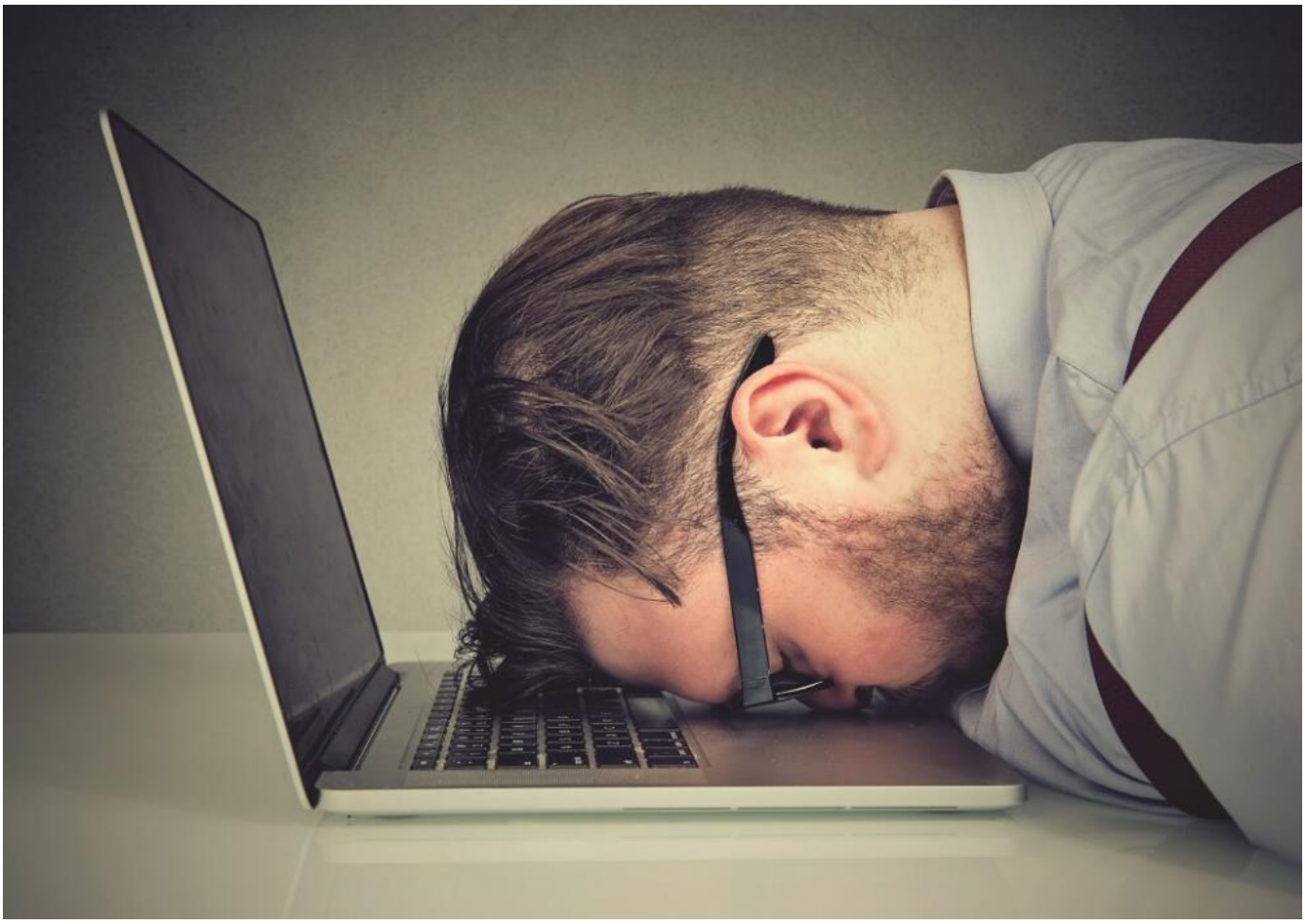
The impact on individuals

Employment Tax



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Matt Parfitt and *Edmund Paul* explore the key considerations around managed service companies and the case of *Christianuyi*

Key Points

What is the issue?

With the imminent introduction of the IR35 changes, contractors and their clients may be looking at how engagement structures could be changed. This could particularly impact individuals providing their services through MSCs.

What can I take away?

Individuals who are in business on their own account could be caught by the MSC legislation and have income from relevant engagements treated as employment income.

What does it mean to me?

Some contractors may be seeking to change the way in which they provide services to end clients with the intention of dissolving their PSC and engaging via a different vehicle.

With the imminent introduction of the IR35 changes, contractors and their clients may be looking at how engagement structures could be changed going forwards. One area of tax legislation that could impact alternative arrangements is the managed service companies (MSC) legislation.

This legislation is particularly pertinent, having been tested for the first time in the recent tax case of *Christianuyi Ltd and others v HMRC*, which has made its way through the First-tier Tribunal, the Upper Tribunal and the Court of Appeal.

All legislative references are to the Income Tax (Earnings and Pensions) Act (ITEPA) 2003.

Background

Prior to the introduction of the MSC legislation, some individuals utilised MSCs to provide their services to end clients in a manner which avoids ITEPA 2003 Part 2 Chapter 8 (the ‘IR35’ legislation). The use of MSCs would be facilitated by a scheme provider who supplied the structure to individuals and administered the scheme. As the MSC was typically a composite company scheme, there may be several worker-shareholders under the arrangement. The scheme provider would be responsible for the scheme’s administration (i.e. putting contracts in place for the work and invoicing the end client) and would charge an administration fee for these services.

In the 2006 Budget, the government noted the mass-marketing of MSCs to avoid income tax and NICs and consulted on proposals to counter this perceived avoidance.

The MSC legislation

The government introduced legislation to combat MSCs as part of Finance Bill 2007 and this is now consolidated within ITEPA 2003 ss 61A to 61J. The effect is to treat payments received by individuals providing their services through the MSC as employment income where certain conditions are met. Broadly, these are where both an MSC and an 'MSC provider' are involved with the arrangement, and the arrangement has an associated tax and/or NIC advantage.

There is an important distinction to be made between the IR35 legislation and the MSC legislation. IR35 legislation does not apply to individuals who are self-employed for tax purposes (by way of the myriad of employment status case law), whereas MSC legislation does not hinge on status as evidenced by *Christianuyi*. Therefore, individuals who are in business on their own account could be caught by the MSC legislation and have relevant engagement income treated as employment income.

What is an MSC?

Section 61B defines a company as an MSC if the following conditions apply:

1. Its business consists wholly or mainly of providing (directly or indirectly) the services of an individual to other persons.
2. Payments are made (directly or indirectly) to the individual (or their associates) of an amount equal to the greater part or all of the consideration for the provision of the services.
3. The way in which those payments are made would result in the individual (or associates) receiving payments of an amount (net of tax and NICS) exceeding that which they would receive if every payment in respect of the service were the employment income of the individual.
4. A person who carries on a business of promoting or facilitating the use of companies to provide the services of individuals (an MSC provider) is involved in the company.

Christianuyi provided some clarity on point 4 above. The argument was made that 'facilitating' and 'promoting' are very broad terms, which could inadvertently capture many different services provided by a business; and therefore the definition should hinge upon whether a business promotes the services of the individual. It was contended that the alleged MSC provider merely advised clients on the use of a company as a vehicle to provide their services, and so would not meet this definition.

However, the courts rejected this argument on the basis that the meaning of the legislation is clear. The judges stated that the legislation will apply where the MSC provider has promoted the use of companies as a structure for the provision of clients' services.

Within s 61B(3), a person will not be deemed to be an MSC provider where they provide legal or accountancy services in a professional capacity. HMRC guidance (ESM 3515) states that this exemption applies only to persons professionally qualified (or training for a professional qualification) regulated by a regulatory body.

When is an MSC provider 'involved with the company'?

Section 61B(2) states that an MSC provider would be 'involved with the company' where the business:

1. benefits financially on an ongoing basis from the provision of the services of the individual;
2. influences or controls the provision of those services;
3. influences or controls the way in which payments to the individual (or associates of the individual) are made;
4. influences or controls the company's finances or any of its activities; or
5. gives or promotes an undertaking to make good any tax loss.

The case considered the above in significant detail.

Condition 1: ongoing financial benefits

The court opined that whilst there is no legislative definition of 'benefiting financially', the words should be given their ordinary meaning and construed accordingly. Therefore, any payment received for the individual's service could mean that this condition is met.

The case also established that a causal link between the services provided and the payments made was not required. This means that where the MSC provider receives a fee and that fee is ongoing (i.e. not a one-off financial benefit), it would fall within the scope of Condition 1. A fee which is not based on the duties performed by the individual (e.g. a fixed accountancy fee) is not intended to be caught by the legislation, although this point has not been considered in detail by the judiciary.

Within the case, the deemed MSC provider earned interest on income tax and NICs deductions taken from individuals' payments. The terms of the arrangement included an agreement to account to clients for any interest earned but the MSC provider did not, in reality, pay this to them. The case found that a financial benefit has been obtained, even if there may not have been a legal basis for them to have obtained this.

Condition 3: influence or control of payments

Next, it was considered whether the MSC provider influenced or controlled the way in which payments are made to the individuals or their associates. The legislation does not specifically prescribe the meaning of 'influence or control'.

The crux of the MSC concept is that participants receive payments in an income tax and NICs efficient way by means of a small salary and dividends. The courts suggested that where an MSC provider merely follows the wishes of a participant, this would not constitute influence or control. However, given the large number of participants who are serviced by the MSC provider, the provider would choose an 'off the shelf' payment model, and a written resolution to declare dividends or board meetings would not be undertaken.

In *Christianuyi*, the MSC provider sold a standardised product to customers. As such, it was found that the provider influenced the way in which payments to customers were paid by promoting the scheme as a method of reducing tax liabilities.

Condition 4: influence of control of the company's finances

The courts confirmed that this condition is drawn widely and will encompass a number of different scenarios.

Where a business is acting merely as an agent, this would indicate that it does not exert either control or influence. However, where an agent acts in a manner

inconsistent with its stated obligations to its customer, it would exert control.

In this case, the alleged MSC provider effectively pushed their clients towards a particular way of operating regarding their banking arrangements.

Whilst there was a commercial rationale for this, it resulted in influence being held over their clients' finances.

The transfer of liability provisions

The legislation includes transfer of liability provisions within s 688A, whereby any underpaid income tax and Class 1 NIC liabilities could transfer from the MSC to:

1. a director or other office holder, or an associate, of the MSC;
2. the MSC provider;
3. a person who (directly or indirectly) has encouraged or been actively involved in the provision by the MSC of the services of the individual; or
4. a director or other office holder, or an associate, of a person (other than an individual) who is within (2) or (3) above.

The legislation requires that before a debt can be transferred to a person within the final two categories above, it must be impracticable to recover the debt from a person within the first two categories. The definition of 'impracticable' is not included within the legislation, although HMRC indicate that where the assets are held offshore this should meet the criteria.

How does this impact businesses?

Whilst typically each shareholder would own below 5% of the intermediary's shares (the threshold required for the IR35 legislation to apply), the MSC legislation can also impact arrangements where individuals provide their services via PSCs.

Some contractors may seek to change how they provide services to end clients in light of the upcoming IR35 legislative changes, intending to dissolve their PSC and engage via a different vehicle. An unrelated third-party entity could ultimately engage with end clients for the individual's services, but these arrangements could fall within the scope of the MSC legislation, depending on the precise structure. The transfer of liability provisions are drafted widely and state that HMRC can pursue 'a person who (directly or indirectly) has encouraged or actively involved in the

provision by the MSC of the services of an individual’. A liability could potentially arise for the end clients of a contractor working via such an arrangement.

HMRC have indicated that end clients will fall outside of the transfer of liability rules, as long as they have not influenced the provision of services of the individual. This particular point was not considered in Christianuyi and is an untested part of the legislation. However, businesses should consider whether any entities within their contractual chain could be deemed MSCs.

There were numerous references to Hansard in the FTT. The judges determined that these references could not be relied upon in this case as the legislation is clear. Statements of a sponsoring minister can only be relied upon where the statutory language is ambiguous.