

Tax Tip of the Month - Beware IR35...

...It's Still Alive and Dangerous

The all out war between the taxman and the one man service company has been going on so long now that most people are getting a little blasé about it. But all of the weaponry devised by HM Revenue & Customs is still out there, and one of the most controversial (at the time) and apparently powerful weapons in the taxman's hands was the so called "IR35" rules, which actually came into force as long ago as the Finance Act 2000. If you provide your personal services through a limited company, don't be fooled into thinking that this legislation is not really a live issue any more. It's still very much alive and kicking. The purpose of this piece is to ensure that you don't inadvertently fall into its grasp.

What follows is by no means of interest only to military historians. This war is still going on, and you need to know where the enemy's strengths are.

Personal Limited Companies for Fun and Profit

It all started with the comparatively innocuous practice of individuals changing from being employees to providing their services through a limited company. This was well worth doing for a number of reasons.

Firstly, if the money was kept in the company, you ended up paying a measly amount of tax on your

income, something like 20% instead of the 40% income tax you would have paid.

Secondly, national insurance flies out of the window, because, unlike the situation with an employment relationship, payments to a company aren't subject to national insurance liability.

Thirdly, if you had a company with money in it, you could spread the tax load by giving the shares in your company to a spouse, and then paying dividends to that spouse. If he or she wasn't working, this was a good way of using up their lower rate tax threshold and making a permanent saving in income tax

(All the above is put in the past tense, but actually, come to think of it, if you read and profit from this article, there's no reason why it shouldn't still all apply now!)

Of course, if there's one thing the taxman doesn't like, it's seeing large numbers of people paying less tax than they might be doing. So "IR35" was introduced, which says that, if the limited company is simply the medium of what would otherwise be an employment situation, the whole company structure is effectively ignored and Pay As You Earn and national insurance are due immediately on the company's income. This legislation was introduced in a typically cack-handed and impractical form, and gave rise to howls of outrage throughout the one man service company industry (so to call it).

Then, as the months and years passed, an interesting situation started developing. Whilst there are probably

no reliable statistics out there, it appeared that the Revenue were taking an awful lot of IR35 cases – and losing. The whole problem with IR35, from the Revenue’s point of view, was that, in order for it to apply, an immensely complex set of considerations needed to be gone through, to determine whether the relationship between the individual and the payer “would have been” one of employment without the company in the middle. This is actually one of the most difficult tests to apply in practice and there is a huge pile of case law to look at every time such a case goes to appeal.

The Revenue’s resources, reading between the lines, were so inadequate, given the huge number of situations they would in theory need to take to appeal, that it was a bit like a single swordsman, with a wooden sword, facing a crowd of ten thousand furious Zulus waving assegais.

Organised Resistance

Add to this, the fact that a large number of agencies have sprung up in recent years like mushrooms whose raison d’etre is to provide all the necessary admin and ancillary services to individuals for them to operate through companies. In return for doing all the paperwork, these agencies took a cut of the individual’s earnings.

Not only did these agencies very often undertake to provide “IR35 proof” contracts, but they also ensured, by their sheer bulk, that the Revenue stood no real chance of applying their legislation in practice.

So the effect of this, inevitably, has been more legislation, in the form of the “Managed Service Companies” onslaught. This legislation is very relevant indeed to one man service companies, but only if that company is being administered for them by an appropriate agency.

The effects of MSC applying to you are firstly that IR35 is automatically assumed, and secondly, that, if your company doesn't pay the tax and national insurance (unfortunately there were a huge number of defaults which almost looked premeditated) the agency itself became liable.

So where are we now?

The net result is not so much that one man service companies are no longer viable. Nor is it the case that the Managed Service Companies legislation has replaced IR35. In fact, MSC and IR35 are now twin weapons in the taxman's hands (although it would be more appropriate to compare MSC to a squadron of tanks).

So, providing you steer clear of an MSC style agency to run your company, we are actually still back in the old IR35 territory, and, as we said earlier, those three big advantages of operating through a company, which are the lower tax rate on retained profits, the lack of national insurance, and the ability to spread income round the family, are still just as much available – providing you don't fall into “IR35”.

So here is a quick set of bullets, listing the features you need to ensure are present to avoid getting caught:-

Get a written contract in “IR35 proof” form, to evidence the legal relationship between you and the user of your services.

Retain as much discretion as possible as to the manner, timing, and location of the provision of your services.

Preferably, be non specific as to whether you or someone else sent by you actually provides the services concerned. If this is not acceptable, ensure that there is a suitable “substitution” clause in the contact.

If possible, arrange for remuneration to be on the basis of results rather than time spent.

Where appropriate, arrange your own liability insurance.

Where appropriate, provide your own equipment etc.

Ensure that you have all the “trappings” of being in business on your own account, including letterhead, business name, accounting system, and, preferably, more than one client!

Ensure that the contract provides for you to make good any defective or late work in your own time and at your own expense.

Avoid being “part and parcel” of your client’s organisation, by being given a title within the organisation, using canteen and sports facilities etc.

Of course, none of the above is new, but what we think definitely needs to be highlighted at present is the fact that one man service companies are still very much a valid tax saving option. All you need to do is steer clear of the battle zone.

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