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Using individuals via a services company: tax considerations

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Introduction

The labour market has become more complex in recent years, with many individuals choosing to go into business on their own account and sell their services to clients either directly, as a sole trader, or through a variety of intermediaries, such as partnerships or services companies.

Where an individual provides his services through a company, the arrangement is generally structured so that the services company supplies the individual to the client (sometimes via an employment agency) in exchange for the payment of a fee

Why would an individual use a services company?

There are a number of commercial and tax reasons why an individual may choose to supply his services through a company.

The primary commercial advantage is that the company's liability is limited.

From a tax perspective, depending on the profits of the services company, it is possible for the individual to make tax savings by paying himself primarily by way of dividend rather than salary. Unlike salary, dividends are not subject to employee or employer NICs. In addition a 45% taxpayer will currently pay tax at an effective rate of 38.1% on dividends from a UK company in excess of a tax free allowance (which for tax year 2018-19 is £2,000), rather than 45% on earnings in excess of £150,000.

What are the types of services companies?

In broad terms there are two types of services company: personal services companies ("PSC") and managed services companies ("MSC").

With a PSC, the individual exercises management and financial control over the company.

With a MSC, there is a MSC provider ('Provider') who is 'involved' with the MSC. In contrast to PSCs, it is the Provider (rather than the individual) who is exercising control over the business. For example the individual usually takes no part in the on-going management or financial control of the company. Instead, the Provider handles payments between the client and the MSC, deducting a fee for the work it carries out and arranging for the payment of the individual. In other words the Provider is normally a person in the business of providing a generic company structure for one or more individuals and administering that structure.

Personal service companies: the impact of "IR35"

In 2000 HMRC, concerned by the perceived loss of tax through the use of PSCs, introduced anti-avoidance legislation (known as IR35).

In broad terms, IR35 applies where the individual personally provides services to a client

and:

> Ignoring the existence of the intermediary, the individual would be an employee of the client; or

> Ignoring the existence of the intermediary, the individual would be an officeholder of the client e.g. a director; or

> The individual is an officeholder and the services he provides through the intermediary relate to that office.

In other words, assuming the individual is not an officeholder, IR35 will not apply if the relationship between the individual and the client is one of self-employment.

Where IR35 applies generally the PSC (rather than the client) is required to operate PAYE and NICs on deemed employment income (this is broadly the fees received by the PSC from clients less certain permitted expenses). However, there are a number of exceptions to this general rule as summarised below.

In addition, in April 2017, IR35 was amended in circumstances where the individual provides his services via a PSC to the public sector. The public sector organisation is responsible for determining whether IR35 applies and, if it considers that IR35 does apply, the entity paying the PSC will generally be responsible for deducting income tax and employee NICs from, and accounting for employer NICs on the fees it pays to the PSC (excluding VAT). An organisation to which the Freedom of Information Act 2000 or Freedom of Information (Scotland) Act 2002 applies is a public sector organisation for these purposes.

Managed service companies: further anti-avoidance legislation

MSCs were formed with a view to avoiding the application of IR35. As a result, in 2007 HMRC introduced further anti-avoidance legislation to deal specifically with MSCs.

Unlike IR35, the MSC legislation applies irrespective of the relationship between the individual and the client. If a company is a MSC it is automatically required to operate PAYE and pay NICs on the fees it receives from clients less certain permitted expenses.

What are the tax risks for a private sector client?

Any private sector client receiving services from an individual via a services company should consider whether it has any tax exposure and, if so, how best to protect itself.

It is imperative that the client has a valid contact with the services company and that it acts in accordance with that contract (e.g. ensuring the payment is made to the services company on receipt of an invoice rather, than to the individual). It is also important for the client to carry out due diligence on the services company, to make sure that the services company actually exists and is solvent. If the client does not have a valid contract with the services company, HMRC will treat the arrangement as a sham and treat the individual as an employee of the client.

Assuming there is a valid contract in place, the risk will, in part, depend on where the services company is tax resident.

If the services company does not have a presence in the UK, the client may be liable to operate PAYE, deduct employee NIC and pay employer NIC unless the individual has a No Tax (NT) Code from HMRC (confirming that no PAYE deductions should be made) and an A1 certificate or certificate of coverage from their home country social security authorities (confirming that no UK NICs are due).

Where the services company has a presence in the UK, under current law the risk depends on whether the individual is supplying his services through a PSC or a MSC.

Where IR35 applies, under current law, it is the PSC, rather than the client, which is required to account for PAYE and NICs. That said, the Government has announced it will launch a consultation in 2018 to consider whether the public sector rules referred to above should also apply in the private sector. While there are, as yet, no details available on the proposals, it is likely that the public sector rules will be extended to the private sector. Accordingly, private sector clients will become liable for determining whether IR35 applies and, if so, operating PAYE and NICs.

If (i) the individual is contracting via a MSC; (ii) the MSC fails to pay the PAYE and NICs; and (iii) it is impracticable for HMRC to recover the PAYE and NICs from the directors of the MSC or the Provider, HMRC may transfer some or all of the PAYE and NICs liabilities to a third party (such as a client or the directors and officers of the client) if that third party encouraged or was actively involved in the provision of the services of the individual through a MSC.

What steps should a private sector client take?

Ways in which a private sector client may be able to limit its risk under current law include:

> Ensuring that it carries out due diligence on the services company

> Ensuring that it has a valid contract with the services company

> Ensuring that the contract gives the client the right to deduct PAYE and employee NICs should the law change in the future

> Seeking a comprehensive PAYE/NICs indemnity from the services company

> Ensuring that it neither encourages nor is actively involved in the provision of services through a company

> Seeking warranties that the services company is not and will not become a MSC and that it is complying and will continue to comply with its PAYE/NICs obligations.

inbrief

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