

IR35 AND DIVIDEND STRATEGY

As IR35 matures as a tax system, its become apparent that traditional strategies for managing dividends from a small company potentially affected by IR35 may need to be reviewed.

IR35 works by compelling the company to distribute a minimum amount of income as salary, and for this salary to be taxed and subject to NI under the PAYE system – its therefore the responsibility of the company, as employer, to operate IR35.

Where there is an IR35 assessment made after an Employers Compliance Review which results in an IR35 fail, in the first instance HMRC will assess the company for the extra tax / NI due.

What if the company hasn't got the money? Its commonly thought that HMRC can then turn to the contractor, as employee, to collect the debt, but this isn't always the case. In fact under current legislation HMRC can only turn to the contractor if the contractor has received monies without IR35 being applied and knew that the company wilfully failed to deduct tax / NI.

That is a very high hurdle for HMRC to cross, particularly where IR35 is acknowledged to be a complicated, nebulous and difficult to apply piece of legislation. A typical Employers Compliance Review by HMRC will last well over a year, often three or four years, and will ultimately be decided on technicalities – against that background , to establish a wilful failure is very difficult.

So what does this mean in practice? Well there are two implications.

First, make sure you act with due diligence with respect to IR35 and retain the evidence:

- Review your contracts before signing, and challenge any terms you don't like or which look IR35 unfriendly
- Have your contracts professionally reviewed
- Raise points from the review with your agent / client
- Obtain and retain a portfolio of IR35 friendly evidence about your working practices

A contractor who does this is in a much stronger position all around with respect to IR35, but doubly stronger if there was a dispute about whether there had been a wilful failure to operate IR35.

IR35 AND DIVIDEND STRATEGY - continued

The second implication relates to dividend policy in your company.

This is best illustrated with an example - meet Freda. Freda is an IT contactor, earning £100k pa. She believes she is outside of IR35. She has a £8k salary each year and needs another £40k to live off.

Historically the advice would be to take a £40k dividend each year and leave the rest in the company – this would actually leave £34k of retained profit in the company each year, Corporation Tax paid, but not Personal Tax paid. Her annual tax bills (2006/07 rates) would:

PAYE/NI	£1,099
Corporation Tax	£17,408
Personal Tax	£3,175
 Total each year	 £21,682

Now, supposing HMRC undertook an Employers Compliance Review and Freda was, reluctantly, forced to concede. Ignoring any penalties and interest, her annual tax bill at 2006/07 rates would be:

PAYE/NI	£39,508
Corporation Tax	£950
 Total each year	 £40,458

So Freda is worse off by just under £19k pa.

Now, supposing instead of leaving retained profit in the company, Freda had taken the maximum possible dividend which would have been £74k. Her annual tax bills (2006/07 rates) would be:

PAYE/NI	£1,099
Corporation Tax	£17,408
Personal Tax	£11,675
 Total each year	 £30,182

So she is paying £8k more tax each year - £30k compared to £22k but unless HMRC can prove a wilful failure to operate IR35, her spare money is safe.

Bear in mind that any HMRC Employers Compliance Review is going to go back several years and will take two, three or maybe four years to conclude. Suppose HMRC went back five years on Freda. What would the effect of the differing strategies be?

Under the traditional strategy after five years Freda would have £170k in her company (£34k x five years). The extra tax/NI due under IR35 would be five years by £40k - £22k = £90k. There are more than enough funds in the company to pay this, so Freda loses £90k of the reserves in her company, and HMRC collect the full IR35 liability.

IR35 AND DIVIDEND STRATEGY - continued

However had Freda taken the maximum dividend possible then the £170k would be in her name, not the company name, and having paid £8k pa more personal tax, over five years she would have £130k extra in her own name – and unless HMRC could prove a wilful failure to operate IR35 those monies would be safe. Following this example on, the best advice to Freda in these circumstances would be to immediately place her company into liquidation under the control of an Insolvency Practitioner. The only funds in the company would be those saved up for this years Corporation Tax, PAYE, NI and VAT (assuming Freda is drawing monthly dividends) so HMRC get nothing extra from their IR35 assessment – in fact they lose out to the tune of the liquidators fees.

A word of caution – you cannot safely swap between these strategies once an IR35 investigation has started, and certainly you cannot draw a large dividend to drain the company after an IR35 decision has been made against your company. To be safe you would need to be operating the maximum dividend approach each year consistently.

In conclusion, the traditional advice of minimising dividends and building up funds in the company minimises tax liabilities but does leave funds at risk from IR35 attacks. An amended strategy, with a maximised dividend each year results in an increase in tax due each year, but gives protection against IR35 assessments provided there has not been a wilful failure to operate IR35.

© Garbetts
January 2007