CALCULATING THE DEEMED EMPLOYMENT PAYMENT

Tolley®Guidance

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Disclaimer

Calculating the deemed employment payment

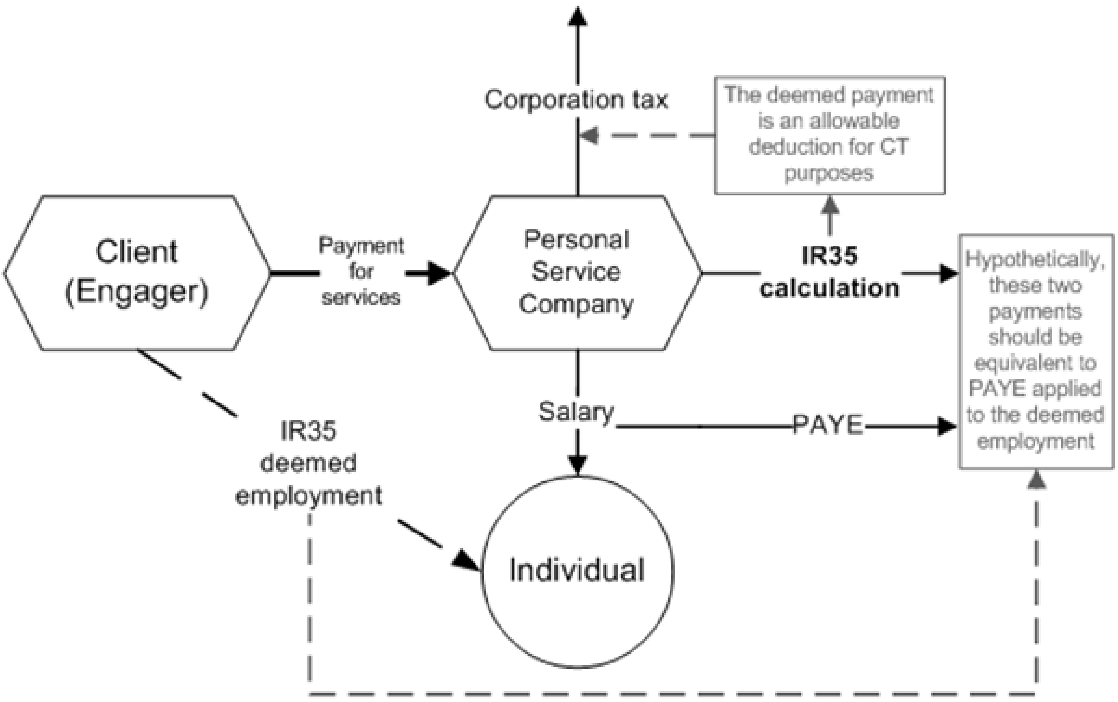
Produced by Tolley

Many people supply their services to clients, not directly as a self-employed person, but via a company. The tax and NICs advantages of this way of working are significant. See the Introduction to personal service companies guidance note.

Since April 2000, anti-avoidance legislation, known as 'IR35', catches individuals who would be employees of their clients if they were engaged directly rather than using a service company. See the Employed or self-employed guidance note.

The intention of IR35 is to collect roughly the same tax and NICs as would have been paid if an individual was employed directly by his client. The obligation to calculate and pay the tax and NICs rests with the service company and not the client.

The diagram below shows the interaction of the IR35 calculation with a personal service company structure.



Separate legislation exists for tax and NICs. For tax, the calculation is known as the 'deemed employment payment' calculation, for NICs it is the 'attributable earnings' calculation.
ITEPA 2003, ss 48-61
SSCBA 1992, s 4A (subscription sensitive)
Social Security Contributions (Intermediaries) Regulations (SI 2000/727) (subscription sensitive)

In most cases the calculations are identical, but not invariably. Those who provide services as teachers, cleaners, non-executive directors or entertainers may be subject to special rules. The same is true of cross-border workers - see the Other points guidance note.

The calculation generally

If one or more engagements in a tax year are within IR35, the intermediary must calculate and pay over the PAYE and NICs. The intermediary is normally a company, but could be a partnership or even an individual (see The rules for personal service companies guidance note).

A service company worker may have a number of contracts during the year, not all of which fall within IR35. Careful record keeping is thus necessary, and some apportionment may be required.

The steps

The IR35 calculation has eight steps. Each step, other than Step 7, is on cash basis for both tax and NICs. Records must therefore be kept on both a cash basis for IR35, and an accruals basis for accounting and other tax requirements such as corporation tax.
ITEPA 2003, s 54

HMRC provide a helpful calculator, which is particularly useful for working out the NICs and the implications of pension payments. However, the calculator only goes as far as 2014/15 at present.

Step 1

Add up the total amount of all payments and other benefits received by the service company in that year in respect of all IR35 engagements. Use the VAT exclusive amounts, whether or not the VAT flat rate scheme for smaller businesses has been adopted.
BIM31585

This total is then reduced by 5%, which represents a round sum expense allowance designed to cover the extra costs of working through a service company. Examples of the type of expenses envisaged are accountancy and filing fees, the cost of seeking new contracts and training. For the purposes of this calculation, there is no requirement that the company actually spend 5% on this sort of expense - it may spend more, less, or nothing at all.

Step 2

Sums received by the individual directly from the client are included here.

In most cases, payments or benefits made directly to the individual by the client are provided by reason of his employment with the service company. They are thus already taxable and subjected to NICs under the normal employment income and NICs rules. They will be included at Step 7, with salary and other employee benefits.
ITEPA 2003, s 62, 70(1)(b), 201(2)
EIM20503

Partners, however, do not have an employment, and Step 2 is thus designed to catch payments or benefits provided by clients directly to partners who are within the scope of the rules. It is, however, rare for partners to be within IR35.

ESM3115

Step 3

This gives relief for expenses which would have been deductible from the individual's salary had he been employed by the client and paid for the items himself.

In general the expenses must have been incurred 'wholly, exclusively and necessarily in the performance of the duties of the employment'.
ITEPA 2003, s 336

The rules for travel and subsistence are more generous. In particular, the individual can generally treat the location of the service company as his 'permanent workplace'. As a result travel and subsistence to the client site generally satisfies the 'temporary workplace' tests. These generous travel reliefs are one of the few tax advantages available to those within IR35. See HMRC's response to frequently asked questions .
ITEPA 2003, ss 337-339

Specific relief is also available for a small number of other costs, including:

- incidental overnight expenses (ITEPA 2003, s 240)
- work-related training provided by clients or agents (but not by the service company) (ITEPA 2003, s 250)
- limited home as office costs (ITEPA 2003, s 316) (EIM21610)
- professional fees and subscriptions (ITEPA 2003, ss 343-344)
- professional indemnity insurance (PII) (ITEPA 2003, s 346)

See Simon's Taxes E4.1013

Step 4

Step 4 allows a deduction for capital allowances that could have been deducted from employment income if the worker had been employed by the client and had incurred the expenditure. The assets must have been 'necessarily provided for use in the performance of the duties of the employment or office.'
CAA 2001, s 262

Step 5

This allows a deduction for employer contributions to a registered pension scheme. These contributions are thus not subject to NICs, unlike contributions made by the individual.
FA 2004, Part 4, ss 149-284

Step 6

Step 6 provides a deduction for any employer's NICs already paid for that tax year in relation to the individual: both Class 1 NICs on salary paid in the year, and Class 1A on benefits provided.

The legislation refers to NICs paid 'for' the year, not 'in' the year. Class 1A NICs paid on 19 July following the end of a given tax year are therefore still deductible in that year's deemed income calculation.

Step 7

This allows a deduction for salary paid and benefits provided to the worker by the service company. Both will be taxed in any event under the normal rules for PAYE and P11Ds.

Step 8

Step 8 deducts the employer's NICs on the deemed payment. This is of course itself dependent on the deemed payment, and thus involves a grossing up formula. The HMRC calculator provides a short cut. Again, this only goes up to 2014/15 at present.

The calculation result

When all these steps have been completed, the result gives the individual's deemed employment income from contracts within IR35. The service company is required to pay over the PAYE and NICs due.

See Example 1.

Normal reporting deadlines should be followed, but because of the difficulties in carrying out the calculation within this timetable, estimated figures can be used. If there is a delay paying over tax and NICs, interest is charged. By concession, there are no penalties as long as the tax and NICs are paid by 31 January following the end of the fiscal year.
ESM3182

The deemed payment (ie before employee NICs and PAYE) is deductible for corporation tax purposes, as are the employer NICs.

CTA 2009, s 139

Payment to the individual

Most people need to withdraw money from their service companies to fund normal living costs. There are three ways of doing this, the third of which gives rise to unexpected double taxation. These are to:

- pay sufficient salary during the year so there is no deemed payment at the year end
- pay out the profits of the company as a dividend. Specific legislation prevents double taxation if this route is chosen (ITEPA 2003, s 58)
- calculate the deemed payment at the end of the fiscal year, pay over the tax and NICs, and then withdraw the net amount. However, this will be regarded as a salary payment in the hands of the individual, and will cause further PAYE and NICs to arise. It should thus be avoided.

For further reading see Simon's Taxes E4.1025