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Managed service companies

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Summary

Over the last twenty years there has been an increasing tread for workers to provide their services to clients using an intermediary company. There are two broad types:

> **Personal Service Companies (PSCs)**: the company sells the services of the worker, who is usually the director of the company as well. The worker is paid a salary, and can receive dividends as a shareholder of the PSC.
>
> **Managed Service Companies (MSCs)**: the company sells the worker's services, but the worker has no control over the business. The company is run by a scheme provider, supplying these generic company structures to workers, and administering the schemes. As with PSCs, workers are paid a salary – often set at the National Minimum Wage – along with reimbursed expenses and dividends.

Individuals providing their services this way can make significant tax savings by taking their remuneration in the form of dividends rather than a salary, as this type of income is not liable to National Insurance contributions, and, prior to reforms in 2016/17, could be received tax-free by basic rate taxpayers.

In April 2000 the Labour Government introduced legislation to ensure that income earned by a PSC when the individual was, in effect, being employed by their client, would be taxed as earnings. These statutory provisions - the 'intermediaries' legislation – are often referred to as IR35, after the number of the press notice when this measure was first announced.[1]

Over the next few years HM Revenue & Customs found considerable difficulties to using the IR35 rules to tackle tax avoidance by MSC workers, whose numbers had grown substantially over this time: from around 65,000 in 2002/03 to at least 240,000 in 2005/06. In December 2006 the Labour Government published a consultation paper, alongside the *Pre-Budget Report*, with proposals to remove MSCs from the scope of IR35 and tax MSC workers as employees.[2] Following responses to this document, the Government confirmed it would proceed with these changes in *Budget 2007*.[3] Provisions to determine the income tax treatment of MSCs are contained in the *Finance Act 2007* (section 25 & schedule 3).[4] The new rules came into force on 6 April 2007. At the time it was estimated would raise £350 million in 2007/08, rising to £450 million in 2008/09.[5]

The introduction of this avoidance legislation appears to have dealt with the concerns over the use of MSCs – although there have continued to be developments, both in market practices and in legislative requirements regarding the classification of individuals as an employee or as self-employed for tax purposes,[6] and the application of the IR35 rules.[7]

[1] see, *Personal service companies: introduction of IR35*, Commons Briefing paper CBP914, 6 September 2018. Guidance is published on Gov.uk.

[2] *Pre-Budget Report*, Cm 6984 December 2006 paras 5.98-9. HM Revenue & Customs, *Tackling Managed Service Companies*, December 2006.

[3] *Budget 2007*, HC 342 March 2007 para 5.115

[4] Changes to the scope of NICs to mirror these rules were made by Order (SI 2007/2070), which took effect from 6 August 2007.

[5] *Pre-Budget Report*, Cm 6984 December 2006 p226. Guidance on the MSC legislation is set out in HMRC's Employment Status Manual – see from para 3500.

[6] see, *Self-employment in the construction industry*, Commons Briefing paper CBP196, 23 August 2019

[7] see, *Personal service companies and IR35*, Commons Briefing paper CBP5976, 9 April 2020.

1. Introduction: the taxation of small businesses

The Labour Government's decision to introduce a zero starting rate of corporation tax in April 2002 provides a vivid example of how the tax system for individuals and companies can affect choices about business structures. At the time it was widely argued that the new zero rate would provide a substantial incentive for individuals to incorporate their businesses, and so it proved. In turn, concerned about the "increasing numbers of self-employed individuals adopting the corporate legal form where the change is made for tax reasons rather than as a step to growth" the Labour Government introduced a new minimum rate of corporation tax on distributed profits set at 19% in April 2004.[8]

This was highly controversial. In the *Pre-Budget Report* in December 2005, the Government announced that it would scrap both the zero starting rate and the new minimum rate on distributed profits, and increase investment allowances for smaller businesses to 50 per cent,[9] a policy reversal that was generally welcomed.[10] As the Institute for Fiscal Studies observed at the time, "the impact on tax revenue [of the zero rate] was large enough for the Chancellor to be obliged to close a 'loophole'[11] in the tax system which he himself had introduced only three years earlier."[12]

In the 2004 Budget the Government also stated it would publish a discussion paper on this trend; as it acknowledged, "across many other sectors, the growth in small owner-managed businesses, as well as the changing nature of employment and contractual relationships, is creating challenges for the definitions and boundaries in the tax and national insurance systems between income from self-employment and the remuneration of owner-managers."[13]

Writing in the *British Tax Review* Anne Redston (Chartered Institute of Taxation) argued that the Government had to recognise certain underlying economic forces:

> There is widespread agreement among both workers and engagers that the current tax and regulatory burdens on employment can and should be circumvented for their mutual advantage. In other words, the status quo gives them little or nothing; the alternative structures are preferable to both parties. From a government perspective, this is a complex and long-standing problem, made worse by recent increases in employer NICs and employment regulation.[14]

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8 *Budget 2004*, HC 301, March 2004 para 5.93, 5.95
9 *Pre-Budget Report*, Cm 6701 December 2005 paras 5.92-3
10 Treasury Committee: *Second report: the 2005 Pre-Budget Report*, 25 January 2006, HC739 of 2005-06 para 83
11 Budget Speech, 2004.
12 Institute for Fiscal Studies, *Green Budget 2006*, January 2006 p171. For a longer narrative see, *Taxing small businesses: recent developments*, Commons Briefing paper CBP4009, 8 May 2009.
13 *Budget 2004*, HC 301, March 2004 para 5.93, 5.95
14 "Small business in the eye of the storm", *British Tax Review*, July 2004 pp566-581

In December 2004 the Treasury published this discussion paper[15] which gave an overview of the taxation of small businesses, reproduced in part over the following pages; as it noted, "the way that income and gains are taxed depends on the legal form adopted by the business and, in some circumstances, the nature of the reward that is taken by the owner(s) of the business."[16] The paper sets out the different ways that personal income, and company income are taxed:

> **Personal income**
>
> Personal income is subject to income tax and, where appropriate, NICs based on the nature of the commercial or contractual relationship that gives rise to the income. NICs are paid on income from employment and self-employment and build entitlement to certain social security benefits, in particular state pensions. Where income from a business is directly attributable to an individual (e.g. profits arising to a sole trader or allocated to a partner in a partnership), income tax and, as appropriate, NICs are charged on that income, and income tax relief is allowed for losses against other taxable income of that individual. This is consistent with the underlying relationship between the individual and the business – the individual has access to any profits and gains that they are entitled to, and the tax system therefore taxes the individual on those entitlements.
>
> **Company income**
>
> A business that is operated through a limited company has separate legal status from the individuals that own it. Owners of limited companies are not entitled to immediate access to any funds held in the company, but the company can control the form, amount and timing of any payments to the owners. The company can opt to pay owners a salary (if they are directors or employees) or distribute profits to the owners as dividends (if they are shareholders). When any profits are extracted by way of dividend payments or any other means the company must conform to company law requirements that serve to protect creditors. The tax system follows the underlying relationship between the individual and the business. The profits and gains generated by the business are not taxed as personal income of the business owner, as the owner is not directly entitled to them, nor is the owner entitled to any loss relief against other taxable income as the owner is not directly affected by losses arising in the company.
>
> The company itself is instead taxed on the profits and gains, reflecting the separate legal identity of the business. When profits are extracted by way of a dividend payment, the amounts are also taxed as the personal income of the individual. Through the lower net rate of tax on dividend income (after non-payable tax credits), the tax system reflects the fact that any taxation on a small company creates the potential for 'double taxation' (i.e. tax levied at the company and the individual level on the same underlying profits and gains). The tax treatment of dividends, whether received by an individual who effectively controls the company and works for it as a director, or by unconnected shareholders, reflects the assumption that the dividends are a return on the

[15] *Small companies, the self-employed and the tax system: a discussion paper*, December 2004

[16] There is no discussion of VAT in the paper because the way it is charged and paid does not depend on the legal form adopted by a business.

> shareholder's investment in the company (as distinct from earnings which are a reward for labour).[17]

These differences may give rise to certain anomalies:

> The differing treatment of companies and individuals reflects the fact that the tax system in the UK does not seek to tax "businesses" as such, but only those legal persons (individuals and companies) who are capable of earning income and owning assets. The tax system does not therefore require dividends to be apportioned between different forms of underlying investment. No NICs are payable on dividends, and shareholders are not entitled to employment rights or contributory benefits as a result of receiving dividends. Business income is therefore subject to a mixture of requirements under the personal and corporation tax regimes dependent on the circumstances of the business and its owners.
>
> Although the tax treatments of personal income and company income are consistent with the underlying relationships between businesses and individuals, a range of different interactions can arise between the taxes at the small business level which can give rise, in some cases, to apparent anomalies. The interactions between the taxes can also have an impact on behaviour – as has been seen in the trend in tax-motivated incorporation. Yet the tax effect of the various legal structures is not as straightforward as common perceptions may suggest. The tax treatment under each legal structure will vary depending on the circumstances of the business.[18]

In addition, the choice of legal form would have important consequences for the burdens of compliance placed on the owners:

> Owners of unincorporated businesses are required to self-assess their income from the business on their personal tax return. The Inland Revenue accepts reduced tax calculations from self-employed persons with profits under £15,000 a year – the 'three line-account'. Where businesses are incorporated, the company is required to self-assess profits on a corporation tax return separately from the returns prepared by its shareholders. The directors, employees and shareholders will also have to complete their own tax returns in the normal way. This is a necessary effect of the legal separation of the company as a distinct taxpaying entity and is one of the responsibilities that goes with company form …
>
> It is important to note that small businesses that incorporate are effectively opting in to a legal form where the benefits of incorporation – limited liability and the ability to raise external equity – need to be balanced with the obligations that are necessary to protect the creditors of the company above other capital providers. Offering a clear and fair approach to investors and creditors has made the limited liability company a popular business vehicle, while the speed and simplicity of the arrangements for forming a company in the UK is seen as one of the UK's competitive strengths. But the necessary minimum level of regulation that goes with this must apply to all companies, as a protection for external creditors to balance the limitation of

17 *Small companies, the self-employed and the tax system: a discussion paper*, December 2004 paras 4.2-4.8

18 *op.cit.* paras 4.7-10

liability, and this may make a limited company an unsuitable vehicle for some smaller businesses.

Similarly, although there are a number of specific features that apply a different treatment for smaller companies, there is no differentiation between small and large companies in the application of the essential features of the corporation tax regime. This regime covers all companies in the UK, from simple owner-managed entities, to

FTSE100 enterprises with complex structures and transactions. The treatment of incorporated businesses under the corporation tax system offers the benefits of consistency, familiarity and in most cases, simplicity to those, whether based in the UK or investing from overseas, who wish to use a UK company to do business.

However such an approach may itself be a cause of tensions in the tax system that can have a disproportionate effect on some small businesses. For example, rules that are designed to prevent avoidance can add compliance and administrative costs to businesses. This also means that small, relatively straightforward businesses must understand and comply with rules that are also capable of being applied to more complex business structures. As a consequence these rules can affect or be perceived to affect some small businesses more than larger concerns. This must be balanced against the benefits provided by the company form where it is commercially appropriate for the business.[19]

[19] *op.cit.* paras 4.11-15. The paper also gave a series of worked examples showing how different commercial and tax issues arise over the standard life cycle of a business.

2. Consultation on MSCs: Pre-Budget Report 2006

As noted above, in December 2005 PBR the Government announced it would scrap the zero starting rate, noting that most respondents to the discussion paper had "favoured simplification over options which risked introducing additional complexity." It also stated it would "continue to keep the structure of tax and NICs under review to ensure an appropriate balance between fairness for individuals and employers, incentives to work, save and invest, and reducing administrative burdens."[20] In the 2006 Budget the Government noted a new development in this area – the mass-marketing of 'managed service companies' (MSCs) to individuals as a means to avoid tax:

> 5.85 Since the Pre-Budget Report, further evidence has emerged that employment income is being disguised as dividends in order to take advantage of the small companies' tax rate, often encouraged by promoters of mass-marketed managed service company schemes. There is also evidence of some agencies, contractors and employers requiring workers to use corporate structures, thereby denying them employment rights as well as avoiding paying their fair share of tax and NICs.
>
> 5.86 The Government believes that all individuals and businesses must pay their fair share of NICs and tax, irrespective of legal form. It will continue to review the tax and NICs systems to ensure that this is the case and will bring forward proposals for discussion that are consistent with simplicity for compliant businesses, support for businesses in their aspirations to grow and maintaining the attractiveness of the UK as a business location. As the first stage of this review the Government will consult on action to tackle disguised employment through managed service company schemes.[21]

In December 2006 the Government confirmed that MSCs were being used extensively to avoid tax, and published draft legislation to tackle the problem. Although there was considerable evidence that many of those supplying their services through MSCs were, in effect, employees, HMRC had found that in many cases, their earnings were not being taxed as such. This was because there were serious difficulties in applying the 'intermediaries' legislation to MSCs. IR35, as this legislation is also known, was introduced in April 2000 to counteract the use of Personal Service Companies for the same purpose: that is, filtering earnings from employment through this corporate body, primarily to prevent it being charged NICs. To appreciate the problem, it is necessary to look at the differences between these two corporate forms, to show why this is the case, and the following paragraphs quote extensively from HMRC's consultation document.

The first point to make is that in the years before this reform, there had been an increasing trend for workers to supply their services through an intermediary company, often as an alternative to 'agency work'. In an

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20 *Pre-Budget Report*, Cm 6701 December 2005 para 5.92, 5.94

21 *Budget 2006*, HC 968, March 2006 p 116

agency arrangement, the end client pays the agency for the work carried out, the agency deducts their fee from the payment and then operates PAYE on the wage paid to the worker. The worker pays income tax and NICs on their earnings, though it is the agency which is liable for the employer's NICs, rather than the end client. The contract between the worker and the agency gives each of them greater flexibility to end the arrangement than would exist between employer and employee. That said, "the agency remains a permanent part of the contractual chain between the parties. Agency workers are entitled to core rights including health and safety, and social security guarantees such as maternity pay."[22]

By contrast, workers may provide their services to end clients or agencies through an intermediary company.[23] The worker is employed by the company and the company's business is the provision of the worker's labour services. Depending on the terms and conditions of any particular engagement, the worker may be self-employed, or employed by the end client. Working in this way individuals may well surrender employment rights. It is widely perceived that an individual working through an intermediary company is not entitled to employment rights from an agency or end client (though employment tribunals and the Courts can look through the corporate structure to the underlying relationship).[24]

Intermediary companies may be divided in two types, related to the degree of financial and management control the worker exercises. In the first case, the worker chooses to go into business on his own account and establishes a company whose business is selling his services. He will be a shareholder, and often a director of the company, known as a Personal Service Company (PSC). By contrast Managed Service Companies (MSCs) are established by scheme providers, who may be companies specialising in just this type of operation. Although the worker is a shareholder, usually they take no part in the company's management and may be unaware of the arrangements the scheme provider makes with end clients on the supply of their services.

At this time HMRC estimated that there were around 150 scheme providers, of which 10 provided the vast majority of workers, with tens of thousands of workers in their schemes. Following the consultation paper HMRC carried out further analysis, and found that some MSC workers were, in fact, in business on their own account. Nevertheless, "it is still a small proportion and for the vast majority of such workers the underlying nature of the contracts in which they are involved is one of employment."[25] Moreover, scheme providers might simply move workers from one MSC to another, when an assignment finished, rather than the worker taking the company with them.

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22 *Tackling Managed Service Companies*, December 2006 para 2.3

23 Apparently an agency is involved for about 90% of workers in MSC arrangements.

24 That said, an employee of the MSC the worker is entitled, in theory, to the full range of employment rights from the MSC. (*Tackling Managed Service Companies* paras 2.5, 2.35).

25 HM Revenue & Customs, *Managed Service Companies – full regulatory impact assessment*, March 2007 para 44, para 8

MSC schemes may be based on having just one worker per company, or, in a composite company scheme, ten to twenty worker-shareholders. In the latter case, the size of the company would be restricted to ensure profits do not exceed the threshold for the small companies' rate of corporation tax. The day-to-day operation of these schemes was similar; as HMRC consultation document explained, the mechanics of an engagement with a client "tends to work as follows":

- a worker will agree to undertake an assignment for an agency;
- the worker will join the MSC - if he has not already done so - sometimes this will be at the suggestion of the agency;
- the MSC scheme provider will provide him with the company name, share certificate and employment contract, and undertake to carry out the company administration;
- details of the agreed assignment are provided to the scheme provider who puts in place contracts for the work to be provided through the MSC. The contracts contain the terms under which the worker will be provided; they are usually in standard form, altered only for assignment-specific matters such as hourly rate or location of work;
- the individual (or the agency) then informs the MSC scheme provider on a regular basis how many hours have been worked; these are then invoiced to the end client by the MSC scheme provider. Finally, the end client pays the scheme provider or MSC via the agency;
- when funds are received, the MSC scheme provider deducts an administration fee, retains an amount to cover tax and NICs and pays the balance into the worker's bank account – usually as a mix of salary, dividends and expense reimbursements. All the calculations relating to these payments are carried out by the MSC scheme provider;
- the MSC itself often does not move with the worker from one assignment to the next – indeed the scheme provider may place another worker in the vacated MSC, rather than the worker taking the company with them. This is in contrast to PSCs where the company is clearly associated with its owner manager (the worker). [26]

The consultation document provided illustrations of how contracts and payments work in these three types of intermediary company, compared with agency arrangements; for convenience these useful diagrams are reproduced in an appendix to this note.

The purpose of the intermediaries legislation is to ensure income tax under PAYE and NICs is charged on income earned by an intermediary company for any contract where the worker is effectively the client's employee. It works as follows:

- Where an individual (the "worker") personally performs, or is under an obligation personally to perform, services for

[26] *Tackling Managed Service Companies* pp10-11

the purposes of a business carried on by another person (the end client);

- but does so via an intermediary (e.g. a service company); and
- works for the end client in such a way that they would be regarded as an employee of the client, had they worked for them directly rather than via the service company;
- the service company has to deduct PAYE and pay NICs in respect of the worker on, broadly, all of the money the service company receives in respect of the work done for the end client by that worker.[27]

A service company may have a number of clients and contracts during the year and each engagement must be considered separately. For MSCs, as for all service companies, this means that each engagement for each individual needs to be considered separately in order to ascertain the nature of that contract. Although HMRC had issued guidance for MSC scheme providers showing how the IR35 rules would apply to MSCs in August 2002 and December 2004,[28] it found this was not working in practice:

> The contract-by-contract approach required by the legislation is very resource-intensive. A detailed consideration of the nature of the underlying contract governing each assignment is appropriate in the case of PSCs which have a variety of engagements, some of which will be contracts of employment while others are self-employment. However, in the case of MSCs where the worker is almost invariably not in business on his own account and the underlying relationship with the end client is one of employment the contract-by-contract approach is less appropriate. And, in view of the growth in these schemes, it is difficult in practice to counter them on a sufficiently wide scale.
>
> Furthermore, the legislation necessarily operates retrospectively even where those using the schemes comply with it – the tax liability is established at the end of the tax year and is not due for payment until some months later. Where there is non-compliance, HMRC has to establish liability after the event and this, combined with the transient nature of many MSC workers, makes it very difficult to enforce payment of tax and NICs. Even where the MSC is still operating and the liability has been established, MSC scheme providers have simply closed down their existing operations and started up new MSCs. Because the MSCs have no assets, the debt cannot be enforced against the company and the tax and NICs due cannot be collected.[29]

The number of workers in MSCs grew significantly in the early years of the decade. At the time HMRC estimated their number had grown over the three years 2002/03 to 2005/06 from around 65,000 to at least 240,000. Responses to the consultation indicated this number was "significantly higher."[30]

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27 *Tackling Managed Service Companies* p11

28 "Composite Service Companies and the 'Service Company' legislation ('IR35')", Tax Bulletin issue 60, August 2002 pp956-7; "Composite and Managed Service Companies and the 'Service Company' legislation (IR35)", Tax Bulletin issue 74, December 2004 pp1165-8.

29 *Tackling Managed Service Companies*, December 2006 p 15

30 Managed Service Companies – regulatory impact assessment, March 2007 para 13

There are no restrictions on using MSCs in any particular sector, though "they have a significant presence in construction, information and telecommunications sectors and engineering. There is also increasing evidence of their use in healthcare and teaching, where there is intensive advertising to mobile professionals from overseas to encourage them to join MSCs when they sign up with agencies for temporary work in the UK." The schemes used two methods to avoid tax:

> The worker in an MSC is usually paid a salary at the National Minimum Wage (this is necessary because he is usually an employee of the MSC), and the rest of his remuneration is paid in the combination of reimbursed expenses and dividends to minimise the tax and NICs paid.
>
> MSCs often use the rules on tax relief for employee travel to reduce the tax and NICs liability of individual workers. Workers in MSCs are treated as having one employment (with the MSC). This allows each location they work at to be treated as a temporary workplace (unless the period of continuing work at that place lasts, or it is reasonable to assume it will last, more than 24 months). This means that the worker is able to get tax relief on the cost of travel from home to what would otherwise have been his permanent workplace. He is also able to get relief for the cost of overnight accommodation and subsistence. HMRC compliance activity has also found instances of MSCs paying travel expenses free of tax and NICs even where no relief is due.[31]

Scheme providers made these tax advantages a major selling point in their advertising MSCs, as well as emphasising that workers would have no management responsibilities and that providers would tackle any problems arising from the IR35 rules.[32]

The department also noted some other problems arising from the growth of MSCs:

- The ability of workers in MSC schemes to avoid the IR35 rules allowed them to compete unfairly against those who complied with the legislation.
- Many workers in MSC schemes appear to be unaware about the loss of their employment rights from entering this corporate form. Concerns had been expressed that unscrupulous scheme providers would exploit workers' lack of financial control over their MSC.

The document went on to propose a series of characteristics "core to the MSC business model", to provide an effective legal definition of MSCs, one that was well-targeted (so, excluding PSCs), clear and robust (that is, not easily circumvented by scheme providers making small changes to their arrangements). MSC schemes would be ones that fulfilled four criteria:

> - the services of workers are provided by companies to others;

31 *Tackling Managed Service Companies*, December 2006 paras 2.30, 2.23-4

32 Treasury Minister John Healey quoted some examples when the provisions relating to MSCs in Finance Bill 2007 were considered by the Committee of the Whole House (HC Deb 30 April 2007 cc1325-6).

- the majority of the money earned by the worker for their services provided through the company is paid to the worker;
- a person termed the "scheme provider" (or their associate) exercises control over the company's finances or general management; and
- the workers whose services are being provided do **not** exercise control.[33]

For schemes that fell within the scope of this definition, the new tax charging provisions would be as follows:

> Where a worker providing their services through an MSC receives payment for those services, the MSC is treated as making a payment of employment income to the worker. The MSC will be obliged to operate PAYE and pay NICs in the usual way … Under this new tax treatment, in deciding what expenses can be deducted in arriving at the amount to which tax and NICs apply, the cost of travel between the worker's home and the place at which they work for the end client is not an allowable expense. This is because in determining what, if any, expenses are deductible, the worker is treated as an employee of the end client. The cost of travel to each engagement is therefore not allowable. This puts a worker in the same position as they would have been had they worked directly for the end client.

HMRC also proposed new rules for the pursuit of debts from 'appropriate third parties':

> HMRC currently has powers to transfer debts for PAYE and NICs relating to an individual employee and unpaid by their employer to that employee.[34] However, this requires the employee to have been aware of the employer's "wilful" failure to deduct the PAYE due. In the light of the scale of non-compliance with the Intermediaries legislation and the difficulties in recovering PAYE and NICs from MSCs, the Government has decided to introduce specific legislation in relation to MSCs which will allow PAYE and NICs debts due from them to be transferred to appropriate third parties who have been involved directly or indirectly in, and who have materially benefited from, the MSC's provision of services.[35]

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33 *Tackling Managed Service Companies*, December 2006 para 3.10
34 Regulation 72, Income Tax (PAYE) Regulations SI 2003/2682; Regulation 86, Social Security (Contributions) Regulations SI 2001/1004.
35 *Tackling Managed Service Companies*, December 2006 paras 4.4, 4.7, 4.13-4

3. Responses to the consultation

Some commentators argued that the Government's proposals were "highly aggressive", though the *Financial Times* also reported concerns that these schemes were being used to exploit workers:

> Chas Roy-Chowdhury, of the Association of Chartered Certified Accountants, said the measure brought the tax system into disrepute because it would be retrospective since current schemes could not be unwound immediately. Chris Sanger of Ernst & Young, the professional services firm, said measures allowing Revenue & Customs to recover tax debts from scheme promoters were more commonly associated with tackling outright fraud … Alan Ritchie, general secretary of Ucatt, the building workers' union, said: "Not only are unscrupulous companies robbing the Treasury of revenue, they are doing so at the expense of workers' employment rights. In some cases, workers have been left with very little option other than to get involved in the schemes and in many of those cases they are unaware of what they were signing up to and any tax risks that may be involved." [36]

In a piece which appeared in the journal *Tax Adviser*, the authors argued that there were two underlying problems which were not being addressed: the wish of clients to avoid the costs of employment rights, and the different treatment of earnings and dividends for NICs:

> The extra costs of employment rights, imposed by government, have led to a boom in the large corporates' use of agency and temporary workers … The clients insist on dealing only with limited companies or LLPs, so that the workers' employment rights stay with a third party. They could use self-employed contractors, but faced with the risk of retrospective re-categorisation by HMRC, with consequent PAYE and NIC liabilities, or professional costs in fighting a status case (which might be about tax and NIC, or might equally be about holiday pay, or national minimum wage, or unfair dismissal, or various types of unlawful discrimination), the clients take the option with the lowest risk combined with the best savings. Employment agencies take the same line, and understandably so.
>
> The document acknowledges the employment rights problem, but fails to address it in any way (indeed, 'there is unlikely to be any significant impact on the labour market', according to para 5.14). The proposed changes do not force workers into employment contracts with associated rights and protections: the document simply proposes changes to take more tax and NIC than would otherwise be due on the amounts drawn by the shareholder-workers, mainly as dividends.
>
> And there's the nub of the problem. If we had a system that taxed dividends at the same rate as employment income, and treated them as earnings for NIC purposes, there would be no tax or NIC driver behind the use of MSCs. Arguably, this is addressed directly by the proposed new charges, but it's fixing something that shouldn't be broken in the first place. And the changes don't affect IR35, we are told, which clearly does need fixing, on the Treasury's own admission. [37]

[36] "Laws to curb tax avoidance unveiled", *Financial Times*, 7 December 2006
[37] "MSC schemes: an unfair competitive advantage?", *Tax Adviser*, March 2007 p15

In March 2007, just before the Budget, the Chartered Institute of Taxation (CIOT), and the Tax Faculty of the Institute of Chartered Accountants, each published detailed responses. The CIOT suggested that the problem of MSCs might have been avoided had HMRC committed sufficient funds on IR35 compliance; that said, the approach proposed by the department appeared to be the best one:

> **2. The current position**
>
> 2.1 We acknowledge that some MSCs are responsible for significant underpayments of Pay as You Earn (PAYE) and National Insurance Contributions (NICs), as a result of the failure to apply the Intermediaries legislation (IR35) properly; we further acknowledge that this is a serious issue that HM Revenue & Customs (HMRC) cannot ignore.
>
> 2.2 We also understand that the enforcement of the proper application of IR35 by HMRC is difficult, due to the vast number of contracts involved and the requirement to test each contract individually; collection of debts which are found to be due is also very difficult, and sometimes impossible, because of the lack of assets within each service company and the problems under current law of transferring the debts to either the worker or the provider of the arrangements.
>
> 2.3 However, we consider that the strong growth in MSCs and the apparent disregard, among some MSCs, for IR35 arises partly from a failure adequately to resource the enforcement of IR35 when it was first introduced. Had more resources been deployed to enforce the rules at the outset, these further legislative changes might not have been required.
>
> **3. The underlying issues**
>
> 3.1 We know that both HMRC and HM Treasury (HMT) are aware that behind the continued growth in MSCs lie inherent differences in the amounts of tax paid by the employed, the self-employed and those working through a company outside of IR35. While these differences survive, the temptation to arbitrage them for all parties (engager, worker and intermediate agencies) will be very high.
>
> 3.2 Employers bear extremely heavy NIC costs and burdensome employment law risks, and employees also bear high NICs and few allowable expenses. For many low income workers, moving from one job to another, employment "rights" are worthless. Commercially, what is important to these workers is the amount of cash they take home. They are willing to give up employment rights for a little extra cash and can, therefore, easily be persuaded that working through a MSC is "best" for them.
>
> **4. Alternative approaches**
>
> 4.1 It would have been possible for the Government to see the MSC issue as merely a symptom of this underlying arbitrage opportunity, and to abandon the current policy approach taken by the Government, which we understand to be as follows:
>
> - Those who are self-employed, or who would be self-employed if they worked directly for the engager, should have a lower rate of tax and NICs than if they were employed; and

> - If an intermediate service company or agency supplies the worker, it is these bodies which have the primary responsibility for the tax and NICs, not the end-users.
>
> 4.2 More radical solutions than those set out in this document could, for instance, have included:
>
> - The imposition of NICs on dividends for small businesses, at least up to a certain level; or
> - Following the outcome of the Muscat case (Muscat v Cable and Wireless (UKEAT/0661/04/LA)), the imposition of employee levels of tax and NICs on the engagers (ie, ignoring the service companies).[38]
>
> 4.3 We understand that the Government is fully aware of the underlying tension here, and of the possibility of deploying one or more of these radical options. In our view, the approach set out in this MSC consultation is the more proportionate and balanced one, seeking to deal, as it does, with the immediate issue rather than introducing a more fundamental change that would affect a much greater number of workers and engagers.
>
> 4.4 Equally, we understand why the alternatives, either leaving the current situation as it is or using existing enforcement powers, are not (or are no longer) acceptable.[39]

By contrast the Institute of Chartered Accountants argued the start date for the new rules should be postponed "allowing time for a further, more detailed consideration of the fundamental issues":

> We have seen correspondence from MSCs to their customers offering them an alternative service which essentially involves setting up each individual employee in their own personal service company, of which the individual is the sole shareholder and director. The individual is asked to self-certify that they are not within the rules of IR35, a task which is likely to be beyond the tax knowledge level of the average worker. This rather suggests that MSC providers have already identified ways in which they believe they can operate within the revised rules.
>
> We have had confirmation from Companies House that there were 56,218 new companies registered in February 2007, while a more usual monthly figure would be approximately 28,000. In one week alone, there were 20,000 new companies registered. Our initial conclusion is that the proposed new rules may not work and may cause more problems than they solve …
>
> Ultimately, these problems are deep-rooted and stem from a number of sources.
>
> First, in relation to tax and national insurance, they are the culmination of the long-standing distinctions in our tax system between employees and the self-employed and the treatment of small companies as a separate legal entity from that of the owner manager.
>
> Second, we suspect that the move to MSCs is also being driven by the increasing red tape surrounding employment law, with the result that many would-be employers are reluctant to take on

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[38] [In this case the Court found that there was a genuine implied contract of employment between a worker and their client, even though the worker's services were provided by an intermediary company; the case was discussed in, "E-Nuff is not enough", *Taxation*, 18 May 2006.]

[39] CIOT, *Tackling MSCs: CIOT comments*, 1 March 2007 pp 1-3

> employed staff directly. The additional administration costs of implementing the proposed system appear to be considerable. This is in direct contrast to the drive to reduce costs in other areas of tax following the KPMG Administrative Burdens report last year. We think that the Government needs to address the underlying problem and seek to identify a comprehensive solution rather than tinker around at the edges of problem, only to find that workers in MSCs adapt into something similar that appears to sidestep these provisions.[40]

HM Treasury published a summary of all the responses to the consultation alongside the Budget.[41] Nearly all respondents agreed that the existing rules were not being applied by all MSCs, though there were different views on the *extent* of non-compliance. Businesses complying with the rules confirmed that they were being undercut by MSCs, and respondents confirmed that in some sectors workers had little or no choice but to join a scheme. Although there was general agreement about the criteria proposed for identifying MSCs, there were concerns about this test focusing on the 'control' exercised by the worker.

Similarly, although nearly all respondents agreed that the transfer of debts was necessary to make the new rules effective, there were concerns about the range of third parties to be made potentially liable, and the deadline for bringing in these rules:

> The majority view was that third parties should be included within the debt transfer provisions, but only when they were directly involved in, and aware of, the use of an MSC scheme. There was concern that although it was the Government's objective not to include anyone who didn't know, or could reasonably be expected to know, that they are dealing with an MSC, the draft legislation did not meet this aim. Several suggestions were made regarding the circumstances in which debts should be transferred, including when a third party had financially benefited or was financially involved in an MSC scheme, or was negligent, or had acted fraudulently.
>
> Employment agencies and their representatives were particularly concerned that they could find themselves liable for debts before they were able to check whether the workers they were engaging were operating through MSCs. They therefore requested a delay in the implementation of the debt transfer provisions for third parties. Without such a delay, they said they would be unable to advise workers about the new measures, with the danger of workers moving to non-compliant arrangements.[42]

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40 ICAEW, *TAXREP 26/07: Tackling MSCs*, 8 March 2007 paras 9-12, 14-16

41 HM Treasury, Tackling Managed Service Companies: summary of consultation responses, March 2007

42 *op.cit.* p10

4. Budget 2007

In *Budget 2007* the Government stated that responses to its consultation had "shown widespread support for action on MSCs", though it would be "amending its approach in response to some key concerns raised in the consultation":

> The definition of an MSC will be strengthened to give greater clarity and certainty; the scope of the transfer of debt legislation will be clarified; and the Government will delay the application of the debt transfer legislation to third parties (other than MSC scheme providers, and directors, office holders or associates of the MSC) until 6 January 2008.[43]

Further details were given in a Budget Notice published at the time; this summarised the new rules, and their scope:

> Managed Service Companies (MSCs) are mass marketed service companies provided by MSC providers to large numbers of individuals. They are intermediaries and as such they fall within the scope of Chapter 8 of the *Income Tax (Earnings and Pensions) Act 2003 (ITEPA)* and section 4A of the *Social Security Contributions and Benefits Act 1992 (SSCBA)/Social Security Contributions and Benefits (Northern Ireland) Act 1992*.
>
> This legislation treats payments received by individuals providing their services through intermediaries (primarily service companies) to be earnings from employment where certain conditions are met. These conditions are that if the intermediary is ignored, the terms under which the individual provides services to the client are such that the individual would be regarded as an employee of the client. Tax and National Insurance contributions are calculated after the end of the tax year in which the payments were received by the individual.
>
> Whether Chapter 8 of *ITEPA* does or does not apply is considered on a contract by contract basis. Where therefore either an individual has a number of contracts throughout the year, or large numbers of individuals work through such intermediaries, large numbers of engagement terms must be considered to determine whether or not Chapter 8 applies. Chapter 8 of *ITEPA* also provides that in calculating travelling expenses which are not subject to tax, the individual is deemed to be employed by the intermediary. The effect of this is that the cost of travel to each engagement is an allowable expense and is deducted before calculating the sum (the "deemed employment payment") on which PAYE must be applied.
>
> Chapter 8 of *ITEPA* is now disapplied in respect of Managed Service Companies. The new Chapter 9 of *ITEPA* (and in due course mirroring National Insurance legislation) will apply to intermediaries which are "Managed Service Companies" (MSCs). Rather than look at individual engagement terms between individuals and clients as in Chapter 8 of *ITEPA*, Chapter 9 of *ITEPA* defines an MSC by reference to certain criteria. These relate both to the characteristics of the company and the characteristics of the business of the MSC provider. Whether Chapter 9 applies will be determined largely by reference to the MSC provider. Where a person is determined to be an MSC provider, Chapter 9 will apply to all service companies made available by that person.

[43] *Budget 2007*, HC 342, March 2007 para 5.115

> Broadly, an MSC provider includes businesses which are involved in promoting or facilitating the use of companies to provide the services of individuals.
>
> There will be exclusions from Chapter 9 for employment agencies and employment businesses which do not influence or control the finances of the companies or the way in which payments to individuals are paid. There will also be an exclusion for people providing professional accountancy and legal services. In addition, a power is being taken to exclude through regulations other people from being an MSC provider where a case can be made. This power will enable the legislation to be adapted where necessary to reflect commercial developments.

This notice also gave details of equivalent changes to NICs legislation, the treatment of travel expenses, and the provisions to allow for the recovery of tax debts from third parties:

> Where a company is within the definition of an MSC, all payments received by an individual providing their services through the company, which are not already treated as employment income, are deemed to be employment income. Chapter 9 of *ITEPA* (and in due course mirroring National Insurance legislation) provide for how an MSC must calculate a "deemed employment payment" in order to arrive at the sum to be subject to PAYE. The deemed employment calculation and the operation of PAYE must be undertaken when an individual receives a payment and not after the end of the year as with Chapter 8.
>
> Unlike Chapter 8 of *ITEPA*, in Chapter 9 of *ITEPA*, the individual will be treated, in calculating travelling expenses which can be paid without deduction of tax, as if they were employed by the client. The effect of this will be that the cost of travel to each engagement is not an allowable expense and cannot be deducted before calculating the sum on which PAYE must be applied.
>
> A new section 688A will be inserted in *ITEPA* enabling PAYE regulations to provide for the recovery from specified persons set out in the section, of any amount of PAYE that an officer of HMRC considers should have been deducted by the MSC. The persons are: the director or office holder of the MSC, the MSC Provider, or any person who directly or indirectly has encouraged, facilitated or otherwise been actively involved in the provision of the services of individuals through MSCs.
>
> PAYE regulations will be laid providing the statutory mechanism for how MSCs debts that cannot be recovered from MSCs are transferred to those persons specified in section 688A. The regulations also provide appeal provisions. Mirroring Social Security Regulations will provide for the transfer of Class 1 National Insurance debts of MSCs to the same specified persons.[44]

The estimated yield to the Exchequer of these measures was £350 million in 2007/08, £450 million in 2008/09 and £250 million in 2009/10. The projected yield was higher in the earlier years as the reduction in corporation tax receipts from MSCs would not feed through until after the increase in PAYE and NICs receipts.[45] The department's regulatory impact assessment noted this cost would be borne by MSC scheme providers, workers, agencies and end clients:

[44] HM Revenue & Customs Budget Note BN46, 21 March 2007 paras 6-15
[45] *Managed Service Companies – regulatory impact assessment*, March 2007 para 34

Responses to the consultation confirmed that the proceeds of these contrived tax and NICs arrangements are shared between the various parties involved. However, the exact share and therefore the impact of the measures varies between sectors.

> In all sectors the MSC scheme provider benefits by taking a significant proportion of the proceeds of the contrived tax arrangement as a fee. Those agencies involved in running MSC schemes or directing workers into them also benefit, but other agencies who are not actively involved in the schemes are unlikely to benefit as representations suggest this is a competitive sector and profit margins are small. Some respondents to the consultation thought that in general workers choose to enter MSC schemes and are the main beneficiaries of the arrangements.
>
> It was also suggested that ensuring MSC workers pay tax and NICs at the same level as other employees would lead some highly skilled workers to move abroad. However, others thought that the measures included in the consultation document would lead to wage inflation as workers demanded higher gross wages, meaning that end users and agencies are the main beneficiaries of the arrangements.
>
> The Government believes that the proceeds of the arrangements are currently shared by the MSC scheme providers, workers and end users and agencies and that the impact on wage inflation or migration would therefore be limited.[46]

In his Budget speech the then Chancellor Gordon Brown explained that these changes were part of a wider package of measures affecting the taxation of small companies:

> I need to act to deal with individuals artificially incorporating as small companies to avoid paying their due share of tax—a practice that, if left unaddressed, would cost the rest of the tax-paying population billions of pounds. I will take action in a way that will not raise the tax burden on the self-employed and small businesses overall.
>
> To reduce the tax difference between self-employment and small company incorporation, I will raise the small companies rate in three stages from 20p this year to 22p. I will recycle all those revenues to legitimate small businesses investing for the future. Small firms will be able to claim the new 100 per cent. relief for new capital investment up to £50,000, a 175 per cent. tax credit for R and D, and the new tax credit for environmental investment. A small company with profits of £150,000 and investing £50,000 of that will effectively pay tax of just 15 per cent. A firm investing the same from profits of £100,000 will pay tax of 11 per cent.—lower than today.[47]

The Budget report gave some more detail on the Labour Government's approach to 'tax-motivated incorporation':

> The Government remains concerned that the corporation tax system is being used to achieve a reduction of personal tax and national insurance liabilities, through the extraction of labour income as dividends. The Government considers that this has eroded the balance between providing low rates of corporation tax to encourage business investment and maintaining a tax

[46] *op.cit.* paras 51-55
[47] HC Deb 21 March 2007 c820

> system that is fair for all. It has therefore decided to refocus the way in which the tax system supports investment by small businesses, to provide better incentives for those businesses that reinvest their profits for growth.
>
> Budget 2007 announces the introduction of an Annual Investment Allowance that will provide a major cash-flow benefit to those small businesses that invest to grow their business. The Government will be increasing the Small Companies Rate to reduce the advantage of incorporation and extraction of labour income by way of dividends, providing a fairer outcome for all.[48]

The increase in the small companies rate would be phased in over three years;[49] a consultation exercise on the new Annual Investment Allowance was launched in July that year. The Budget report summarised these changes:

> **Re-focusing the incentives for small companies**
>
> - a phased increase in the small companies' rate from 19 per cent to 20 per cent from April 2007, 21 per cent from April 2008 and 22 per cent from April 2009 to reduce the differential between incorporated and unincorporated businesses;
> - the 50 per cent first year allowance for small enterprises will continue to April 2008;
> - the introduction of an Annual Investment Allowance (AIA) available to all businesses regardless of size and regardless of their legal form. This new allowance will mean that 100 per cent of expenditure up to £50,000 on general plant and machinery (other than cars) can be offset against taxable profits. The AIA will be effective from April 2008 and will target support on all businesses that are investing for growth. It will be particularly beneficial to small and medium sized businesses.[50]

At the time the Government estimated that these changes would be broadly revenue-neutral. In 2009/10 the phased increase in the small companies rate, combined with the withdrawal of 50% first year allowances, was estimated to raise £900 million. The new AIA was estimated to cost £920 million in the same year.[51]

During the debate on the Budget resolutions George Osborne, then shadow Chancellor, argued that the change would have a significant impact on the health service:

> One Budget measure that will affect the NHS has not really had an airing yet. It is buried in table A2, on page 210, and is called "Tackling Managed Service Companies". That is Brown-speak for a stealth tax that will raise £350 million next year and £450 million the year after. Will the Secretary of State for Education and Skills confirm that the biggest user of managed service companies in the country is the NHS? Will he explain to the Chancellor that if he puts their taxes up they will put their fees up and that hospital

48 *Budget 2007*, HC 342 March 2007 para 5.113
49 Section 3 of the *Finance Act 2007* (clause 3) sets the rate, and the fraction used in calculating marginal relief, for the financial year 2007 only.
50 *Budget 2007*, HC 342 March 2007 p 51
51 *Budget 2007*, HC 342 March 2007 p 208

> trusts will end up footing the Bill for his entirely self-defeating stealthy manoeuvre?[52]

At the conclusion of the four day debate, Theresa Villiers, then shadow Chief Secretary argued that for small companies, the Chancellor had "raised rates and made the system more complicated, so we will be voting against his proposals on small business":

> The Chancellor has delivered a double whammy with a new tax hit on contractors through managed service companies. David Frost of the British Chambers of Commerce has said: 'This is a substantial rise and will hit those looking to grow their business.' Paula Tallon of Chiltern tax advisers has summed it up: 'Small companies are getting thumped again.'[53]

Speaking for the Liberal Democrats, Vincent Cable, also raised concerns about the potential on certain sectors where many workers provided their services through MSCs:

> There is evasion of national insurance and we understand that the Revenue has an obligation to try to deal with it, but our practical experience is that the Government's actions, unless they are carefully calibrated, will be completely counter-productive. Although there are people who cheat, hundreds of thousands of people need to operate on flexible contracts. Unless the tax system captures that there will be considerable costs. I shall give some examples.
>
> Grant Thornton, the tax adviser, has already warned that one of the knock-on effects of cracking down on contractors will be a big increase in the cost of the Olympics, because the project will be financed by flexible contractors. If we lose them, the costs will rise. The main user of flexible contract workers is the NHS, whose costs will rise if the Government get things wrong. Public sector IT contracts are already escalating out of control and that situation could be seriously aggravated. Although the Government can reasonably claim that they have improved the tax system through simplification in some respects, there are many areas where they already have caused, or will cause, serious damage.[54]

The following day Mark Prisk – then shadow Minister for Business & Enterprise – raised the issue, in a debate on small business in Westminster Hall, saying, "[The Government's] plans to limit managed service companies follows on from [its] … crude attempts with the IR35 legislation. No one is against preventing unreasonable tax evasion, but the crude way in which this Government seek to attack the self-employed damages legitimate enterprises, especially in fields such as IT, health care and professional services."[55]

Writing in a tax newsletter one commentator was strongly critical, calling the measures "fiscal Polyfilla applied to the crumbling IR35 legislation … This is simply treating the symptoms not the cause; if there is to be a hypothetical employment relationship between the worker

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[52] HC Deb 22 March 2006 c970

[53] HC Deb 27 March 2007 c1427. Both Conservatives and Liberal Democrats voted against the Budget resolution dealing with MSCs, though the House approved of it by 293 votes to 234 (*op. cit.* c1450).

[54] HC Deb 27 March 2007 cc1370-1

[55] HC Deb 28 March 2007 c441WH

and the end-user of his services, then the PAYE and NIC responsibilities should rest firmly on that end-user."[56]

The issue came up a few days later when the Chancellor gave evidence to the Treasury Committee on 29 March. Peter Viggers MP asked about the wider changes proposed for corporation tax on small companies. As part of his answer Mr Brown said:

> We have had individuals artificially incorporating as companies for purely taxation purposes, and one of the problems that we have found, faced and had to act upon is that people who are coming to work in this country are being encouraged to form, and work through, managed services companies even before they come into this country. We faced the prospect of schemes that are being marketed right across Eastern Europe, encouraging people to set up companies purely for the purposes of avoiding taxation, and I hope that this Committee will take this issue seriously.[57]

The issue was not discussed at length in the Committee's report on the Budget, though in written evidence John Whiting (CIOT/PWC), commented:

> On "tax-motivated incorporation", is this intended to be a signal that the Treasury wants small businesses to operate unincorporated? If so, is that realistic or even preferable? Given the number of changes to this area of the tax code in recent years, surely it is time for a coherent look at the whole incorporated/unincorporated divide and how the tax system impacts on it, including perhaps reliefs for disincorporation.[58]

MSCs were one of the topics in *Finance Bill 2007* to be considered by the House of Lords Economic Affairs Committee.[59] Mr Whiting was one of those from the private sector who gave evidence, and most of them appear to have concurred with his view that the underlying cause was not being addressed: that is, the difference in tax and NICs payable by a taxpayer operating through different structures.

For its part the Committee argued that "there can be no satisfactory long-term resolution of [this problem] … without tackling the underlying structural issues, however difficult they may be to resolve":

> We therefore recommend that the Government should review the taxation of employees and small businesses operating in various forms with a view to making structural changes to reduce the differences in outcome in terms of tax and NICs payable whether an individual is employed, self-employed or operating through a company. This will overlap with the review of small business that we [also recommend] … and should provide a good opportunity to help meet our recommendations on simplification generally.[60]

56 "Mrs Rochester unlocks the attic", *CCH Taxes Weekly News*, 21 March 2007 p 2
57 *The 2007 Budget*, HC 389-II of 2006-07, 23 April 2007 Q 248 Ev 36
58 *op.cit.* Ev 56
59 The Committee began publishing reports on the annual Finance Bill in 2003. Given the Commons precedence on financial matters, these were from the point of view of tax administration, clarification and administration.
60 *Fourth report: Finance Bill 2007*, 20 June 2007, HL121 of 2006-07 paras 128-9. See para 48 for the Committee's proposal for a review of small business taxation.

5. Finance Bill 2007

5.1 Initial reactions and debate at Second Reading

Provisions to determine the income tax treatment of MSCs were included in the *Finance Bill,* published after the Budget.[61] At the time the *Financial Times* reported that some firms that had provided MSC schemes were planning to leave the market entirely:

> Providers of managed service companies have been taken aback by the scale of the crackdown, which only became apparent with publication of the finance bill. Giant, the contractor services provider, said this week it was pulling out of the personal service company market. It was "not prepared to put our clients, both contractors and agencies . . . in financial jeopardy".
>
> Until last month, most managed service company providers believed the legislation would be ineffective because their clients could transfer to personal service companies that would preserve their tax advantages. But the government tried to block this loophole in the bill by making it clear it would target all specialist providers of services other than accountancy to one-man limited companies. Giant said a typical contractor earning £50,000 a year might be liable for £10,000 in unpaid tax and national insurance, plus interest and fines, if they received services from a specialist provider of services to one-man companies. Most of its clients are expected to join its "umbrella" services company in which they will pay more tax and NI, although they will still be able to offset their business expenses.[62]

Writing on the *AccountingWeb* site, one practitioner commented that for many now in MSCs the best advice "is probably to try to move back into the employed workforce. Most of them do not have the necessary skills to operate through a personal service company, and there are no real tax savings on offer, as they are likely to be caught by IR35 in any event." They also commented that very many of those in MSCs "have absolutely no idea of what they are caught up in."[63]

The *Daily Telegraph* reported different reactions from two companies advising intermediary companies:

> Giant Group warned providers of services to one-man limited companies risk "financial ruin'' if they continue to do so. John Chaplin, tax director at KPMG and one of Giant's advisers, said: "This is the end for companies specialising in promoting and facilitating tax advantageous services to one-man limited companies, regardless of whether they are badged as accountants or not.'' … Matthew Brown, Giant's managing director, said: "HMRC is determined to drive specialist providers of services to one-man limited companies out of business regardless of the agencies and contractors being damaged in the process.''

61 They now form section 25 & schedule 3 of *FA2007*. As noted above, changes to the scope of NICs to mirror these rules were made by Order (SI 2007/2070), agreed without debate under the negative procedure.

62 "Tax crackdown risks 'ruin' for agencies", *Financial Times*, 7 April 2007

63 "Managed service companies – picking up the pieces", *AcountingWeb.co.uk*, 24 April 2007

> But Barry Roback, chief executive of rival JSA, described such advice as "scaremongering''. His firm closed its managed service company service down in December and believes the provision of its remaining accountancy services - it is regulated by the Institute of Chartered Accountants of England and Wales - is legal. "While we need to look carefully at some of the services that we provide our personal service clients and, perhaps, change the way we operate, as professional accountants we don't feel the legislation prevents us from providing book-keeping and accountancy services to our clients,'' he said.[64]

As indicated by these comments, some companies involved in MSC schemes told clients that they would not be captured by the new rules, because the company was merely acting as the client's accountant.[65] One of the tests for an MSC company is that an MSC provider is involved in its operation – that is, a person "who carries on a business of promoting or facilitating the use of companies to provide the services of individuals."[66] In this context someone would not be considered an MSC provider "merely by virtue of providing legal or accountancy services in a professional capacity."[67] On 13 April HMRC published a notice on their website, to clarify the scope of this exemption:

> In response to the legislation published at Budget, a number of providers are telling their clients that they (the providers) are not MSC providers, rather that they are accountants. They are therefore telling clients that their companies are not caught by the legislation. Based on the advertising material seen, it is HMRC's view that many of these organisations are MSC providers as defined in the new legislation. Whether or not the new tax rules apply will depend on the precise relationship between the MSC provider and the client company.
>
> Individuals operating through service companies, particularly those who believe that prior to 6 April they would have been within "IR35", should consider carefully their and their company's relationship with the MSC provider. If a service company is within the legislation and the company fails to operate PAYE, this could result in individuals being held personally liable for the PAYE debts of the company.[68]

In a detailed examination of the new rules in *Taxation*, Anne Redston argued that although some would be unhappy with the new rules, the Government should be "given credit for consulting on what is, essentially, anti-avoidance legislation, and for amending the rules in response to representations." She went on to conclude by saying, "Not everyone will be happy with the new MSC rules, but HMRC and the Treasury should be given credit for consulting on what is, essentially, anti-avoidance legislation, and for amending the rules in response to representations. The Government clearly hopes that this third round in the battle against MSC structures has delivered a knock-out blow. It

64 "Stop helping contractors reduce bills, firms warned", *Daily Telegraph*, 6 April 2007
65 The issue was raised in an article on the internet-based *Accounting Web* site: "Can an accountant be an MSC provider", 16 April 2007.
66 New subsection 61(B)(1)(d) to Chapter 9 of *ITEPA* – as contained in para 4 to part 1, schedule 3 of *Finance Bill 2007*.
67 New subsection 61(B)(3) to Chapter 9 of *ITEPA*
68 HMRC, Employment status - MSC providers, 13 April 2007

remains to be seen whether the providers pick themselves up and continue the fight."[69]

A separate concern about the new rules related to the recovery of MSC debts from third parties. One practitioner writing in *Taxation* suggested that this would encourage the use of corporate and offshore directors, as MSC directors and providers sought to protect themselves from this potential liability.[70] The journal published HM Treasury's response to this concern the following week:

> We are confident that the legislation will be effective. Persons will be less likely to deal with parties operating outside the UK in view of the fact that a consequence could well be that such persons themselves become liable for the MSC's tax debts. The legislation requires that HMRC firstly consider transfer of debt to the MSC's director, which in many cases is the worker.
>
> The second person to be considered is the MSC provider. The transfer of debt provisions have association rules which in addition to the normal definition of associate, are widened in respect of MSC providers to include persons who act in concert. HMRC are aware that certain persons already operate from outside UK tax jurisdiction and that this will be seen as one way of avoiding the transfer of debt provision.
>
> HMRC are confident that the legislation will be effective by virtue of a combination of the:
>
> - association rules; and
> - the fact that those persons within the ambit of ITEPA 2003, s688A who are within the UK tax jurisdiction will be reticent to deal with parties who are operating from outside the UK, if the consequence of such a relationship is that they could become liable for an MSC's PAYE and NICs debt.[71]

In a briefing prepared for the Finance Bill's Second Reading, the Institute of Chartered Accountants commented on this aspect of the new rules:

> The transfer of debt provisions will ensure that where an MSC incurs a PAYE / Class 1 National Insurance debt, and that debt cannot be recovered from the company, the debt may be transferred to specified persons. These will primarily be the MSC's director and the MSC Provider. There is an exclusion for certain services provided by accountants but the precise scope of the exclusion is unclear.
>
> Many of our members provide a variety of services for MSCs but are acting properly and within our ethical code and professional conduct rules. They are concerned that if the exclusion is not clarified, they could become liable for debts incurred by their clients when they have been acting entirely within the law and the professional conduct rules that govern their services. There needs to be a properly targeted exclusion clause. The new rules will also define director's liabilities in such a way that may impact on legitimate business structures. The ICAEW in anxious to ensure that members businesses are not harmed and that consultation

69 "Round three", *Taxation*, 5/12 April 2007
70 "Managed service companies", *Taxation*, 22 March 2007
71 "Feedback: managed service companies", *Taxation*, 29 March 2007

> will continue so as to ensure that these rules are workable and properly targeted.[72]

Some small business groups complained that the new Annual Investment Annual would not compensate many individuals who have incorporated 'in good faith':

> The Federation of Small Businesses said its members, meeting a few days after the Budget at its annual conference in Belfast, were incensed, seeing it as a blunt weapon to tackle a scam by a minority of people. "There will be a lot of small businesses that were incorporated for good reason and don't invest large amounts," it said. "What small companies needed was an injection of imagination and creativity at all levels of business," says Susanna Freedman, founder and managing director of Tsuko, an Edinburgh-based brand consultancy with 12 employees. "Yet while the chancellor talked up the increasing importance of investment in research and development, skills and innovation, he has effectively increased the tax burden on small and medium-sized enterprises." But what irks small companies is that many do not invest on such a scale … A survey by the Forum of Private Business found 82 per cent of members saw the tax rise as damaging …
>
> Most small companies have yet to work out what it means to them, said John Richards, managing partner of RMT, a Newcastle-based firm of accountants that handles the business affairs of owner-managed businesses. They will realise the effects only when they review their tax liabilities next year - and even with small increases, the impact could be damaging. "If you are at the margin every penny counts . . . It's hard for some to make a living and a profit. Any increase in tax affects what is left in the business, what they can invest and take home."[73]

The *Finance Bill 2007* received its Second Reading on 23 April 2007, and the new rules for MSCs were raised by several Members. Speaking for the Liberal Democrats Julia Goldsworthy argued that the solution did not deal with the "underlying problem … there is no balance between the taxation systems for the employed and the self-employed." Ms Goldsworthy was also concerned as to whether HMRC would have sufficient resources to deal with a potential "explosion in the number of individuals who register themselves as personal service companies."[74] Stewart Hosie raised concerns about the knock-on impact for government departments and local authorities:

> I understand that a large number of the people who may be affected by the provision work in IT as independent freelance IT contractors and consultants. I also understand that one in four of those work for Government Departments or local government departments. If they are expected to bear an additional cost burden, it is almost certain that that additional cost will be passed on to the employer—a Government Department or local authority department—and there will be a corresponding requirement for more spending by Government in order to pay for the consequences of the change to managed service companies.[75]

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72 ICAEW, *Parliamentary Briefing: Finance Bill 2007 – Second Reading*, April 2007 p4
73 "Tax to curb migrants stings small companies", *Financial Times*, 10 April 2007
74 HC Deb 23 April 2007 c 688
75 HC Deb 23 April 2007 c 745

Speaking for the Conservatives, Theresa Villiers focused on freelancers who transferred from an MSC to a PSC to avoid the new rules:

> In seeking to crack down on abusive behaviour, the Government are in danger of hitting all contractors who have incorporated and chosen to outsource some of the administration and finance connected with their company … One of the worrying consequences of these proposals is that many contractors who have—understandably, given the complexity in the tax system and in regulation— allowed an adviser to take some of the burden of administration off their shoulders will have to set up their own personal service companies … According to the Institute of Chartered Accountants, we are already seeing the symptoms of the changes involving managed service companies, because well over 56,000 new companies were registered in February—around double the usual monthly figure.
>
> Freelancers, as well as having to set up their own companies and being unable to outsource, are likely to see the bill for professional advice go up because of the risk that their advisers could find themselves caught by the definition of a managed service company provider; those professionals could find themselves liable for the tax debts of their clients. It is difficult to know in advance how the carve-out for professional advisers in proposed new section 61B(3) will be interpreted. While some basic accountancy and legal services may steer clear of the rocks, how will everyday tax advice, company formation and company secretarial work be treated? We will have to wait for a court decision before we can understand the legal position with confidence, leaving freelance workers and their professional advisers in an expensive limbo in the meantime.[76]

In response to this point the then Financial Secretary John Healey said:

> The hon. Lady was particularly concerned about freelancers. It is only freelancers operating through MSCs who are affected by the changes. Freelancers who are engaged directly by an agency, who are in business on their own account and run their own personal service company, or who are in other business structures such as umbrella companies, are not affected. That is because, in the vast majority of cases, MSCs are used to disguise employment, and the existing rules that ensure employed levels of tax and national insurance contributions are not applied.
>
> The measure in the Bill therefore ensures that workers in MSCs pay the same tax and national insurance as other employees, thus providing a more level playing field for businesses and workers who comply with the rules. Freelance workers can still work flexibly. In fact, many employment agencies and their representative body—the Recruitment and Employment Confederation —support the measures in the Bill.[77]

The Minister went on to underline the Government's aims in reforming small business taxation:

> The lower rates of tax have resulted in a significant number of people incorporating to take advantage of them, not to invest in business, but simply to extract the company profits in a way that reduces their personal tax and national insurance liabilities. They are doing that while still carrying out the same economic activity

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76 HC Deb 23 April 2007 cc665-6
77 HC Deb 23 April 2007 c756

> that they carried out before they incorporated. The tax break is clearly being subsidised by those companies that are following the rules and by ordinary taxpayers. We are therefore refocusing the provision of investment incentives on small businesses.[78]

In evidence to the Lords Economic Affairs Committee on 21 May, Peter Curwen, director of Tax and Budget at HM Treasury, presented updated statistics on the numbers of incorporations, showing a significant drop in April. Mr Curwen suggested that this might be attributed to the tighter definition of MSCs announced in Budget 2007, and the realisation that workers in MSCs could not simply avoid the new rules by badging themselves as a PSC:

> We had the highest weekly figure of incorporations ever in the second week of February when it was nearly 21,000, with the highest average weekly incorporations as a monthly total in March. What happened then was that, of course, we had the Budget in 2007 which included a more robust definition of MSCs and, as you will notice, the level of incorporations fell back significantly in April.
>
> It is too early to be certain, particularly as Easter fell in April, but it does suggest that the final definition that we produced at the Budget is proving more effective … we simply do not accept that the increase in companies set up after the publication of draft legislation at PBR were bona fide personal service companies; rather they were MSCs slightly re-hashed. If such companies operate under an MSC provider the MSC compliance strategy will apply, which is to look first and foremost at the provider itself, and that was the advantage of the robust definition we published at the Budget. What it means is that the HMRC can police the small number of MSC providers.[79]

The Committee noted that the fall might simply reflect the finite number of individuals involved in these schemes,[80] and while it took the view that this legislative solution was the only option, it went on to say that it was "not persuaded that the position concerning the effectiveness of the new legislation is as comforting as HMT/HMRC portray. We recommend that they keep under close scrutiny the operation of the new legislation."[81]

5.2 Debate at the Committee stage & Government amendments

The detailed provisions to determine the income tax treatment of MSCs were initially set out in schedule 3 of the Bill; clause 25 of the Bill (now section 25 of the *Finance Act 2007*) simply referred to the schedule and provided that it should have effect from 6 April 2007. Clause 25 was debated by the Committee of the Whole House on 30 April 2007.[82] On this occasion the Government successfully resisted an amendment to

78 HC Deb 23 April 2007 c759
79 *Finance Bill 2007*, HL Paper 121-II, Ev114
80 Malcolm Gammie of the Institute for Fiscal Studies had suggested this might happen when he gave evidence on 25 April (HL Paper 121-II of 2006-07 Q27).
81 *Finance Bill 2007*, HL paper 121-I of 2006-07 paras 137-9
82 HC Deb 30 April 2007 cc1305-1332

postpone implementation of the new rules until a review had been undertaken on their potential impact.

Speaking for the Conservatives Theresa Villiers argued that "a fundamental problem with schedule 3 is the collateral damage that it will cause … [it] could hit many genuine freelancers who operate entirely legitimately and are genuinely self-employed":

> There was a short window between the end of the consultation on 2 March and the publication of the Finance Bill and the start of the new rules on 6 April. The statutory element of the third-party debt provisions went into the Bill even before the consultation period was finished. Surely that suggests that the Treasury proposes to take only limited notice of the representations that have been made. IR35 had many problems, as I have outlined, but at least the Government took a lengthy period to finalise and implement that measure.[83]

Speaking for the Liberal Democrats, Vincent Cable raised concerns about the test for MSCs and whether companies and practitioners would be confident about which companies would be included. Dr Cable suggested a six-month delay in implementing the rules, "to give the relevant organisations an opportunity to assimilate the secondary legislation, which we have not seen", given that "the six-month contract is the standard period for many contractor-type relationships."[84] On the specific question of secondary legislation, during the debate on schedule 3 in Public Bill Committee two weeks later, the then Financial Secretary, John Healey, said:

> It is precisely because the Treasury and the Government are keen to consult fully that the regulations that will flow from the schedule are not provided to accompany the debate. The draft regulations on the PAYE debt transfer were published for consultation on 8 February, and the consultation closed on 30 April.
>
> I think that hon. Members will agree that we should consider the comments fully and in detail before proceeding. As was explained in the letter of 9 May that the Chief Secretary wrote to you, Mr. Illsley, your co-Chair, Mr. Gale, and Opposition Front-Bench spokesmen, copies of which have been made available to the Committee, we have committed to publish the PAYE and national insurance regulations next month, which we will lay before the House when the Bill has Royal Assent.[85]

Turning back to the debate on 30 May, the Financial Secretary opposed any delay in implementation, underlining the point that the exploitation of MSCs represented "a significant and unacceptable risk to the public purse" and suggesting that the consultation process had been successful in accommodating concerns about the new rules:

> The amendments are not necessary because the legislation was published for consultation last December, alongside a partial regulatory impact assessment. During the course of the

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83 HC Deb 30 April 2007 c1307, c1313

84 HC Deb 30 April 2007 cc1316-7

85 PBC 15 May 2007 c171. The regulations relating to both PAYE and NICs were laid before the House on 23 & 26 July (SI 2007/2068, 2069, 2070 & 2071). Guidance relating to the legislation was published on 10 July.

> consultation, officials dwelt in detail on the proposals with a wide range of parties. We received 81 written representations and we set out the points that were made in a summary of the consultation responses, which I published last month.
>
> Not only did the consultation confirm our analysis of the problem and the need to tackle it, it provided the further evidence that we needed to inform the full regulatory impact assessment, which was published at the same time as the Finance Bill and which covers many of the issues that the hon. Member for Chipping Barnet [Mrs Villiers] is concerned about in her amendment. Importantly, the responses to the consultation have allowed us to refine the approach that the legislation takes in a way that enables us to deal with the key concerns that have been raised.[86]

Debate on schedule 3 took place over two sittings of the Public Bill Committee on 15 May 2007, and focused on two aspects of the rules: the definition of an MSC provider and it whether this might capture accountants, tax advisers and lawyers simply providing their normal professional services to clients; and, the range of third parties from whom HMRC might recover tax debt incurred by an MSC.[87]

In the first case, the Government resisted a series of amendments tabled by the Opposition with the aim, as Mrs Villiers put it, "that a sensible line is drawn between those professionals operating on an ordinary, day-to-day basis and the dubious operators whom HMRC wants to shut down."[88] The MSC rules are set out in a new chapter – chapter 9 - of the *Income Tax (Earnings and Pensions) Act (ITEPA) 2003*. Within this, the definition of an MSC – determined largely by reference to the MSC provider – is contained in new section 61B of *ITEPA*. Section 61B(2) establishes that an MSC provider is a person "involved" with an MSC, and who:

> (a) benefits financially on an ongoing basis from the provision of the services of the individual,
>
> (b) influences or controls the provision of those services,
>
> (c) influences or controls the way in which payments to the individual (or associates of the individual) are made,
>
> (d) influences or controls the company's finances or any of its activities, or
>
> (e) gives or promotes an undertaking to make good any tax loss.

New sections 61B(3) and (4) provide two broad brush exclusions, so as accountants, lawyers, and recruitment agencies providing their professional services are not defined as MSC providers:

> (3) A person does not fall within subsection (1)(d) merely by virtue of providing legal or accountancy services in a professional capacity.
>
> (4) A person does not fall within subsection (1)(d) merely by virtue of carrying on a business consisting only of placing individuals with persons who wish to obtain their services (including by contracting with companies which provide their services); but this subsection does not apply if the person, or an associate of the

86 HC Deb 30 April 2007 c1326, c1331
87 PBC 15 May 2007 cc147-193
88 PBC 15 May 2007 c150

> person, does anything within any of paragraphs (c) to (e) of subsection (2).[89]

Many professional bodies expressed concern about whether these exclusions would work in practice.[90] The Institute of Chartered Accountants suggested that, "without clarification the purpose of this legislation will be misunderstood and many traditional accountants and advisers will inadvertently be brought within the remit of this legislation":

> Many professional accountants will, on detailed consideration of the circumstances, recommend a corporate structure to a client and then provide the client with an off-the-shelf company for that purpose. It would appear to us that a professional accountant who advises his client to incorporate in this way is 'promoting' the use of companies (to use the wording in new section 61B(1)(d)) and, if he provides an off-the-shelf company for this purpose, he is 'facilitating' the use of companies (also to use the wording in new section 61B(1)(d)). However, these activities are an incidental part of a professional accountant's business of providing the best all-round service to his client.
>
> Whilst HMRC has said in meetings that they will explain in guidance where they intend to draw the line between firms of accountants and tax advisers referred to above and others who carry on business of actively promoting and facilitating the use of companies to provide the services of individuals, that is no substitute for having a legal definition. This is because, if the definition is not incorporated into the law, the courts cannot consider the point in cases of dispute and so taxpayers cannot be certain of their rights and obligations.[91]

In Committee the Financial Secretary argued that the wording would work in the way that was intended:

> Section 61B(2) sets out five tests of involvement. If one of these tests is met, the company is an MSC. It is important to emphasise that this measure needs to be considered only if there is an MSC provider. For example, a tax adviser providing tax advice is not an MSC provider and therefore the tests set out in proposed section 61B(2) are not considered.
>
> The five activities defining "involved" go beyond the services provided by accountants. Some have suggested that the word "influences" in proposed section 61B(2) captures all the advice given by accountants and advisers, but there is a distinct difference—I think that hon. Members would accept that there is a difference—between a person who provides independent, tailored advice to a client, who is then able to consider that advice before accepting it or rejecting it, and the person who simply supplies a client with a standard solution or product that the client accepts. It is not the intention that the former situation—the provision of advice—be considered to be influencing in this context. However, the latter situation—supplying a standard solution or product—is regarded as influencing …
>
> Let me turn to new section 61B(3) and reinforce the fact that a person who merely provides legal or accountancy services in a

89 Bill 86 27 March 2007 p90

90 see, for example, the evidence presented to the Lords Economic Affairs Committee (*Finance Bill 2007*, HL Paper 121 of 2006-07 paras 149-152).

91 ICAEW, *Finance Bill 2007: detailed representations TaxRep36/07*, 4 May 2007 p8

> professional capacity is not an MSC provider involved with their client. There is a specific exclusion—this is the point about which the hon. Lady is concerned—from subsection (1)(d) for those who provide such services. Let me try to make this absolutely clear: even when the specific exclusion does not apply, the purpose of the legislation is not to include within the definition of MSC provider accountants, tax advisers, lawyers and company secretaries who provide advice or other professional services to companies in general. Those persons are not in the business of promoting or facilitating the use of companies to provide the services of individuals, nor are they regarded as involved with the company in the way in which the legislation envisages.
>
> Perhaps I could just give this example … When an individual asks a tax adviser for help or advice in setting up a business to provide that individual's services to end users, the tax adviser considers the individual's position and might recommend a corporate structure that includes the payment of dividends to the individual as a shareholder worker. The tax adviser is not acting as an MSC provider.[92]

The Minister went on to introduce one technical amendment – to new section 61B(4) – to ensure that "an employment business or agency [might] influence a worker's company or its finances to the extent that that relates to the placing of the individual with an end client" and not come within the scope of the definition.[93] As a result the section reads as follows:

> (4) A person does not fall within subsection (1)(d) merely by virtue of carrying on a business consisting only of placing individuals with persons who wish to obtain their services (including by contracting with companies which provide their services).
>
> (5) Subsection (4) does not apply if the person or an associate of the person—
>
> (a) does anything within subsection (2)(c) or (e), or
>
> (b) does anything within subsection (2)(d) other than influencing the company's finances or activities by doing anything within subsection (2)(b).

The Lords Economic Affairs Committee noted that if interested parties were not convinced by the Government's arguments, "they should make further representations setting out the detail of the changes that they think are still necessary." The Committee went on to note:

> The drafting of the guidance on this provision will be vital in ensuring that it operates without collateral damage. We recommend that HMRC enters into full consultation with the private sector in developing this guidance to achieve full clarity, both generally and particularly on those points on which our private sector witnesses might continue to have doubts.[94]

The second issue discussed at length in Committee were the provisions for the transfer of debt from an MSC to one or more third parties, where HMRC are unable to recover unpaid tax and NICs from the MSC

[92] PBC 15 May 2007 cc175-6
[93] PBC 15 May 2007 c178 (Amendment No. 97)
[94] *Finance Bill 2007*, HL Paper 121 of 2006-07 para 156

itself. John Whiting at the CIOT set out the profession's concerns in evidence to the Lords Economic Affairs Committee on 9 May:

> I think the basic proposal is justified and is realistic because otherwise it would be too easy for an MSC user to alienate him or herself from any wealth and possibly pass it to their spouse and say, "I have no money left to make this worth pursuing." It would be too easy to strip the value out of the company and say there is nothing to pursue yet the proprietor or the provider of the company has wealth, so as a principle I think it is unremarkable in the sense that it is a necessary part of the provisions. The concern is that it potentially goes very wide. We have concerns, for example, that could an ordinary employee of a company that provides these managed service companies—a secretary—be caught by these provisions? It could catch business partners, relatives, very remotely. It needs again to be properly targeted in terms of whoever is actively involved, which is an amendment which has been made, and proportionate to their involvement.[95]

In Committee the Government resisted calls to provide a form of vetting by the Special Commissioners for tax officers involved in this work. Mrs Villiers had argued the MSC provisions should be "enforced and administered by specialist units at HMRC."[96] In response the Minister said, "to require the administration of the PAYE system for MSCs to be dealt with by different HMRC officers from those who deal with employers in general seems an extraordinary proposition, which is rather impractical and therefore not appropriate":

> If the amendments were adopted, that would result in a wholly anomalous situation whereby employer debts that are established generally would be dealt with by the trained staff in whichever part of HMRC was most appropriate, but identical functions related to MSCs would be vested in specially authorised officers who would fulfil precisely the same role as their non-authorised colleagues.[97]

In evidence to the Lords Economic Affairs Committee on 21 May, Dave Hartnett, then Director General of Business, explained that HMRC were "going to deal with debt transfer in a very particular way":

> It will be handled by a special unit we are setting up to deal with this so we can guarantee an absolutely consistent approach and if difficulties do arise, and I do not expect them to, they can be referred to policy makers very quickly indeed. If I wanted to offer you an analogy I think I would probably look back to the measures introduced really rather a long time ago, seven or eight years ago, in relation to delinquent directors whose actions in relation to a corporate led to a loss of national insurance contributions, where they actually had to be involved in the delinquency for us to be able to recover national insurance contributions from them. This will work rather like that.[98]

However, the Government went on to introduce three amendments in response to concerns about the scope of the transfer provisions. Schedule 3 inserts a new section 688A into *ITEPA 2003*, enabling PAYE regulations to provide for the recovery from specified persons set out in

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95 *Finance Bill 2007*, HL Paper 121-II of 2006-07, Ev 73 Q175
96 PBC 15 May 2007 c183
97 PBC 15 May 2007 c189
98 *Finance Bill 2007*, HL Paper 121-II of 2006, Ev 113 Q313

the section, of any amount of PAYE that an officer of HMRC considers should have been deducted by the MSC. Initially as drafted section 688A(2) & (3) specified those persons:

> (2) The persons are—
>
> (a) a director or other office-holder, or an associate, of the MSC,
>
> (b) an MSC provider,
>
> (c) a person who (directly or indirectly) has encouraged, facilitated or otherwise been actively involved in the provision by the MSC of the services of the individual, and
>
> (d) a director or other office-holder, or an associate, of a person (other than an individual) who is within paragraph (b) or (c).
>
> (3) A person does not fall within subsection (2)(c) merely by providing legal or accountancy advice in a professional capacity.[99]

The first of these amendments removed the word "facilitated" from section 688A(2)(c). As the then Financial Secretary explained to the Committee, by removing this word, "only those who have encouraged or been actively involved in the provision by the MSC of the services of the individual will fall within its scope":

> Both tests require the third party to have an active role, so those who simply use MSC workers will not be caught. If an end client did more than simply use MSC labour, for example by telling those who it employed that they must move to an MSC, it would fall within the scope of the measure as that would be regarded as encouragement.[100]

Mr Healey went on to explain the purpose of the two other amendments:

> Government amendments Nos. 99 and 100 reflect the consideration that we have given to concerns that employment businesses or agencies might be within the scope of the debt transfer provision, simply as a result of carrying on their normal business of placing individuals. We have considered the risk that such activity might be regarded as "actively involved" under proposed new section 688A(2)(c), and have decided to remove that risk by expanding the exclusion, as set out in proposed new section 688A(3), so that the mere placing of individuals with clients is not within the scope of the provisions. An employment business will be within that scope where it is involved beyond such activity, perhaps by advising workers to use an MSC.[101]

New section 688A(3) now reads as follows:

> (3) A person does not fall within subsection (2)(c) merely by virtue of—
>
> (a) providing legal or accountancy advice in a professional capacity, or
>
> (b) placing the individual with persons who wish to obtain the services of the individual (including by contracting with the MSC for the provision of those services).

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99 Bill 86 27 March 2007 p96
100 PBC 15 May 2007 c190. (Amendment No. 98)
101 PBC 15 May 2007 cc190-1

For its part the Lords Economic Affairs Committee made comments similar to the ones it had made on the definition of MSCs: first, the onus laid on the profession to review these provisions in the light of the amendments made and the assurances provided by both the Minister and officials, and second, the importance of any published guidance to provide clarity for those potentially affected by these rules.[102]

5.3 Debate at Report stage

At the Report stage of the Bill on 26 June, the Opposition tabled a number of amendments, on quite similar lines to those tabled in Committee. Introducing these amendments, Theresa Villiers said, "welcome though the Financial Secretary's words of comfort in Committee were, and welcome though HMRC guidance will be, the protection of a change in the statute will still be needed to remedy the problems with the drafting of schedule 3."[103] As in Committee, the Opposition's concerns focused on the likelihood that accountants or lawyers offering advice to clients would be treated as MSC providers, and the wide range of persons HMRC would be entitled to recover third party debts from. None of these amendments were successful. In responding to the debate the then Financial Secretary, Mr Healey, mentioned the impact the new rules had already had:

> It seems that some MSC providers are winding up or changing their businesses because there is no longer a tax and national insurance advantage from operating an MSC scheme. That reinforces the point that such schemes existed only to avoid tax and national insurance, and now that that has been stopped, they have no real reason to continue in business … we have been watching carefully the impact of the legislation in the sectors that it might affect, and we have no evidence that it has had any adverse effects on employment. Our assessment to date is that the new rules have been operated by many providers since April with no apparent disruption to the labour market.[104]

Following the completion of the Bill's progress in the Commons, HM Revenue & Customs published detailed guidance for those affected by the new rules on 10 July 2007. This drew on the Minister's comments in Public Bill Committee when the scope of the new rules were debated on 15 July, before going on to provide some examples. On the vexed question of who is, and who is not, an MSC provider, the guidance made a series of following observations:

> The legislation provides a specific exemption for persons being MSC Providers (involved with a company) merely by virtue of providing legal or accountant services in a professional capacity. This specific exemption applies only to persons professionally qualified (or training for a professional qualification) regulated by a regulatory body. But simply because a person is not exempt merely by virtue of providing legal or accountancy services in a professional capacity, does not mean that they are an MSC Provider. Persons who promote or facilitate companies generally,

[102] *Finance Bill 2007*, HL Paper 121-I of 2006-07, paras 168-9
[103] HC Deb 26 June 2007 c253
[104] HC Deb 26 June 2007 c266

as opposed to companies specifically to provide the services of individuals, are not MSC Providers.

The Financial Secretary to the Treasury, John Healey, said in Parliament on 15 May 2007: "The first element that must be satisfied is that a person is carrying on a business of promoting or facilitating companies to provide the services of individuals, not a business to promote or facilitate companies generally. For that reason, those promoting or facilitating companies generally—for example, company formation agents—are not MSC providers. The same would be true of training providers and a number of companies that may provide advice."

An accountancy/tax adviser, whether or not professionally qualified, who provides advice to clients who are service companies is not an MSC Provider merely by virtue of their client base. The test is whether a person is carrying on a business (or a discernable part of their business) of promoting or facilitating the use of companies to provide the services of individuals. The Financial Secretary to the Treasury, John Healey, said in Parliament on 15 May 2007:" When an individual asks a tax adviser for help or advice in setting up a business to provide that individual's services to end users, the tax adviser considers the individual's position and might recommend a corporate structure that includes the payment of dividends to the individual as a shareholder worker. The tax adviser is not acting as an MSC provider."

Simply because a person is a lawyer or accountant does not automatically exempt them from being an MSC Provider—the ultimate test is whether a person is carrying on a business (or a discernable part of their business) of promoting or facilitating the use of companies to provide the services of individuals.

Examples:

The following are **not** an MSC Provider by virtue of the activity described:

- A firm of accountants carrying on a business of being accountants (irrespective of the percentage of the client base which is individuals operating through service companies)
- A Tax Adviser carrying on the business of being a Tax Adviser generally
- A Company Formation Agent
- A Chartered Secretary
- An Employment Business/Agency undertaking its core business of placing work seekers (including those operating through companies) with end clients
- Service providers providing services to companies generally, for example insurance companies, payroll bureaux etc.
- A Trade Association operating in the service sector

The following **are** an MSC Provider

- A Service Provider *carrying on a business specifically of marketing and/or providing corporate solutions* and services to individuals providing their services to end clients

- A firm of accountants *carrying on a discernable part of their business specifically to market and/or provide corporate solutions* and services to individuals providing their services to end clients. (In this case the firm would only be an MSC Provider in respect of that discernable part of the business.)
- A business which terms itself a Tax Adviser, Service Provider or whatever but which *specifically markets and/or markets corporate solutions* and services to individuals providing their services to end clients.[105]

In August 2007 HMRC confirmed it would monitor the impact of the legislation:

> As part of HMRC's monitoring the effects of Chapter 9 ITEPA, letters will be issued shortly to those known Service Providers whom HMRC believes to be MSC Providers. The letters will asks Service Providers for limited information on the business models provided to clients and the numbers of clients within each business model. Provision of the information is purely voluntary but as many Service Providers advertise their business models, HMRC anticipates a good response.

At the same time, HMRC gave some guidance on two further issues arising from these changes, relating to recruitment businesses, and certain offshore arrangements:

> **Recruitment Businesses**
>
> Some Service Providers report that Recruitment Businesses are refusing to deal with Service Providers who provide service companies to workers. It is clearly important that Recruitment Businesses consider the implications of the transfer of debt provisions and take reasonable steps to mitigate their exposure to those provisions. However, it is important to remember that the legislation was introduced to address the issue of workers seeking to avoid employed levels of tax and NICs. It was not introduced to stop those genuinely in business on their own account providing their services though service companies. HMRC has provided guidance to help Recruitment Businesses take a balanced view on their risk under the transfer of debt provisions.
>
> **Current arrangements**
>
> HMRC is aware of a number of offshore arrangements providing the services of workers to UK clients which claim to be outside Chapter 9 ITEPA. Such arrangements may be outside the legislation. However, irrespective of the claims made by the Service Providers, if any of these arrangements fall within Chapter 9 and there is subsequently an irrecoverable PAYE/National Insurance debt, HMRC will consider the transfer of debt provisions.
>
> Some offshore arrangements claim that Chapter 8 (IR35) and Chapter 9(MSCs) do not apply in offshore locations. Such statements are misleading. Where a worker is resident in the UK and the work is carried out in the UK, the intermediary (in Chapter 8) or MSC (in Chapter 9) is treated as having a place of business in the UK and, subject to other qualifying criteria, Chapter 8 and 9 do apply.

[105] HMRC, *MSC Guidance on Chapter 9 & s688A,* July 2007 pp 8-9

HMRC is also aware of the marketing of arrangements on the Internet which appear to fall within the scope of Chapter 9 ITEPA in that they are marketed on the basis of saving employer's NICs and marketed to workers historically providing their services under contracts of service. Where HMRC compliance activity identifies a failure to apply Chapter 9, and the consequential PAYE and National Insurance liability is irrecoverable from the MSC, HMRC will consider the transfer of debt provisions.[106]

[106] *Managed Service Companies: News*, August 2007

6. Subsequent developments

Following the introduction of the MSC legislation, concerns about the exploitation of this corporate form abated. In December 2008 HMRC issued guidance as some individuals sought to avoid the MSC legislation by establishing themselves as an officer or partner in the company concerned. Having taken legal advice HMRC stated that, in and of itself this would **not** preclude these individuals from meeting the statutory test of being an MSC provider.[107] However, this did not give rise to any debates similar to those when the legislation was first introduced.

Contractors and tax professionals continued to raise concerns about the avoidance legislation which *preceded* the MSC rules – IR35. In 2010, on the 10-year anniversary of its introduction, there were many calls for IR35 to be abolished. In a piece on this issue, *Taxation* quoted Anne Redston as saying, "the managed service companies rules of 2007 removed the worst cases from the IR35 legislation, and what it left are people who are either genuinely outside IR35 or who do their best appear to be unaffected."[108] Following the 2010 General Election the incoming Coalition Government stated that it would "review IR35, as part of a wholesale review of all small business taxation and seek to replace it with simpler measures that prevent tax avoidance but do not place undue administrative burdens or uncertainty on the self-employed, or restrict labour market flexibility."[109]

After its first Budget, the Coalition Government established a new advisory body, the Office of Tax Simplification (OTS). One of the OTS' first commissions was a review of small business taxation, and it completed an interim report just before the 2011 Budget. While the OTS set out a number of options for reforming IR35, it made no mention of amending the MSC rules. The authors acknowledged that amending or withdrawing IR35 posed a risk to "several areas of Government revenue" though "the managed services company legislation does give some protection in this area." The report gave some evidence of the impact of the MSC rules:

> No reliable data is available as to the current numbers affected by IR35, but HMRC data from forms P35 [the annual tax return employers must complete] in 2007/08 and 2008/09, show that 70,000-75,000 declare themselves as service companies annually. Of these, 30,000 applied IR35 or the Managed Service Company legislation in 2007/08, while in 2008/09 this number had dropped to 9,500.
>
> Concerns have been raised with this data as the questions are reported to have caused difficulties. Some ignored the questions on the basis that there is no legal definition of a "service company" or that answering the questions would trigger an IR35 investigation. HMRC's service company definition is also wide enough to capture small incorporated companies, for example, an

107 *Managed Service Companies: News*, December 2008 – see also, "When is an MSC not an MSC?", *Taxation*, 11 December 2008.
108 Sector looks to post-election IR35 reform", *Taxation*, 29 April 2010
109 HM Government, *The Coalition: our programme for government*, May 2010 p10

> accountancy practice with multiple clients, premises and staff not affected by IR35. [110]

As it transpired in the 2011 Budget the Coalition Government announced that IR35 would be retained "as abolition would put substantial revenue at risk," though it wished to make "clear improvements in the way IR35 is administered."[111]

Subsequently HMRC's approach to administering IR35 was criticised in a report by a House of Lords Committee, established by the House on an *ad hoc* basis in November 2013. In their report, published in April 2014, the Committee agreed that the abolition of IR35 would be unwise "if the legislation has the Exchequer protection effect claimed for it by HMRC", though it raised doubts about these revenue estimates:

> HMRC told us that such a measure would put £550 million of revenue at risk. This figure is an estimate[112] and was not, in our view, directly substantiated by any publicly available information. Given that the justification for maintaining the IR35 provisions relies almost entirely upon this calculation of a deterrent effect, we believe that HMRC should publish a detailed assessment to justify maintaining the IR35 legislation.[113]

In June 2014 the Coalition Government published its response to this report; this included an assessment of the cost of abolishing IR35, which put the direct Exchequer cost at £30m, but the total impact, taking into account the responses of individuals and directors, at £550m. It is worth underlining that in this assessment, HMRC noted that, "these behavioural assumptions are inherently difficult to estimate."[114] The report also presented some evidence of the impact of the MSC rules:

> Martin Hesketh of the Freelancer and Contractor Services Association (FCSA) told us that the MSC legislation had changed the working structures of "tens of thousands" of people, by ensuring that those working through limited companies have to take on directly the responsibilities of ownership, directorship and management. The net result of this had been to push low paid individuals - who did not want or were not able to manage these responsibilities - out of the limited company arena. The ICAEW and Contractor Calculator echoed this view.[115]

In March 2015 the OTS completed a major review of employment status. Though IR35 lay outside the project's terms of reference, the report noted the impact of certain legislative reforms on trends in employment status, and, as part of this, the continued success of the MSC regime:

> There is … a current and worrying trend that inappropriate vehicles are being used to provide the services of semi-skilled or

110 *Small business tax review*, March 2011 p40, p39
111 *Budget 2011*, HC 836 March 2011 para 2.203. see also, Letter from Exchequer Secretary to Michael Jack, Chairman, OTS, 9 May 2011
112 [HMRC officials gave some details of the methodology in written evidence to the Committee: Select Committee on Personal Service Companies, Oral and written evidence, April 2014 p164]
113 *Personal service companies*, HL Paper 160 of 2013-14, 7 April 2014 pp54-5, p5
114 The estimate is for 2010/11. Annex 1, *Personal service companies: the Government's response*, Cm 8878, 9 June 2014 pp13-14. HMRC gave the same £550m estimate the following year: *IR35: Estimating the administrative burden*, 12 March 2015.
115 HL Paper 160 of 2013-14, 7 April 2014 para 145

> unskilled workers in order to bypass legislation, avoid the National Minimum Wage and tax and, more specifically, employers' NICs. This is not a new phenomenon as was seen in the mid-70s when the amendments to legislation in the construction industry resulted in wide use of the personal service company.
>
> The use of personal service companies grew in the late 1980s when the amendments to what was section 134 *Income and Corporation Taxes Act 1988*[116] were made. After the 'agency tax' legislation was enacted in 1988, it became established practice to provide the services of an individual through a limited company, either to protect the agency from a tax liability or as a more tax efficient vehicle for the individual.
>
> As a result of the growth of personal service companies in 1999, IR35 was introduced.[117] In order to bypass the IR35 legislation, managed service companies became popular, but this deprived the Exchequer of tax and as a result, in 2003 the MSC legislation[118] was enacted. This legislation has all but closed down the use of managed service companies to avoid tax.[119]

In 2016 HMRC won a tribunal case on the application of the MSC rules, a judgement upheld by the Upper Tribunal two years later.[120] In turn these decisions were upheld by the Court of Appeal in March 2019,[121] and permission to appeal was refused by the Supreme Court in December that year. Subsequently in February 2020 HMRC updated guidance it had issued after the Upper Tribunal judgement underlining that "the decision is now final and HMRC will use it to challenge such arrangements":

> HMRC won a case in the First-tier Tribunal (FTT) involving attempts to avoid PAYE Income Tax and Class 1 National Insurance contributions on employment income. HMRC successfully argued that the managed service companies (MSC) legislation (Chapter 9 of Part 2 of the Income Tax (Earnings and Pensions) Act 2003 and equivalent National Insurance contributions legislation) applied to arrangements established and run by a third party – Costelloe Business Services Limited.
>
> Following an appeal, the Upper Tribunal (UT) agreed with the original FTT decision that the appellant's companies were operating as MSCs.
>
> In addition to the original decision, the UT considered 2 additional areas.
>
> Firstly, the definition of an MSC provider as 'a person who carries on a business of promoting or facilitating the use of companies to provide the services of individuals'. This decision confirms HMRC's

116 Now section 44 *Income Tax (Earnings and Pensions) Act (ITEPA) 2003* (consolidating legislation from 1975 in section 38 *Finance (No.2) Act* and then in 1978 in the *Social Security (Categorisation of Earners) Regulations* for National Insurance.)

117 The IR35 legislation is more formally Section 60 and schedule 12 *FA2000*, now sections 48-61 *ITEPA 2003*

118 Chapter 9, Part 2 and Section 688A, Part 11 *ITEPA 2003*

119 Office of Tax Simplification, *Employment Status report*, March 2015 pp44-5

120 *Christianuyi Ltd & Ors v HM Revenue and Customs* UKFTT 272 (TC) (21 April 2016); and, *Christianuyi Ltd and Others v The Commissioners for HM Revenue and Customs* [2018] UKUT 10 (TCC). See also, "Who pulls the strings?", *Taxation*, 22 March 2018; "How involved are you?", *Taxation*, 23 June 2016

121 *Christianuyi Ltd & Ors v Revenue And Customs* [2019] EWCA Civ 474. See also, "Managed service company status confirmed", *Taxation*, 8 April 2019.

> view that if the answer to both of the following questions is yes, a person is an MSC provider.
>
> - Does the person promote or facilitate the use of a company?
> - Does that company provide the services of individual?
>
> Secondly, the UT decided that 'influences' or 'control' has a wider meaning than that expressed in the FTT decision. In this case, Costelloe Business Services Limited influenced how payments were made to workers through the use of a standard product, by causing the workers to receive wages and dividends instead of just wages.
>
> When workers buy into such products, allowing the MSC provider to determine the amount to be paid as a dividend and to carry out the administrative steps to affect this, it amounts to 'control'.
>
> A further appeal on 5 March 2019 resulted in the Court of Appeal (CoA) agreeing with the UT decision about the definition of an MSC provider. The Court ruled that 'Costelloe Business Services Limited was undoubtedly an MSC provider and that the appellant's companies are undoubtedly MSCs'.[122]

In her comments Lady Justice Rose argued that, "the business that the Government was trying to catch in the definition is precisely the business that Costelloe runs":

> What I glean from the 2006 Consultation and the 2007 Response is that the Government was concerned to define "MSC provider" in a way that focused on the role of that company in the overall arrangement and on its characteristic features. The Government recognised the need to strike a balance between attaining clarity and certainty on the one hand and ensuring that the measures could not easily be worked around by MSC providers wanting to avoid the liabilities that the Government wished to impose.
>
> That is why the draft legislation moved from a "control" based test to a test which first limits MSC providers to those whose business is that of promoting or facilitating MSCs and secondly stipulates that the business must be involved with the MSC by providing the kinds of services MSC providers typically offer.[123]

HMRC's guidance on this case goes on to warn contractors that "if you're ever tempted to enter an avoidance scheme, remember that you can end up significantly worse off. If the scheme looks too good to be true, it almost certainly is":

> Where a company is set up to provide a worker's services to an engager and the MSC legislation applies, amounts paid to an MSC for those services that are not already subject to PAYE Income Tax and Class 1 National Insurance contributions (for example, share dividends), are treated as employment income.
>
> HMRC's firm view, now supported by the above decisions, has always been that these types of arrangements do not work.
>
> HMRC continues to open enquiries into users of similar arrangements that include the provision of workers in many

[122] HMRC, *Managed Service Company legislation: unpaid PAYE and Class 1 NI contributions avoidance schemes* (Spotlight 32), updated February 2020

[123] *Christianuyi Ltd & Ors* [2019] EWCA Civ 474 para 31, para 33

different industry sectors, including road haulage, healthcare and education.

HMRC will investigate and challenge these arrangements through every route open to it (including litigation) and seek full settlement of the tax due, plus interest and penalties where appropriate.

We expect those using these or similar arrangements to pay the tax and National Insurance contributions they owe following this emphatic win for HMRC.

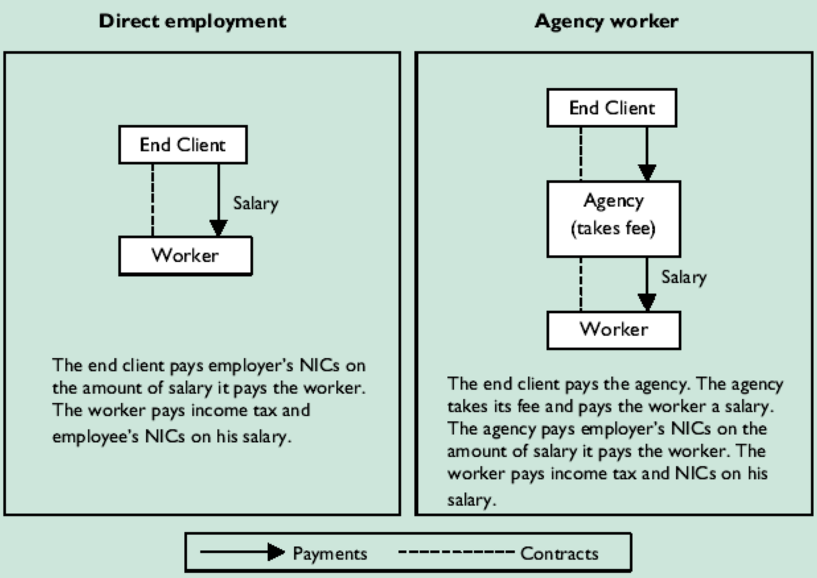
If any part of the tax and National Insurance contributions are irrecoverable, HMRC will transfer unpaid debts to others, including the service company's directors, the MSC provider and the MSC provider's directors and associates. All are jointly and severally liable for the debts.[124]

[124] HMRC, *Managed Service Company legislation: unpaid PAYE and Class 1 NI contributions avoidance schemes* (Spotlight 32), updated February 2020

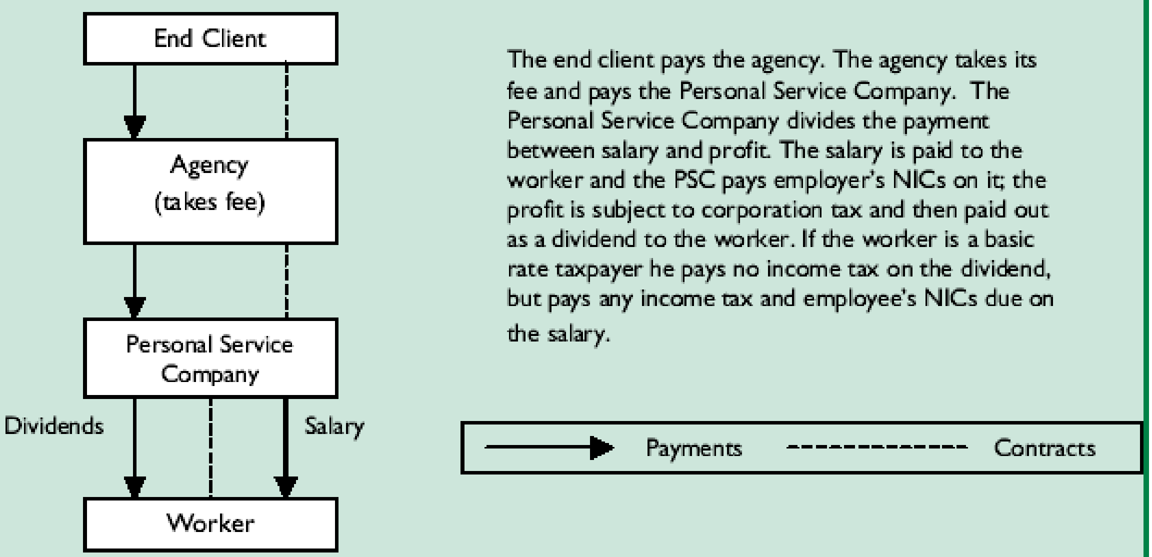
7. Appendix: How intermediary companies work

HMRC's 2006 consultation document *Tackling Managed Service Companies* included four diagrams, showing how contracts and payments operate across agency arrangements, PSCs and the two types of MSC – compared with the standard employer/employee relationship. For convenience these are reproduced below.

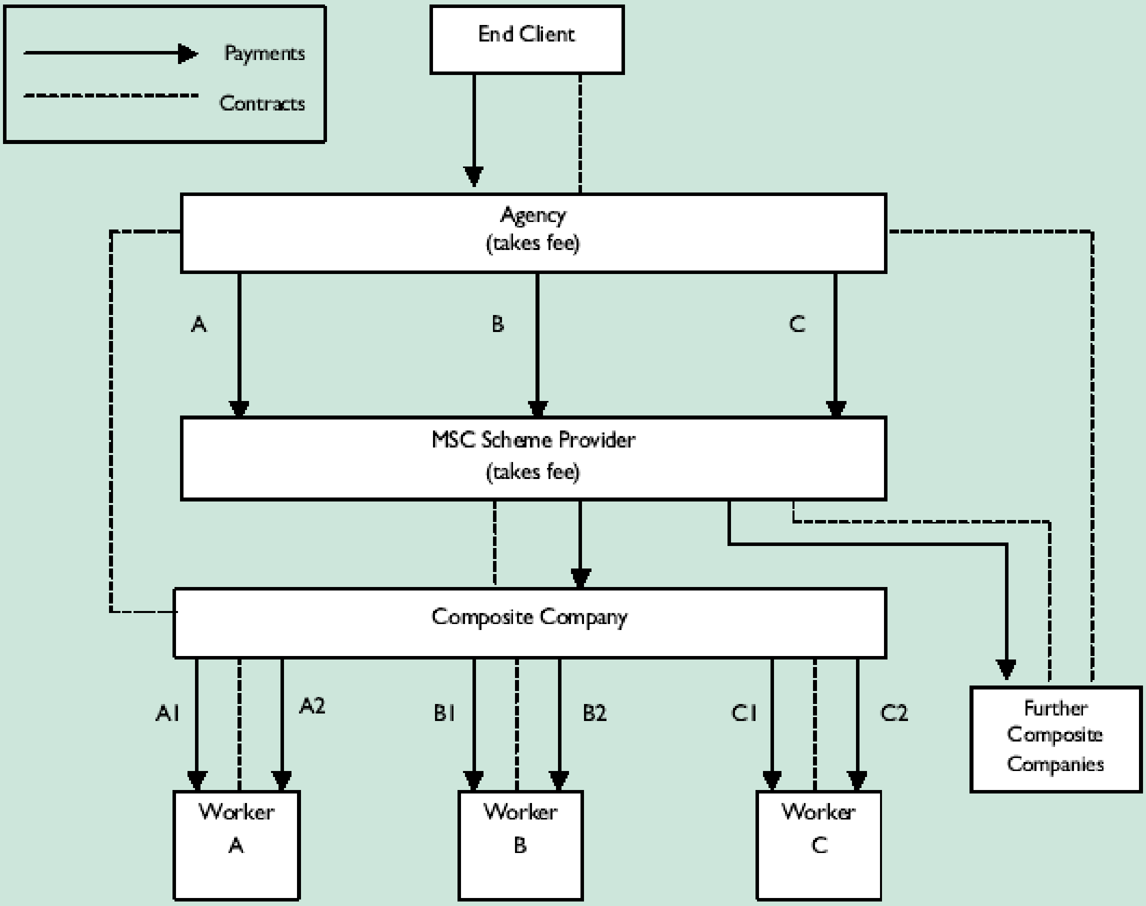
Box 2.1: Direct employment by an end client (left) and working through an agency (right)



Box 2.2: Working through a Personal Service Company (via an agency)



Box 2.4: Structure of a Composite Company scheme



The Composite Company illustrated contains three workers, labelled A to C (in practice, such companies typically contain between ten and twenty workers). The end client pays the agency a fee for the services of the three workers. The agency then takes its fee and pays the MSC scheme provider. The MSC scheme provider takes its fee in turn, and then pays the Composite Company. Each worker usually holds a separate class of share within the Composite Company so that they can receive only the amount of remuneration due for their own work.

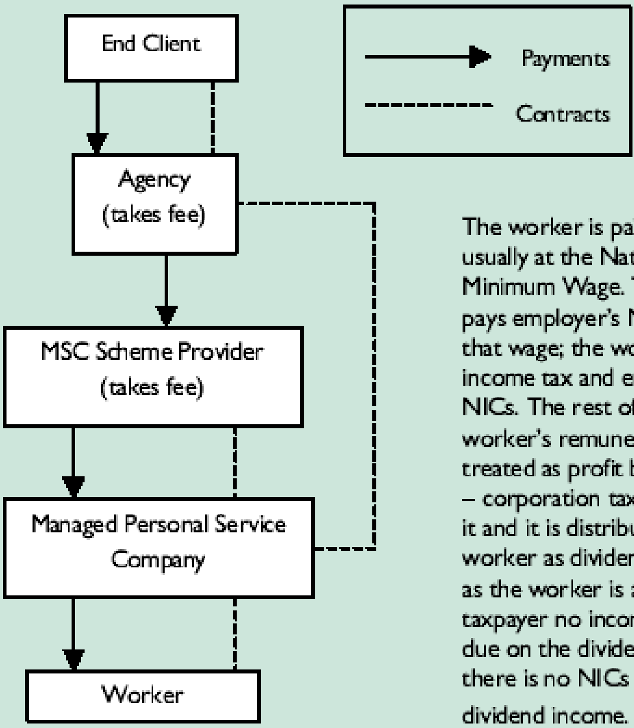
The Composite Company usually pays each worker a salary at the National Minimum Wage – labelled A1, B1 and C1. The workers pay income tax and employee's NICs on this salary and the Composite Company pays employer's NICs. The remaining remuneration for each worker is subject to corporation tax as the profit of the Composite Company and then paid out in dividends. Each worker usually has his own share class paying out dividends – labelled A2, B2 and C2. As long as they are basic rate taxpayers, there is no income tax due on these dividend payments, and there is no NICs charge on dividend income.

Box 2.5: Structure of a Managed Personal Service Company scheme

Step 1 – End client pays agency for services of worker and agency takes fee.

Step 2 – Agency pays MSC scheme provider. MSC scheme provider takes fee.

Step 3 – MSC scheme provider arranges payment of the worker through the MSC in a mixture of salary and dividends.



The worker is paid a salary, usually at the National Minimum Wage. The MSC pays employer's NICs on that wage; the worker pays income tax and employee's NICs. The rest of the worker's remuneration is treated as profit by the MSC – corporation tax is paid on it and it is distributed to the worker as dividends. As long as the worker is a basic rate taxpayer no income tax is due on the dividends and there is no NICs charge on dividend income.

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