

What is a 'personal service company'?

Many contractors choose to work for clients using their own **limited companies**, sometimes referred to by the taxman as 'personal service companies'. They do so for many reasons, often because clients and recruitment agencies won't hire the self-employed, which leaves contractors outside of **IR35** with few choices.

The term 'personal service companies' was devised by **HMRC** following the introduction of IR35 by the then Chancellor Gordon Brown, who originally proposed the legislation in the March 1999 pre-budget, with IR35 becoming law in April 2000.

So just what is a personal service company?

This is where things get tricky. Because there is no clear definition in law of what actually constitutes a personal service company, HMRC often use this lack of clarity to their advantage when investigating the tax affairs of contractors.

In the contracting sector, the generally accepted definition of a personal service company is a limited company that typically has a sole director, the contractor, who owns most or all of the shares.

The contractor's personal service company generally supplies professional services to end user clients, either directly or via an agency. The professional services, typically IT or engineering, are delivered by the contractor and, just to reinforce the point, they are also the owner and director of the business.

No choice for contractors

Limited companies can be a tax efficient way for contractors to work, as they tend to split their income between **salary and dividends**, which means they do not pay, for example, employers or employees Class 1 National Insurance Contributions on a large part of their overall income. However, one of the main reasons contractors outside of IR35 use their own limited companies is because that is what clients demand: no limited company, no work!

Clients do not want even the slightest risk of there being a contract of service, or an employment relationship, with their contractors. That's because they simply do not want all the hassles and expense that come from hiring an employee. So, by using a contractor's limited company in a contract for services, clients are effectively highlighting that they do not have and do not wish to have an employer-employee relationship with the contractors.

Many clients also choose to use agencies as yet another buffer between them and the contractor. After all, one of the biggest benefits of using contractors is that they are flexible and can be used to work on projects on an as needed basis. So using an agency means it is relatively easy to quickly and easily buy in the skills needed.

By using a limited liability company, contractors are also insulated to a certain extent from business risk. When contractors work for the sort of blue chip clients who might sue suppliers to cover themselves if things go wrong, this is a significant benefit.

Then came IR35

Professionals from many backgrounds have been using their own limited companies to better provide services for their clients for over a century. However, with the introduction of IR35 in 2000, HMRC decided that this was no longer an acceptable business model in every case.

IR35 is designed to generate additional tax revenue for the Treasury by treating legitimate service providers, like contractors, as employees, and taxing them accordingly. The legislation was introduced to tackle the small number of contractors who were genuinely abusing the previous system, but HMRC has since used it to target the contracting sector as a whole.

Due to poor planning and ineffective consultation, when the IR35 legislation was introduced it was discovered that a huge number of small and micro businesses would be also be affected, including many that had been trading for decades.

And so the term personal service company began to be used by HMRC to describe businesses they considered as tax evaders and potentially the subject of tax investigations.

The future of 'one man bands'

Despite the best efforts of HMRC and the Treasury, contractors and the trade bodies that represent them – such as the **Professional Contractors Group** (PCG) – stubbornly refuse to be cowed by the succession of tax laws that have followed the introduction of IR35.

It seems to be an unfortunate side effect of what was legislation initially designed to tackle a small, but real, problem that the role of the independent, flexible

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and entrepreneurial professional services supplier has come under attack by the Treasury and HMRC.

Yet despite this, contractors using their own limited companies – or, as HMRC label many of them, ‘personal services companies’ – remain in high demand.

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