

Tackling Managed Service Companies

December 2006



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INTRODUCTION

1.1 It is a long-standing principle that the tax treatment of income is determined by its nature – that is, income which is properly employment income should be taxed as such.¹ Consistent with this principle the Government seeks to ensure that even if an individual is working through a company, but the underlying nature of the contract is one of employment, tax and national insurance contributions (NICs) should be paid at employed levels.

1.2 At Budget 2006 the Government announced that it would consult on action to tackle Managed Service Companies (MSCs). MSCs are corporate structures through which workers provide labour services. In contrast to Personal Service Companies, workers in MSCs are almost invariably not in business on their own account and the underlying nature of the contracts in which they are involved is one of employment. As discussed in Chapter 2, there are existing rules (the Intermediaries legislation)² to ensure that the correct tax and NICs treatment is applied, but these rules are in the vast majority of cases not being followed by MSCs, which are therefore avoiding employed levels of tax and NICs.

1.3 As a result the strong growth in MSC schemes constitutes a significant and increasing risk to the Exchequer and those using MSC schemes are gaining an unfair competitive advantage over compliant workers and businesses. In addition, some workers are entering MSC schemes without understanding that they may be giving up employment rights.

1.4 Enforcing the current rules is difficult with MSCs because of the large and growing number of workers involved and the resource-intensive nature of the legislative test. Furthermore, even when a debt has been established as the result of an investigation by HM Revenue and Customs, MSCs can escape payment because they have no assets and can generally be wound up or simply cease to trade, with workers moving to a new MSC. The Government has therefore decided to remove MSCs from the scope of the Intermediaries legislation and to apply a tax treatment to those working in MSCs which means they will pay tax and NICs at the same level as other employees. Personal Service Companies will not be within the scope of these measures, with the Intermediaries legislation remaining in place as at present.

1.5 An effective definition of MSCs is key to this approach and the Government is therefore consulting on the legislation to ensure that MSC schemes are accurately targeted. Chapter 3 explains how the draft legislation works, with the complete draft clauses set out in Annex B. The Government believes that the draft legislation strikes the right balance between being well-targeted, clear about who is affected and who is not, and robust against avoidance. Getting the definition of MSCs right in legislation is not straightforward, however, and the Government would welcome comments on the questions for consultation set out at paragraphs 3.14 to 3.16.

1.6 Chapter 4 discusses the tax treatment which will apply to MSCs falling within the definition. Employed levels of tax and NICs will be applied to all income received by workers in MSCs in relation to services provided through the MSC, with the MSC obliged to operate Pay As You Earn (PAYE) and deduct tax and Class 1 NICs on that

¹ Note that employment status in tax law is not necessarily the same as employment status for employment law purposes.

² Chapter 8, Part 2, Income Tax (Earnings and Pensions) Act, 2003; Section 4A, Social Security Contributions and Benefits Act 1992; Social Security (Intermediaries) Regulations 2000, SI 2000/727.

income. This legislation will also apply the same rules for tax relief for travel expenses as for other employed workers. The related draft legislation on the tax charge is set out in Annex B with an explanatory commentary in Annex C and the Government also welcomes comments on these draft clauses as set out at paragraph 4.11.

1.7 The Government will also address the problem of MSCs escaping payment of tax and NICs that are due by allowing the recovery of these debts from appropriate third parties. The Government aims to publish this draft legislation for discussion by the end of January 2007 and welcomes comments on this issue in the intervening period as set out at paragraph 4.20.

1.8 The expected impact of these measures on the main participants and on the wider operation of the labour market is reviewed in Chapter 5.

1.9 The legislation will be introduced in Finance Bill 2007 with the aim of changes starting to take effect from 6 April 2007. The consultation period will give those involved in MSC schemes time to assess the implications and arrange their affairs accordingly.

1.10 Chapter 6 sets out details of the consultation process. Comments should be submitted by 2 March 2007.

2

PROVISION OF LABOUR SERVICES IN THE MODERN LABOUR MARKET

This chapter describes the way labour services are provided in the modern labour market. It examines in more detail the structures referred to as Managed Service Companies (MSCs), the schemes through which they are provided and the appropriate tax treatment for income received by workers in these schemes. Because the workers are almost invariably not in business on their own account, and the underlying nature of the contracts is that of employment, the existing rules should ensure that employed levels of tax and national insurance contributions (NICs) are paid – but in the vast majority of cases MSCs are not complying with this legislation. As a result, the strong growth in MSC schemes constitutes a significant and increasing risk to the Exchequer; those using MSC schemes are gaining an unfair competitive advantage over compliant workers and businesses; and some workers are entering schemes without understanding that they may be giving up employment rights. The Government will therefore remove MSCs from the current rules and will apply employed levels of tax and NICs to income received by workers in respect of services provided through MSCs.

TODAY'S LABOUR MARKET

Modern flexible labour market

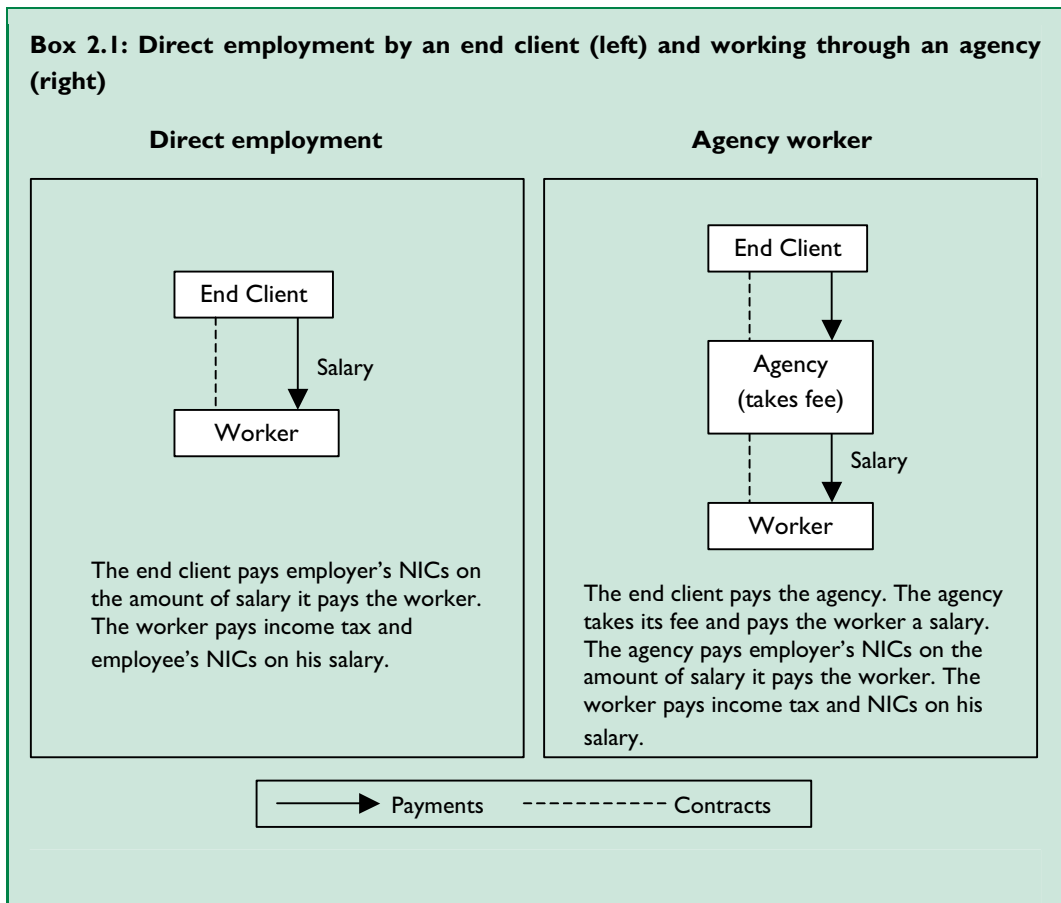
2.1 Britain's labour market is characterised by adaptability and flexibility to promote employability and competitiveness – combined with a strong Government commitment to fairness.¹ There is a wide variety of patterns and types of work available. The model of full-time work with one employer for a worker's entire working life is becoming less common, with increasing opportunities for part-time work, fixed term contracts, multiple employments and agency work. This variety of patterns provides individuals with more choice about how they want to work and gives businesses the flexibility to respond swiftly to new opportunities as they arise.

Labour market relationships

Direct employment

2.2 Direct employment of the worker by the employer is illustrated on the left hand side of Box 2.1. The worker is paid a salary on which the employer operates Pay As You Earn (PAYE) so that the individual pays income tax and employee's national insurance contributions (NICs) on their earnings and the employer pays employer's NICs. The worker also benefits from full employment rights such as protection from unfair dismissal, redundancy payments, and maternity or paternity leave.

¹ *Success at Work: Protecting vulnerable workers, supporting good employers*, DTI, March 2006.



Agency workers 2.3 Agency work is a common choice for many individuals. Agency workers are not usually engaged by the agency under a contract of employment, but instead use a contract which allows more flexibility for either party to terminate the contract. The agency in turn supplies the agency worker to the end client who needs the labour services. 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.

2.4 In an agency arrangement, as shown on the right hand side of Box 2.1, 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 as before but here it is the agency which is liable for the employer's NICs.

Working through an intermediary company 2.5 In recent years there has been an increasing trend for workers to provide their services to end clients or agencies through an intermediary company. The worker is employed by the company and the company's business is the provision of the worker's labour services. 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).

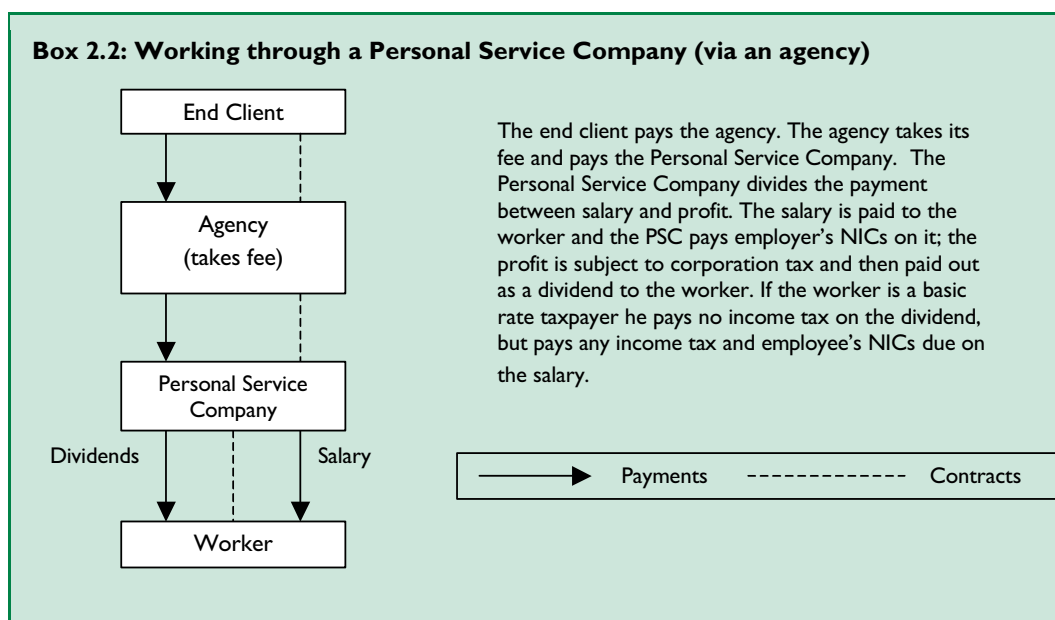
2.6 When the company supplies the services of the worker to an end client the nature of the relationship between worker and end client may be either one of employment or self-employment. A worker's status, that is whether they are employed or self-employed, is not a matter of choice – it depends on the terms and conditions of the engagement.

2.7 The provision of services through an intermediary company takes a number of different forms, of which the main ones are described below.

Working through an intermediary company - Personal Service Companies

Personal Service Companies

2.8 If a worker chooses to go into business on his own account selling his labour services to an end client he may choose to be self-employed (sole trader or partnership) or set up a company. Where the business of a company consists of selling the services of its worker it is known as a Personal Service Company (PSC). The worker is usually a director of the PSC. While PSCs may supply the worker's services direct to the end client, in practice they more often find work through an agency. The end client pays the agency, which deducts its fee, and then pays the PSC for the services of the worker. The worker may draw a salary from the PSC but, as a shareholder of the company, is also able to receive dividends. This is illustrated in Box 2.2.



Working through an intermediary company - Managed Service Companies

Managed Service Companies

2.9 Managed Service Companies (MSCs) are also intermediary companies through which the services of a worker are provided to an end client. These are often known as “composites” or “managed personal service companies” (these structures are described in more detail below). In contrast to PSCs, the worker in an MSC is almost invariably not in business on his own account and is not exercising control over the business. This control lies with the provider of the MSC, referred to as the “scheme provider”.

MSC scheme provider

2.10 The presence of a scheme provider is a key feature of MSCs. MSC scheme providers are businesses (usually companies) which provide these generic company structures and then administer the schemes.

2.11 MSC scheme providers range from those who specialise in the provision of MSC schemes, often in a particular sector, to larger concerns who operate MSC schemes as one part of a wider business. Some employment agencies have set up separate MSC scheme providers. Overall HM Revenue and Customs (HMRC) estimates there are

around 150 MSC scheme providers in total, with around ten of these accounting for the vast majority of workers in MSCs.

2.12 In an MSC scheme the worker obtains work engagements, usually via an agency, in the normal way. The worker supplying services usually takes no part in the on-going management or financial control of his MSC and is typically not a director of the company (but rather a worker-shareholder). Instead, the MSC scheme provider handles payments between the agency and the MSC, deducting a fee for the work it carries out and arranging for the payment of the worker. The worker is often unaware of the details of the arrangement or its implications.

2.13 The marketing of MSCs schemes emphasises that the worker will not be involved in running the company – they simply receive payments for their services (see Box 2.3).

Box 2.3: Advertising by a number of different MSC scheme providers emphasises that the worker is not involved in running the company and will receive payments in a similar way to if they were an employee

“In a nutshell – we handle the boring administration that helps you keep more of your earnings and keep your free time for the things you enjoy.”

“We will also carry out all the administration and payroll, so that you can enjoy all the benefits of being an employee and a shareholder of your own limited company, without the hassle.”

“...Hassle free without any of the usual headaches and costs associated with owning your own limited company.”

“You can choose to be paid monthly or weekly”

“You agree with your agency whether you will be paid weekly, two-weekly or four-weekly and tell us which pay frequency you have agreed.”

“[We perform] all administration and management of each company.”

Source: MSC scheme provider websites

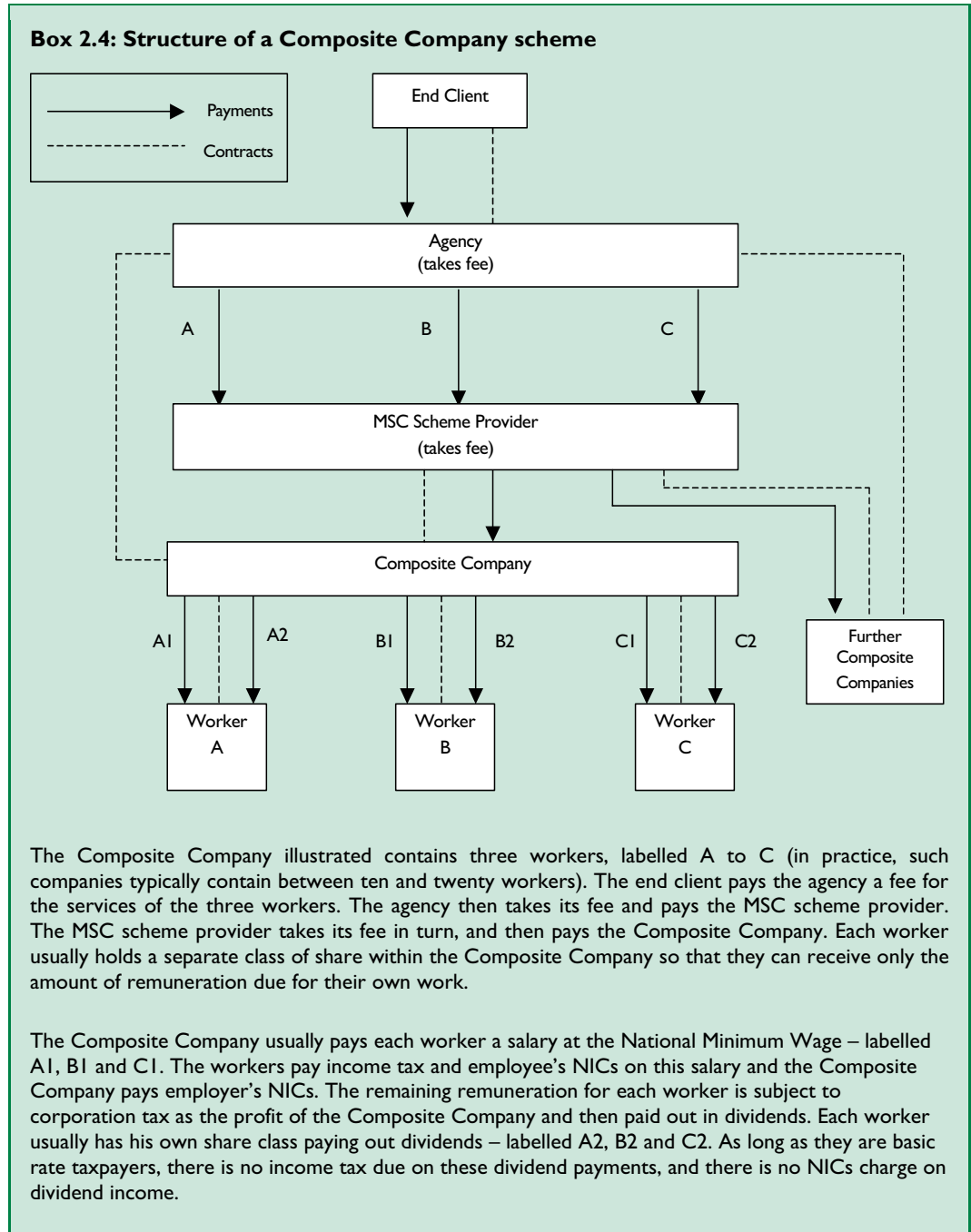
2.14 The specific arrangements of MSC schemes vary, but described below are two common structures through which MSC schemes operate - Composite Companies and Managed Personal Service Companies. For simplicity in this consultation document both types of structures are referred to as Managed Service Company schemes.²

Composite Company schemes

2.15 In a Composite Company scheme several (typically ten to twenty) otherwise unrelated workers are made worker-shareholders of a company (the “Composite Company”). The size of the Composite Company is restricted to ensure that profits do not exceed the threshold for the small companies’ rate of corporation tax. Each worker usually holds a different class of share in the company. This enables the Composite Company to pay different rates of dividend to each worker, and in practice the dividend received will be directly related to the company’s income from the end client for work undertaken by that worker (see Box 2.4).

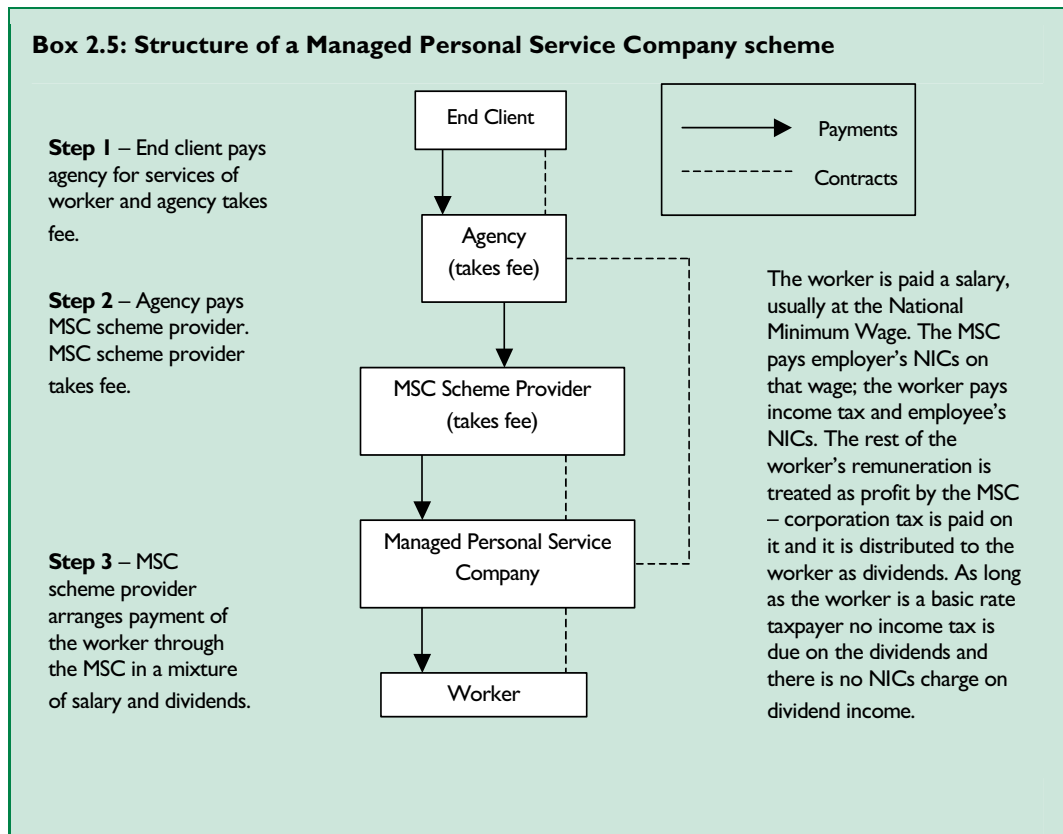
² In some contexts the term ‘managed services companies’ is used to refer to companies that supply services to end clients and/or also manage the services of other suppliers to that end client. In such arrangements the end client only has a direct contractual relationship with the ‘managed services company’. This is an entirely different business model to MSC schemes.

2.16 The MSC scheme provider, or a person associated with the MSC scheme provider, may be a director of the Composite Company - the worker-shareholders are typically not – and will normally exercise full financial and management control of the MSC.



Managed Personal Service Company

2.17 In a Managed Personal Service Company (MPSC) scheme, in contrast to a Composite Company, there is only one worker per company structure (the Managed Personal Service Company) (see Box 2.5). The MSC scheme provider performs similar functions for MPSCs as for Composite Companies – it usually provides a director and exercises financial and management control of the company, typically performing this function for many MPSCs.



Operation of MSCs in practice

2.18 In practical terms the day-to-day operation of MSCs is similar whether they are Composite Companies or MPSCs. As illustrated in the diagrams above, there is generally an agency between the MSC and the end client (in fact some agencies have themselves set up associated MSC scheme providers). The mechanics of an engagement with an end 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).

TAX CONSEQUENCES OF OPERATING THROUGH INTERMEDIARY COMPANIES – PSCS AND MSCS

Intermediaries legislation

2.19 Where a worker provides his services through an intermediary company the basic question of employment or self-employment status arises. The tax treatment of services provided through an intermediary is governed by the Intermediaries legislation (also known as “IR35”).³ This looks at the contractual nature of the relationship between the worker and the end client to establish whether the contract is akin to one of employment. 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.

2.20 Where the contract is one of employment – *a contract of service* - the legislation requires the intermediary company to pay employed levels of tax and NICs on that part of the income deemed to be employment income and not already taxed as employment income (see Box 2.6).

Box 2.6: Summary of how the Intermediaries legislation works

The effect of the Intermediaries legislation is that:

- where an individual (the “worker”) personally performs, or is under an obligation personally to perform, services for 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.

2.21 Where the contract has the characteristics of self-employment – *a contract for services* – the Intermediaries legislation does not apply. Where the worker is a shareholder this offers the opportunity to receive the reward for his services in the form of dividends rather than, or as well as, salary. By paying dividend income in place of salary both the worker and end client can avoid paying employed levels of tax and NICs.

³ Chapter 8, Part 2, Income Tax (Earnings and Pensions) Act 2003; Social Security (Intermediaries) Regulations 2000, SI 2000/727.

MSCS ARE ALMOST INVARIABLY DISGUIISING EMPLOYMENT

2.22 In contrast to PSCs, the worker is almost invariably not in business on his own account and the underlying nature of the contracts in which he is involved is one of employment. The Intermediaries legislation should ensure that employed levels of tax and NICs are paid but HMRC's compliance activity suggests that in the vast majority of cases MSC schemes are not complying with this legislation.

MSCs avoid paying employed levels of tax and NICs

2.23 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.

Travel expenses

2.24 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.

2.25 HMRC compliance activity has also found instances of MSCs paying travel expenses free of tax and NICs even where no relief is due.

2.26 The higher income resulting from working through an MSC scheme is a central part of the marketing by MSC scheme providers (see Box 2.7).

Box 2.7: Advertising by MSC scheme providers highlights higher income (gained through avoiding employed levels of tax and NICs)

Most websites of MSC providers include calculation tools so that a worker can quickly work out the change in his take home pay if he moves from employment to an MSC:

"As well as saving you time, we can also save you money by reducing the amount of tax payable increasing net pay by anything up to 30 per cent."

"Up to 30 per cent increase in income."

"Take home more of your income – As a temporary worker or contractor, you can take home more of your income..."

Source: MSC scheme provider websites

Risk of investigation

2.27 MSC scheme providers are aware that the Intermediaries legislation may deter workers from entering schemes and so some offer workers "IR35 proof contracts" and "IR35 insurance" (see Box 2.8).

Box 2.8: Advertising by MSC scheme providers tries to reassure workers about the possibility of investigation by HMRC

“As part of our commitment to contractors, [the scheme] offers comprehensive protection against tax investigation.”

“[We provide] 100 per cent indemnity against potential IR35 tax liabilities.”

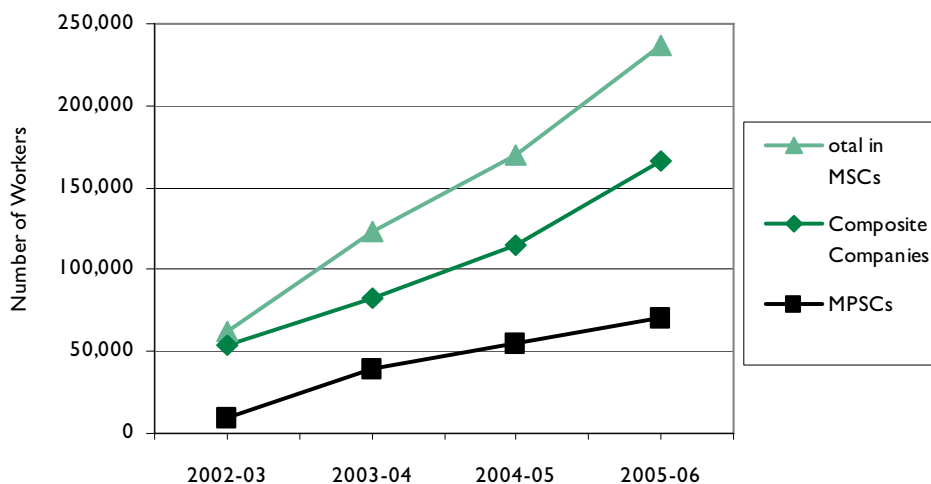
Source: MSC scheme provider websites

Increasing use of MSCs

2.28 The number of individuals working through MSCs is growing rapidly. There are around 150 MSC scheme providers currently operating in the UK with about ten large ones providing the vast majority of workers in MSCs.

2.29 There is a degree of uncertainty attached to estimates in this area but HMRC analysis suggests that the number of workers in MSCs has grown from around 65,000 in 2002-03 to at least 240,000 in 2005-06 (see Chart 2.1).

Chart 2.1: Number of workers in Managed Service Companies broken down into Composite Companies and Managed Personal Service Companies (MPSCs)



Source: HMRC

2.30 While information on the range of sectors in which MSCs operate is limited, 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. There is no restriction on the sectors in which MSCs can operate and some MSC scheme providers appear to be specialising in sectors such as contract cleaning, transport and the oil and nuclear industries.

Problems caused by growth of MSCs

Exchequer losses **2.31** There is a degree of uncertainty attached to estimates of losses of tax and NICs from the failure of MSCs to operate the Intermediaries legislation. However, given the large and growing number of workers operating through MSCs, the use of MSC schemes constitutes a significant and increasing risk to the Exchequer.

Loss of level playing field for business **2.32** Those workers operating through service companies who do comply with the Intermediaries legislation, and therefore pay their fair share of tax and NICs, may be undercut by those who supply their services through an MSC that does not comply with the legislation. Not surprisingly therefore, compliant service companies have made representations that they are currently at risk of losing clients to MSC scheme providers. Similarly some agencies who properly advise on and apply the Intermediaries and agency legislation⁴ have said that they risk losing business to agencies who automatically put workers into MSCs.

2.33 It has been suggested that MSCs are simply providing low cost access to the corporate form to individuals who wish to provide services through an intermediary company. But workers in MSCs are almost invariably not in business on their own account and the underlying nature of the contracts in which they are involved is one of employment – the schemes are therefore avoiding employed levels of tax and NICs. The Government encourages fair competition where providers of professional services offer support services to companies allowing them to achieve economies of scale - provided they do so in a way that ensures these companies comply with the law and pay the appropriate levels of tax and NICs.

Loss of employment rights **2.34** Company structures can also be used in an attempt to remove the worker's entitlement to statutory employment rights from the end client or from the agency. It is widely perceived that an individual working through an intermediary company such as an MSC is not entitled to employment rights from the end client (or agency, where one is involved). While an employment tribunal can look through the corporate structure at the underlying relationship, only a small minority of cases will reach this stage and the Government has received representations about the potential loss of employment rights for workers from working through an MSC scheme.⁵

2.35 Where an individual understands the consequences of incorporation he may make a considered decision – but many workers entering MSC arrangements are unaware of the rights they are giving up. It is suggested that in some sectors workers have little choice other than to join an MSC scheme.

2.36 Concerns have also been expressed that because of their lack of financial control over the company, workers in MSC schemes could be vulnerable to unauthorised deductions and other irregularities. While this is not an issue for the vast majority of MSC scheme providers, there is a risk for those involved with less scrupulous providers.

Loss of level playing field for employees **2.37** The Government has also received representations from those concerned that where MSC schemes are common this depresses the market rate for the job.

⁴ Chapter 7, Part 2, Income Tax (Earnings and Pensions) Act 2003.

⁵ As an employee of the MSC the worker is of course entitled, in theory, to the full range of employment rights from the MSC.

Improving compliance of MSCs with the Intermediaries legislation

2.38 HMRC has emphasised that MSCs are within the scope of the Intermediaries legislation and need to apply it where necessary. For example Tax Bulletin 60 (August 2002) outlined how the rules apply to Composite Companies and Tax Bulletin 74 (December 2004) made clear that they apply to MPSCs.

2.39 Two specialist compliance teams were set up by HMRC in 2003 to focus on MSC schemes. These units have built up a high level of expertise and understanding of these arrangements and have had some success in requiring MSCs to apply the Intermediaries legislation. But enforcing compliance with the Intermediaries legislation poses particular problems in the case of MSCs.

Applying the Intermediaries legislation to MSCs

2.40 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.

Problems in collecting tax and NICs due

2.41 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.

2.42 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. Box 2.9 provides an example.

Box 2.9: Case study of liquidation to avoid tax and NICs liabilities

Several Composite Companies, administered by an MSC scheme provider, were reviewed by HMRC. The review concluded that the Composite Companies had been wrongly paying travel and subsistence expenses free of tax and NICs and raised concerns about the application of the Intermediaries legislation.

The MSC scheme provider set up a new set of Composite Companies. The Composite Companies under review ceased to trade on a Friday, the new Composite Companies took on the workers the following Monday, and the workers continued as if nothing had happened.

Because of their lack of assets, HMRC was unable to collect the tax and NICs due from the old Composite Companies. The Composite Companies are separate legal entities, so the liability of the Composite Companies could not be transferred to the MSC scheme provider or the workers.

Source: HMRC compliance activity

Limited liability partnerships **2.43** There is evidence of schemes moving to using Limited Liability Partnerships (LLPs) instead of companies. Although workers, as partners, are not able to avoid paying employed levels of tax and NICs to the same extent as workers who are shareholders in an MSC, they are able to pay self-employed levels of tax and NICs and those engaging workers in this way pay no employer's NICs (see Box 2.10).

Box 2.10: Case study of the use of Managed Limited Liability Partnerships

The employees of a car import firm were moved into an MSC. Although their jobs were exactly the same as when they were employed, they were paid in dividends instead of receiving a salary.

When this arrangement was challenged under the Intermediaries legislation, the workers were again moved overnight into a new structure. This time they became partners in a Managed Limited Liability Partnership. They then began for the first time to claim travelling expenses for the same home to work journey that they had been making previously.

Source: HMRC compliance activity

GOVERNMENT RESPONSE

2.44 The Government seeks to ensure that, where the underlying nature of an individual's contract is one of employment, tax and NICs should be paid at employed levels, even if the individual is working through a company.

2.45 Workers in MSCs are almost invariably not in business on their own account and the underlying nature of the contracts in which they are involved is one of employment and so they are within the Intermediaries legislation. However these rules are in the vast majority of cases not being followed by MSCs – and this regime was never intended to deal with widespread non-compliance on the scale displayed by MSCs. The Government will therefore remove MSCs from the scope of the Intermediaries legislation and will apply employed levels of tax and NICs to income received by workers in respect of services provided through MSCs. The package of measures to achieve this is described in Chapters 3 and 4.

2.46 The Intermediaries legislation will remain in place for PSCs as at present. It is therefore important that the scope of the proposed legislative changes is carefully defined so as to target MSCs. The next chapter sets out the characteristics of MSCs and explains how this is reflected in the draft legislation.

3

IDENTIFYING MANAGED SERVICE COMPANIES

An effective definition of Managed Service Companies is key to the Government's approach to ensuring that the right amount of tax and national insurance contributions (NICs) is paid on engagements through MSCs.

This chapter therefore sets out the key characteristics which distinguish MSCs from other business structures, and in particular that differentiate MSCs from Personal Service Companies (PSCs). The characteristics identified form the basis of the approach taken by the draft legislation. This chapter describes the draft legislation defining MSCs and seeks views on whether all the characteristics of MSCs have been captured and whether the draft legislation strikes the right balance between the objectives of being well-targeted, clear about who is affected and who is not, and robust against avoidance.

CHARACTERISTICS OF MSCs

3.1 Chapter 2 described the usual structures of Managed Service Company (MSC) schemes and the way they operate. Features described include:

- in Composite Companies tens of otherwise unrelated workers hold different classes of shares in the same company;
- in Managed Personal Service Companies (MPSCs) the scheme provider is the common link between many otherwise unrelated companies of this type;
- the worker in an MSC is generally not a director of the company, although he is a shareholder (an individual in business on his own account through a company would almost invariably be a director of the company); and
- the MSC usually does not move with the worker as it would if it were really his business.

3.2 But defining MSCs in these functional terms is unlikely to prove robust against attempts to restructure to avoid being caught by the new provisions. The focus is therefore on those characteristics which are core to the MSC business model and which distinguish these structures. It is important to note that some of these individual features may well be present to a greater or lesser degree in other structures; it is the presence of these characteristics in combination that is key to identifying MSC schemes.

3.3 As discussed in Chapter 2, MSCs provide the services of individual workers to end clients, often through a contractual chain involving employment agencies. To this extent, they share some of the characteristics of Personal Service Companies (PSCs). But the presence and role of the MSC scheme provider is a distinguishing characteristic of the MSC. The MSC scheme provider markets MSC structures and makes them available to workers and also has an ongoing role in the administration and management of the company.

Role of scheme provider in the MSC structure

- 3.4** MSC scheme providers play a central role in the structure of the MSCs by:
- setting up the companies and allocating individual workers to them;
 - often providing, usually via a nominee company, a company director and a company secretary for the MSC; and
 - often providing corporate directors for hundreds or even thousands of MSCs.

Role of scheme provider in financial and management control

3.5 The MSC scheme provider exercises a high degree of financial and management control over the MSC.¹ In this context “control” takes its general meaning (and not the meaning specified in section 416 or 839 of the Income and Corporation Taxes Act 1988). In MSC structures typically the MSC scheme provider:

- exercises general control over the structure and management of the company. For example, on setting up the company, the MSC scheme provider determines the number of shareholders and is responsible for allocating classes of shares;
- has control of the bank account into which the income of the MSC is paid. This is often a single account into which the income of many MSCs is paid. Often the MSC does not have its own bank account;
- deducts from the income flowing into the bank account his own fee and retains an amount intended to meet the MSC’s future corporation tax liability on its profits together with the Pay As You Earn (PAYE) and national insurance contributions (NICs) due on the salary paid to the worker (generally paid at the rate of the National Minimum Wage), earning interest on the retained sum until the tax and NICs are to be paid; and
- makes the decisions on how income generated by the worker is converted into maximum take home pay. The only decision the worker really makes is how many hours to work and what expenses to claim.

Lack of control by the worker

3.6 The worker is therefore not exercising financial or management control over the MSC (see Box 3.1). This is very different from the normal provision of services by an accountant or professional adviser to a client company.

Box 3.1: Examples from MSC scheme advertising which show the lack of financial and management control on the part of the worker

“We administer your limited company: we manage your company bank account.”

“[You are] an employee operating on a limited company basis.”

Source: MSC scheme provider websites

¹ Although the workers in MSCs hold shares in their MSC, this control is only nominal and effective control is with the MSC scheme provider.

The draft legislation

Aims of the legislation 3.7 The draft legislation aims to define an MSC based on these distinguishing characteristics and to ensure that as far as possible the definition is:

- well-targeted – including in its scope those structures that are intended to be within its scope without capturing other structures;
- clear – easy to judge whether a structure falls within the definition; and
- robust – not easily circumvented by MSC scheme providers making small alterations to their arrangements.

3.8 The Government recognises that any workable definition will involve trade-offs between objectives.

3.9 The draft legislation in Annex B defines MSCs, takes them out of the scope of the current rules applying to workers providing their services through an intermediary, and applies a new tax treatment. Payments received by workers in relation to their services provided through an MSC will be treated as employment income subject to the normal PAYE and NICs rules. This chapter focuses on defining MSCs as distinct from other corporate forms and Chapter 4 describes how the tax charge will operate.

3.10 The legislative definition of an MSC works in two stages. The first is to describe an MSC as one which provides the services of workers and which does so through a “managed service company scheme”. The second stage is to define a “managed service company scheme”. This is defined as a scheme or arrangement that fulfils four criteria:

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

3.11 “Company” is defined as meaning a company or partnership of whatever description. If the new legislation covered only limited liability company MSCs, it is likely that MSC scheme providers would simply set up Managed Limited Liability Partnerships (LLPs) and continue to disguise employment that way. The legislation will therefore cover LLPs and, because there is potential to exploit Limited Partnerships and General Partnerships in a similar manner to LLPs, it covers all types of partnerships.

3.12 The definition of MSCs is not intended to include Personal Service Companies. The key distinction here is about who exercises financial and management control. In a PSC it is the worker (who is usually a director of the company) who will usually exercise control of the company, including control of the company bank account. An accountant or other professional adviser may give advice and provide services to the company, such as running the payroll, but this does not amount to control.

3.13 In view of the central role performed by the definition of an MSC, the draft clause defining the scope of the provisions (clause 61B in Annex B) is analysed in detail in the table below.

Box 3.2 Explanation of Section 61B ‘Meaning of “managed service company”’

This commentary on the draft clauses is a guide to the Government’s intention as to how the legislation would operate if enacted in this form.

Draft legislation	Explanation
61B (1) A company is a “managed service company” if –	This subsection defines an MSC by reference to two criteria. Both criteria must be satisfied for a company to fall within the definition.
(a) its business consists wholly or mainly of providing (directly or indirectly) the services of individuals to other persons, and	The first criterion is that the business carried on by the company must be that of, or must mainly be that of, supplying the services of individual workers to those who wish to purchase them. The criterion applies whether the services are supplied directly or indirectly. MSCs, Personal Service Companies, Umbrella Companies ² and employment agencies would all meet this criterion in isolation but, to be an MSC, the other criterion must also be met.
(b) it provides those services in pursuance of a managed service company scheme.	The second criterion refers to the nature of the arrangements under which the company supplies the services of the workers. It introduces the term “managed service company scheme” which is defined in subsection (2).
(2) “Managed service company scheme” means a scheme or arrangement –	Subsection (2) defines “managed service company scheme” by reference to three criteria, all of which have to be met for these new provisions to apply.
(a) under which the services of individuals (“the workers”) are provided (directly or indirectly) by companies to other persons,	The first criterion makes clear that the nature of the scheme or arrangement must involve companies providing the services of individual workers to those who wish to purchase their services. The criterion applies whether the services are supplied directly or indirectly.

² In an Umbrella Company (also known as a management company) the worker is an employee of that company and his engagements through an employment agency are routed via the company. The worker is paid a salary on which employed levels of tax and NICs are paid.

<p>(b) under which the greater part of the consideration for the provision of the services is paid (directly or indirectly) to the individuals or their associates, and</p>	<p>The second criterion is that the scheme or arrangement entails the payment of most of the amount paid in return for the services of the individuals whose services have been supplied directly or indirectly, to those individuals, or to their associates.</p>
<p>(c) in the case of which the person who makes the scheme or arrangement available (“the scheme provider”), or an associate of the scheme provider, exercises control over the finances or general management of the companies (and the workers do not exercise control over such matters).</p>	<p>The third criterion relates to the key role played by the scheme provider in an MSC scheme. It is the role of the scheme provider and the control they exercise which particularly distinguishes the arrangements targeted by these new provisions.</p> <p>First of all, the scheme provider is identified as making available the package of arrangements under which the services of workers are supplied. Then, crucially, it goes on to identify the scheme provider, or an associate of the scheme provider, as exercising control over the finances or general management of the companies which as a result of the scheme or arrangement are directly or indirectly providing the services of individuals. In this context “control” takes its general meaning and not that specified in section 416 or 839 of the Income and Corporation Taxes Act 1988. The legislation described here relates to who is controlling the companies in practice and not to rights to exercise control. Finally, it is important to note, the paragraph makes clear that in a MSC scheme the workers whose services are being supplied are not themselves exercising control of the companies supplying their services.</p>
<p>(3) In this section “company” means a body corporate or partnership.</p>	<p>This subsection makes clear that the term company in this definition includes partnerships as well as corporate bodies.</p>

CONSULTING ON THE LEGISLATIVE DEFINITION

Questions for consultation 3.14 The Government would welcome views on the scope of the draft legislation and, in particular, whether there are other defining characteristics of MSCs that should be reflected in the legislation.

3.15 The Government is keen to keep the legislation as simple as possible so that people can make their own judgements as to whether their business arrangements meet the criteria for being defined as an MSC or not. There will be additional guidance

to assist the lay reader. **The Government would welcome views on the clarity of the legislation.**

3.16 At the same time, it is important that the legislation should be robust against attempts to circumvent it by re-structuring or devising new arrangements purporting to be outside its scope. **The Government would therefore welcome views on whether the legislation could be strengthened further and, if so, how.**

4

CHANGES IN THE TAX TREATMENT OF MANAGED SERVICE COMPANIES

This chapter describes the proposed new tax charging provisions to be applied where services are provided through Managed Service Companies.

It also describes supporting measures to improve the information available to HM Revenue and Customs to monitor the effectiveness of the proposed changes and to improve the targeting of compliance activity.

TAX TREATMENT FOR MSCS

4.1 The Government proposes to introduce legislation in Finance Bill 2007 to:

- oblige the Managed Service Company (MSC) to operate Pay As You Earn (PAYE) on the income received by workers in the MSC in relation to their services provided through the MSC (national insurance contributions (NICs) obligations will arise by virtue of regulations to be laid immediately after the Finance Act receives Royal Assent);
- apply rules for tax relief for travel expenses to put MSC workers in the same position as other employed workers by treating each of their engagements with an end client as if it was a separate employment with the end client, carried out at a permanent workplace; and
- address the problem of MSCs escaping payment of tax and NICs due by allowing the recovery of these debts from appropriate third parties where the MSC does not pay.

4.2 Draft legislation on the tax charge and related provisions is included in this document at Annex B, with a commentary on the key provisions at Annex C. The proposed measures on debt transfer are outlined in broad terms in this chapter and the Government aims to publish draft legislation for comment by the end of January 2007.

The tax charge

4.3 As described in Chapter 2, workers in MSCs are almost invariably not in business on their own account and the underlying nature of the contracts in which they are involved is one of employment. The approach of the new provisions therefore is to ensure that those within their scope will pay tax and NICs as though they had been directly employed.

4.4 The new legislation will mean that the existing Intermediaries legislation no longer applies to MSCs and those working through them. Instead, 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.

4.5 Under the draft new provisions (draft clause 61C in Annex B), it does not matter whether the worker receives payment:

- directly from the MSC or via a third party; or

- in person or to an associate of the worker (for example their spouse); or
- in cash or non cash form; or
- described as a “dividend” or some other type of income.

The MSC is still treated as making a payment of employment income to the worker, and the worker is treated as having received it.

“Deemed employment payment” **4.6** Draft clause 61D covers the calculation of the amount of money to which PAYE and NICs is to be applied (the draft legislation calls this the “deemed employment payment”). The effect of these measures is that the MSC will pay employer’s NICs on the amount received for the services of the worker **less** any allowable expenses. Income tax and employee’s NICs will be due on the amount received for the worker’s services, **less** allowable expenses, **less** the amount of employer’s NICs payable. The MSC is responsible for paying to HMRC on a monthly basis the employer’s and employee’s NICs and the income tax due under PAYE.

Travel expenses **4.7** 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.

Distributions **4.8** Draft clause 61G in Annex B covers the situation should the MSC pay dividends which, under these new provisions, are treated as part of the employment income of the worker. The legislation provides for relief to be given to avoid a double charge to tax.

Calculating the MSC’s profits **4.9** In calculating the profits on which the MSC has to pay either corporation tax (as a company) or income tax (as a partnership), account needs to be taken of this new treatment of sums received by the worker. In respect of those sums, the company, or partnership, is only allowed to deduct in working out its profits:

- the amounts paid out to the worker in the form of employment income;
- the amounts treated as employment income of the worker by these new provisions;
- the employer’s NICs on both of those; and
- the expenses paid out to the worker (which the worker is entitled to deduct from taxable earnings).

4.10 This is in the draft legislation in Annex B as section 164A Income Tax (Trading and Other Income) Act 2005 and Paragraph 7 (to supplement Chapter 5 Income and Corporation Taxes Act 1988).

Question for consultation **4.11** Government would welcome comments on the draft legislation on the tax charging provisions, including treatment of expenses, at Annex B – this is supplemented by detailed explanation of the clauses at Annex C.

Transfer of PAYE and NICs debts

4.12 Currently, where HM Revenue and Customs (HMRC) successfully identifies that the Intermediaries legislation applies to an MSC and establishes the PAYE and NICs

liability, in practice the debt often cannot be collected. As described in Chapter 2, effective enforcement action to collect the debt is often not possible because these companies generally have no tangible assets and it is easy for the company to be wound up or simply cease trading and for workers to move to a new MSC.

4.13 HMRC currently has powers to transfer debts for PAYE and NICs relating to an individual employee and unpaid by their employer to that employee.¹ However, this requires the employee to have been aware of the employer's "wilful" failure to deduct the PAYE due.

4.14 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.

Appropriate third parties

4.15 The proposed legislation will list the parties to whom the debt might be transferred. It is envisaged that the list of appropriate third parties, who could have been involved directly or indirectly in the MSC's provision of services and materially benefited from it, will cover:

- the MSC scheme provider (as defined in the proposed legislation outlined above);
- a person in accordance with whose directions or instructions the directors of the company (the MSC or the scheme provider) are accustomed to act (a shadow director);
- an associate of the MSC or scheme provider (as defined in s60, Part 2, Chapter 8 Income Tax (Earnings and Pensions) Act 2003);
- connected persons in relation to the MSC or scheme provider (as defined in s839 Income and Corporation Taxes Act 1988); and
- controlling parties in relation to the MSC or scheme provider (as defined in s840 Income and Corporation Taxes Act 1988).

4.16 Where any of the parties listed are bodies corporate, it is proposed that liability will be joint and several between the company and its officers.

4.17 The Government would welcome views on to what extent the draft legislation should cover other parties who have materially benefited from the MSC's provision of services (such as the agency through which the services were provided). For example, this might be appropriate where a debt is irrecoverable because a scheme provider or other party has moved operations or assets offshore.

4.18 The proposed legislation will allow HMRC to seek to recover the PAYE and NICs debt of an MSC from any one of the parties actively involved with the MSC who is within the scope of the legislation. HMRC will issue a notice directing that the debt be transferred to a specified third party. It is intended that the party will have a right of appeal on the grounds that:

¹ Regulation 72, Income Tax (Pay As You Earn) Regulations 2003, SI 2003/2682, Regulation 86, Social Security (Contributions) Regulations 2001, SI 2001/1004.

- they are not a party within the scope of the legislation; or that
- while a party within the scope of the legislation, they were not involved directly or indirectly in the MSC's provision of the services of the workers and that they did not materially benefit from the MSC's provision of those services.

4.19 If the debt proves irrecoverable from that party then the notice can be cancelled and a new notice issued to another party. Any party subsequently issued with a notice will also have a right of appeal.

Question for consultation 4.20 The Government aims to publish draft legislation covering the transfer of debt by the end of January 2007 for discussion. **The Government would welcome comments in the intervening period.**

When will the tax changes take effect?

4.21 The Government intends to introduce legislation in Finance Bill 2007 so that:

- the income tax changes are intended to take effect from 6 April 2007. All payments received after that date will be deemed to be employment income and subject to deduction of tax under PAYE;
- changes in the national insurance rules are intended to take effect after Royal Assent by way of changes to the NICs regulations. Following that date, the MSC will have to account for employer's and employee's Class 1 NICs on all deemed employment income, alongside payment of tax under PAYE.

4.22 It is intended that the proposed legislation on debt transfer will have effect from the date of Royal Assent but will relate to debts incurred from 6 April 2007.

4.23 It will be important for scheme providers operating MSC arrangements, the workers providing their services and those to whom services are provided to have a clear understanding of the proposed changes and the implications for them. The Government plans a targeted information campaign to assist the parties involved in MSC schemes in understanding and preparing for the intended changes.

SUPPORTING INFORMATION MEASURES

4.24 The responsibility for considering the new legislation and ensuring that they have made the appropriate tax and NICs deductions and payments lies with MSCs. HMRC will be responsible for ensuring compliance with the new rules.

4.25 In order to monitor the effectiveness of the changes and to better target compliance activity, the Government will introduce specific supporting measures to improve the information available to HMRC, as outlined below.

P35 return 4.26 Information about the application of the Intermediaries legislation is currently obtained through the end of year return completed by employers (the P35). Two questions on the P35 form will be revised. These currently ask:

- Are any of your contracts caught by IR35?; and
- If so, have you paid your tax by attaching it to a P14?

4.27 These questions will be revised to ask:

- Are you a service company? (with a clear definition of “service company” to enable a judgment to be made readily); and
- If yes, have you operated the Intermediaries legislation or the new MSC legislation?

4.28 The changes will be made to the P35 form covering the tax year 2007-08.

ITSA return 4.29 Two additional questions will also be asked on the Income Tax Self Assessment (ITSA) return asking if any income (of whatever nature) in the return is derived from the taxpayer’s provision of their services via a service company and, if so, the amount. These changes will be introduced to the ITSA return form for 2007-08.

5

IMPACT OF THE MEASURES

This chapter looks at the expected impact of the measures on the main participants and on the wider operation of the labour market.

THE CURRENT SITUATION

5.1 These measures are targeted specifically at Managed Service Company (MSC) schemes and there will be no wider consequences for other contractors such as Personal Service Companies (PSCs), where the current rules continue to apply. For MSC schemes, the overall impact of the tax charging provisions set out in Chapter 4 will be to remove their ability to avoid employed levels of tax and national insurance contributions (NICs). The consequences for the different parties involved will depend on how much they each currently benefit from the scheme.

5.2 The proceeds of these contrived tax and NICs arrangements are shared between the various parties involved - the MSC scheme provider, the worker, the agency and the end client. The amount by which each party benefits varies according to competitive forces such as the number of MSC scheme providers within the sector, the demand for workers' skills and the level of competition by agencies for the workers and for contracts from end clients.

MSC scheme provider

5.3 The MSC scheme provider always benefits, taking a significant proportion of the proceeds of the contrived tax arrangement as a fee. This fee is usually either fixed at a particular sum each week, or a percentage of the payments to the MSC. Usually it is between £15 and £35 per week, or around £800 - £1,800 over a year for each worker. This is significantly more than the fees that an accountant might typically charge a small business for preparation of accounts, corporation tax computations and filing, and routine meetings and enquiries (usually around £400-£700 per year).

5.4 Some MSC scheme providers also profit from the interest accruing on the amounts deducted from incoming payments against the MSC's corporation tax liability. The tax is generally withheld by the MSC scheme provider as soon as the worker is paid - but it may be up to two years before the corporation tax needs to be paid to HM Revenue and Customs (HMRC).

Worker

5.5 In most cases the worker receives a proportion of the proceeds of the contrived tax arrangement in increased take-home pay - the increased income compared with employment is generally the key selling point used to attract workers into MSC schemes, as illustrated in the advertising material discussed in Chapter 2. The most common scenario is for the proceeds to be shared between the MSC scheme provider and the worker, although in many cases workers are unaware that the MSC has avoided paying employed levels of tax and NICs.

5.6 In rare cases, the worker does not receive any share of the proceeds. This can happen where workers sign paperwork they do not understand and subsequently work through an MSC without understanding any of the implications. HMRC compliance units have anecdotal evidence of this happening to vulnerable workers such as recent immigrants, but individual workers in such situations have been reluctant to co-operate with investigations.

Employment rights **5.7** On other occasions the worker may understand the implications of working through a company, particularly in terms of loss of employment rights, but is given little choice (see Box 5.1).

Box 5.1: Sometimes workers are given little choice about working through MSC schemes

Bolt-on MSC schemes for the whole workforce

In so-called “bolt-on” MSC schemes, a scheme provider approaches an end client and sets up a specific MSC scheme for that end client. The existing employees are all moved into the MSC scheme, despite the fact they are carrying out the same activity as when they were direct employees.

Individual worker

In one particular case a worker was taken on to replace a direct employee. The worker had exactly the same role as the employee who was his predecessor. However, he was told that he was to be paid via an MSC scheme and given no alternative option.

Source: HMRC compliance activity

Agencies **5.8** The evidence available suggests that agency fees do not tend to vary according to whether an MSC is involved. But agencies who use MSC schemes may be able to gain more business by offering workers higher take-home pay or end clients lower prices. Additionally, an agency could gain a share of the proceeds of the contrived tax arrangements if the price for a worker negotiated with an end client assumes Pay As You Earn (PAYE) is being operated and NICs are being paid, but the agency does not do so, because the worker is in an MSC scheme, and does not pass on all the reductions to the worker. Agencies are required to operate PAYE and pay NICs on payments made to agency workers where the worker is being directed by the end client, but not on payments made with respect to individuals working through companies. Some agencies have set up an associated MSC scheme and encourage their workers to join it, removing the obligation on the agency under the agency legislation to operate PAYE and pay NICs.

End client **5.9** Where an agency is involved (around 90 per cent of workers in MSC arrangements) the evidence suggests that the end client does not tend to share the proceeds of the contrived tax arrangement, or only does so to a small extent (the main benefit to the end client of agency workers, whether in MSC schemes or not, is often the lack of employment obligations). This may be because agency price structures for different types of workers are set by the wider market and do not tend to vary when an MSC is involved. In the case of one large agency, the fee is agreed with the end client first and the worker is then asked whether he wants to work through an MSC or as an agency worker on PAYE. The tax difference is usually made clear, although the impact on employment rights may not be.

5.10 However, some end clients can gain a share of the proceeds of the contrived tax arrangement, especially where they contract directly with the MSC (around ten per cent of workers in MSC arrangements). In other cases, the end client may benefit if the agency charges a lower gross amount for a worker in an MSC scheme.

WHAT WILL CHANGE AS A RESULT OF THESE MEASURES

5.11 By taking specific and targeted action against MSC schemes the Government is achieving its objectives in a way that is compatible with the labour market continuing to operate as at present and in a way that does not impact on those in business on their own account.

Exchequer protected

5.12 These measures will ensure that those currently in MSC schemes will pay the appropriate level of tax and NICs. There is a degree of uncertainty attached to estimates of revenue losses from the failure of MSCs to operate the Intermediaries legislation; based on cautious assumptions the estimated yield to the Exchequer of these measures is £350 million in 2007-08, £450 million in 2008-09 and £250 million in 2009-10.¹ The package will also deter future use of MSC schemes, protecting the Exchequer against future losses.

Level playing field for compliant businesses

5.13 These measures will help restore a level playing field for those businesses which apply the Intermediaries legislation correctly – including providers of professional services to contract workers, agencies and PSCs. Those end clients who ensure that they only contract with compliant businesses will no longer be undercut by those who, knowingly or unknowingly, use MSC workers.

Labour market flexibility unaffected

5.14 There is unlikely to be any significant impact on the labour market as a result of these measures. Workers will be more likely to work as agency workers or employees, rather than through MSCs, and therefore be entitled to the relevant employment rights. End clients who value the flexibility of agency workers or contract workers will be able to continue to use them – and agencies will be able to continue to supply them – as at present. And those who are in business on their own account will be able to continue to operate through PSCs.

PARTIAL RIA

5.15 A partial Regulatory Impact Assessment (RIA) is published at Annex D of this document. This analyses the main economic and sectoral impacts of the measure based on information currently available. The final RIA, which will benefit from the consultation, will be published alongside the final measures at Budget 2007.

¹ This is higher in the earlier years as the reduction in corporation tax receipts from MSCs does not occur until after the increase in tax and NICs receipts.

6

THE CONSULTATION PROCESS

TIMETABLE FOR CHANGE

Date	Action
6 December 2006	Publication of draft legislation on definition and tax charge – consultation period begins
Around end January 2007	Publication of draft national insurance contributions (NICs) regulations and draft legislation relating to transfer of debt
2 March 2007	Close of consultation period
Budget 2007	Final package of measures
Finance Bill 2007	Legislation for full package of measures
6 April 2007	Subject to Parliamentary approval, new rules start for income tax, expenses and debt transfer provisions
After Royal Assent of the Finance Bill	Subject to Parliamentary approval, new rules start for NICs

SUMMARY OF QUESTIONS FOR CONSULTATION

6.1 The draft legislation relating to the definition and tax charging provision is set out in Annex B. The Government aims to publish draft legislation on the debt transfer provision by the end of January 2007 for comment.

Definition of MSCs

6.2 The definition is discussed in Chapter 3 with a detailed commentary on the clauses.

6.3 The Government would welcome views on the scope of the draft legislation and, in particular, **whether there are other defining characteristics of Managed Service Companies (MSCs) that should be reflected in the legislation.**

6.4 The Government is keen to keep the legislation as simple as possible so that people can make their own judgements as to whether their business arrangements meet the criteria for being defined as an MSC or not. There will be additional guidance to assist the lay reader. **The Government would welcome views on the clarity of the legislation.**

6.5 At the same time, it is important that the legislation should be robust against attempts to circumvent it by re-structuring or devising new arrangements purporting to be outside its scope. **The Government would therefore welcome views on whether the legislation could be strengthened further and, if so, how.**

Tax charging provision

6.6 The tax charging provisions are discussed in Chapter 4, with a detailed commentary in Annex C.

6.7 The Government would welcome comments on the draft legislation on the tax charging provisions, including treatment of expenses.

Debt transfer provision

6.8 The debt transfer provision is discussed in Chapter 4 and the Government aims to publish draft legislation by the end of January 2007 for discussion. **The Government would welcome comments on this issue** in the intervening period.

PROCESS AND TIMETABLE FOR CONSULTATION

6.9 Comments on this consultation should be sent by 2 March 2007 to:

John Wrathmell
MSC Consultation
HM Treasury
Room 2/N2
1 Horse Guards Road
London
SW1A 2HQ
or e-mail: msc.consultation@hm-treasury.gov.uk
Telephone queries: 020 7270 6114

Confidentiality Disclosure

6.10 Information provided in response to this consultation, including personal information, may be published or disclosed in accordance with the access to information regimes (these are primarily the Freedom of Information Act 2000 (FOIA), the Data Protection Act 1998 (DPA) and the Environmental Information Regulations 2004).

6.11 If you want the information that you provide to be treated as confidential, please be aware that, under the FOIA, there is a statutory Code of Practice with which public authorities must comply and which deals, amongst other things, with obligations of confidence. In view of this it would be helpful if you could explain to us why you regard the information you have provided as confidential. If we receive a request for disclosure of the information we will take full account of your explanation, but we cannot give an assurance that confidentiality can be maintained in all circumstances. An automatic confidentiality disclaimer generated by your IT system will not, of itself, be regarded as binding on HM Treasury (HMT) or HM Revenue and Customs (HMRC).

6.12 HMT and HMRC will process your personal data in accordance with the DPA and in the majority of circumstances, this will mean that your personal data will not be disclosed to third parties.

ABOUT THE CONSULTATION PROCESS

6.13 This consultation is being conducted in accordance with the consultation criteria in the Cabinet Office Code of Practice (see Box 6.1). If you wish to access the full version of the Code, you can obtain it at:

www.cabinetoffice.gov.uk/regulation/Consultation/Code

Box 6.1: The consultation criteria

1. Consult widely throughout the process, allowing a minimum of 12 weeks for written consultation at least once during the development of the policy.
2. Be clear about who may be affected, what questions are being asked, and the timescale for responses.
3. Ensure that your consultation is clear, concise and widely accessible.
4. Give feedback regarding the responses received and how the consultation process influenced the policy.
5. Monitor your department's effectiveness at consultation, including through the use of a designated consultation co-ordinator.
6. Ensure your consultation follows better regulation best practice, including carrying out a Regulatory Impact Assessment if appropriate.

If you feel that the consultation does not satisfy these criteria, or if you have any complaints about the process, please contact:

Duncan Calloway

Better Regulation Unit

Telephone: 020 7147 2389 or duncan.calloway1@hmrc.gsi.gov.uk

A

GLOSSARY OF TECHNICAL TERMS

Note: this glossary defines terms as they are used in the main body of the document and not as they appear in existing or any proposed legislation. Words may have different meanings in other contexts or documents. For example employment status and its vocabulary often differ in tax law and employment law.

Agency

Agency in this document is used to refer to an agency which supplies workers to end clients and remains part of the ongoing relationship between worker and end client (technically known as an *employment business*). This differs to an introduction agency (known as an *employment agency*). These terms are defined in the Employment Agencies Act 1973, as amended by the Employment Relations Act 1999.

Agency legislation

Subject to certain conditions, the agency legislation (s44-47, Chapter 7, Part 2, Income Tax (Earnings and Pensions) Act 2003) applies where a worker provides services to a client through a third party in such a way that, technically, the worker is not an employee of either.

Subject to certain conditions, the services rendered by the worker are, for income tax and national insurance contributions (NICs) purposes, treated as if they were the duties of an employment held by the worker. The agency is treated as the secondary contributor for Class 1 NICs purposes.

Agency worker

An agency worker is an individual who is engaged on a temporary basis through an agency for a third party organisation (the end client).

Composite Company

A type of Managed Service Company. See paragraphs 2.15 to 2.16 for a description.

End client

An organisation which requires labour services. For example, in a direct employment relationship, the end client is the employer.

Intermediaries legislation (IR35)

Unless otherwise stated, in this document *the Intermediaries legislation* refers to both the income tax and the NICs rules that govern the treatment of services provided through an intermediary. The rules are contained within Chapter 8, Part 2, Income Tax (Earnings and Pensions) Act, 2003, Section 4A, Social Security Contributions and Benefits Act 1992, and Social Security (Intermediaries) Regulations 2000, SI 2000/727.

The aim of the legislation is to eliminate the avoidance of tax and NICs through the use of intermediaries, such as service companies or partnerships, in circumstances where an individual worker would otherwise -

- for tax purposes, be regarded as an employee of the client; and
- for NICs purposes, be regarded as employed in employed earner's employment by the client.

The legislation ensures that, if the relationship between the worker and the client would have been one of employment had it not been for an intermediary, such as a service company or a partnership, the worker pays broadly tax and NICs on a basis which is fair in relation to what an employee of the client would pay.

**Managed
Personal Service
Company (MPSC)**

A type of Managed Service Company. See paragraph 2.17 for a description.

Worker

Used in this document to refer to anyone, whether employed or self-employed, who provides a service to an end client. Note that the term has a more specific meaning in employment law.

Managed service companies

CONTENTS

1 Managed service companies

- Schedule – Managed service companies
 - Part 1 – Amendments of ITEPA 2003
 - Part 2 – Other amendments
 - Part 3 – Calculation of profits for corporation tax purposes

1 Managed service companies

- (1) The Schedule contains provisions about managed service companies.
- (2) The Schedule has effect for the tax year 2007-08 and subsequent tax years.

SCHEDULE

Section 1

MANAGED SERVICE COMPANIES

PART 1

AMENDMENTS OF ITEPA 2003

- 1 ITEPA 2003 is amended as follows.
- 2 In Chapter 2 of Part 2 (tax on employment income), in section 7(5) (meaning of “employment income” etc) for paragraph (a) substitute –
 - “(a) Chapters 7 to 9 of this Part (agency workers, workers under arrangements made by intermediaries, and workers providing services through managed service companies),”.
- 3 In Chapter 8 of that Part (workers under arrangements made by intermediaries), in section 48(2) (scope of the Chapter) for the “or” at the end of paragraph (a) substitute –
 - “(aa) applies to services provided by a managed service company (within the meaning of Chapter 9 of this Part), or”.
- 4 After that Chapter insert –

“CHAPTER 9

MANAGED SERVICE COMPANIES

*Application of this Chapter***61A Scope of this Chapter**

- (1) This Chapter has effect with respect to the provision of services by a managed service company.
- (2) Nothing in this Chapter –
 - (a) affects the operation of Chapter 7 of this Part (agency workers), or
 - (b) applies to payments subject to deduction of tax under section 555 of ICTA (payments to non-resident entertainers and sportsmen).

61B Meaning of “managed service company”

- (1) A company is a “managed service company” if –
 - (a) its business consists wholly or mainly of providing (directly or indirectly) the services of individuals to other persons, and
 - (b) it provides those services in pursuance of a managed service company scheme.

- (2) “Managed service company scheme” means a scheme or arrangement –
- (a) under which the services of individuals are provided (directly or indirectly) by companies to other persons,
 - (b) under which the greater part of the consideration for the provision of the services of an individual is paid (directly or indirectly) to the individual or an associate of the individual, and
 - (c) in the case of which the person who makes the scheme or arrangement available (“the scheme provider”), or an associate of the scheme provider, exercises control over the finances or general management of the companies (and the individuals do not exercise control over such matters).
- (3) In this section “company” means a body corporate or partnership.

The deemed employment payment

61C Worker treated as receiving earnings from employment

- (1) This section applies if –
- (a) the services of an individual (“the worker”) are provided (directly or indirectly) by a managed service company (“the MSC”),
 - (b) the worker, or an associate of the worker, receives (from any person) a payment or benefit which can reasonably be taken to represent remuneration for the services, and
 - (c) the payment or benefit is not employment income received by the worker directly from the MSC.
- (2) The MSC is treated as making to the worker, and the worker is treated as receiving, a payment which is to be treated as earnings from an employment (“the deemed employment payment”).
- (3) The deemed employment payment is treated as made at the time the payment or benefit mentioned in subsection (1)(b) is received.
- (4) In this Chapter –
- “the worker” has the meaning given by subsection (1),
 - “the relevant services” means the services mentioned in that subsection, and
 - “the client” means the person to whom the relevant services are provided.
- (5) Section 61E supplements this section.

61D Calculation of deemed employment payment

- (1) The amount of the deemed employment payment is the amount resulting from the following steps –
- Step 1*
 Find (applying section 61E) the amount of the payment or benefit mentioned in section 61C(1)(b).
- Step 2*

Deduct (applying Chapters 1 to 5 of Part 5) the amount of any expenses met by the worker that would have been deductible from the taxable earnings from the employment if—

- (a) the worker had been employed by the client to provide the relevant services, and
- (b) the expenses had been met by the worker out of those earnings.

If the result at this point is nil or a negative amount, there is no deemed employment payment.

Step 3

Assume that the result of step 2 represents an amount together with employer's national insurance contributions on it, and deduct what (on that assumption) would be the amount of those contributions.

The result is the deemed employment payment.

- (2) In step 2 of subsection (1), the reference to expenses met by the worker includes, where the MSC is a partnership and the worker is a member of the partnership, expenses met by the worker for and on behalf of the partnership.
- (3) In step 2 of subsection (1), the expenses deductible include the amount of any mileage allowance relief which the worker would have been entitled to in respect of the use of a vehicle falling within subsection (4) if—
 - (a) the worker had been employed by the client to provide the relevant services, and
 - (b) the vehicle had not been a company vehicle (within the meaning of Chapter 2 of Part 4).
- (4) A vehicle falls within this subsection if—
 - (a) it is provided by the MSC for the worker, or
 - (b) where the MSC is a partnership and the worker is a member of the partnership, it is provided by the worker for the purposes of the business of the partnership.
- (5) For the purposes of subsection (1) any necessary apportionment of payments or benefits that are referable partly to the provision of the relevant services and partly to other matters is to be made on a just and reasonable basis.

61E Sections 61C and 61D: application of rules relating to earnings from employment

- (1) The following provisions apply for the purposes of sections 61C and 61D.
- (2) A “payment or benefit” means anything that, if received by an employee for performing the duties of an employment, would be earnings from the employment.
- (3) The amount of a payment or benefit is taken to be—
 - (a) in the case of a payment or cash benefit, the amount received, and
 - (b) in the case of a non-cash benefit, the cash equivalent of the benefit.

- (4) The cash equivalent of a non-cash benefit is taken to be—
 - (a) the amount that would be earnings if the benefit were earnings from an employment, or
 - (b) in the case of living accommodation, whichever is the greater of that amount and the cash equivalent determined in accordance with section 398(2).
- (5) A payment or benefit is treated as received—
 - (a) in the case of a payment or cash benefit, when payment is made of or on account of the payment or benefit;
 - (b) in the case of a non-cash benefit that is calculated by reference to a period within a tax year, at the end of that period;
 - (c) in the case of a non-cash benefit that is not so calculated, when it would have been treated as received for the purposes of Chapter 4 or 5 of this Part (see section 19 or 32) if—
 - (i) the worker had been an employee, and
 - (ii) the benefit had been provided by reason of the employment.

61F Application of Income Tax Acts in relation to deemed employment

- (1) The Income Tax Acts (in particular, the PAYE provisions) apply in relation to the deemed employment payment as follows.
- (2) They apply as if—
 - (a) the worker were employed by the MSC to provide the relevant services, and
 - (b) the deemed employment payment were a payment by the MSC of earnings from that employment;
 but this is subject to subsection (3).
- (3) No deduction under Part 5 (deductions allowed from employment income) or section 232 (mileage allowance relief) may be made from the deemed employment payment.
- (4) The worker is not chargeable to tax in respect of the deemed employment payment if, or to the extent that, by reason of any combination of the factors mentioned in subsection (5), the worker would not be chargeable to tax if—
 - (a) the worker were employed by the client to perform the relevant services, and
 - (b) the deemed employment payment were a payment by the client of earnings from that employment.
- (5) The factors are—
 - (a) the worker being resident, ordinarily resident or domiciled outside the United Kingdom,
 - (b) the client being resident or ordinarily resident outside the United Kingdom, and
 - (c) the relevant services being provided outside the United Kingdom.
- (6) Where the MSC is a partnership and the worker is a member of the partnership, the deemed employment payment is treated as received

by the worker in the worker's personal capacity and not as income of the partnership.

- (7) Where—
- (a) the worker is resident in the United Kingdom, and
 - (b) the relevant services are provided in the United Kingdom, the MSC is treated as having a place of business in the United Kingdom, whether or not it in fact does so.

Supplementary provisions

61G Relief in case of distributions by managed service company

- (1) A claim for relief may be made under this section where the MSC—
 - (a) is a body corporate,
 - (b) is treated as making a deemed employment payment in any tax year, and
 - (c) either in that tax year (whether before or after that payment is treated as made), or in a subsequent tax year, makes a distribution (a “relevant distribution”).
- (2) A claim for relief under this section must be made—
 - (a) by the MSC by notice to an officer of Revenue and Customs, and
 - (b) within 5 years after 31st January following the tax year in which the distribution is made.
- (3) If on a claim being made an officer of Revenue and Customs is satisfied that relief should be given in order to avoid a double charge to tax, the officer must direct the giving of such relief by way of amending any assessment, by discharge or repayment of tax, or otherwise, as appears to the officer appropriate.
- (4) Relief under this section is given by setting the amount of the deemed employment payment against the relevant distribution so as to reduce the distribution.
- (5) In the case of more than one relevant distribution, an officer of Revenue and Customs must exercise the power conferred by this section so as to secure that so far as practicable relief is given by setting the amount of a deemed employment payment—
 - (a) against relevant distributions of the same tax year before those of other years,
 - (b) against relevant distributions received by the worker before those received by another person, and
 - (c) against relevant distributions of earlier years before those of later years.
- (6) Where the amount of a relevant distribution is reduced under this section, the amount of any associated tax credit is reduced accordingly.

61H Meaning of “associate”

- (1) In this Chapter “associate”—

- (a) in relation to an individual, has the meaning given by section 417(3) and (4) of ICTA,
 - (b) in relation to a company, means a person connected with the company, and
 - (c) in relation to a partnership, means any associate of a member of the partnership.
- (2) But if—
- (a) a managed service company (“the MSC”) is a partnership, and
 - (b) a person is an associate of another person by virtue only of being a member of the partnership,
- the person is to be treated, for the purposes of this Chapter as it applies in relation to the MSC, as if he were not an associate of that other person.

61I Interpretation

In this Chapter—

- “associate” has the meaning given by section 61H,
- “business” means any trade, profession or vocation,
- “the client” has the meaning given by section 61C(4),
- “employer’s national insurance contributions” means secondary Class 1 or Class 1A national insurance contributions,
- “national insurance contributions” means contributions under Part 1 of SSCBA 1992 or Part 1 of SSCB(NI)A 1992,
- “managed service company” has the meaning given by section 61B,
- “PAYE provisions” means the provisions of Part 11 or PAYE regulations,
- “the relevant services” has the meaning given by section 61C(4), and
- “the worker” has the meaning given by section 61C(4).

- 5 In Part 2 of Schedule 1 (index of defined expressions) insert at the appropriate places—

“associate (in Chapter 9 of Part 2)	section 61H”
“business (in Chapter 9 of Part 2)	section 61I”
“the client (in Chapter 9 of Part 2)	section 61C(4)”
“employer’s national insurance contributions (in Chapter 9 of Part 2)	section 61I”
“national insurance contributions (in Chapter 9 of Part 2)	section 61I”
“managed service company (in Chapter 9 of Part 2)	section 61B”

“PAYE provisions (in Chapter 9 of Part 2) section 61I”

“the relevant services (in Chapter 9 of Part 2) section 61C(4)”

“the worker (in Chapter 9 of Part 2) section 61C(4)”.

PART 2

OTHER AMENDMENTS

- 6 In Part 2 of ITTOIA 2005 (trading income), in Chapter 11 (trade profits: other specific trades), after section 164 insert –

"Managed service companies

164A Calculation of profits of firms which are managed service companies

- (1) This section applies for the purpose of calculating the profits of a trade, profession or vocation carried on by a managed service company (“the MSC”) which (in connection with the trade, profession or vocation) provides, directly or indirectly, the services of an individual (“the worker”) to another person.
- (2) A deduction is allowed for –
 - (a) the amount of any deemed employment payment treated as made by the MSC to the worker in respect of the services, and
 - (b) the amount of any employer’s national insurance contributions paid by the MSC in respect of any such deemed employment payment.
- (3) The deduction under subsection (2) is allowed for the period of account in which the deemed employment payment is treated as made.
- (4) The amount of the deduction allowed under subsection (2) is limited to the amount that reduces the profits of the firm for the tax year to nil.
- (5) The deductions listed in subsection (6) are the only deductions allowed for expenses incurred in respect of any payments or benefits received (from any person) by the worker or an associate of the worker in respect of the services.
- (6) The deductions are –
 - (a) the deduction under subsection (2) (made in accordance with subsections (3) and (4)),
 - (b) the amount of any employment income paid by the MSC to the worker in respect of the services,
 - (c) the amount of any employer’s national insurance contributions paid by the MSC in respect of any employment income paid as mentioned in paragraph (b), and

- (d) the amount of any expenses in respect of the services that are met by the worker (and reimbursed by the MSC) and are deductible under step 2 of section 61D(1) of ITEPA 2003.
- (7) In this section –
 - (a) “associate”, “deemed employment payment”, “employer’s national insurance contributions” and “managed service company” have the same meaning as in Chapter 9 of Part 2 of ITEPA 2003;
 - (b) “payment or benefit” (and “receipt” of a payment or benefit) are to be interpreted in accordance with section 61E of that Act.”

PART 3

CALCULATION OF PROFITS FOR CORPORATION TAX PURPOSES

- 7 (1) This paragraph applies for the purpose of calculating for corporation tax purposes the profits of a business carried on by a managed service company (“the MSC”) which (in connection with the business) provides, directly or indirectly, the services of an individual (“the worker”) to another person.
- (2) A deduction is allowed for –
 - (a) the amount of any deemed employment payment treated as made by the MSC to the worker in respect of the services, and
 - (b) the amount of any employer’s national insurance contributions paid by the MSC in respect of any such deemed employment payment.
- (3) The deduction under sub-paragraph (2) is allowed for the period of account in which the deemed employment payment is treated as made.
- (4) If the MSC is a partnership, the amount of the deduction allowed under sub-paragraph (2) is limited to the amount that reduces the profits of the partnership for the period of account to nil.
- (5) The deductions listed in sub-paragraph (6) are the only deductions allowed for expenses incurred in respect of any payments or benefits received (from any person) by the worker or an associate of the worker in respect of the services.
- (6) The deductions are –
 - (a) the deduction under sub-paragraph (2) (made in accordance with sub-paragraphs (3) and (4)),
 - (b) the amount of any employment income paid by the MSC to the worker in respect of the services,
 - (c) the amount of any employer’s national insurance contributions paid by the MSC in respect of any employment income paid as mentioned in paragraph (b), and
 - (d) the amount of any expenses in respect of the services that are met by the worker (and reimbursed by the MSC) and are deductible under step 2 of section 61D(1) of ITEPA 2003.
- (7) In this paragraph –
 - (a) “associate”, “business”, “deemed employment payment”, “employer’s national insurance contributions” and “managed

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Managed service companies
Schedule – Managed service companies
Part 3 – Calculation of profits for corporation tax purposes

service company” have the same meaning as in Chapter 9 of Part 2 of ITEPA 2003;

- (b) “payment or benefit” (and “receipt” of a payment or benefit) are to be interpreted in accordance with section 61E of that Act.



EXPLANATION OF DRAFT CLAUSES ON THE TAX CHARGE

The table below explains the main clauses relating to the tax charge on Managed Service Company (MSC) workers. The legislation is set out in the left hand column with the explanation on the right.

This commentary on the draft clauses is a guide to the Government’s intention as to how the legislation would operate if enacted in this form.

61C Worker treated as receiving earnings from employment

Draft legislation	Explanation
61C(1) This section applies if-	<p>This section sets out the circumstances in which an individual worker operating through an MSC is treated as having received earnings from an employment.</p> <p>Subsection (1) identifies 3 criteria that determine when a worker is treated as receiving earnings. All three criteria must be satisfied for a worker to be treated as receiving earnings from employment.</p>
(a) the services of an individual (“the worker”) are provided (directly or indirectly) by a managed service company (“the MSC”),	<p>The first criterion is that it is an MSC that provides the services of an individual worker to a party who wishes to purchase the services (a client). Whether the services of the worker are provided directly or indirectly by the MSC, the criterion is still met.</p>
(b) the worker, or an associate of the worker, receives (from any person) a payment or benefit which can reasonably be taken to represent remuneration for the services, and	<p>The second criterion is that the worker who has provided their services to the client via a MSC receives something in return for those services by way of a payment or some other benefit. The criterion is met:</p> <p>even if the worker receives the payment or benefit from some person other than the MSC;</p> <p>even if the payment or benefit is received by an associate of the worker (e.g. their spouse);</p> <p>if it is reasonable to take the payment or benefit as being in return for the services provided, even if it is not described as such.</p>
(c) the payment or benefit is not employment income received by the worker directly from the MSC	<p>The third criterion is that the payment or benefit received by the worker is not paid by the MSC as wages or salary and already subject to Pay As You Earn (PAYE) and national insurance contributions (NICs).</p>
(2) The MSC is treated as making to the worker, and the worker is treated as receiving, a payment which is to be treated as earnings from an employment (“the deemed employment payment”).	<p>Subsection (2) provides that where a worker receives a payment which meets the criteria in subsection (1), irrespective of whether the payment is actually made by the MSC, the MSC is treated as making a payment to the worker of earnings from an employment, from which PAYE and NICs must be deducted. The worker is also treated as receiving a payment of earnings. The payment is termed “the deemed employment payment”.</p>

<p>(3) The deemed employment payment is treated as made at the time the payment or benefit mentioned in subsection (1)(b) is received.</p>	<p>This subsection provides that the date on which the worker received the payment in respect of their services to the client is the date on which the deemed employment payment is treated as made, and therefore the date on which the MSC's obligation to deduct PAYE and NICs arises.</p>
<p>(4) In this Chapter-</p> <p>“the worker” has the meaning given by subsection (1)</p> <p>“the relevant services” means the services mentioned in that subsection, and</p> <p>“the client” means the person to whom the relevant services are provided</p>	<p>This subsection defines three terms used in the new Chapter 9, Part 2, Income Tax (Earnings and Pensions) Act 2003:</p> <p>worker means an individual providing their services through a MSC to a client, whether directly or indirectly;</p> <p>relevant services mean the services provided by the worker to the client through the MSC;</p> <p>client means the party to whom the services of the worker are provided- i.e. the end client, not an employment agency.</p>
<p>(5) Section 61E supplements this section</p>	<p>This subsection refers to section 61E which sets out various rules relating to payments and benefits: definitions, the calculation of a cash equivalent, and the dates payments or benefits are treated as received.</p>

61D Calculation of deemed employment payment

Draft legislation	Explanation
	This section explains how the MSC works out the amount of the deemed employment payment on which PAYE and NICs is due.
<p>61D(1) The amount of the deemed employment payment is the amount resulting from the following steps -</p> <p><i>Step 1</i> Find (applying section 61E) the amount of the payment or benefit mentioned in section 61C(1)(b)</p> <p><i>Step 2</i> Deduct (applying Chapters 1 to 5 of Part 5) the amount of any expenses met by the worker that would have been deductible from the taxable earnings from the employment if-</p> <p>(a) the worker had been employed by the client to provide the relevant services, and</p> <p>(b) the expenses had been met by the worker out of those earnings.</p> <p>If the result at this point is nil or a negative amount, there is no deemed employment payment.</p> <p><i>Step 3</i> Assume that the result of step 2 represents an amount together with employer's national insurance contributions on it, and deduct what (on that assumption) would be the amount of those contributions. The result is the deemed employment payment.</p>	<p>This subsection sets out a three step process to arrive at the sum to be subjected to PAYE and NICs.</p> <p>The MSC first takes the payment or benefit received by the worker (whether or not it was paid by the MSC). Section 61E provides an explanation of how a payment which is not cash is converted to a cash equivalent for the purposes of calculating the deemed employment payment.</p> <p>The MSC deducts from the amount of the payment received by the worker expenses that are allowable under the Income Taxes Acts. However, the amount of allowable expenses is to be worked out, not on the basis that the worker is employed by the MSC and that each engagement with an end client represents a temporary workplace, but rather:</p> <p>as if the worker had been employed to provide their services by the client, and</p> <p>the worker had paid the expenses out of their taxable pay.</p> <p>Because the expenses to be deducted are calculated on this basis, the worker is not entitled to claim expenses for travel to the client's premises, nor to any associated accommodation or subsistence costs.</p> <p>If allowable expenses (having regard to the above factors) equal or exceed the payment or benefit received by the worker, there is no deemed employment payment to be subject to PAYE and NICs.</p> <p>The amount left after allowable expenses have been deducted from the payment or benefit received by the worker represent two amounts:</p> <ol style="list-style-type: none"> 1. the amount of earnings to be subject to PAYE and employee's NICs; and 2. employer's NICs on those earnings <p>The MSC must calculate how much of the amount remaining after step 2 would represent the employer's NICs due on a payment of the rest of the amount to the worker. The employer's NICs are deducted from the result of step 2. The remaining amount on which PAYE and employee's NICs is to be deducted is the deemed employment payment.</p>

<p>(2) In step 2 of subsection (1), the reference to expenses met by the worker includes, where the MSC is a partnership and the worker is a member of the partnership, expenses met by the worker for and on behalf of the partnership.</p>	<p>This subsection clarifies the expenses allowable when the MSC is a partnership. Where the MSC is a partnership in which the worker is a partner, allowable expenses met on behalf of the partnership can also be deducted in arriving at the deemed employment payment.</p>
<p>(3) In step 2 of subsection (1), the expenses deductible include the amount of any mileage allowance relief which the worker would have been entitled to in respect of a vehicle falling within subsection(4) if-</p> <p>(a) the worker had been employed by the client to provide the relevant services, and</p> <p>b) the vehicle had not been a company vehicle (within the meaning of Chapter 2, Part 4).</p>	<p>This subsection, together with subsection (4), clarifies what expenses can be deducted by the MSC in calculating the deemed employment payment in respect of mileage allowance relief. Mileage allowance relief is deductible to the extent that the worker would have been entitled to it if:</p> <p>the worker had been employed to provide their services by the client; and</p> <p>the vehicle in respect of which a mileage allowance was paid was not a company vehicle made available to the worker by the client but not for private use</p>
<p>(4) A vehicle falls within this subsection if-</p> <p>(a) it is provided by the MSC for the worker, or</p> <p>(b) where the MSC is a partnership and the worker is a member of the partnership, it is provided by the worker for the purposes of the business of the partnership.</p>	<p>This subsection sets out the type of vehicle for which a mileage allowance referred to in subsection (3) would be allowable. The type of vehicle is:</p> <p>one provided for the worker by the MSC; or</p> <p>where the MSC is a partnership of which the worker is a member, one provided by the worker for the purposes of the business of the MSC.</p>
<p>(5) For the purposes of subsection (1) any necessary apportionment of payments or benefits that are referable partly to the provision of the relevant services and partly to other matters is to be made on a just and reasonable basis.</p>	<p>Payments or benefits received by a worker providing their services through a MSC will, in the first instance, be considered to relate to the provision of those services. However, where part of a payment or benefit received by a worker cannot reasonably be considered to be in respect of the services, but that part is not clearly identifiable, the payment or benefit is to be split on a fair and reasonable basis between the amount in respect of services provided and the amount received for other reasons.</p>

Section 164A ITTOIA 2005 Calculation of profits of firms which are managed service companies

Draft legislation	Explanation
	This is a new section to be added to the Income Tax (Trading and Other Income) Act 2005 (ITTOIA), after section 164, about the deductions allowable in computing the profits of an MSC which is not a body corporate for income tax purposes.
164A(1) This section applies for the purpose of calculating the profits of a trade, profession or vocation carried on by a managed service company (“the MSC”) which (in connection with the trade, profession or vocation) provides, directly or indirectly, the services of an individual (“the worker”) to another person.	This subsection sets out that the section applies for calculating the profits for tax purposes of MSCs providing the services of individual workers to other persons.
(2) A deduction is allowed for- (a) the amount of any deemed employment payment treated as made by the MSC to the worker in respect of the services, and (b) the amount of any employer’s national insurance contributions paid by the MSC in respect of any such deemed employment payment.	This subsection sets out the allowable deductions in computing a MSC’s profits in relation to deemed employment payments. The allowable deductions are: the amount of any deemed employment payment which the MSC is treated as making to the worker for their services; and the amount of employer’s NICs paid on any deemed employment payment which the MSC is treated as making.
(3) The deduction under subsection (2) is allowed for the period of account in which the deemed employment payment is treated as made.	This subsection provides that the deduction for a deemed employment payment and associated employer’s NICs is allowable in the MSC’s accounting period in which the deemed employment payment is treated as made (that is, when the worker received payment in respect of their services).
(4) The amount of the deduction allowed under subsection (2) is limited to the amount that reduces the profits of the firm for the tax year to nil	This subsection restricts the amount of the deduction for a deemed employment payment and associated employer’s NICs to the amount needed to reduce profits to nil – that is, such deductions cannot create losses.
(5) The deductions listed in subsection (6) are the only deductions allowed for expenses incurred in respect of any payments or benefits received (from any person) by the worker or an associate of the worker in respect of the services	This subsection sets out that only the deductions listed in subsection (6) may be made in respect of expenses relating to payments (or benefits) received by workers (or their associates) in respect of the provision of their services.
(6) The deductions are- (a) the deductions under subsection (2) (made in accordance with subsections (3) and (4),	Deductions are restricted to: deemed employment payments and associated employer’s NICs, subject to the restrictions regarding accounting periods and the creation of losses;

<p>(b) the amount of any employment income paid by the MSC to the worker in respect of the services,</p> <p>(c) the amount of any employer's national insurance contributions paid by the MSC in respect of any employment income paid as mentioned in paragraph (b) , and</p> <p>(d) the amount of any expenses in respect of the services that are met by the worker (and reimbursed by the MSC) and are deductible under step 2 of section 61D(1) of ITEPA 2003.</p>	<p>wages and salary subject to PAYE and employee's NICs, paid to workers by the MSC;</p> <p>employer's NICs due on the wages and salary subject to PAYE and employee's NICs paid to workers by the MSC; and</p> <p>expenses reimbursed to the worker by the MSC that are allowable in calculating the deemed employment payment (that is, calculated as if the worker had been employed directly by the client).</p>
<p>(7) In this section-</p> <p>(a) "associate", "deemed employment payment", "employer's national insurance contributions" and "managed service company" have the same meaning as in Chapter 9 of Part 2 of ITEPA 2003;</p> <p>(b) "payment or benefit" (and "receipt" of a payment or benefit) are to be interpreted in accordance with section 61E of that Act.</p>	<p>This section defines certain terms by reference to the provisions of Chapter 9 ITEPA 2003. Specifically:</p> <p>associate, deemed employment payment, employer's national insurance contributions and MSC, all have the meanings set out in Chapter 9 ITEPA;</p> <p>payment or benefit and receipt of payment or benefit, take the meaning set out in section 61E of Chapter 9, ITEPA.</p>

Paragraph 7 Calculation of profits for corporation tax purposes

Draft legislation	Explanation
	This paragraph applies the same provisions as in the draft S164A for the purposes of calculating the profits of an MSC subject to corporation tax.
7(1) This paragraph applies for the purposes of calculating for corporation tax purposes the profits of a business carried on by a managed service company (“the MSC”) which (in connection with the business) provides, directly or indirectly, the services of an individual (“the worker “) to another person.	This sub-paragraph sets out that the paragraph applies for calculating the profits for corporation tax purposes of MSCs providing the services of individual workers to other persons.
(2) A deduction is allowed for- (a) the amount of any deemed employment payment treated as made by the MSC to the worker in respect of the services, and (b) the amount of any employer’s national insurance contributions paid by the MSC in respect of any such deemed employment payment.	This sub-paragraph sets out the allowable deductions in computing a MSC’s profits in relation to deemed employment payments. The allowable deductions are: the amount of any deemed employment payment which the MSC is treated as making to the worker for their services; and the amount of employer’s NICs paid on any deemed employment payment which the MSC is treated as making.
(3) The deduction under sub- paragraph (2) is allowed for the period of account in which the deemed employment payment is treated as made.	This sub-paragraph provides that the deduction for a deemed employment payment and associated employer’s NICs is allowable in the MSC’s accounting period in which the deemed employment payment is treated as made (that is, when the worker received payment in respect of their services).
(4) If the MSC is a partnership, the amount of the deduction allowed under sub-paragraph (2) is limited to the amount that reduces the profits of the partnership for the period to nil.	This sub-paragraph restricts the amount of the deduction for a deemed employment payment and associated employer’s NICs to the amount needed to reduce profits to nil – that is, such deductions cannot create losses.
(5) The deductions listed in sub- paragraph (6) are the only deductions allowed for expenses incurred in respect of any payments or benefits received (from any person) by the worker or an associate of the worker in respect of the services.	This sub-paragraph sets out that only the deductions listed in subsection (6) may be made in respect of expenses relating to payments (or benefits) received by workers (or their associates) in respect of the provision of their services.
6) The deductions are- (a) the deductions under sub- paragraph (2) (made in accordance with sub-paragraphs (3) and (4),	Deductions are restricted to: deemed employment payments and associated employer’s NICs, subject to the restrictions regarding accounting periods and the creation of losses;

<p>(b) the amount of any employment income paid by the MSC to the worker in respect of the services,</p> <p>(c) the amount of any employer’s national insurance contributions paid by the MSC in respect of any employment income paid as mentioned in paragraph (b) , and</p> <p>(d) the amount of any expenses in respect of the services that are met by the worker (and reimbursed by the MSC) and are deductible under step 2 of section 61D(1) of ITEPA 2003.</p>	<p>wages and salary subject to PAYE and employee’s NICs, paid to workers by the MSC;</p> <p>employer’s NICs due on the wages and salary subject to PAYE and employee’s NICs paid to workers by the MSC; and</p> <p>expenses reimbursed to the worker by the MSC that are allowable in calculating the deemed employment payment (that is, calculated as if the worker had been employed directly by the client).</p>
<p>(7) In this paragraph-</p> <p>“associate”, “business” “deemed employment payment”, “employer’s national insurance contributions” and “managed service company” have the same meaning as in Chapter 9 of Part 2 of ITEPA 2003;</p> <p>“payment or benefit” (and “receipt” of a payment or benefit) are to be interpreted in accordance with section 61E of that Act.</p>	<p>This paragraph defines certain terms by reference to the provisions of Chapter 9 ITEPA. Specifically:</p> <p>associate, deemed employment payment, employer’s national insurance contributions and MSC, all have the meanings set out in Chapter 9 ITEPA;</p> <p>Payment or benefit and receipt of payment or benefit, take the meaning set out in section 61E of Chapter 9, ITEPA .</p>

D

PARTIAL REGULATORY IMPACT ASSESSMENT

PURPOSE AND INTENDED EFFECT

Policy objective

D.1 The Government is taking action to prevent Managed Service Company¹ (MSC) schemes being used to disguise employment income, so avoiding paying the appropriate level of income tax and national insurance contributions (NICs).

D.2 Workers in MSCs are almost invariably not in business on their own account and the underlying nature of the contracts in which they are involved is one of employment. There are existing rules (the Intermediaries legislation²) to ensure that the correct tax and NICs treatment is applied, but these rules are in the vast majority of cases not being followed by MSCs. Enforcing these rules is resource-intensive because of the nature of the legislative test and the growing number of workers in MSC schemes. As a result the strong growth in MSC schemes constitutes a significant and increasing risk to the Exchequer and those using MSC schemes are gaining an unfair competitive advantage over compliant workers and businesses. In addition some workers are entering MSC schemes without understanding that they may be giving up employment rights. Ensuring employed levels of tax and NICs are paid by those in MSC schemes will deter use of these schemes, protect the Exchequer and restore a level playing field for compliant businesses.

Background

D.3 MSCs are intermediary companies that are used to provide the services of a worker to an end client, usually via an agency.

D.4 The tax treatment of services provided through an intermediary is governed by the Intermediaries legislation (also known as “IR35”). This looks at the nature of the relationship between the worker in the intermediary and the end client and constructs a “notional contract” between them. Where the contract has the characteristics of self-employment – *a contract for services* - the normal tax rules apply. Where the contract is one of employment – *a contract of service* - the legislation requires the intermediary company broadly to pay employed levels of tax and NICs on payments to the worker.

Rationale for Government intervention

D.5 Workers in MSCs are almost invariably not in business on their own account and the underlying nature of the contracts in which they are involved is one of employment. HM Revenue and Customs (HMRC) has emphasised that service companies, and particularly MSCs, need to consider and, where appropriate, apply the Intermediaries legislation.³ In 2003 HMRC set up two specialist compliance teams to focus on these schemes.

¹ See the glossary and Chapter 2 of the consultation document *Tackling Managed Service Companies* for definitions of the terms used in this partial RIA.

² Chapter 8, Part 2, Income Tax (Earnings and Pensions) Act, 2003; Section 4A, Social Security Contributions and Benefits Act 1992; Social Security (Intermediaries) Regulations 2000, SI 2000/727.

³ See HMRC Tax Bulletins 60 (August 2002) and 74 (December 2004).

D.6 However despite focused compliance activity by HMRC, the Intermediaries legislation is in the vast majority of cases not being applied by those running MSC schemes. Enforcing these rules is difficult because of the number of workers involved in MSC schemes, and the resource-intensive nature of the legislative test.

D.7 Even in the event of an investigation successfully demonstrating a Pay As You Earn (PAYE) and NICs liability, MSC scheme providers have escaped PAYE and NICs debts by winding up the company or simply ceasing to trade. As a result, because MSCs generally have no assets, the debt cannot be enforced against the company and the tax and NICs due cannot be collected.

D.8 MSC schemes often also take advantage of the tax relief available to employees for the reimbursement of travel expenses and overnight subsistence. Employees are able to claim travel and subsistence costs for home-to-work travel free of tax and NICs when they are at temporary workplaces. MSC schemes make use of these rules on the basis that each of the worker's assignments represents a temporary workplace since the worker is treated as having one overarching employment with the MSC. This approach allows workers in MSCs – whose underlying contract is almost invariably one of employment - a more favourable tax and NICs position than employed workers.

D.9 There is a degree of uncertainty attached to estimates in this area but HMRC analysis suggests that the number of workers in MSCs has grown from around 65,000 in 2002-03 to at least 240,000 in 2005-06.

D.10 The Intermediaries legislation was never intended to deal with widespread non-compliance on the scale seen with MSCs. In view of this and the strong growth in the number of MSC schemes, the Government has decided that specific action against MSC schemes is required.

Consultation

D.11 The consultation document *Tackling Managed Service Companies* sets out the Government's policy for tackling MSCs (Option 3). An effective definition of MSCs is key to the approach and the Government is therefore consulting on the draft legislation to ensure that MSCs are accurately targeted. The Government also invites comments on the legislation related to the tax charge that will be applied. The relevant draft clauses are included and explained in the consultation document. The Government will also address the problem of MSCs escaping payment of tax and NICs that are due by allowing the recovery of these debts from appropriate third parties. The Government aims to publish this draft legislation for discussion by the end of January 2007 and welcomes comments on this issue in the intervening period.

OPTIONS

Option 1: Do nothing

D.12 Taking no action would mean using the Intermediaries legislation to ensure that the correct tax and NICs treatment is applied to MSCs where the underlying nature of an engagement is that of employment. HMRC would continue to enforce this legislation as at present.

Option 2: Invest more resources in enforcing the Intermediaries legislation

D.13 As described above, the tax treatment of services provided through an intermediary company is governed by the Intermediaries legislation, but these rules are in the vast majority of cases not being applied by those running MSCs schemes. One response to this would be to invest more resources in enforcing this existing legislation. This could involve more compliance activity, wider publicity and use of existing HMRC powers to pursue the directors or officers for unpaid NICs.

Option 3: Define MSCs and tax those in them as employees

D.14 This option would define MSCs and then apply a specific tax and NICs treatment to them so that those in the schemes paid the same level of tax and NICs as other employees. It would also remove access to more generous tax relief for travel and subsistence costs incurred by MSC workers who claim that each engagement is a separate employment.

D.15 In response to the debt collection problems experienced with MSCs this option would include measures to allow the recovery of MSCs' PAYE and NICs debts from an appropriate third party where the MSC does not pay.

D.16 The effectiveness of this measure would be better monitored, and compliance activity would be better targeted, through the use of improved information:

- two existing questions on the annual employer's end of year return (P35) would be replaced with more specific questions for forms relating to 2007-08 and onwards; and
- two questions would be added to the Income Tax Self Assessment return for 2007-08 and onwards.

COSTS AND BENEFITS

Option 1: do nothing

Benefits D.17 The only benefit of doing nothing would be that it would provide an opportunity to continue to gather information to inform subsequent action. But HMRC's extensive compliance work in this area means that there is already a strong evidence base to inform policy.

Costs D.18 There is a degree of uncertainty attached to estimates in this area but HMRC analysis suggests that the number of workers in MSCs has grown from around 65,000 in 2002-03 to at least 240,000 in 2005-06. The tax and NICs losses from MSC schemes are therefore substantial and increasing. This is an unacceptable risk to the Exchequer.

D.19 The current significant losses of tax and NICs would increase, leaving compliant workers and businesses to bear a disproportionate share of tax. More workers would enter MSC schemes often without understanding that they may be giving up employment rights.

D.20 There are also economic costs in that the unfair competitive pressures caused by MSCs would persist and grow. At the moment MSCs prevent a level playing field for

businesses in the provision of both professional and personal services, in the supply of agency workers and in the supply of labour in some sectors (see the competition assessment at paragraphs D38-41 for more information).

Option 2: Invest more resources in enforcing the Intermediaries legislation

Benefits D.21 It is preferable to make existing legislation work if possible as this allows a quicker response than introducing new legislative measures and does not place new compliance costs on business.

D.22 Increasing the compliance effort directed at MSCs would increase the number of successful investigations under the Intermediaries legislation. But given strong recent growth in MSC schemes, the labour-intensive nature of HMRC's compliance work in this area and the fact that even in the event of a successful investigation there are problems collecting the debt (see paragraph D7), this option is unlikely to deter non-compliance with the Intermediaries legislation. Use of HMRC powers to pursue directors or officers for the unpaid NICs would still require a debt to be established under the Intermediaries legislation (and in any case would not enable recovery of tax).

Costs D.23 To achieve an appreciable impact this option would require substantially increased HMRC compliance resources devoted to this area of work. This would mean either additional resources or reprioritising activity to the detriment of other compliance work. Given the enforcement problems associated with applying the Intermediaries legislation to MSCs this would be a substantial opportunity cost since compliance resources could be used in more cost-effective ways.

Option 3: Define MSCs and tax those in them as employees

Benefits D.24 This measure would stem the loss of tax and NICs from disguised employment through MSCs. There is a degree of uncertainty attached to estimates of revenue losses from the failure of MSCs to comply with the Intermediaries legislation. However, the number of workers operating through MSCs suggests that substantial amounts are being lost to the Exchequer and that based on current trends, this will continue to grow. Based on cautious assumptions, the estimated yield to the Exchequer of these measures is £350 million in 2007-08, £450 million in 2008-09 and £250 million in 2009-10 (this is higher in the earlier years as the reduction in corporation tax receipts from MSCs does not occur until after the increase in PAYE and NICs receipts). The package will also deter future use of MSC schemes, protecting the Exchequer against future losses.

D.25 There would be additional gains from reducing the competitive disadvantage faced by those companies who are compliant with the Intermediaries legislation, workers already in PAYE who work in sectors where others are not compliant but who undertake the same activity for the same end clients, and compliant providers of services to contractors – these are laid out in the Competition Assessment (paragraphs D38-41).

Costs D.26 The financial costs of increased tax and NICs would be borne by those who are currently unfairly benefiting from paying incorrect levels of tax and NICs through MSC schemes. As discussed in the consultation document *Tackling Managed Service Companies*, the proceeds of the contrived tax arrangement can be shared in various ways between scheme provider, worker, agency and end client.

D.27 All MSC scheme providers would face the one-off compliance cost of assessing the impact of the legislation. However this would be approximately equivalent to checking that they were compliant with the Intermediaries legislation and would consist of examining the legislation or guidance that HMRC issued, and comparing it with the arrangements for each company within the scheme.

D.28 If a scheme provider were to continue to offer MSCs most would not face an additional burden of having to operate PAYE as many scheme providers already operate PAYE on behalf of the MSC on a portion of the workers' remuneration. This is because many MSC workers are technically employees of the MSC and so under legislation have to be paid a salary at least equivalent to the National Minimum Wage.

D.29 While workers in MSCs are almost invariably not in business on their own account, there may be a limited number of workers who are in business for themselves and using MSCs as a corporate vehicle. These workers would face the one-off compliance cost of moving into Personal Service Companies (PSCs) to avoid paying employed levels of tax and NICs. However they should not generally face increased costs as the ongoing administrative costs of employing an accountant are lower than the typical fees paid to a scheme provider (see also the Small Firms Impact test, paragraphs D36-37).

D.30 Although the Government's aim is to target clearly the scope of the measure on MSC schemes some PSCs might face the modest one-off compliance cost of assessing the new measures in order to conclude that they do not apply.

D.31 The measures would be supported by two new information requirements. The increased compliance costs of replacing two questions on the P35 with two new ones would be minimal as the information they request would be similar to that requested by the current two questions. It is estimated that the two new questions on the ITSA return would in the first instance place modest compliance costs on individuals. It is anticipated that for more than 95 per cent of those filing the return there would only be a negligible increase in time taken. The information required to answer one of the two questions would be readily available from that already collated to complete other sections of the Return.

SECTORS AND GROUPS AFFECTED

D.32 There are estimated to be about 150 MSC scheme providers, of which ten provide the vast majority of workers since they have tens of thousands of workers in their schemes. There is then a handful of scheme providers which have between 10,000 and 15,000 workers in MSCs. Some of these offer umbrella companies⁴ as well. About half a dozen providers have 3,000-5,000 workers in their MSCs; these MSCs are generally composites rather than MPSCs. Finally there is a long tail of providers who have fewer than 3,000 workers in their schemes.

D.33 Estimates suggest that around 90 per cent of workers in MSC schemes find work through an employment agency, the rest contracting directly with end clients. As a result of these measures agencies may find increased numbers of workers wishing to work as agency workers and hence agencies will have to operate PAYE to deduct tax and

⁴ In an Umbrella Company (also known as a management company) the worker routes a series of agency contracts through the company. The worker is treated as having an ongoing employment with the company and is paid a salary to which PAYE and NICs applies.

NICs in respect of them. Since this is a standard function of an agency this is a limited additional burden.

D.34 While information on the range of sectors in which MSCs operate is limited, 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. There is no restriction on the sectors in which MSCs can operate and some MSC scheme providers appear to be specialising in sectors such as contract cleaning, transport and the oil and nuclear industries.

D.35 No adverse equality impacts have been identified under Option 3. The measures in Option 3 are compatible with the European Convention on Human Rights. Any equality impacts will again be assessed in the full Regulatory Impact Assessment when the final legislation is published at Budget 2007.

SMALL FIRMS IMPACT TEST

D.36 The legislation is not intended to capture those in Personal Service Companies (PSCs), where the Intermediaries legislation will remain in place. The Government is consulting to ensure that the measures are well-targeted and clear as to who is affected and who is not.

D.37 As noted above, there may be a limited number of MSC workers who are in business on their own account, and the underlying contract is one of self-employment. In order to continue to trade in the corporate form but not pay employed levels of tax and NICs - when their underlying contract is one of self-employment - these workers would have to move into PSCs. They should not face increased financial costs given that the fees charged by MSC scheme providers are typically more than the annual fees charged by an accountant to a PSC for full financial and company administration, though they would have to take on the financial and management control of their own company. Scheme providers typically charge between £15 and £35 a week - around £800 - £1,800 over a year - whereas an accountant would typically charge £400-£700 to a small business for preparation of accounts, corporation tax computations and filing, and routine meetings and enquiries.

COMPETITION ASSESSMENT

D.38 The impact of the proposed measure was assessed by applying the competition filter to the affected sectors. It was found that an in-depth competition assessment is not warranted because the estimated impacts on competition are not significant. But taking action against MSCs ought to enhance the competition process for the following reasons.

D.39 The Government has received representations from those providers of professional services who are compliant with the Intermediaries legislation and who are losing their clients to non-compliant MSC scheme providers. Similarly some agencies that properly advise on and apply the Intermediaries and Agency legislation risk losing their clients to agencies who automatically put workers into non-compliant MSCs.

D.40 Those individuals who supply their services through an intermediary company to a third party and who are compliant with the Intermediaries legislation may be undercut by those who supply their services through a non-compliant MSC.

D.41 MSC workers who are avoiding paying employed levels of tax and NICs are working alongside employees who are paying the appropriate levels. This can unfairly distort the market rate for the job.

ENFORCEMENT, SANCTIONS AND MONITORING

D.42 The new measures, which will be considerably less resource-intensive for HMRC to apply to MSCs than the Intermediaries legislation, will be enforced with existing HMRC compliance resources. The normal penalties for non-payment of tax and NICs under PAYE will apply (subject to the proposed transfer of debt provision to specified third parties). Paragraph D16 described new information measures that will provide information to monitor compliance.

CONCLUSION

D.43 The Government is taking action to prevent MSC schemes being used to disguise employment income, so avoiding paying the appropriate level of income tax and NICs. Action must be taken to address the significant losses to the Exchequer, to restore a level playing field for compliant businesses, and to reduce the attractiveness of the schemes to workers who can enter schemes without understanding what they are giving up in terms of employment rights.

D.44 The Intermediaries legislation applies to MSCs but was never intended to deal with widespread non-compliance on the scale seen with MSCs. The nature of the problem means it cannot be addressed simply through additional compliance resources. The Government has therefore decided that specific action on MSC schemes is required and is consulting to ensure that they are effectively targeted.

D.45 Any comments on this partial regulatory impact assessment should be made by **2 March 2007** to:

John Wrathmell

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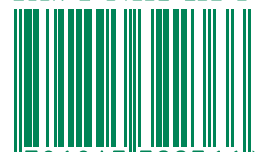
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