HMRC is likely to step up use of IR35 to clamp down on the abuse of personal service companies for tax avoidance, says Peter Rayney.

The vexed issues surrounding tax avoidance are never far from the front pages these days. And IR35, the taxman’s weapon that tackles the abusive use of personal service companies (PSCs), remains firmly in the spotlight.

Following intense media scrutiny and criticism, HMRC is likely to be increasing its investigations into PSCs following revelations about the way many of the BBC’s top stars were using them to avoid PAYE and National Insurance contributions (NICs).

The Professional Contractors Group (PCG) estimates that there are currently some 600,000 one-man ‘limited companies’. Given that PSCs enable high earners to avoid the 50% income tax rate, many entertainers, high-profile footballers, sports stars, TV and radio presenters, and well-paid freelancers are increasingly using them.

**WHY USE A PSC?**

Individuals set up PSCs to provide services to their clients or to end-users. Typically, the individual will hold 100% of the PSC’s share capital (although some shares may also be held by their spouse to enable them to benefit from tax-efficient dividend income). The individual ‘worker’ will frequently be the only director of the PSC and the PSC will contract with clients/end-users to supply the services of the director.

The PSC will invoice the clients for the sales value of providing the services of the director. The director-shareholder will often extract most of the net post-tax profit as tax-efficient dividend. In recent years, since the combined income tax/NIC rates are now significantly higher than corporation tax rates, PSCs are often used to retain profits at the relatively low rates of corporation tax.

Historically, the growth in the use of PSCs was fuelled by the desire of ‘employers’ to avoid the regulatory burdens of employment. Furthermore, by engaging a PSC, this offered ‘employers’ greater protection from the potential PAYE and NIC liabilities that might arise if a ‘self-employed’ contractor working for them was subsequently re-categorised as an employee.

**THE BIRTH OF IR35**

In 1999, the then Labour government decided that ‘something must be done’ to deal with the fast growing use of PSCs. The proposals came in the 1999 Budget papers, enacted in Finance Act 2000 (after extensive consultation). The legislation is now contained in Chapter 8, Part 2, Income Tax (Earnings and Pensions) Act 2003 (ITEPA 2003).

The so-called IR35 provisions probably remain one of the most controversial areas of UK tax legislation. Judicial review actions were brought by the PCG in 2001 and 2002 in an attempt to abolish the IR35 legislation but both failed.

**RISK FACTORS**

HMRC has three levels of IR35 tax risk assessment, determined by the relevant PSC’s points rating – the greater the number of points, the lower the IR35 risk.

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<tr>
<th>LOW RISK</th>
<th>MEDIUM RISK</th>
<th>HIGH RISK</th>
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<tr>
<td>more than 20 points</td>
<td>10 to 20 points – strong possibility of a review</td>
<td>less than 10 points – IR35 review will be carried out</td>
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CASe Study
IR35 CALCULATIONS
Rob owns the entire share capital of Barry Island Entertainments Ltd (BIEL), which provides services to the TV and media industry. BIEL makes up its accounts to 5 April each year.

The company’s fee income and expenses for the year ended 5 April 2012 have now been analysed and all its income and expenses relates to relevant engagements (ie, services that would be regarded as an employment if they had been undertaken by Rob directly).

The income from BIEL’s relevant engagements and related expenses for the year ended 5 April 2012 is set out in the table. BIEL must account for PAYE tax and NIC on the deemed salary.

HMRC appreciates that many PSCs will have difficulty in making the full PAYE and NIC payment by the normal 19 April deadline. By concession, HMRC will accept a provisional payment on 19 April and a subsequent balancing payment.

IR35 IN PRACTICE
The IR35 provisions seek to apply PAYE and employment-based NICs to any income received by the PSC (after deducting allowable expenses) that would have been employment income had it been received by the worker personally.

Consequently, it is first necessary to identify any income (or benefits) the PSC receives from ‘relevant engagements’, which is income that would have been treated as employment income if it has been received directly by the worker.

This effectively requires a ‘self-employment versus employment’ analysis test to each of the income sources or contracts of the PSC.

Furthermore, although the written contractual terms of each engagement will be important, HMRC will always look to see that they reflect the reality of the working relationship between the relevant parties.

EMPLOYED V SELF-EMPLOYED TESTS
Since IR35 is aimed at the supply of personal services, the contract and the reality of the working arrangements should (as far as is practicable) reflect that there is:

- a business-to-business relationship under which services are being provided (rather than a worker or person);
- a genuine right of substitution enabling the PSC to provide a suitably qualified substitute or delegate;
- no mutuality of obligations so that the client or end-user is not obliged to offer work to the PSC nor is the PSC obliged to accept the work if offered;
- no control over the way that the company performs its work under the contract;
- an appropriate level of financial risk – this means, for example, that the company should be responsible for correcting any defective work (at its own cost) and for taking out appropriate public liability and professional indemnity insurance; and
- an independent business being carried out and the worker provided by the PSC is not seen as part of the client’s/end-user’s organisation.

In demonstrating ‘self-employment’ status, it is always best to avoid the type of benefits commonly made available to employees such as holiday pay, employee-type benefits (eg, car or van), sick pay and so on.

Importantly, the supply of the services of a director is not within the scope of the IR35 legislation.
Looking forward, HMRC’s ‘pilot’ introduction of an IR35 ‘risk based’ points test should provide the owners of PSCs with a helpful indication of their potential IR35 tax risk. This is computed on a points-based assessment, which almost appears to resemble the voting procedure at a Eurovision Song Contest.

There are three levels of IR35 tax risk, which are determined by the relevant PSC’s points rating – the greater the number of points, the lower the IR35 risk.

- low risk – more than 20 points – it is unlikely that HMRC will check whether IR35 applies;
- medium risk – 10 to 20 points – HMRC believes that there are some pointers where IR35 could apply and it is likely to carry out a review; and
- high risk – less than 10 points – it is almost certain that an IR35 review will be carried out by HMRC.

HMRC’s 12 tests and respective points’ allocation used to assess the potential IR35 status of a PSC are summarised above.

According to HMRC, the business entity tests are simply an extension of its existing risk-based approach to investigation work. The tests are currently being piloted and may be refined depending on feedback to HMRC.

Nevertheless, the IR35 risk-scoring approach should provide PSCs with a reasonable diagnostic tool for assessing their potential IR35 risk since they assess most of the ‘badges of self-employment and employment’ with appropriate weightings (although some tax advisers disagree with the relative point allocations). The points-based approach may also provide some useful comfort for those PSCs with a points tally of more than 20 (ie, rated as ‘low risk’). HMRC recommends that PSCs retain their IR35 points score, with back-up evidence.

The so-called IR35 provisions probably remain one of the most controversial areas of UK tax legislation.
the worker who performed the engagement, subject to the permitted deductions allowed by statute (s54 ITEPA 2003). The permitted deductions from the income comprise:

- a general deduction equal to 5% of the gross receipts from relevant engagements (net of VAT) to cover all the other costs of running the company including seeking other work and training.
- the normal expenses of employment allowable under s336 ITEPA 2003 and other deductions allowed by part 5, chapters 1 to 5, ITEPA 2003, such as professional indemnity insurance premiums and professional subscriptions:
- capital allowances on plant and equipment that are used for the relevant engagements;
- company pension contributions;
- employer's NICs (including Class 1A NICs) due on actual remuneration and benefits in kind;
- the final amount of employer's NICs due on the deemed salary; and
- the total of the payments and benefits received by the worker during the year.

It is important to note that the calculation of the deemed salary payment must be made on a tax year basis (ie, to 5 April). The deemed salary payment is generally treated as made on the 5 April (s50(3), ITEPA 2003).

Given that the company will wish to deduct this deemed salary payment for corporation tax purposes on 5 April, it is normally recommended to have 5 April as the company’s year-end for corporation tax purposes. This avoids potential double taxation issues. Refer to the case study for a worked example of a typical IR35 calculation.

HMRC’S APPROACH

Given the widespread publicity of high-profile individuals using PSCs to avoid tax, there is likely to be renewed HMRC interest in the area. Owners of PSCs should therefore be vigilant and ensure they adopt the correct tax reporting procedures. They should also be taking appropriate steps to deal with any potential IR35 issues now, perhaps using HMRC’s ‘business entity’ tests to assist them in assessing the risks. Watch this space.

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