



# IR 35

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The IR 35 is aimed to eliminate the avoidance of tax and National Insurance Contributions (NICs) through the use of intermediaries, such as service companies or partnerships. The legislation is not targeted at any particular occupation or business sector.

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

## Application of IR 35

Broadly, it applies to those engagements where if you had provided the services directly to the client under a contract between you and the client, you would have been an employee of the client.

In addition you must receive or have rights entitling you to receive a payment or benefit that is not employment income. 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.

The rules will apply if you can answer 'yes' to the following questions.

- Do you work set hours, or a given number of hours a week or a month?
- Do you have to do the work yourself rather than hire someone else to do the work for you?
- Can someone tell you at any time what to do, when to work or how to do the work?
- Are you paid by the hour, week or month?
- Can you get overtime pay?
- Do you work at the premises of the person you work for, or at a place or places he or she decides?
- Do you generally work for one client at a time, rather than having a number of contracts?

The rules will NOT apply if you can answer 'yes' to the following questions:

- Do you have the final say in how you do the work for the client?
- Can you make a loss on the contract?
- Do you provide the main items of equipment you need to do the job for the client, not just the small tools many employees provide for themselves?
- Are you free to hire other people on your own terms to do the work you have taken on?
- Do you pay them out of your own pocket?
- Do you have to correct unsatisfactory work in your own time and at your own expense?
- Do you have a number of customers at one time?

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 Implications of IR 35

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.

### Allowable expenses:

- normal employment 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.

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.

**Example:**

A contractor (sole director and shareholder) earns £35,000 p.a. through a service company. The spouse acts as company secretary and receives a salary of 3,000 for services to the company. The contractor takes a salary of £10,000 and the remainder of net income is taken as dividend.

<b>Gross contract income</b>	<b>35,000</b>
<b>Schedule E type expenses</b>	
Business travel	1,200
Professional subs, Insurance, Admin	300
Other allowable expenses	100
<b>Total</b>	<b>1,600</b>
<b>Other business expenses</b>	
Spouse's salary	3,000
Accountancy / Legal Fees	765
Training , Advertising,	400
Printing, postage, stationery, telephone, bank	450
<b>Total</b>	<b>4,565</b>
<b>Contractor's salary</b>	<b>10,000</b>
<b>Employer's NIC</b>	<b>620</b>

<b>Contracts pass IR35 Company accounts</b>	
Gross contract income	35,000
Less Schedule E type expenses	-1,600
Less other business expenses	-4,565
Less contractor salary & Employer NI	-10,620
Net profit before tax	18,215
Less corporation tax @ 20%	3,643
Net profit after tax	14,572
Less dividend paid	-14,572
Retained in company	0

<b>Cash in contractor's hands</b>	
Contractor's salary	10,000
Less PAYE tax	-834
Less employee's NIC	-397
Add dividend	14,572
Add spouse's salary	3,000
<b>Total cash in hand</b>	<b>26,341</b>

<b>Contracts fail IR35</b>	
Gross contract income	35,000
Less Schedule E type expenses	-1,600
Less flat rate allowance of 5%	-1,750
Less contractor salary and employer NI	-10,620
Net profit before tax	21,030
Less employer's NIC on deemed salary	-2,628
Less deemed salary	18,401
Net profit before tax	0
Less corporation tax @ 20%	0
Net profit after tax	0
Retained in company	0

<b>Cash in contractor's hands</b>	
Contractor's salary	10,000
Add deemed salary	18,401
Total salary	28,401
Less expenses greater than 5% rate	-2,815
Less PAYE tax	-4,883
Less employee's NIC	-1,973
Add spouse's salary	3,000
<b>Total cash in hand</b>	<b>21,730</b>

3,000  
Calculation of the deemed payment, submitting form P35 and paying HMRC have to be done by 19 April.

**Managed Service Companies (MSCs)**

MSCs attempt to avoid the IR35, however, new rules from 6 April07 will require MSCs to account for PAYE on all payments received by individuals.

The 'specified persons' who must pay PAYE and NIC will be the MSC's directors and the person(s) who provided the company to the individual. In certain cases the debt can also be transferred to persons who encourage or are actively involved in individuals' provision of their services through MSCs. This provision will take effect after 6 January08.

**Partnerships**

For Partnerships the rules will apply where:

- an individual, (either alone or with one or more relatives), is entitled to 60% or more of 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'

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