

## Employment status - briefing What is working for yourself?

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### 1. Introduction

Those who work for themselves are not a homogenous group they are a collective defined by tax and employment rights that not many people seem to understand. There isn't even a label that can be given to this group to clearly define them, other than they are just not employed.

In general, there are two categories for tax – employed or self-employed and three categories for employment rights – employed, self-employed and limb (b) worker. This can cause some problems where the individual is a worker for employment rights and pays tax as a self-employed person. This happens most often in the so-called 'gig' economy, see below.

A person can, for example, be a self-employed sole trader or a limited company director. They are not one and the same. A self-employed sole trader trades with unlimited liability and pays Class 2 & 4 NICs and income tax. Whereas, a limited company has limited liability and pays corporation tax, firstly, and then NICs and income tax on salary and income tax on dividends. A limb (b) worker pays tax as a self-employed person but, has basic 'day one' employment rights.

## 2. Self-employed

### 2.1 Defined

There is no legal definition for self-employed. A self-employed person is defined by case law which determines whether they are employed or self-employed. Self-employment is not a choice and it is ultimately up to the courts to decide what your status is if it is challenged by HMRC for tax purposes.

Self-employed people might describe themselves as<sup>1</sup>:

- Running their own business
- Working for themselves
- Freelancing
- Partner
- Sub-contractor (usually in construction)
- Agency worker (usually PAYE)

The first four are all, in fact, one and the same thing for tax purposes apart from the agency worker who is not self-employed at all, but is on the payroll. The agency worker may be a limb (b) worker but, may also be governed by the **Agency Workers Regulations 2010**.

The self-employed are a group categorised by their tax status. They pay tax as an unregistered individual except for their **Unique Taxpayer's Reference** (UTR). They also trade without a limit on their liability, which is often a reason why they might incorporate their business, for more details on this see 'Incorporation' below. So, if a claim is made against them, they could lose their assets including the family home.<sup>2</sup>

### 2.2 Self-employed tax

They pay National Insurance Contributions (NICs) of Class 2 fixed rate of currently 9% and Class 4 on profits between an upper and lower level. NICs confer the right to benefits and the self-employed get some benefits but, not the same benefits as an employee. They also pay income tax at the same rate as an employee. The main difference is that the employer would pay 13.8% NICs on the employee's salary, whereas there is no such contribution for the self-employed<sup>3</sup>.

### 2.3 Sole trader

A self-employed person can also be referred to as a '**sole trader**', very often the term self-employed sole trader is used. Although the self-employed may trade alone, it does not preclude them from employing people.

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<sup>1</sup><https://www.ons.gov.uk/employmentandlabourmarket/peopleinwork/employmentandemployeetypes/articles/coronavirusandselfemploymentintheuk/2020-04-24>

<sup>2</sup> A concept called SEPA – Sole Enterprise with Protected Asset was proposed by Rebecca Seeley Harris when she was a Senior Policy Adviser at the Office of Tax Simplification – this would protect the main assets of the self-employed person.

[https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/563407/SEPA\\_final\\_report\\_271016.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/563407/SEPA_final_report_271016.pdf)

<sup>3</sup> This also applies when an engager works with a Personal Service Company unless the PSC is a deemed employee under OP21.

These terms do not and should not be used to reference those who are incorporated. So the terms such as a self-employed director are mutually exclusive.

## 2.4 Coronavirus support

During the Coronavirus pandemic the Government provided the self-employed with the **Self-employed Income Support Scheme (SEISS)**. In order to claim you needed to be eligible and self-employed. You could not claim **SEISS** if you provided your services through a limited company or if you were a **freelancer** on-payroll but, not an employee.

## 2.5 The self-employed in numbers

Self-employed (as at January 2021) 4.5 million (dropped from 5 million)

Self-employed Income Support Scheme (SEISS) support<sup>4</sup>

- Around 5 million individuals reported self-employment income for the tax year 2018 to 2019 and had their data assessed for potential SEISS eligibility. Via this process, 3.4 million self-employed individuals were identified as potentially eligible for the SEISS scheme.
- By 30 September 2.3 million (67%) of the potentially eligible population had claimed a second SEISS grant with the value of these claims totalling £5.7 billion
- The average value per claim was £2,500
- Around 91% of claimants are aged between 25 and 64 years old.

Of the 1.6 million that did not meet the SEISS criteria:

- 1.4 million (87%) had trading profits less than non-trading profits (eg. income from employment or investment income) – the so-called 50-50 rule;
- 0.5 million (33%) had trading profits of £0 or made a loss; and
- 0.2 million (11%) had trading profits over £50,000.

(N.B. Individuals may be counted more than once if they have trading profits which meet more than one of these criteria which explains why the figures sum to more than 1.6 million)

## 3. Incorporation

### 3.1 Defined

The incorporation might be called a:

- Limited company
- One-man band
- One-man (or woman) limited company
- Personal service company
- Limited Company Contractor

None of these has a legal definition, so no matter how the company is described, it has to abide by the same rules as an ordinary limited company.

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<sup>4</sup> <https://www.gov.uk/government/publications/self-employment-income-support-scheme-statistics-october-2020/self-employment-income-support-scheme-statistics-october-2020>

Neither the director nor the company are in the bracket of self-employment and should not be referred to as such. Even though some sole directors may feel as if they are self-employed, but just through a company, they are not.

### 3.2 Separate Legal Entity

An incorporated business is a **separate legal entity** in law to the person who runs it. So, the person who is the director has formal legal duties to run the company. The **turnover** ( which is the money which comes into the company) is not theirs to use and they will have to pay corporation tax (currently at 19%) on the profits. It is the company's money and has to be extracted from the company as salary or dividends, amongst other methods.

### 3.3 Reasons for incorporation

Those who incorporate their business do so partly for the limited liability that the company gives them. In 2014, HMRC commissioned an independent survey by Ipsos MORI into the reasons for incorporation<sup>5</sup> and these were given as:

- Enhanced credibility
- Limited liability
- Meeting the criteria for certain government contracts
- Obtaining finance
- Formalised structure
- Tax and NI savings

Some believe that these companies are incorporated purely for tax reasons but, the evidence says otherwise.

### 3.4 Director / shareholder

When a person incorporates their business they will become a **shareholder** in the business. They will also become a **director** but, this is separate to being a shareholder. As an **executive director**, they are responsible for the day to day running of the company. A director is not necessarily an employee, this is the topic of much legal debate but, the case law has questioned whether you can in fact be an employee of your own limited company. If the director is an employee, they will only be so if they have a **contract of employment**.

### 3.5 Person of Significant Control

If you are a **sole director** and **majority shareholder**, you will also be a **Person of Significant Control** (PSC) in the company. This is not to be confused with a PSC or **Personal Service Company** – that is purely incidental. A Person of Significant Control has more than a 25% share in the company, so there can only be a maximum of 4 such people in the company.

### 3.6 Incorporation in numbers

There are<sup>6</sup>:

- 2 million actively trading small companies
- 1.157 million micro-entities

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<sup>5</sup> HMRC Research Report 317 - [https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/342335/HMRC\\_Research\\_Report\\_317\\_-\\_Reasons\\_behind\\_incorporation.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/342335/HMRC_Research_Report_317_-_Reasons_behind_incorporation.pdf)

<sup>6</sup> BEIS Business Population Estimate (BPE) 2020 – published October 2020: <https://www.gov.uk/government/statistics/business-population-estimates-2020>

- 946,000 non-employing companies

According to the Business Population Estimate, a non-employing company is assumed to have only one working director.

A micro-entity has 2 out of the following:

- a turnover of £632,000 or less
- £316,000 or less on its balance sheet
- 10 employees or less

These are all part of the small company population.

## 4. Personal Service

### 4.1 Personal Service Company

A **Personal Service Company** or **PSC** is a term that was originally coined by HMRC but, is now in common usage. It is used to describe a person who provides their services through a limited company but, usually, they are a sole director and majority shareholder and are actually providing the services themselves. The term has been commonly used in reference to a piece of tax legislation called IR35<sup>7</sup>, it is also used in the public sector rules for off-payroll working<sup>8</sup> which came into force in 2017. It will also be used in the off-payroll working reforms to the private sector (OP21)<sup>9</sup> from 6 April 2021.

### 4.2 Deemed employee

The reason for the term is that HMRC believes that these PSCs are providing their services personally and if it wasn't for the imposition of the intermediary i.e. if they weren't trading through a company, they would be a 'deemed employee'. A **deemed employee** is a person who pays tax as an employee, but is not an employee and does not have any equivalent employment rights or benefits. The point being that HMRC believes that these people have incorporated for tax purposes and their employment status should in reality be an employee, where the 'client' should be paying employment taxes. One of the problems of this being the loss to the Treasury of the 13.8% Employers' NI contribution.

## 5. The Dividend issue

### 5.1 Introduction

A dividend is a sum of money that is paid out by a limited company to someone who owns shares in the company i.e. a shareholder. Only a limited company can pay dividends because they are the only type of business that issues shares. Sole traders, the self-employed, partnerships and Limited Liability Partnerships (LLPs) cannot pay dividends because they do not issue shares.

A director of a limited company can pay themselves a dividend out of profits and often do this as part of the income structure. So, there are broadly two types of dividends – investment and income.

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<sup>7</sup> Chapter 8, Part 2 of ITEPA 2003 - <https://www.legislation.gov.uk/ukpga/2003/1/part/2/chapter/8>

<sup>8</sup> Chapter 10, Part 2 of ITEPA 2003 - <https://www.legislation.gov.uk/ukpga/2017/10/schedule/1/part/2>

<sup>9</sup> The reforms to Chapter 10

[https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/816296/Rules\\_for\\_off-payroll\\_working\\_from\\_April\\_2020\\_-\\_Explanatory\\_note.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/816296/Rules_for_off-payroll_working_from_April_2020_-_Explanatory_note.pdf)

## **5.2 Salary and dividends**

There is a commonly used phrase that these limited company directors 'pay themselves in dividends'. This is not entirely accurate and is designed to infer that they are in some way doing something they shouldn't. A director will also pay themselves a wage or salary but, the dividend is a reward for their shareholding in the company. They are entitled to take a dividend but, it has to be out of the profit in the company. If the company does not have sufficient profit, you cannot take a dividend.

The common payment structure used by the limited company director but, not by all, is where a basic low salary is taken, and the rest is taken in dividends. There are various reasons for this, one of the reasons being that the director doesn't always know how much they are able to pay themselves per month because the income of the company may fluctuate on a monthly basis. There are seasonal companies particularly that will make money in some seasons and then not in others.

## **5.3 Contractors & PSCs**

There are some companies, sometimes known as 'contractors' who are the target of the IR35 and OP21 legislation. HMRC believe that the way in which these contractors work is like an employee. They often work through an agency and with a client. Working on the client site, 5 days a week, for months at a time, sometimes years. These companies or personal service companies HMRC believe routinely pay themselves a low salary and high dividends on an equal monthly basis. The reason being that the dividends attract less tax, you will only pay income tax on a dividend rather than NICs. The last known published figures by HMRC for contractors or PSCs in this sector in 2012 was 260,000 companies, although it is likely to be nearer perhaps 300,000 now.

## **5.4 Off-payroll**

This figure is likely to have been affected firstly by the off-payroll working in the public sector legislation and then, secondly, it will be affected by OP21, as many contractors will stop working through a limited company. This is, however, a small subset of the whole which is 2 million actively trading small companies. So, to refer to all these companies as 'those paying themselves in dividends' is a gross misstatement and has a direct negative impact on the perception of these company directors.

## **5.5 Coronavirus**

How they get paid is actually largely irrelevant to whether they should receive support from the Government during a global pandemic that has so far lasted 10 months and is set to last many months more. Although ordinarily the Government would not be expected to support the limited companies, no company can be expected to survive without Government assistance in these extraordinary times.

## **6. Gig Economy**

The gig economy is so-called because it refers to a person having 'gigs' of work or short stints of work where one person does a variety of jobs. The gig economy is mainly made up of people who pay tax as a self-employed person, but are categorised as a limb (b) worker. So, they also have basic employment rights.

## **7. Other facts**

### **Contracts**

An employee works under a contract of employment also known as a **contract of service**. A self-employed sole trader is engaged by a **contract for services**, as is a limited company were it supplies services.

### **Determining employment status**

When deciding whether someone is employed or self-employed, the **employment status test** is used. The employment status test is also used to determine whether someone who provides their services through a limited company is employed or self-employed. The same terminology is used which can be confusing.

The employment status test refers to determining status for both tax and employment rights purposes.

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Rebecca is a leading expert in 'employment status' including IR35, off-payroll working and the law involving independent contractors and the self-employed for the purposes of tax and employment law. She was also a Senior Policy Adviser to the Office of Tax Simplification giving advice on employment status, the gig economy, small company taxation, etc.