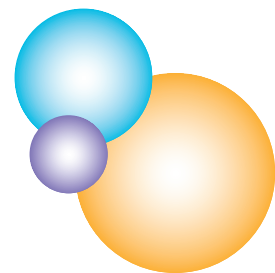


Step-by-step Guide

# A Guide to IR35



**wellers**  
contractors

IR35 refers to a press release that was issued by the Inland Revenue (that's the IR bit) originally in March 1999 and then after they admitted getting it a bit wrong, again in September 1999.

Basically, Contracting was going through such an explosion of popularity, that seemingly everyone in the country was purchasing Limited Companies and announcing that they were now self-employed Contractors.

The point of the press release was to introduce some guidance from the Inland Revenue to be able to determine who should be able to Contract and those people who should not.

What was identified was the difference between someone who owned their own company, was registered for VAT, invoiced properly and themselves, did not receive holiday pay or sick pay and managed their own workload – these individuals were called 'genuine contractors'.

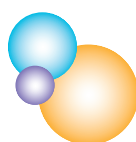
In contrast, these circumstances were compared with examples of what was referred to as 'Employees in Disguise'. Essentially where individuals working for companies as an employee on a Friday, resigned, but started back at work on the following Monday, as a Contractor, but did exactly the same job with the same degree of controls in place and so on. This was deemed to be stretching the rules somewhat.

## An introduction to IR35

For many years, people leaving jobs to become self-employed were advised to instead set up one man companies to provide their services. One reason for this might be the security offered by limited liability, but in many cases was undertaken to create the opportunity for some quite substantial savings, particularly of national insurance contributions (NICs).

Consider James and Robert, who have for many years worked as managers in a local professional business. They have, until now, each been paid a salary of £75,000 pa. In 2009/10, each would pay income tax of £19,930.00 and primary Class 1 NICs of £4,509.60. In addition, their employer would pay secondary Class 1 NICs of £8,867.84 x 2 = £17,735.68. So, at a cost to his employer of £83,867.84, James would receive £50,560.40 net. Likewise Robert.

James and Robert decide to become self-employed. James finds office accommodation and begins to build up his own client base. Robert instead arranges to work for different firms - say mornings for one and afternoons for a second. In the first case, there is little doubt that James's change to self-employment would be genuine, but in the second there is a strong case for saying that rather than having become self-employed, Robert in reality has two jobs, and PAYE tax and NICs (both primary and secondary) are payable.



The rules for people like James and Robert have existed for many years. As you will see, the tests for deciding whether someone is accepted as self-employed for tax purposes are a little vague, but if Robert in reality has what amount to two part-time jobs, the mechanics exist for him to be classified as an employee of the two firms he works with, and for PAYE to be operated accordingly. The effect of all this is for extra costs, in the form of primary and secondary Class 1 NICs to be payable by Robert and his employers.

### A possible solution

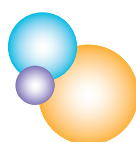
To avoid this, Robert could in the past have set up a limited company, and contracted for the company to provide his services to the two customers. Robert would then have been both the owner of, and an employee of, his own Limited Company. He could then choose to take part of his remuneration in the form of dividends - with scope for a substantial increase in his income.

Assume that Robert's company has profits, before Robert takes any salary or dividends, of £83,867.84, and that he takes £7,200 in salary and the balance of the profits, after tax, in the form of dividends.

First, we need to consider the company's tax position - the company will have to pay Robert his salary and secondary Class 1 NICs of £189.44, but the remaining profit will be charged to corporation tax - amounting to £16,060.46. On this basis, Robert can take net dividends of £60,417.94 - plus, of course, his salary of £7,200.

Robert's tax position for 2009/10 would be:

<b>Salary</b>	<b>7,200.00</b>
<b>Gross income</b>	<b>74,331.00</b>
<b>Dividend</b>	<b>60,417.94</b>
<b>Add tax credit</b>	<b>6,713.10</b>
<b>Income tax</b>	<b>13,638.20</b>
<b>Gross income (say)</b>	<b>74,331.00</b>
<b>Personal allowance</b>	<b>6,475.00</b>
<b>Primary Class 1 NICs</b>	<b>162.80</b>
<b>Taxable income</b>	<b>67,856.00</b>
<b>Net income</b>	<b>60,530.00</b>
<b>Tax at 10% on</b>	<b>37,400.00</b>
<b>Tax at 32.5% on</b>	<b>30,456.00</b>
<b>Compared with</b>	<b>50,560.40</b>
<b>Tax due</b>	<b>13,638.20</b>
<b>A saving for Robert of</b>	<b>9,969.60</b>
<b>Primary Class 1 NICs</b>	<b>162.80</b>



The aim of the IR35 legislation is to stop people who, if they were claiming to be self-employed would in fact be re-classified as employees with all the consequences for primary and secondary Class 1 NICs, using an intermediary. This intermediary being in the form of a personal service company or a partnership to obtain a tax advantage over other workers.

IR35 achieves this by forcing the company to operate PAYE in respect of an amount of notional remuneration, being basically the difference between the company's profit on work caught by the IR35 rules and the remuneration drawn by the owner-director in respect of that work. For more details, and an example of the calculation of notional remuneration, see our separate webguide on personal service companies.

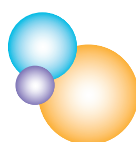
Of course, on the facts, James will not be caught by the IR35 rules, and could set up a limited company through which he can operate his business. For more details on the pros and cons of running your business through a limited company, see 'Should You Form a Limited Company?'.

Operating his business through a limited company could save James over £3,300 compared with operating as a self-employed sole practitioner.

<b>Self-employed profit</b>	<b>83,867.84</b>
<b>Gross income</b>	<b>83,867.84</b>
<b>Personal allowance</b>	<b>6,475.00</b>
<b>Taxable Income Tax</b>	<b>77,393.00 23,477.14</b>
<b>Class 2 NICs</b>	<b>-124.80</b>
<b>Tax at 20% on £37,400.00</b>	<b>7,480.00</b>
<b>Tax at 40% on £39,992.84</b>	<b>15,997.14</b>
<b>Class 4 NICs</b>	<b>-3,452.73</b>
<b>Tax equals</b>	<b>23,477.14</b>
<b>Net income</b>	<b>56,813.18</b>
<b>Class 2 NICs</b>	<b>124.80</b>
<b>Compared with</b>	<b>60,530.00</b>
<b>Class 4 NICs</b>	<b>3,452.73</b>
<b>Costing James</b>	<b>3,716.82</b>

**IR35 - Who is caught by these rules?**

The IR35 rules aim to catch anyone who, by placing an intermediary between himself and his employer, gains some tax (including NIC) advantage.



### **Your Own Limited Company**

The example most frequently quoted is the consultant who, rather than working under a direct contract with a customer, contracts his services through his one-man company. Such a company has become known as a personal service company - a company which exists to provide the services of one or more particular individuals. The test for IR35 is whether, ignoring the existence of the company, the contract as it operates between the customer and the consultant is one which would lead to the consultant being classified as an employee of the customer, rather than self-employed. If the answer is that the consultant would, indeed, be classified as an employee, then IR35 applies. If he would be classified as self-employed, it does not.

If you operate your business through a personal service company, IR35 will only apply to you if:

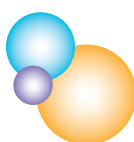
- **More than 5% of the ordinary share capital of the company is owned by you or your family, or**
- **You or your family are entitled to more than 5% of any dividends the company pays, or**
- **You are in a position to be able to receive payments or benefits from the company which are not salary i.e. not earnings to which PAYE is applied, but which represent payment for the services you provide to relevant clients.**

### **Partnerships**

Another example is a member of a partnership - self-employed - who is contracted by the partnership to a client under terms that would amount to an employment if the contract had been directly between the partner and the client. HM Revenue & Customs have in the past quoted the example of a vet in a large veterinary practice who is contracted to work by the local zoo for set hours per week. In this example, it is the services of one particular partner which are contracted, and as such, IR35 would apply. But if the zoo had instead contracted for the practice to provide any vet of suitable qualification and experience, it is unlikely the contract would be caught by IR35.

Again, there are restrictions on cases where IR35 will apply. For those providing their services through a partnership, the rules will not apply unless:

**You and / or your family are entitled to at least 60% of the profits of the partnership, or**  
**Work for one client generates all or most of the partnership's income, or**  
**Your profit share reflects the payments received for your services to clients in circumstances where the IR35 rules apply.**



### **IR35 - How can I avoid it?**

There are several ways you can avoid IR35 - although they may not be palatable to you, or your customers.

First, you can avoid IR35 altogether by rewarding yourself for all work done in a form subject to PAYE. IR35 was intended to stop the avoidance of tax and NICs through the use of intermediaries - if there is no avoidance, there will be no IR35 liability.

Second, you could give up your current arrangements and seek to join the staff of your main customers. This might get around IR35, but it will limit your options and increase the costs of your customers (through NIC, holiday pay, etc.)

Finally you could examine and, where appropriate, re-write your contracts. A great deal of care must be taken, not only to ensure that the terms of your contract(s) are such that IR35 will not apply, but also to ensure that they will stand up to HM Revenue & Customs scrutiny. In particular, HM Revenue & Customs might seek to prove that although your contract might on the face of it be one to which IR35 could not apply, in fact the manner in which your relationship with your client operated was one which fell within IR35. In this case HM Revenue & Customs will insist that IR35 be applied to earnings under the contract.

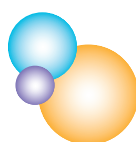
If you wish to put your contracts to the IR35 test, HM Revenue & Customs will give its views - but remember that this view will be based on the information provided. If, in fact, IR35 should apply, HM Revenue & Customs will not be bound by any previous decision.

#### **IR35 - The problem with deemed payments**

If you have established that some of your work will be caught by IR35 and that PAYE tax and NICs will have to be accounted for on a deemed salary payment at 5 April 2009, can you now put IR35 from your mind? Well, you can if you are happy to take the balance of your earnings out of the company in the form of dividends, or to leave them in the company, but if you should take the earnings as salary in 2009/10, did you know that you will have to account for PAYE tax and NICs again, on the actual payment?

Leaving the net earnings in the company will not of itself create a tax charge, although it may have implications for capital gains tax in the future. Nor does taking the earnings out in the form of dividends - HM Revenue & Customs have confirmed that subject to certain reporting requirements, they will effectively ignore any dividends which represent earnings already taxed under the IR35 rules.

However, all salary taken after the deemed payment date of 5 April in any tax year must be subjected to PAYE, whether it represents earnings of the current year or earnings on which tax and NICs have already been paid as an IR35 deemed payment.



### What can I do to avoid this double charge?

Assuming you do actually want to extract the earnings from the company, you have two choices:

- First, you can take the earnings in the form of dividends. This might be expected to create problems for those wishing to invest in personal pensions, but the fact that the deemed payments are relevant earnings should alleviate this, or
- Second, you could simply pay yourself enough in salary during the year to avoid having anything caught by IR35. If you look at the computation rules you will see that the deemed payment is after deducting actual payments in the year.

Of course there are two other options - either to end your current work structure and join your customer's payrolls, or less drastically, to re-arrange your contracts so that they do not fall foul of IR35.

### Going into the construction industry

#### The construction industry scheme

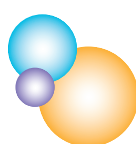
There are special tax rules affecting the construction industry, which are designed to ensure that tax is paid by workers in the sector whether they are employed or self employed. The Construction Industry Scheme places obligations on contractors - those who engage labour for construction work - and failure to operate the scheme correctly carries very significant financial penalties.

#### Construction contract

Tax must be deducted at source from a payment under a construction contract, which is a contract between a contractor and a subcontractor for construction services. The definition of construction services for this purpose is very wide and includes not only obvious building work but also, for example, the cleaning of newly constructed premises before the occupiers move in, and landscaping associated with building projects. There is detailed guidance in the HM Revenue and Customs booklet CIS 340 to help you decide whether you are carrying on construction operations or not.

#### Contractors

For the purposes of the construction industry tax scheme, the contractor is the person who makes payments to subcontractors for construction work. Contractors are required to register under the scheme and to operate the scheme on any payments made. Contractors are required to make monthly returns of payments made under the scheme. It is important to note that it is possible to be both a contractor and a subcontractor, where 'engaged' within a 'chain' of businesses on a construction project. In this case it is necessary to make deductions from payments made even if deductions may be suffered on payments received. The arrangements for offsetting these tax deductions against each other depends on whether the business is a limited company or not.



### **Subcontractors**

Subcontractors are engaged to provide labour on a construction project. It is not possible to be a subcontractor in a 'materials only' supply. In this case it is necessary to register under the scheme and, subject to meeting certain criteria, the business may qualify to be paid without deductions.

### **Contractors - what you must do**

Research by the sector skills councils has revealed the 2012 Olympics needs around 13,000 construction workers and 1,500 electricians and plumbers a year between now and 2012.

### **Register as a contractor**

The first step is to register for the scheme. This is necessary before anyone is paid under the scheme. If the business already has a payroll for employees, the registration process will require the payroll reference. Once registered returns are required on a monthly basis (more details of this follow). The penalty for late registration can run into thousands of pounds as the contractor will be fined for each late monthly return.

### **Employment status**

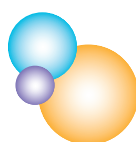
When someone is engaged to provide labour on a contraction project checks must be carried out to you establish their employment status. This does not apply if the subcontractor is a limited company, but otherwise guidance should be sought from HM Revenue and Customs to help you decide. The Construction Industry Scheme only relates to self employed workers, and employees should be placed on the payroll and have PAYE and NIC deducted. There is more detail on this often difficult area in Employed or Self Employed?

### **Verification**

Once the person's employment status is determined, it is necessary to establish whether tax should be deducted from payments and what rate. This requires basic details from the subcontractor, including the name of the individual or business through which the trade is conducted, the unique taxpayer reference (UTR) number applying to the business and the national insurance number for individuals or company registration number of a limited company.

When a subcontractor is engaged for the first time, it is necessary to contact HM Revenue and Customs to verify the tax status of subcontractor. The response will advise whether the subcontractor is registered for gross or net payments. Some subcontractors will be 'unmatched' as a response which can mean either that the identity information may be incorrect, or that the person is not registered under the scheme. Verification responses include a verification number, which should be retained.

Once verified, payments to the subcontractor can continue without further verification so long as a payment was made in the current or two previous tax years. HM Revenue and Customs will advise, in writing, if the registered tax status of any of the subcontractors changes otherwise the same tax treatment should continue to apply



### **Paying subcontractors**

When a subcontractor is registered for gross payment there is no need to make any deductions from payments; but payments must not be made to anyone else, such as a nominee at the request of the subcontractor without first checking the nominee's CIS status.

Where a subcontractor is registered for net payment CIS tax at a rate of 20% should be deducted from the full amount of the payment made less a deduction for the cost of materials. Tax must be deducted from any profit element on materials, and also from allowances for travel. However, if the subcontractor is registered for VAT, no deduction is made from the VAT element of invoices.

Where a subcontractor is unmatched, tax at 30% will apply to the payment. However, it is worth checking the details used, as it may be that an error was made when asking for verification. If a 30% deduction applies, then the verification number will need to be recorded against the payment and provided to HM Revenue and Customs and the subcontractor with details of the payment.

Contractors must issue a payment statement to each subcontractor who has suffered tax on payments. The statement may cover all payments in a tax month, or each individual payment. Although there is no prescribed format, payment statements must include certain information, and HM Revenue and Customs provide a suitable format on the internet at [www.hmrc.gov.uk](http://www.hmrc.gov.uk). There is a penalty for failure to issue payment statements to subcontractors.

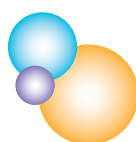
### **Returns**

Each tax month, contractors are required to make a return of all payments to subcontractors, including those that did not suffer tax on payments. The return can be made on paper or online, but must be filed within 14 days of the end of the tax month - that is by 19th of each month. Nil returns are required when no payments have been made. The penalty for late returns is a minimum of £100 per month late.

The return also includes declarations by the contractor that all subcontractors needing verification have been verified, and that employment status has been considered, and that none of the subcontractors listed is an employee.

Our Tax and business calendar includes the main details of HMRC filing requirements for CIS forms.

Contractors who do not expect to make payments under the scheme for at least six months can register as inactive, but will be fined if they forget to notify HM Revenue and Customs if this situation changes before the six months expires.



### **Compliance issues**

Contractors who also work as subcontractors should be aware that compliance failures as contractors can affect their status as subcontractors, and may lead to losing gross payment status.

### **Subcontractors - what you must do**

#### **Registration**

It is not necessary to register under the Construction Industry Scheme if work is only undertaken directly for private customers, as they are not liable to operate the scheme. Otherwise, the consequence of not registering under the scheme is that 30 percent tax will be deducted from any payments received. In order to receive payment without deduction of tax it will be necessary to satisfy a number of additional tests.

Registration can be initiated by contacting HM Revenue and Customs process you can telephone the Revenue and Customs CIS helpline on 0845 366 7899, which is available seven days a week. You will need to provide your National Insurance number to obtain registration. If you do not have a National Insurance number you will need to visit a tax office in person with proof of identity.

#### **Registration for gross payment**

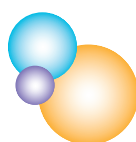
Established businesses in the construction sector can apply to register for gross payment. Once registered, payments will be made without deduction of 20% CIS tax. In order to register for gross payment, the subcontractor needs to satisfy:

- **The business test**
- **The turnover test, and**
- **The compliance test.**
- 

The business test is relatively easy to satisfy - it is necessary to demonstrate that there is an established business supplying construction services in the UK which is run largely through a bank account. The turnover test requires that in the 2 month period before application the construction turnover (excluding cost of materials and VAT) exceeded £30,000, or £30,000 per partner or director for a partnership or limited company respectively. For a large partnership or company, the maximum turnover limit is £200,000.

#### **The compliance test**

The business and owner(s) must be up to date with all of tax obligations in order to register for gross payment - the test looks at the 12 months preceding the date of application and requires that all returns have been filed on time by the applicant(s), and that all tax due has been paid on time. Further, if asked for information by HM Revenue and Customs, this was provided as requested.



Once registered for gross payment, the turnover and compliance conditions are reviewed on a regular basis (at least once a year), and if a subcontractor is found to be in breach then HM Revenue and Customs will withdraw net payment status. Unless the subcontractor appeals against this ruling, the change of status will be notified to all contractors who have used the contractor's services in the current or two previous tax years, with the consequence that a tax deduction of 20% will be made on all future payments.

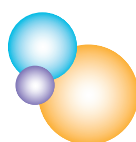
In looking at the compliance history of subcontractors, HM Revenue and Customs do ignore some minor breaches of the rules, so any or all of the following in the 12 month review period would be ignored:

- **Three late submissions of the CIS contractor monthly return, including 'nil' returns - up to 28 days late**
- **Three late payments of CIS/PAYE deductions - up to 14 days late**
- **One late payment of Self Assessment tax - up to 28 days late**
- **Any employer's end of year return made late**
- **Any late payment of Corporation Tax - up to 28 days late, including where any shortfall in the payment has incurred an interest charge but no penalty**
- **any Self Assessment return made late**
- **Any payment not made by the due date, where it is less than £100.**

### **Keeping records**

Whenever a payment is received from which tax has been deducted, the contractor has an obligation to provide a payment advice showing the details of the payment and the tax deducted. This can be provided for each payment, or otherwise on a monthly basis (for each tax month). It is important that these payment advices are retained as they include details of the tax deducted which is then available for offset against your tax liabilities.

Limited company subcontractors can deduct the tax suffered from any payments of PAYE, NIC or CIS tax due to be made to HM Revenue and Customs or otherwise reclaim this tax at the end of the tax year after submitting the end of year payroll return. Any other tax owing will be withheld before a repayment is made.



## **IR35 - Important dates**

### **19 April 2009**

The deadline for calculating the income from work caught by IR35 in 2008/09, the remuneration drawn in respect of that work, and the payment to HM Revenue & Customs of the appropriate amounts of income tax and primary and secondary Class 1 NICs. A provisional payment may be made, if you cannot calculate the final figure by 19 April, although interest will be charged until on any underpaid balance.

### **19 May 2009**

The deadline for filing forms P14 and P35. If your payment on 19 April included a provisional 'IR35 payment', this should be made clear on the P35.

### **31 January 2010**

The final deadline for providing accurate figures and payment of any balance of PAYE tax and NICs. Penalties, in addition to interest, will be charged if any balance of the 2008/09 IR35 payment remains outstanding after 31 January 2010.

Now, if not sooner. You need to review all your contract to consider whether IR35 applies. Consult us if you are unsure.

### **19 April 2010**

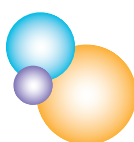
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If any of this is guide is not clear in any way please do not hesitate to contact us. The office here is open from 9am until 7pm so please feel free to call anytime. Alternatively we can arrange a time to give you a call or make an appointment to meet and discuss your requirements.

Telephone 020 7901 1190 or contact us online at [www.wellerscontractors.co.uk](http://www.wellerscontractors.co.uk)

