MANAGED SERVICE COMPANIES

Who is likely to be affected?

1. Individuals providing their services through Managed Service Companies (MSCs), the providers of MSCs, and persons who actively encourage, facilitate or are otherwise actively involved in individuals' provision of their services through MSCs.

General description of the measure

2. Legislation will be introduced in Finance Bill 2007 to define a "Managed Service Company". It will deem income received by individuals providing their services through MSCs, not already treated as employment income, to be employment income. The consequence of this will be that MSCs will have to operate Pay As You Earn (PAYE) income tax and Class 1 National Insurance contributions on all payments received by individuals in respect of services provided through such companies.

3. Where an MSC incurs a PAYE / Class 1 National Insurance debt, and that debt cannot be recovered from the company, HM Revenue and Customs (HMRC) may transfer the debt to specified persons. These will primarily be the MSC's director and the person who provided the company to the individual (the MSC Provider.) Subject to certain restrictions, an MSC's debt can also be transferred to persons who encourage, facilitate or are otherwise actively involved in individuals' provision of their services through MSCs.

Operative date

4. MSCs will be required to operate and account for PAYE on all payments received by individuals providing their services through MSCs, where such payments are received on or after 6 April 2007. The requirement to operate Class 1 National Insurance will be due from a date specified in Social Security regulations to be laid shortly after the date on which the Finance Bill receives Royal Assent.

5. Provided Royal Assent takes place before 6 August 2007, the transfer of debt provision will have effect on and after that date, and will relate to debts incurred for directors or office holders of MSCs and MSC providers (and associates of those persons), and to debts incurred on or after 6 January 2008 for other persons.

Current law and proposed revisions

6. Managed Service Companies (MSCs) are mass marketed service companies provided by MSC providers to large numbers of individuals.

They are intermediaries and as such they fall within the scope of Chapter 8 of the Income Tax (Earnings and Pensions) Act 2003 (ITEPA) and section 4A of the Social Security Contributions and Benefits Act 1992 (SSCBA)/Social Security Contributions and Benefits (Northern Ireland) Act 1992. This legislation treats payments received by individuals providing their services through intermediaries (primarily service companies) to be earnings from employment where certain conditions are met. These conditions are that if the intermediary is ignored, the terms under which the individual provides services to the client are such that the individual would be regarded as an employee of the client. Tax and National Insurance contributions are calculated after the end of the tax year in which the payments were received by the individual.

7. Whether Chapter 8 of ITEPA does or does not apply is considered on a contract by contract basis. Where therefore either an individual has a number of contracts throughout the year, or large numbers of individuals work through such intermediaries, large numbers of engagement terms must be considered to determine whether or not Chapter 8 applies.

8. Chapter 8 of ITEPA also provides that in calculating travelling expenses which are not subject to tax, the individual is deemed to be employed by the intermediary. The effect of this is that the cost of travel to each engagement is an allowable expense and is deducted before calculating the sum (the “deemed employment payment”) on which PAYE must be applied.

9. Chapter 8 of ITEPA is now disapplied in respect of Managed Service Companies. The new Chapter 9 of ITEPA (and in due course mirroring National Insurance legislation) will apply to intermediaries which are “Managed Service Companies” (MSCs).

10. Rather than look at individual engagement terms between individuals and clients as in Chapter 8 of ITEPA, Chapter 9 of ITEPA defines an MSC by reference to certain criteria. These relate both to the characteristics of the company and the characteristics of the business of the MSC provider

11. Whether Chapter 9 applies will be determined largely by reference to the MSC provider. Where a person is determined to be an MSC provider, Chapter 9 will apply to all service companies made available by that person. Broadly, an MSC provider includes businesses which are involved in promoting or facilitating the use of companies to provide the services of individuals.

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

13. Where a company is within the definition of an MSC, all payments

received by an individual providing their services through the company, which are not already treated as employment income, are deemed to be employment income. Chapter 9 of ITEPA (and in due course mirroring National Insurance legislation) provide for how an MSC must calculate a "deemed employment payment" in order to arrive at the sum to be subject to PAYE. The deemed employment calculation and the operation of PAYE must be undertaken when an individual receives a payment and not after the end of the year as with Chapter 8.

14. Unlike Chapter 8 of ITEPA, in Chapter 9 of ITEPA, the individual will be treated, in calculating travelling expenses which can be paid without deduction of tax, as if they were employed by the client. The effect of this will be that the cost of travel to each engagement is not an allowable expense and cannot be deducted before calculating the sum on which PAYE must be applied.

15. A new section 688A will be inserted in ITEPA enabling PAYE regulations to provide for the recovery from specified persons set out in the section, of any amount of PAYE that an officer of HMRC considers should have been deducted by the MSC. The persons are: the director or office holder of the MSC, the MSC Provider, or any person who directly or indirectly has encouraged, facilitated or otherwise been actively involved in the provision of the services of individuals through MSCs. PAYE regulations will be laid providing the statutory mechanism for how MSCs debts that cannot be recovered from MSCs are transferred to those persons specified in section 688A.The regulations also provide appeal provisions. Mirroring Social Security Regulations will provide for the transfer of Class 1 National Insurance debts of MSCs to the same specified persons.

16. Consequential changes will be made to provide for the rules relating to the calculation of profits of Managed Service Companies. Changes will be made to the Income Tax (Trading and Other Income) Act 2005 for the purpose of calculating, for income tax, the profits of an MSC. Changes will be made to Schedule 12 of the Finance Act 2000 for the purposes of calculating, for corporation tax, the profits of an MSC.

17. The relevant National Insurance Contributions legislation in the SSCBA will be amended to mirror the relevant Income Tax treatment.

18. The new legislation will provide interpretations, particularly the definition of "associate".

Further advice

19. If you have any questions about this change, please contact either HMRC North Service Company Unit on 0114 296 9430, or HMRC South Service Company Unit on 01823 358 437. A full Regulatory Impact Assessment for this measure will be published alongside the Finance Bill. Information about Budget measures is available on the HM Revenue & Customs website at www.hmrc.gov.uk