Useful but not conclusive. If you work full time this is not practical.

- **Dismissal** You are engaged for a particular task. No rights of dismissal apply.

Clients may be unwilling to accept this. It is often part of their 'control' aspects.

- **Part of the organisation** You are an independent expert, not part of the company paying you.

If you work in a team with company employees you will need to show that you differ substantially from them.



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The company is responsible for deciding whether or not each contract is subject to the IR35 rules. If not, then income can be distributed by a mixture of salary and dividends. The above will help you to decide if the rules apply to you. If you are not liable we suggest that you document why this is the case in as full a detail as possible. If you are still uncertain, after reading this, as to whether your contract is caught, please consider the following or seek our advice.

Several law firms are specialising in giving an opinion with prices starting from approximately £100 + VAT. Insurance is also available where your contract is assessed as being outside the scope of IR35. If the Inland Revenue do challenge the decision and if further tax and interest and penalties become due, these will be met by the insurer. Please contact us for further details.



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IR35 in more detail

Where the contract *is* subject to IR35, the total income from that contract less certain expenses (see next section) will be liable to be taxed under PAYE and NI legislation. Any undrawn salary will be taxed at the 5th April each year. This is known as 'deemed payment'.

Example

Total income arising from a contract liable to IR35	£	60,000
<u>Less</u>		
Travel expenses etc.	5,000	
Pension (paid by the company)	6,000	
Salary and employer's NI already paid	38,000	
5% of income arising from IR35 contracts	<u>3,000</u>	
		<u>52,000</u>
Balance: 'deemed payment' including Employer's NI		<u>8,000</u>

The PAYE and NI due on this deemed amount must be calculated each 5th April and be submitted to the HM Revenue and Customs by 19th April. The deemed payment will be included as earned income on the employee's P60 and therefore personal Self Assessment Tax Return.

An allowance of 5% of the value of relevant contracts to cover overheads is allowable for the purpose of the deemed payment calculation but is not allowable when calculating the company's profits for corporation tax purposes. The company's actual expenses will be allowed instead. If the actual expenses are lower than the 5% allowance, a profit may arise which together with any non-IR35 income will be liable to Corporation Tax. If the actual expenses are greater than the 5% allowance (and if there is little/no IR35 income) a loss may arise for corporation tax purposes.



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Example

		£
Income		60,000
<u>Less</u>		
Travel expenses, etc.	5,000	
Pension	6,000	
Salary and NI'ers paid	38,000	
Salary and NI'ers deemed	8,000	
Overheads actually incurred	<u>5,000</u>	
		<u>62,000</u>
		(2,000)
Interest received (non IR35 income)		<u>1,000</u>
Loss for the year		<u>(1,000)</u>

It may be possible to offset the loss against the profits of the previous year and obtain a corporation tax refund.

The company should therefore generate as much non-IR35 income as possible since this may be used for offsetting overheads, which are greater than 5%.

IR35 income is liable to tax in the fiscal year in which it is received. By delaying the receipt of your earnings until after 5th April you delay the payment of PAYE and NIC thereon.

Retained profits at 5th April 2000 are not affected in any way by IR35.

IR35 does not affect the VAT regime. VAT will be chargeable by registered companies on all work done and VAT can be recovered as incurred.

Company Cars

In order to give relief for travel expenses the user will deduct from the deemed income an amount to cover the costs of business travel. The Revenue have suggested this is done by claiming a mileage allowance for business miles at FPCS rates, in the same way as someone using his own car for business purposes could. The alternative would be to claim the business proportion of the actual costs incurred. You will need to keep a detailed mileage log either way.

Very few clients have a company car. If you do, please ask for our Company Car Help-sheet.



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Allowable Expenses

The following expenses can be deducted, from income arising from a contract subject to the IR35 legislation, in calculating the 'deemed salary'.

- Travel and subsistence under the current rules. If you do not have a copy of our guide to travel and subsistence please request one.
- Employer pension contributions made to an approved scheme, which are allowable under normal rules. Contributions will be calculated on the salary actually drawn in the income tax year plus the deemed salary.
- Professional indemnity insurance premiums where these can be separately identified. If combined with other insurance's they would not be allowed.
- All other expenses eligible for deduction under the normal schedule E rules (see below).
- A further flat rate of 5% of the income under the IR35 rules
- Employers NI

"All expenses eligible for deduction under the normal Schedule E rules" might include:

- *Some business telephone calls*
- *Certain subscriptions to professional bodies*
- *An element of your use of home as office, etc.*

These costs are only allowable if you are obliged to incur them under your contract or they are wholly, exclusively and necessarily incurred in the performance of your duties. It should be remembered that very few employees claim any deductions from their pay.

These are rather old fashioned terms, tested on many occasions in court, and the following have appeared in the judgements:



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Obligated to incur

Unless an employee is obliged to incur the expenditure, he may not claim for it. This term reinforces the term “necessarily”, and means that the employee has no choice about the incurring of the expenditure, and that he has not incurred it by a decision made himself, to make his life easier or to do the job better, but because he had no choice whatsoever but to incur the expenditure in order to perform the duties. In a case considering the term “necessarily” the judge indicated that this meant that “... each and every holder of that office or employment would be obliged to incur...” the expenditure described.

This makes it clear that no deduction would be available if it were the particular circumstances of that employee which gave rise to the expenditure.

Wholly and exclusively

The phrase means that there is no alternative or dual purpose for the expenditure, and is applied at the moment at which the expenditure is incurred, not afterwards. It considers WHY the money was laid out, and that it was expended ALL and ONLY for the stated purpose.

Where there is a single motive to incurring the expenditure, and that related to the employment, then there will be no problem obtaining deduction. Where there is a possible secondary motive, even if less important or even a subconscious motive, this will exclude the expenditure from deduction. The most obvious secondary motive normally attacked is that of personal need or benefit, which is used to exclude a wide range of business and job related expenditure.

In the performance of the duties

The expenditure must be laid out while actually doing the work, which has been a difficult test to satisfy. The most important recent case is Smith V Abbott, which disallowed expenditure, which the judge decided, was incurred in improving their employee’s usefulness to their employer, and in preparing them to carry out their duties, rather than in the actual performance of the duties.

A distinction has to be drawn between expenses allowable in the calculation of the deemed salary and those allowable for corporation tax purposes. The above section in italics refers to the rules, which have evolved for PAYE purposes and will be used in calculating the deemed salary. For example, telephone calls to your agency advising them of the hours you have worked or seeking a new contract would not fall within the above rules. Telephone calls enabling you to further the project you are working on would be allowable in calculating your deemed salary. However, both types of calls would be allowable for corporation tax purposes and you should claim for them. It is only when calculating the deemed salary that they cannot be taken into account.



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TAX PLANNING

- **Retained profits**

Retained profits are not affected by IR35, you can distribute them as dividends or continue to hold them in the company. It is sensible to ensure that you have sufficient personal income in the current tax year to use your personal allowance and basic rate band for tax purposes. This means ensuring gross income does not exceed £42,475 in 2010/11. Consider issuing a dividend or voting more salary to achieve this where necessary.

- **Pension contributions**

Pension contributions will become the most effective optional way of saving tax and National Insurance (NI). Company contributions to either a personal scheme or to a company scheme are allowable expenses and will reduce both the tax and employers NI liability. You should take full advantage of the potential for contributions to a pension plan. *NB* Company contributions to a personal scheme have to be gross payments - please see your Financial Advisor for further details and advice.

We have teamed up with a well-respected, national firm of Independent Financial Advisors (IFA's) who specialise in the 'contractor' sector. They will be able to offer advice to you on the best scheme to suit your individual circumstances and the maximum allowable contributions. Please call us for further details.

- **Non IR35 income**

Maximise your non-IR35 income. Consider putting any part time income through the company. If you run two companies one for contract work and one for other income, consider merging them. Make your bank balance work for you by putting it into a high interest account.

The advantage of this is that you will have more income against which to offset the expenses incurred.

- **Training**

The HM Revenue and Customs have stated that any training provided by clients or agencies will not count as a taxable benefit and no tax charge will arise. So get the agency or your client to pay the bill for training even if you take a lower pay rate – it will save you tax.

- **Accounting Year End**

A year-end shortly after the 5th April e.g. 30th April rather than (say) January, February, March year-ends may give a cash-flow advantage. This will give faster relief against Corporation Tax for the deemed payment. However if you take almost all of your income as salary during the course of the year leaving a negligible deemed salary this will not be so relevant.



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Action Points

- **Before signing a contract**

Decide whether your contract is subject to IR35. Consider whether there is an opportunity to get the contract amended to take it outside the scope of IR35

- **Shareholdings**

Consider whether to make a lower earning spouse/partner a shareholder so that profits (if any) not liable to IR35 can be distributed to them as dividends **BUT** only do this after consultation with us.

- **Company car owners**

If you have a company car you should start to keep records of business miles for the purposes of the deemed salary.

- **Training**

As the revenue have stated that you will not be taxed on any training provided by clients or agencies consider asking for further training, if appropriate, from them.

- **Book-keeping changes**

Where you do your company's book-keeping and to assist in the calculations required we recommend that the book-keeping columns in your records should show income split between that subject to IR35 and non IR35 income. Please introduce separate columns for this. Expenditure should have separate columns for pension, allowable travel and a column for other expenditure allowable for IR35 purposes (if any).

- **Income**

Delaying the receipt of income until after the 5th April will defer by one year the PAYE and NI thereon.

- **Expenses**

Your company should reimburse you for your March (and earlier) expenses before 5th April to help minimise your tax liability. Pension premiums are allowable in the fiscal year in which they are paid. The premiums paid before 5th April will be beneficial 12 months earlier than those paid on the 6th April.



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Important Dates

- **5th April**

The deemed salary is calculated as at this date on receipts liable to IR35 from the previous 6th April.

PAYE/NIC due for the tax year:

- **19th May**

The Employers Annual Return (form P35) together with forms P14 are to be submitted to HM Revenue and Customs by this date.



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- **Paying the deemed salary**

There is no expectation by the Inland Revenue that the deemed salary less PAYE and NI will be paid to the contractor. As far as they are concerned IR35 is a tax raising exercise only. The deemed salary after deductions need not be distributed. It can thus become retained profits within the company.

From the contractors viewpoint he/she has paid PAYE and NI on a sum of money and they can see no reason to leave this in the company. There are two possible problems. Firstly, there may not be enough money in the company. An extreme example is where a company has utilised its funds to buy a company vehicle for use by its director.

Secondly, if available funds up to the 'net' deemed salary are paid as salary after the 5th April you will be taxed twice on this. You will be taxed under the normal rules i.e. PAYE/NIC are due in the month in which your salary is paid, but you will already have suffered PAYE/NIC under the IR35 provisions. This is clearly unreasonable but presumably is designed to encourage you to take your deemed salary as you earn it. This double taxation effect can be countered by paying a dividend instead (see below).

Advantage: by paying deemed salary with your March salary it turns deemed salary into actual salary and enables the company to account for its taxes and P35 returns by their due dates avoiding interest and penalties. The company is able to claim the salary as a deduction against its profits, subject to Corporation Tax, at the earliest possible date.

To avoid the double taxation referred to above, dividends should be paid instead. They should be paid to each shareholder in the normal way.

An election should be made so that these dividends are not taxed on your self assessment tax return because PAYE and NI will already have been incurred on them being part of your deemed salary. Dividends paid to other shareholders can be included for exemption but there is a strict order of set off. This is:

- 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

The effect of the election is that the dividend need not be added to your Tax Return.

For example, a contractor has a deemed salary after PAYE and NI, of (say) £40,000. During the year he paid four quarterly dividends of £7,500 each and a final dividend on 15th May 2012 of £10,000. He should list all five dividends in his letter as he wants to exempt them all from tax.



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The company has to make the claim to its corporation tax office and a suitable form of wording is set out below.

H M Inspector of Taxes
Any Town
WF5 1AB

Corporation Tax Ref:

Dear Sirs

Claim to treat dividends as non taxable under IR35 legislation

To avoid double taxation on a deemed net salary of £35,752 (after deduction of PAYE and NI) treated as paid on 5th April 2007 we wish to have the following dividends treated as non-taxable in the hands of the recipient.

Date	Paid to/Tax Reference			Total
<u>20012/13</u>				
30.04	Mr X	x	3,750	7,500
	Mrs X	x	<u>3,750</u>	
31.07	Mr X	x	3,750	7,500
	Mrs X	x	<u>3,750</u>	
31.10	Mr X	x	3,750	7,500
	Mrs X	x	<u>3,750</u>	
31.01	Mr X	x	3,750	7,500
	Mrs X	x	<u>3,750</u>	

Total to be exempted being the difference between
the deemed salary and the actual salary already
paid in 2012/13 (restricted to the dividends paid) £30,000

Yours sincerely

Mr X
Director