

Tackling Managed Service Companies: summary of consultation responses

March 2007



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INTRODUCTION

1.1 The Government published the consultation document *Tackling Managed Service Companies* in December 2006¹. This document summarises what the Government has learned through the consultation and explains how the approach is being modified in response.

1.2 The Government has confirmed that legislation will be introduced to achieve the objectives set out in the consultation document. But it is responding to key concerns raised during the consultation and will:

- strengthen the definition of a Managed Service Company (MSC) to give greater clarity and certainty;
- amend the debt transfer legislation to make clearer that those simply in receipt of the services of a worker operating through an MSC are not within its scope; and
- delay the application of the debt transfer legislation to third parties (other than MSC scheme providers, and directors, office holders or associates of the MSC) to allow more time to make the necessary changes to their operations.

¹ See http://www.hm-treasury.gov.uk/consultations_and_legislation/consult_fullindex.cfm.

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THE CONSULTATION

2.1 The consultation document *Tackling Managed Service Companies* described the operation of Managed Service Companies (MSCs), the significant and increasing risk they pose to the Exchequer, and the loss of a level playing field for workers and businesses who pay the correct levels of tax and national insurance.

2.2 It also set out how enforcing the current rules (the Intermediaries legislation²) that ensure that the correct tax and national insurance treatment is applied is difficult in practice because of the large and growing number of workers involved in MSCs and the resource-intensive nature of the legislative test.

2.3 A further problem with the existing rules was identified. Where HM Revenue & Customs (HMRC) establishes liability under the current legislation, MSCs can escape payment because they have no assets and can generally be wound up or simply cease to trade, with workers moving to new MSCs.

2.4 The Government's intention is to define MSCs and remove them from the scope of the Intermediaries legislation. Those working in MSCs will pay tax and national insurance contributions (NICs) at the same level as other employees. To address the problem of MSCs escaping payment of tax and NICs, measures to allow the recovery of tax and national insurance debts from third parties were also announced.

Consultation process

2.5 The consultation document included draft legislation which defined MSCs and the consequent tax charging provisions and asked for comments by 2 March 2007.

2.6 The document outlined the approach to be taken on the transfer of Pay as You Earn (PAYE) and NICs debts to third parties. Draft legislation for transferring PAYE debts was subsequently published on 8 February 2007 in the paper *Managed Service Companies: Transfer of Pay as You Earn and national insurance contributions debts*.³ Comments on the primary legislation were requested by 2 March 2007 and on the Regulations by 30 April 2007. Responses on those Regulations will be summarised at that point.

2.7 The published legislation relates only to PAYE debts and the Government intends to introduce legislation to ensure the same approach for national insurance debts.

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 http://www.hm-treasury.gov.uk/consultations_and_legislation/consult_fullindex.cfm

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RESPONSES TO THE CONSULTATION

3.1 A total of 81 individuals and groups responded in writing to the consultation. A series of 21 meetings was also held with Managed Service Company (MSC) scheme providers, providers of services to contractors, employment agencies,⁴ accountancy bodies, tax experts, trade unions, representative bodies for business, employment agencies and contractors, and other interested parties.

3.2 The responses are summarised under five broad headings:

- analysis of problem and the Government's approach;
- definition of an MSC;
- transfer of tax and national insurance debts;
- timing of the implementation of the measures; and
- other issues raised.

Both written responses and messages from meetings are included.

ANALYSIS OF PROBLEM AND THE GOVERNMENT'S APPROACH

3.3 Almost all of those who commented (45 out of 49 written responses which expressed a view) agreed that the existing rules are not being applied by all MSCs and that action is therefore necessary. However, there was a range of views about the extent of non-compliance. Some MSC scheme providers and accountants said that they believed they were complying with the Intermediaries legislation in these schemes by considering fully the circumstances under which workers' services are provided. Other respondents thought that MSC scheme providers put systems in place to give the illusion of compliance. Almost all respondents believed that there are MSC scheme providers who make no attempt to follow existing rules.

3.4 A significant number of businesses operating the current rules said that they are being undercut by those not complying with the rules. This includes those providing services to contractors who say that where they advise that a service company is not appropriate many workers go to another provider who is not so rigorous in considering whether the Intermediaries legislation should apply. Employment agencies who operate the agency legislation⁵ say they are losing business to agencies who automatically put workers into MSCs, often through a link with a preferred MSC scheme provider.

3.5 Respondents confirmed that workers in some sectors have little or no choice other than to join an MSC scheme. Sometimes this was said to be an attempt to remove the worker's entitlement to statutory employment rights from the end client or agency, with workers having to enter MSCs in order to get work; on other occasions they said

⁴ 'Employment agency' is used in this document to refer to an agency which supplies workers to end clients and remains part of the ongoing relationship between the worker and end client (technically known as an *employment business*) See glossary for more detail.

⁵ 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. The services rendered by the worker are, for income tax and 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.

that workers have a superficial choice, but are offered financial inducements to enter MSC structures.

3.6 No respondents disagreed with the Government's intention to avoid bringing Personal Service Companies (PSCs) within the MSC rules.

3.7 Many respondents agreed with the importance of a targeted information campaign to assist the parties involved in MSC schemes in understanding the changes, particularly because the main source of information for workers in MSCs is their scheme provider.

3.8 There was a range of views on the statement in the consultation document that the 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. Some thought all workers in MSCs were disguising an employment relationship; others that the proportion of workers who are in business is significantly higher than described in the consultation document. These variations were in part due to differences in opinion about what constituted "being in business", the particular sector in which the MSC scheme operates, and the view that some workers could be self-employed, but not in business on their own account. A few MSC scheme providers said that they had improved levels of compliance with the Intermediaries legislation in recent years.

3.9 Those respondents who thought the proportion in business was higher than described also suggested that MSC schemes have a role in promoting efficiency by providing a way for individuals in business to outsource their administration and by offering a convenient structure for grouping large numbers of workers. It was suggested that MSC schemes help individuals in business set aside taxes and national insurance due for payment and therefore make collection easier for HM Revenue & Customs (HMRC).

DEFINITION OF AN MSC

3.10 The consultation document *Tackling Managed Service Companies* said that the Government would welcome views on:

- whether there are other defining characteristics of MSCs that should be reflected in the legislation;
- the clarity of the legislation;
- whether the legislation could be strengthened further and, if so, how; and
- the draft legislation on the tax charging provisions.

3.11 In general, respondents agreed that the defining characteristics of MSCs had been correctly identified in the consultation document.

3.12 Most of the respondents who discussed the clarity and strength of the draft legislation focused on the feature in the draft definition that the MSC scheme provider "exercises control over the finances or general management of the companies (and the individuals do not exercise such control)". This was seen to be the key aspect which separated MSCs from PSCs making use of business support services.

3.13 Most respondents did not believe that the term "exercising control" gave sufficient clarity for workers to determine whether they were within the definition. A significant number asked for the individual features which determine "control" to be

made explicit in the legislation, although some recognised that this would weaken the legislation as it could allow MSC scheme providers easily to adjust the structure of their schemes to avoid the definition. Some respondents focused in particular on what constitutes “financial control”, discussing whether a worker having the sole authority to make payments from a bank account, or being able to move that bank account if they left a scheme provider, would give them control.

3.14 Many respondents also believed that the draft legislation was not sufficiently robust to achieve the Government’s aims. There was an acknowledgement that those in business on their own account could move to PSCs but there was concern that MSC scheme providers would move workers to single person companies in an attempt to avoid the definition, and that this process was already beginning. Respondents said that MSC scheme providers would attempt to give some control to the workers in these structure, while continuing their operations very much as before.

3.15 Other suggestions for making the definition more robust were that the tax minimisation motive of MSC schemes should be explicitly included in the definition, or that the definition should focus on the MSC scheme provider itself.

3.16 Some concerns were raised about business structures unrelated to MSCs which respondents thought might be caught by the draft definition. These included employment agencies, law firms, consultancy businesses and multi-national employment structures.

TRANSFER OF TAX AND NATIONAL INSURANCE DEBTS

3.17 Draft legislation to achieve the tax aspect of this was published on 8 February 2007 alongside questions as to whether:

- the legislation brings within its scope all of those potentially involved in the provision of a worker’s services by the MSC and ensures that those simply receiving the services of MSC workers are not included; and
- there are alternative ways to encapsulate in the legislation that a person such as an agency or end client would not be within its scope if they did not know or could not reasonably have been expected to know that they were dealing with an MSC.

3.18 Almost all respondents agreed that the transfer of tax and national insurance debts was necessary to make the package of measures effective. However, views varied as to which parties it was appropriate to transfer debt and there was some concern about the extent of the powers the legislation gives to HMRC to determine the circumstances in which the debts were transferred and their amount.

3.19 A small number of respondents did not believe that the debt should be transferred to the worker in the MSC because if a worker had already had tax and national insurance deducted by the MSC then they could have to pay twice, and because some workers have little choice about entering MSC structures.

3.20 Views on the transfer of the debt to third parties, other than the worker or MSC scheme provider, varied widely. Some thought that the end user and agency should always be liable for the debt, even if they were not aware that an MSC structure was being used, on the grounds that this would remove the demand for MSC structures. Others thought that agencies, or end users, or both, should be excluded from the debt transfer provisions.

3.21 The majority view was that third parties should be included within the debt transfer provisions, but only when they were directly involved in, and aware of, the use of an MSC scheme. There was concern that although it was the Government’s objective not to include anyone who didn’t know, or could reasonably be expected to know, that they are dealing with an MSC, the draft legislation did not meet this aim.

3.22 Several suggestions were made regarding the circumstances in which debts should be transferred, including when a third party had financially benefited or was financially involved in an MSC scheme, or was negligent, or had acted fraudulently.

3.23 Employment agencies and their representatives were particularly concerned that they could find themselves liable for debts before they were able to check whether the workers they were engaging were operating through MSCs. They therefore requested a delay in the implementation of the debt transfer provisions for third parties. Without such a delay, they said they would be unable to advise workers about the new measures, with the danger of workers moving to non-compliant arrangements.

TIMING OF THE IMPLEMENTATION OF THE MEASURES

3.24 There was widespread support for action to address the problem of MSCs and some respondents stressed the need to implement the whole package of measures without delay so that MSC scheme providers would have less opportunity to try to circumvent the new rules.

3.25 However, while respondents recognised the need to address the problem, concerns were raised that the timetable for implementation of the measures was very tight. As stated in paragraph 3.23, employment agencies were particularly concerned about the risk of liability for MSC debts and requested a delay in the implementation of the debt transfer provisions for third parties.

OTHER ISSUES RAISED

Technical Issues **3.26** A number of helpful technical points were made about the wording of the draft legislation. These included whether the use of “companies” in the plural would cover an individual company, concern that the legislation did not meet the Government’s aim of preventing MSCs making use of travel and subsistence expenses, the position of loans used as payments to workers, and clarification of who constitutes a “client”.

Other methods for tackling MSCs **3.27** Although, as discussed above, almost every respondent who commented agreed that the existing rules are not being applied by all MSCs and that action is therefore necessary, not all of those respondents agreed that the measures set out by the Government were the most effective approach for dealing with the problem.

3.28 In particular, a number of MSC scheme providers, employment agencies and accountants suggested an accreditation scheme for MSC schemes which correctly apply the Intermediaries legislation. Suggestions for how such a scheme would operate varied – options put forward ranged from a self-regulating list of approved MSC scheme providers to a pre-transaction clearance system enforced by HMRC.

3.29 Preventing workers on the ‘Working Holidaymaker Scheme’ from operating through a company structure was suggested because a condition of obtaining a visa under this scheme is that the individual does not intend to set themselves up in, or run, a business.

3.30 Suggestions were made for improving the operation of the Intermediaries legislation, while accepting that this would have implications for PSCs as well as MSCs. Bringing MSC schemes within the agency legislation and obliging them to pay workers through PAYE was also put forward.

Umbrella Companies **3.31** The impact of the new measures on Umbrella Companies⁶ was raised in many responses and there was confusion about whether they were within the scope of the legislation. Some respondents thought that Umbrella Companies were caught by the definition, but should be excluded; others that Umbrella Companies were not caught by the definition, but should be.

3.32 Those concerned that Umbrella Companies were caught thought that this would make the UK labour force less flexible as contractors would find it more difficult to move between assignments. Those who thought that Umbrella Companies should be caught said that the expenses rules are being abused by such structures and that excluding them from the measures would give them an unfair tax and national insurance advantage over MSCs.

3.33 Some respondents who accepted the Government's position that Umbrella Companies are not covered by the draft definition still thought that this should be made explicit in the legislation.

Economic Impacts **3.34** Several respondents disagreed with some of the economic and regulatory impacts included in the Partial Regulatory Impact Assessment published alongside the consultation document. Opinions varied on the impact on the UK's flexible labour market, the possibility of wage inflation, and the migration of workers. These issues will be discussed in the Full Regulatory Impact Assessment which will be published alongside the Finance Bill.

⁶ In an Umbrella Company (also known as a management company) the worker is an employee of the 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 national insurance contributions are paid.

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THE GOVERNMENT'S APPROACH INFORMED BY CONSULTATION

4.1 The consultation has shown that there is strong and widespread support for the need to take action to address the growing problem of Managed Service Companies (MSCs) and their non-compliance with existing rules. The Government will therefore be introducing legislation to achieve the objectives set out in the consultation document. However, the consultation has identified some key concerns and, as described below, the Government is amending its approach in response to those concerns.

DEFINITION OF MSCs

4.2 It is clear from responses to the consultation that the focus of the definition on the question of control of the company, with a lack of a precise definition of control, has led to concern that it will be relatively easy for MSC scheme providers to set up new arrangements that give the impression that the worker controls the company. While these arrangements may not in fact escape the definition, the lack of certainty is a cause for concern for those dealing with workers operating through companies.

4.3 The draft definition published in the consultation document focused on the MSC itself and the MSC scheme. It defined a company as an MSC if the services of a worker are provided by way of an MSC scheme. The key criteria defining an MSC scheme is that a person (termed a scheme provider) exercises control over the finances or general management of the company, and the worker does not.

4.4 **The Government has decided to amend the proposed definition in order to focus more on the role and business of the MSC scheme provider and less on the MSC itself and the question of control.**

4.5 This approach is set out in the Budget Note published by HM Revenue & Customs (HMRC). The definition of an MSC builds on the current draft but adds additional criteria, including the provision of such companies by an MSC scheme provider. The new legislation will define an MSC scheme provider by reference to their business, which is facilitating the provision of the services of individuals through companies.

4.6 The definition both describes the nature of an MSC scheme provider's business and sets out what that provision means in practice. The legislation reflects a number of characteristics the Government believes are unique to MSC scheme providers. If a person who is in the business of providing companies to individuals displays those characteristics he is determined to be an MSC scheme provider.

4.7 Where a provider is an MSC scheme provider within the definition, the legislation will apply to all service companies being made available through that business. The legislation will also ensure that MSC scheme providers cannot circumvent the legislation by splitting the constituent elements of their business between various parties in an attempt to claim that no one party is caught by the definition.

4.8 By focusing on the business of an MSC scheme provider in this way, the definition will not catch those who provide services to a service company in the course of a different type of business, such as the provision of accountancy services. Nor for the same reason, will it include employment agencies because their business is not that of being an MSC scheme provider.

4.9 This definition will be more effective than the current draft because it focuses on the role of the MSC scheme provider as the distinguishing characteristic of the MSC and it will enable HMRC to focus on the small number of MSC scheme providers rather than looking at each service company separately.

TIMING OF THE IMPLEMENTATION OF MEASURES

4.10 This legislation will take effect from 6 April 2007 for tax and later for national insurance contributions (NICs) (Regulations will be laid once the Finance Bill has Royal Assent and will apply from the date specified in the Regulations, which is expected to be the 6th of the following month). A number of respondents highlighted the short time available to make the necessary logistical changes. The Government recognises the short timescale but has weighed this against the serious and growing risk to the Exchequer and the support for action and has decided to proceed to the timetable announced at the 2006 Pre-Budget Report.

4.11 However, there are some groups, such as employment agencies and end clients, for whom the timescale will present considerable logistical problems. These parties, unlike the scheme providers or MSC directors, are generally not directly involved in the operation of the MSC and, because of this, there is concern that they will find it more difficult to ensure they are not unwittingly caught by the legislation.

4.12 Representatives of employment agencies and business have confirmed that they are supportive of the Government's action and employment agencies in particular are in a position to reach many of those potentially affected by the legislation. They want to ensure that their activities can be organised in such a way as to help ensure the effectiveness of the measures, including being able to provide guidance to workers, and are concerned that the current timescale will make it difficult to achieve this while ensuring they are not within the scope of the debt transfer provisions.

4.13 Recognising the logistical difficulties for these parties and to allow arrangements to be made that help ensure the effectiveness of the legislation, **the Government will delay the application of the debt transfer provisions to those within the draft section 688A(2)(c) so that PAYE and NICs debts arising before 6 January 2008 cannot be transferred to these parties.**

4.14 The debt transfer provisions as they relate to **MSC scheme providers, and directors and office holders of the MSC will apply to debts arising from the date the legislation has Royal Assent in 2007.**

SCOPE OF THE TRANSFER OF DEBTS LEGISLATION

4.15 As described above, the provision to allow the transfer of PAYE and national insurance debts has been seen by the majority of respondents as necessary to make the package of measures effective.

4.16 The approach taken in the legislation is that HMRC must first seek to recover the debt from the MSC scheme provider and the director or office holder of the MSC. If the debt is not paid, HMRC will then consider whether the debt should be transferred to other parties which have "encouraged, facilitated or otherwise been involved in" the provision by the MSC of the worker. The legislation contains a number of other safeguards, including specifically excluding accountants or lawyers giving professional advice from the scope of the transfer and giving a number of grounds for appeal.

Nevertheless, concerns were expressed that the legislation as it relates to these other parties is too widely drawn and that some could unwittingly be within its scope.

4.17 It was never the intention that those simply in receipt of the services of a worker operating through an MSC should be brought within the scope of the transfer provisions. To make this clearer, the term “otherwise involved” will be changed to “otherwise actively involved”.

OTHER TECHNICAL ISSUES

4.18 Paragraph 3.26 noted some technical improvements suggested for the legislation. These have been reviewed and, where appropriate, the necessary changes will be made to the legislation for the Finance Bill and to the Regulations to be laid once the Finance Bill has Royal Assent.

CONCLUSIONS AND NEXT STEPS

4.19 The consultation has endorsed the Government’s intention to address the problem of MSCs and has added to the evidence of the way these schemes operate and the impact they have. However, the consultation has raised some key concerns and the Government has responded to address them in order to make the legislation more effective in achieving its objectives.

4.20 The approach of the new legislation is described in the Budget Note published by HMRC (www.hmrc.gov.uk).

4.21 The Finance Bill will contain the revised primary legislation. A Full Regulatory Impact Assessment will be published alongside the Finance Bill.

4.22 Comments on the draft Regulations, published on 8 February 2007 in the paper *Managed Service Companies: Transfer of Pay as You Earn and national insurance contributions debts*⁷, are invited until 30 April 2007 and response will be summarised at that point.

⁷ See http://www.hm-treasury.gov.uk/consultations_and_legislation/consult_fullindex.cfm

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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).

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.

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.

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