

IR35 – The Maths

Essentially the decision to pass or fail IR35 is one that is made with tax savings in mind. The limited company which enters into contracts that pass IR35 will have the option of distributing some of the company turnover as dividends. Dividends are technically a return on investment, paid to the shareholders of the company. The taxation advantage of dividends is that they do not attract National Insurance Contributions (NIC).

Alternatively, if the contract fails IR35 the option of a dividend is severely restricted, with the bulk of the income being distributed as salary and bonus; both resulting in full tax and NIC deductions.

Maths for the IR35 Pass Contract

In cases where the contract passes IR35 the director will draw a regular [salary](#) from the company. The [expenses](#) planning will also be maximized, incorporating items such as business travel, computer purchases, mobile phone bills etc. The balance of the company funds are then accrued as profits, which can be distributed as dividends.

Here's an example:

A client generates £400 per day via his limited company. This equates to around £100,000 per annum. To meet the expenditure requirements of the client's household it is recommended that a net salary of £2,500 per month is drawn. In addition the company will reimburse expenses of £5,000 per annum, and the company will make pension payments, into the director's personal pension, of £5,000 per annum. The math's look like this:

Company Turnover		£100,000
Less:	Salary	£42,000
	Employer's NIC	£4,200
	Expenses	£5,000
	Pension Payments	£5,000
		<u>(£56,200)</u>
Company Profits	(Pre tax)	£43,800
Corporation Tax	(20%)	<u>(£8,760)</u>
Net Profit		£35,040

The £35,040 can be distributed as a dividend to the shareholders of the limited company. If, when this income is added to the shareholders' other income from elsewhere, the shareholder remains in a lower tax bracket, there is no more tax or NIC to pay. On the other hand, if this dividend pushes the shareholder into the higher rate tax bracket additional tax will be due. The most that this will ever result in is a further 20% (making the total tax deducted 40%).

As can be seen by the above example, passing IR35 results in the ability to draw dividends; dividends do not attract NIC; so the yield for the shareholder/director is much greater.

Maths for the Fail IR35 Contract

If the engagement that is the source of the funds has to be regarded as a Fail IR35, the limited company loses some of the control over the manner in which the income is paid out. In short, the income from IR35 fail engagements will need to go through the following process: -

Step 1	Calculate the company income from 'employed engagements'	£100,000
Step 2	Deduct 5% for 'employer running costs'	£5,000
	Sub-Total	£95,000
Step 3	Deduct any expenses including business travel or PI insurance	£5,000
	Sub-Total	£90,000
Step 4	Deduct pension contributions	£5,000
	Balance	£85,000
	(to be treated as payment deemed to attract Tax and Employers NIC)	
Step 5	Deduct Employers National Insurance (NIC)	£8,000
	Gross Salary (subject to income tax and employee's NIC)	£77,000

Although this is a bit complicated, you will clearly see that the amounts of NIC payable have increased significantly between the fail IR35 case and the earlier pass IR35 client.

It is, of course, quite possible to have a series of engagements throughout a tax year, some of which are regarded as 'employment' and some of which fall within the 'self employment' categories. In this case only the contracts that fail IR35 are treated as above and income earned through other contracts being taxed under the "old rules". Expenses in the circumstances are apportioned on a reasonable basis between the two types of engagement.