

# Tax temptations

Moving from employment to a personal service company can cause some unexpected complications for the taxpayer, as **SARAH THOMAS** explains.

After a busy week teaching I was looking forward to a quiet drink and catch up with David – my nephew. He arrived quite excited because, having worked as an employee for many years, he had just agreed with his employer that he could leave employment but continue to work for them as a consultant if he set up his own company. He said they would increase his pay by 10% for the first year but, in essence, he could continue doing the same work. Some of his colleagues had gone down this route in the past and he thought there might be tax savings to be made.

A little alarm bell rang in my head, probably as a result of a recent review of the subjects covered in ATT Paper 3 and Paper 4. 'Have you heard about personal service companies, David?' I asked. 'Get the beers in and I will explain.'

Here is a summary of my explanations.

## The potential tax saving?

The aim of the suggestion to work through a personal service company may well be for David's employer to save money by avoiding the application of PAYE. Rather than make a salary payment to the individual, his previous employer would pay a fee directly to the intermediary company for the services provided. Payments between companies will be made gross because, legally, a company cannot be an employee of another company.

### KEY POINTS

- The apparent monetary attractions of an intermediary company.
- If the personal service company legislation applies, the worker is assumed to have received a salary.
- The legislation applies if the worker would be treated as an employee of the ultimate client company if not for the intermediary.
- Some deductions can be taken into account when calculating the deemed salary.
- Secondary Class 1 National Insurance contributions become the liability of the intermediary company.
- The question of whether there is an employee/employer relationship needs careful consideration.



There would certainly be a Class 1 National Insurance saving for his former employer which would no longer need to pay 13.8% secondary contributions. Further, David would need to take into account that his employer would no longer be obliged to make employer contributions to a workplace pension. Thus, for starters, I suggested that David might be justified in asking for a larger pay increase than 10%.

For David, his new intermediary company would be liable to corporation tax on the gross payment (less any allowable deductions). This would be at a lower rate than income tax.

If the 'IR35' rules (ITEPA 2003, Pt 2 ch 8) in relation to personal service companies did not apply, the intermediary company could pay David, as the director/shareholder, in the form of a dividend, instead of a salary. No PAYE income tax or National Insurance contributions would apply to such payment. The personal income tax rates on dividends are lower than on a salary so this, coupled with no Class 1 primary National Insurance contributions would, normally, outweigh the additional corporation tax. However, I explained that we would need to look carefully at the numbers because this was not always the case.

The route suggested by David's employers seems like a good plan, but there's a pitfall: if the personal service company legislation applies, HMRC, in effect, 'pretend' that the worker has received a salary at the end of the tax year and will subject this to income tax and National Insurance. Further, it is the personal service company that must administer PAYE and pay these liabilities – not the former employer; in essence, this means David and his new company.

## When the legislation applies

The legislation applies in situations where the worker would be treated as an employee of the ultimate client company (in David's case, his former employer) if it wasn't for the intermediary company. Several factors are taken into account

when determining whether an individual is an employee, such as the following.

- Is the individual integrated into the business?
- Do they provide their own equipment?
- Can they send a substitute?
- Can they make a loss as well as a profit?

While all facts as in *Employment v Self-Employment* would need to be considered, David realised that it was most likely he would be treated as an employee if it were not for the intermediary company. He did not anticipate that much would change regarding his work soon. I explained that, if in the future he developed his consultancy business so that he had many clients, things might change.

## The deemed salary payment

Where we have a personal service company, a deemed salary payment would need to be calculated. There is a special computation for this amount (ITEPA 2003, s 54). Basically, it is designed to ensure that the disguised salary payments are still taxed as a salary.

The starting point is income received which would have been employment income if received directly by the worker (income from relevant engagements). There are various deductions, including:

- a flat rate 5% deduction for the costs of running the intermediary company;
- the actual salaries and benefits provided to the worker by the intermediary company;
- the employer's National Insurance contributions and pension contributions paid by the intermediary company.

This gives a gross deemed salary payment from which employer's National Insurance contributions on the gross deemed payment is deducted to give the net deemed payment.

Let's have a look at how this might apply in **DT Productions Ltd 1**.

### EMPLOYMENT V SELF-EMPLOYMENT

The factors to be considered in determining whether a worker is employed or self employed include:

- Mutuality of obligation.
- Right of control.
- Provision of own equipment.
- Right of substitution and engagement of helpers.
- Financial risk.
- Opportunity to profit.
- Degree of integration into the organisation.
- Right to terminate the contract.
- The number of paymasters.

These factors would therefore also be used in establishing the relationship for potential personal service companies.

### DT PRODUCTIONS LTD 1

David is to work for Dodge plc through his new company DT Productions Ltd. It is agreed that the engagement falls within the personal service company legislation.

The following information all applies to 2017-18.

DT Productions Ltd:

- receives £50,000 from Dodge plc for the work done by David;
- pays a salary of £10,000 to David;
- pays David's professional subscriptions of £482; and
- pays a contribution to a registered pension scheme of £5,000.

We must now calculate the amount of the net deemed salary for David in 2017/18.

	£	£
Income from relevant engagements		50,000
Less: 5% deduction		<u>2,500</u>
		47,500
Less: Employment expenses (professional subs) (Note 1)	482	
Less: Pension scheme contributions	5,000	
Less: Employers' National Insurance contributions on pay ((10,000 – 8,164) at 13.8%) (Note 2)		253
Less: Actual pay		<u>10,000</u>
Total deductions		<u>15,735</u>
Gross deemed payment		31,765
Less: Employers' National Insurance contributions included (31,765 x 13.8/113.8)		<u>3,852</u>
Net deemed salary		<u>27,913</u>

#### Notes

- (1) Employment expenses paid by the intermediary are deductible only if they would have been deductible from taxable earnings if met by the worker himself.
- (2) There is no Class 1 secondary National Insurance contributions employment allowance available for one-man companies. David would be subject to income tax and class 1 primary National Insurance contributions on both the actual salary of £10,000 and the deemed salary of £27,913. The class 1 secondary National Insurance contributions on the salary and deemed salary now fall to be paid by his intermediary company DT Productions Ltd and not Dodge plc.

Sadly, David was beginning to see that the tax and National Insurance savings might not be as great as he had hoped.

And there was still more, I explained, because his company, DT Productions Ltd, would now have significant reporting obligations:

## DT PRODUCTIONS LTD 2

	£
Gross deemed payment	31,765
<i>Less: Employers NIC included</i>	
Class 1 secondary employer's National Insurance contributions due 22 April 2018	<u>3,852</u>
Net deemed salary	
Reported on FPS on/before 5 April 2018	<u>27,913</u>

Income tax and class 1 primary employee's National Insurance contributions calculated on £27,913 salary are due on 22 April 2018.

## Reporting requirements

Any payments of actual salary during the tax year will need to be paid under PAYE and reported on a full payment submission (FPS) at or before the time of payment. Further, because the deemed salary payment is made on 5 April, the deemed payment must also be reported on a FPS on or before 5 April.

PAYE and Class 1 National Insurance contributions must then be paid over to HMRC as if the deemed salary was an actual salary paid at the end of the tax year as shown in *DT Productions Ltd 2*.

**“The legislation applies if, but for the existence of the intermediary company, the individual would be an employee of the client.”**

Because the deemed salary payment is made on 5 April, any tax or National Insurance contributions is due on 22 April if payment is made electronically (otherwise 19 April).

Because it is unlikely that the exact amount of the payment can be calculated at this stage, HMRC will accept a provisional calculation of the deemed salary payment.

HMRC will also accept estimated payments of PAYE and National Insurance contributions. However, interest will be charged on any liabilities paid late. The company then has until the following 31 January to calculate the accurate deemed payment. Any adjustments to the amount of the deemed payment should be reported by way of an earlier year update submitted to HMRC by 31 January. Any additional tax and National Insurance contributions must also be paid at this date.

We can therefore see that there is much payroll administration for the intermediary company to deal with here, whether or not any actual salary is paid to David.

Finally, having set up a company, there will be an obligation to file a corporation tax return and pay corporation tax on profits made. The income received from the relevant engagement will form part of the profits for corporation tax. However, a deduction will be allowed in calculating profits of the period

## DT PRODUCTIONS LTD 3

The company will be able to deduct the total of £31,765 (being the net deemed salary and the employer National Insurance contributions thereon) in arriving at its taxable profits for the accounting period that includes 5 April 2018.

It is quite common for the company to select a year end of 5 April as this will allow the deemed payment to be deducted as early as possible.

in which the deemed payment is treated as made. As shown in *DT Productions Ltd 3*, this is clearly fair and ensures that the income is not taxed twice.

By now, David was thinking that this arrangement was going to be administratively quite onerous and not as lucrative as he had at first thought. Of course, this was HMRC's intention because the rules are designed to prevent individuals inserting a company between themselves and a client to reduce the tax obligation. In a nutshell, this is anti-avoidance legislation working as intended.

## Summary

We can summarise the effects of the personal service company rules as follows.

- The personal service company legislation applies if, but for the existence of the intermediary company, the individual would be an employee of the client.
- In essence, the rules ensure that income from the client is taxed as salary for the worker.
- The deemed salary payment is calculated using a pro forma (see *DT Productions Ltd 1* above).
- PAYE and Class 1 primary and secondary National Insurance contributions will be due on this deemed salary by 22nd April (if paid electronically).
- HMRC will accept an estimate, with any outstanding amounts due by following 31 January.
- The deemed payment should be reported on a full payment submission (FPS) on or before 5 April.
- The deemed payment and the related employer Class 1 National Insurance contributions can be deducted in arriving at the profits chargeable to corporation tax of the intermediary.

## Conclusion

I believe I put David off before he started. However, if readers or their friends are considering something similar, be careful not to bite off more than can be chewed. Setting up an independent business as a company is perfectly acceptable and most companies will not be affected by the personal service company legislation. However, if there is an employee/employer relationship with a client these rules need careful consideration. ■

**Sarah Thomas** is a senior tutor at Tolley Exam Training. She can be contacted on 020 3364 4500 or [examtraining@lexisnexis.co.uk](mailto:examtraining@lexisnexis.co.uk). Visit [www.tolley.co.uk/products-and-services/exam-training](http://www.tolley.co.uk/products-and-services/exam-training).