

Are you a service company? Contractor limited company P35 and tax return question

Contractors who contract through their own [contractor limited company](#) must complete a P35 Employer Annual Return and submit this to [HMRC](#) by 19th May 2009, or they will suffer an automatic penalty.

The P35 asks for detailed information about income tax and National Insurance Contributions (NICs) for directors and employees, which includes contractors and their spouses.

Last year saw the introduction of a new question 6 that asked contractors whether they considered themselves to be a service company and, if so, were they inside IR35. For most contractors, saying yes was like waving a sign saying, 'HMRC, please come and inspect me!'.

New advice from HMRC

But new advice from HMRC this year, on [page 18 of HMRC's Employer Helpbook E10 \(2009\)](#), suggests that most contractors will have to tick 'yes' for the first box of Part 3 question 6.

The first question asks, 'Are you a Service Company?', and according to the guidance from HMRC, this should be answered 'yes' if:

- o "An individual performed services (intellectual, manual or a mixture of the two) for a client or clients, and
- o The services were provided under a contract between the client and the company of which, at any time during the tax year, the individual performing the services was a shareholder or partner, and
- o The company's income was, at any time during the tax year, derived wholly or mainly (that is, more than half of it) from the services performed by the shareholders or partners personally."

Quite clearly, the overwhelming majority of contractors operate their limited companies in this fashion, where they, as a shareholder, performed most ('wholly or mainly') of the fee earning work for their client.

IR35 and Managed Services Companies legislation

The second question, which asks "...have you operated the Intermediaries legislation (sometimes known as [IR35](#)) or the [Managed Services Companies \(MSC\) legislation](#)?" is potentially more straightforward. It does not necessarily follow that contractors answering 'yes' to the first question must answer 'yes' to the second.

Contractors should know whether they have worked within IR35 and the MSC regulations, as they would have been making provision for the additional income tax and NICs on deemed payments under IR35. If they have, then they answer to the second question is clearly 'yes'.

If the contractor has answered 'no' to the first question, then the answer to the second question is automatically 'no'. However, it is most unlikely that this will arise, because of the way most contractors work and [run their limited companies](#).

Will answering 'yes' result in an investigation?

Based on the new, clearer advice from HMRC on what they see as constituting a service company, it is likely that a significant number of contractors and freelancers who ticked 'no' to the question last year will tick 'yes' this year.

And nearly all those who ticked yes to the first question for the first time this year are likely to tick 'no' for the second question about IR35 and the MSC legislation.

Following the submission deadline on 19th May, HMRC inspectors will suddenly find themselves in a hugely target-rich environment, as a 'yes'/'no' answer leaves the contractor open to a compliance check to ensure their contracts, current and past, are outside of IR35.

The most important question is whether HMRC will have the resources to investigate the potentially hundreds of thousands of 'new' service companies on their patch?

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