

CHAPTER 27

PERSONAL SERVICE COMPANIES

27.1 Introduction

Some while ago, HMRC detected a growing trend for individuals to provide what were essentially **employment services through the medium of an intermediary company, known as a personal service company, primarily to avoid PAYE and National Insurance.**

Illustration 1

A company - Online Tutors Limited (OTL) - has an employee (Dean) who receives a regular salary which is subject to PAYE and NIC on a monthly basis.

Dean decides that he no longer wishes this arrangement to continue, so he resigns his employment and sets up an intermediary company, Deano Limited. The intermediary company - Deano Ltd - has a contract under which it will provide services for the client company, OTL. In return for this, Deano Ltd charges OTL a fee.

Under general law, a company cannot be an employee of another company, so the fee will be paid to Deano Ltd gross - i.e. without deduction of any PAYE or National Insurance.

Dean, being the shareholder and managing director of the company, will still need to be paid, but instead of taking a salary from the intermediary company, he is remunerated in the form of a dividend.

Remember that a dividend is simply a way in which a company can distribute its profits to its shareholders. There are several significant advantages of paying a dividend instead of a salary.

First of all, payments of dividends are not subject to the deduction of tax under PAYE. PAYE is only deducted on earnings such as salaries. There are no National Insurance Contributions on dividends. NICs are paid on earnings and dividends are not regarded as earnings.

It is also considerably cheaper for the individual to receive a dividend than to receive a salary. Salaries are taxed as general earnings and if Dean is a higher rate taxpayer, his salary will be charged primarily at 40%. If Dean receives a salary in excess of £150,000, the excess will be charged to tax at 50%. On the other hand, dividends are only taxed at 10% up to the basic rate threshold and at 32½% up to the higher rate limit. The additional rate of tax for dividends is 42½%. Dividends are deemed to carry a notional 10% tax credit which means basic rate taxpayers will pay no extra tax at all on dividends they receive.

We also need to consider the tax position of the intermediary - i.e. Deano Ltd - and this will become clearer once you have studied the Corporation Tax part of the course. At this point it is sufficient to tell you that small companies will pay corporation tax at a maximum rate of 21% on their taxable profits. This is significantly cheaper than the current top rate of income tax of 50%.

As you will see, by carrying out a relatively simple tax planning idea, Dean will have been able to save a significant amount of both income tax and National Insurance. Many thousands of individuals opted to run their business via a limited company in order to take advantage of what was perceived to be a loophole in the legislation. The personal service company rules introduced in Finance Act 2000 were specifically aimed at plugging this loophole. You may see this legislation referred to as 'IR35 provisions' after the press release which announced the proposed changes.

27.2 The rules

The legislation will only apply in situations where the worker would be treated as an employee of the client if the intermediary company did not exist. So in our previous example, we would need to examine the relationship between the client - this being OTL - and the worker, Dean, ignoring the intermediary company in between.

[ITEPA 2003,
s.49\(1\)\(c\)](#)

We use the normal "employed versus self-employed" criteria to determine whether, under normal circumstances, Dean would be treated as an employee of OTL.

If the answer to this question is "yes", then Dean is caught by the IR35 rules.

If the answer is "no" then he is not. As such, the IR35 legislation will typically catch "one man" companies who work almost exclusively for one major client.

Let us now examine the effect of the rules by returning to our original illustration with a client company, OTL and a worker, Dean. Rather than operating as an employee of OTL, Dean interposes an intermediary company in between. Any payments for services will be made by OTL to the intermediary company. Dean can be remunerated from the company either by way of a dividend or by way of a salary. Any salaries paid to Dean will be subject to PAYE and NIC in the normal way.

The legislation applies to income from "relevant engagements". Relevant engagements in this scenario will simply mean contracts between OTL and the intermediary company.

[ITEPA 2003,
s.50\(4\)](#)

The effect of the rules is to take any income from relevant engagements and deduct any actual salaries paid to the worker, which leaves income which has not been paid out by way of a salary. This excess is then deemed to have been paid out as a salary to the worker on 5 April.

[ITEPA 2003,
s.50\(1\)](#)

In essence HMRC are pretending that the worker has received a salary at the year end and this "pretend salary" will be subject to PAYE and NIC as if it had been an actual salary.

Remember it is far more tax efficient for the worker to draw dividends from the company than salaries, so HMRC wants to make sure that workers are remunerated by way of salaries in order that they can collect tax and NIC under PAYE.

27.3 Calculating the deemed salary payment

[ITEPA 2003, s.54](#)

Once we are satisfied that the worker is caught by the personal service company rules, we need to calculate the "**deemed salary payment**" at the end of the tax year. We do this by using a proforma:

	£
Income from relevant engagements	A
Less: 5% automatic deductions	<u>(B)</u>
	C
Less: expenses paid by employer allowable as deductions from earnings if paid by an employee	(D)
Less: employer pension contributions	(E)
Less: employers NIC on workers pay	(F)
Less: actual salaries and benefits paid	<u>(G)</u>
Gross deemed payment	H
Less: employers NIC on gross payment	
$H \times \frac{12.8}{112.8}$	<u>(I)</u>
Net deemed payment	<u>J</u>

(The steps of this computation are set out in s.54 ITEPA 2003).

The starting point is **income from relevant engagements**. Remember that income from relevant engagements is income paid by a client to an intermediary where the worker would be an employee of the client under normal circumstances. It is possible for an intermediary company to receive income from non-relevant engagements in which case this income is ignored.

From this income we take an **automatic 5% deduction**. This 5% deduction is fixed and is designed to give the worker some compensation for the fact that there will be costs of running the intermediary service company.

Any **expenses paid by the intermediary which would be deductible from taxable earnings** if met by the worker, are also deductible. These will include expenses typically allowable under Section 336 and any qualifying travel expenses and expenses reimbursed to the worker by the employer. Under s.54(6) the worker is treated as having a continuous employment with the intermediary. Therefore, qualifying travel expenses essentially mean travel (and related meal and accommodation costs), incurred in doing the job or travelling to a temporary workplace.

Professional subscriptions and the usual deductions in respect of mileage allowances could also be deducted here. Any contributions made by the intermediary company to an approved pension scheme on behalf of the worker can also be deducted.

Remember that whenever a company pays a salary to a worker, the company will have to pay employer's Class 1 secondary NIC on the worker's pay. This is also deductible in arriving at deemed salary. In addition, any Class 1A contributions paid by the employer on benefits provided to the worker, are also deductible.

Finally we can deduct any **actual salaries paid** to the worker and any cash equivalents of benefits provided by the intermediary company to the worker. This will include company cars, taxable cheap loans etc.

Income from relevant engagements, less all the allowable deductions, leaves the gross payment which is deemed to have been made by the intermediary company at the end of the tax year. Whenever an employer makes a payment of salary - be it real or deemed - the employer must withhold Class 1 secondary National Insurance Contributions. As such, we must recognise that this gross deemed payment at the year end will include an amount of employer's NIC.

The employer's NIC included within the gross payment is the gross amount multiplied by 12.8/112.8. This NIC is an actual cost for the intermediary and it will be paid over to HMRC under PAYE in the normal way.

The gross deemed payment less any employers NIC included within that payment, leaves the net salary which is deemed to have been paid to the worker at the end of the tax year. This **deemed salary is subject to PAYE and National Insurance Contributions** as if it had been a normal salary. The PAYE and NIC must be **paid over** to HMRC 14 days after the end of the tax month which, in this instance, will mean **no later than 19 April**.

In practice it will be very difficult for a company to organise itself so as to accurately calculate the deemed payment and account for the tax and National Insurance within a two week period. HMRC will therefore accept an estimated amount with an adjustment being made later on in the year.

Illustration 2

A client company, Online Tutors Ltd (OTL) uses the services of a worker, Dean. He is caught by the IR35 rules because he would be treated as an employee of OTL were it not for the existence of his intermediary company, Deano Ltd.

The majority of Deano Ltd's income comes from OTL. The fees paid by OTL to the intermediary company in 2010/11 total £50,000. These are income from relevant engagements.

Deano Ltd also performs services for one additional client which here we have called Other Ltd. The fees paid by Other Ltd to Deano Ltd total £8,000. This is income received from non-relevant engagements. This is because under the normal employed versus self-employed rules, Dean will not be treated as an employee of Other Ltd.

In the tax year 2010/11, Deano Ltd paid Dean a salary of £1,000 every month. The only other expense incurred by Deano Ltd is the reimbursement of qualifying travel expenses of £1,500.

In order to calculate the amount of salary which is deemed to have been paid to Dean at 5 April 2011, we use the proforma as follows:

	£
Income from relevant engagements	50,000
Less: 5% deduction	<u>(2,500)</u>
	47,500
Less: travel expenses	(1,500)
Less: employers NIC on pay £(12,000 - 5,715) @ 12.8%	(804)
Less: workers pay	<u>(12,000)</u>
Gross deemed payment	33,196
Less: employers NIC included $£33,196 \times \frac{12.8}{112.8}$	<u>(3,767)</u>
Net deemed salary	<u>£29,429</u>

At this point in your calculation, always do a quick check. If we take the deemed salary paid to Dean of £29,429, and multiply this by the employer's NIC rate of 12.8%, it should give us the employer's NIC of £3,767. Here this will reconcile.

The deemed salary to the worker is subject to PAYE and employee's Class 1 National Insurance Contributions in the normal way. As far as Dean is concerned, when putting together his tax computation for 2010/11, his taxable earnings for the year is the actual salary paid of £12,000 plus the deemed salary of £29,429. This will be taxed on him as non-savings income in 2010/11.

27.4 Implications for the Intermediary

Corporation tax relief

It is important to note that in an exam question, you may also be required to consider the implications for the intermediary company under the personal service company legislation.

The **income received** from relevant engagements will form part of the intermediary company's **profits for corporation tax purposes**.

However, the **gross deemed payment is deductible** in arriving at the intermediary company's taxable profits for corporation tax purposes. Remember, the gross deemed payment is the net payment together with the related employer's national insurance contributions payable by the intermediary company.

[CTA 2009, s.139](#)

The **deduction is allowed in calculating the profits of the period in which the deemed payment is treated as made**. It is not possible to make an accrual in respect of the deemed payment and related national insurance contributions.

Illustration 3

Mark Weston owns 100% of Weston Ltd, a personal service company. The engagements that Mark carries out through Weston Ltd fall under the personal service company rules. Weston Ltd draws up accounts to 31 December each year.

The deemed payment for 2010/11 was £15,000. Weston Ltd is required to pay Class 1 secondary NIC of £1,920 in respect of the payment. The company will be able to deduct the total of £16,920 in arriving at taxable profits. The deduction will be claimed in respect of the year ended 31 December 2011 as the payment is deemed to be made on 5 April 2011, even though it relates mainly to income received by the company in the previous accounting period.

An intermediary company should **consider having a 5 April year end** as this will allow the deemed payment to be deducted as soon as possible.

Claim by intermediary in respect of dividends

Where a personal service company exists, the worker will typically draw money from a company by way of a dividend. If the worker draws a dividend and is also treated as receiving a deemed employment payment under the Personal Service Company rules, the same income is being taxed twice.

In this instance, the **intermediary company will make a claim for relief**. The relief will be given by **setting the deemed employment payment against the dividend** so as to **reduce the amount of the taxable dividend**. In effect therefore, dividends will only be taxed to the extent that they exceed the deemed salary payment (i.e. in most cases the dividends will be ignored).

[ITEPA 2003,
s.58](#)

The relief applies to dividends paid in the same year as the deemed employment payment, or in subsequent years. Relief is given against dividends paid in the same year before those in future years.

[ITEPA 2003,
s.58\(5\)](#)

PAYE administration required by the Intermediary

Any salaries etc., paid by employers to their workers, need to be summarised on an end of year form P35.

The P35 is normally due no later than 19 May following the end of the tax year. HMRC have recognised that there is a relatively short period of time between the date of the deemed payment and the due date for filing of the form P35 so they have said they will accept forms P35 which contain provisional figures. **Amended forms P35** can be submitted to HMRC no later than 31 January following the end of the tax year.

Whilst HMRC will accept provisional forms P35 and will accept an estimated payment of PAYE and NIC on 19 April, they have stated that they will charge interest on any tax and NIC which happens to be paid late.

27.5 Other points

The rules only apply where the worker owns more than 5% of the shares in the intermediary company. This is very likely to be the case in the vast majority of instances because if a worker sets up an intermediary service company, it is likely that he will want to control that company by having more than half of the shares. Hence the 5% rule will be satisfied in nearly every instance.

[ITEPA 2003, s.51](#)

It is not possible to avoid the IR35 legislation by having a partnership interposed in the middle instead of a company.

[ITEPA 2003 s.52](#)

The IR35 rules will apply to a worker who supplies his services through a partnership as long as that worker, together with his associates, is **entitled to 60% or more of the profits of the partnership**.

[ITEPA 2003 s.52\(2\)](#)

The partnership can deduct the amount of the deemed employment payment together with the employer's Class 1 national insurance contributions in respect of the payment in arriving at taxable profits. As we saw when the intermediary was a company, the deduction is made for the period in which the deemed payment is treated as made.

[ITTOIA 2005, s. 163](#)

However, the amount of the deduction is limited to the profits of the partnership. This means that the deduction can reduce profits to nil but cannot create a loss.

[ITTOIA 2005, s. 164](#)

Services provided by **domestic workers such as nannies and butlers** are also within the scope of the rules.

[FA 2003, s.136 amending s.49\(1\)\(a\)](#)

27.6 Managed Service Companies (MSCs).

A "Managed Service Company" (MSC) is a service company which provides workers / contractors with a composite company to manage their invoicing and accounting. Some of these composite companies or MSCs were also set up with the intention of helping workers avoid falling foul of the IR35 rules.

In a typical composite company structure, a number of contractors become non-director shareholders in a company ("MSC Ltd"). MSC Ltd is managed by the scheme provider - this is normally a separate company set up solely for this purpose.

The contractor carries out work for a client, and the client is invoiced by MSC Ltd. The client pays MSC Ltd.

MSC Ltd pays an arrangement fee to the scheme provider, and thereafter pays the contractor by way of a low salary plus dividends on his shares (hence avoiding PAYE and NIC). Typically contractors will have different classes of shares in MSC Ltd to make the allocation of dividends straightforward.

The contractor does not have to worry about invoicing (all he does is provide work-sheets etc to MSC Ltd), and all compliance obligations for the company will be dealt with by MSC Ltd.

The contractor is **not caught by IR35 as he does not have more than 5% of the shares** in MSC Ltd.

[ITEPA 2003, s.51\(4\)](#)

Even if the contractor should technically be caught by IR35, HMRC simply does not have the manpower to challenge all potential cases. It was estimated that around 200,000 individuals worked through the medium of an artificial composite company operated by a dedicated scheme provider. The scheme provider would, of course, charge a management fee for assisting the contractors in reducing their tax and NIC liabilities.

In the Pre-Budget Report in December 2006, the Government announced plans to attack these structures and remove the tax advantages that composite companies offered their clients. Legislation was introduced in Finance Act 2007 (inserted as S.61A onwards ITEPA 2003).

[ITEPA 2003, s.61A](#)

From 6 April 2007, all payments received by individuals who provide their services through a MSC or composite company will be subject to PAYE. This will mean that **whenever an MSC pays a dividend to a contractor, the MSC must withhold tax and NIC under PAYE;**

[ITEPA 2003, s.61D & s.61G](#)

The amount of the payment is calculated in accordance with s.61E ITEPA 2003. Any expenses which would have been allowable from employment income if met by the worker can be deducted. However, in this case each engagement will be treated as a separate employment and therefore the cost of travel to each engagement is not an allowable expense. No deduction is given for the 5% notional costs of running the company.

[ITEPA 2003, s.61E](#)

This can have the effect that a deemed payment calculated under the MSC rules will be higher than that under the "normal" IR35 rules (see illustration below);

Where PAYE liabilities cannot be recovered from the MSC, **HMRC can transfer the debt** to either the directors of the MSC, the scheme provider or other persons involved in the MSC (i.e., potentially the contractors themselves where all other attempts to recover the debt have failed).

[ITEPA 2003, s.688A](#)

Illustration 4

Theresa Mason and Julie Eastwood are Change Management Consultants, who both worked on a freelance rationalisation project for the Equitas Group, a large insurance company based in Cambridge. Both live in London and usually work in and around the city, but they travelled daily to Cambridge for the project.

The project lasted for 9 months. Each was paid a fee of £100,000.

Theresa Mason is employed by Mason Consulting Ltd, a company in which she is managing director and sole shareholder. She accepts that her engagement with Equitas falls under the IR35 legislation. Mason Consulting Ltd met Theresa's travel costs to and from Cambridge of £9,000.

Julie Eastwood provides her services through Watertight Solutions Ltd, a company which falls within the Managed Service Companies legislation. Julie personally incurred travel costs to and from Cambridge of £9,000.

This was their only income from engagements in 2010/11.

A deemed employment payment is calculated for each as follows.

	<i>Theresa (IR35)</i>	<i>Julie (MSC)</i>
	£	£
Income from relevant engagement	100,000	100,000
Less: 5%	<u>(5,000)</u>	<u>(NIL)</u>
	95,000	100,000
Less: deductible travel costs	<u>(9,000)</u>	<u>(NIL)</u>
	86,000	100,000
Less: employers NIC		
((payment - 5,715) × $\frac{12.8}{112.8}$)	<u>(9,110)</u>	<u>(10,699)</u>
Deemed payment	<u>76,890</u>	<u>89,301</u>

Theresa is an employee of her own company, so travel to and from Equitas is travel to a temporary workplace and is deductible under the normal rules for employment related expenses.

However, these rules will not apply for Julie as she is treated as an employee of the client, so her travel expenses are not deductible in calculating the deemed payment.

Under the definition of a "Managed Service Company", some businesses may have been unfairly treated as "MSC providers". There are therefore exemptions for the following:

- a) Providers of legal & accountancy services in a professional capacity. For example, recommending a sole trader to incorporate then assisting with payroll and other compliance functions, would not make the accountant an "MSC provider"; and
- b) Employment agencies who merely place individuals with other persons who wish to obtain their services.

[ITEPA 2003, s.61B\(3\)](#)

[ITEPA 2003, s.61B\(4\)](#)

27.7 Where are we now...?

If an individual is operating through their own personal service company, the rules in ss48-61 ITEPA 2003 apply in order to establish the deemed payment assessable as employment income. If an individual has shares in a managed service company, a deemed employment payment must be calculated in accordance with s.61E ITEPA 2003. Since the anti avoidance legislation in respect of managed service companies was introduced there has been a significant fall in the number of such companies. One alternative is for an individual to use an 'umbrella' company.

In this structure, the worker does not own shares in the umbrella company, so he cannot take dividends. Instead the umbrella company is paid by the client, takes an administration fee, then remunerates the worker via earnings taxed under PAYE. Workers use umbrella companies for ease of invoicing and accounting. All remuneration is taxed at source under PAYE and therefore there is no need to calculate a deemed employment payment.

As you can see, in every instance where a worker is providing services for one client, whether they use an MSC, an umbrella company or their own personal service company, the broad effect is the same - any remuneration received from their chosen structure should be subject to tax & NIC at source under PAYE. Only those who would not be an employee of their client under the "employed v self-employed" rules should now escape PAYE.

Example 1

Winston owns 100% of the shares of Churchill Ltd. The arrangement falls within the provisions of the personal service company legislation. The company had income from relevant engagements of £75,000 in 2010/11 of which £7,000 was paid to Winston as a salary.

Calculate the deemed payment to Winston on 5 April 2011.

Example 2

Which of the following expenses paid by an intermediary company is not deductible in calculating the workers deemed salary on 5 April?

- a) Contributions to an approved pension scheme
- b) Professional subscriptions reimbursed
- c) Claim 1A NIC on benefits provided to worker
- d) Donations to charity under Gift Aid

Answer 1

	£
Relevant engagements	75,000
Less: 5% deduction	<u>(3,750)</u>
	71,250
Less: employers NIC on pay	
£(7,000 - 5,715) @ 12.8%	(164)
Less: workers pay	<u>(7,000)</u>
Gross deemed payment	64,086
Less: employers NIC	
£64,086 × $\frac{12.8}{112.8}$	<u>(7,272)</u>
Net deemed payment	<u>£56,814</u>

Answer 2

The answer is **D** as the rest are allowed.