MANAGED SERVICE COMPANIES

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The taxation of personal services has become increasingly complicated in recent years with legislative provisions layered on top of one another and further complexity being promised. Unfortunately, unless services are provided by a self-employed individual (a question which has its own difficulties) it will be necessary to consider the application of all of these provisions, the very fact of which might in itself have tax consequences. An added difficulty is that it is not always practical for persons to provide services as a self-employed individual.

For the person providing personal services, it is now necessary to consider each of the following, unless it is to be accepted that everything received directly or indirectly in respect of such services is to be subject to income tax as employment income, and subject also to class 1 NICs as earnings:

- Firstly, the provisions applicable to agency workers (Chapter 7, Part 2 ITEPA 2003) ("the Agency provisions").

- Secondly, if or to the extent those do not apply (section 61A ITEPA 2003), the provisions applicable to managed service companies may be in point (Chapter 9, Part 2 ITEPA 2003) ("the MSC provisions").

- Thirdly, and provided only that the MSC provisions have not applied (section 48 ITEPA 2003), the provisions applicable to workers under arrangements made by intermediaries may be in point (Chapter 8, Part 2 ITEPA 2003) ("the Intermediaries provisions").

- Finally, if the provider of services has avoided all of the above, it may be necessary to consider the settlements legislation (Chapter 5, Part 5 ITTOIA 2005) ("the Settlements legislation") (Although *Jones v Garnett* [2007] UKHL 35 has provided some clarity in this respect, it was announced on 26 July 2007 that new legislation is to be introduced to reverse the effects of that decision).

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It is to be noted that these provisions apply equally to services provided through a partnership as they do to services provided through a company (see sections 46(1), 49(3) and 61C(3) ITEPA 2003). Where services are provided through an unincorporated association the Agency Provisions and the Intermediaries Provisions can apply and the Intermediaries legislation can even apply to services provided through an individual. The Settlements legislation defines a settlement as including "any disposition, trust, covenant, agreement, arrangement or transfer of assets" (section 620(1) ITTOIA 2005) and as such potentially has an equally wide application.

It is also to be noted that the mere fact that payment for services would not be treated as employment income if provided directly to the individual concerned is no longer sufficient to oust the application of ITEPA 2003. This is one of the major changes introduced by the MSC provisions.

The MSC provisions

The most recent and far reaching provisions are the MSC provisions and it is proposed to consider these in the course of this article.

The MSC provisions which appear to have been introduced not to close any loophole or defect in the existing legislation, but to make it easier for HMRC to treat income as employment income.

In particular, they are a response to the argument that the Intermediaries provisions have no application because a worker would not have been treated as an employee if directly contracted by the client. By ensuring that the position in a notional contract between a worker and a client is no longer relevant, HMRC no longer need expend resources on determining that question.

They are also apparently introduced for purely economic and social reasons:

> "*The measures aim to deal with the unfairness that, as businesses have told us, those who follow the rules and pay the required tax and national insurance contributions are being undercut by those who do not apply the rules correctly. There are concerns—Committee members on this side will be conscious of them—that some workers are encouraged or even forced to use managed service companies without understanding that they might, at the same time, be losing some of their employment rights*" (The Financial Secretary to the Treasury (John Healey), Finance Bill Committee, 15th May 2007).

Unfortunately, while it is recognised that some persons in business on their own account should not be subject to PAYE and class 1 National Insurance contributions,

there appears to have been a failure to derive a satisfactory principle under which these persons are to be identified. It is, however, clear that mass marketed schemes are intended to be targeted, regardless of the employment status.

The result of this intellectual incoherence has been an adoption of an approach to the drafting of the legislation which is becoming increasingly common, namely, drafting the legislation in the widest possible terms on the basis that HMRC will only apply it at its discretion. Given the offensive nature of this approach, there may very well be an argument that extremely vague words are to be given a restrictive interpretation (see for example the requirement of bounty in the Settlements legislation). It cannot, however, be assumed that any Court will adopt such an approach.

What is a managed service company?

Section 61B ITEPA 2003 (introduced by Schedule 3 FA 2007) now provides:

> ***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 an individual to other persons,*
>
> *(b) payments are made (directly or indirectly) to the individual (or associates of the individual) of an amount equal to the greater part or all of the consideration for the provision of the services,*
>
> *(c) the way in which those payments are made would result in the individual (or associates) receiving payments of an amount (net of tax and national insurance) exceeding that which would be received (net of tax and national insurance) if every payment in respect of the services were employment income of the individual, and*
>
> *(d) 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 with the company.*
>
> *(2) An MSC provider is "involved with the company" if the MSC provider or an associate of the MSC provider-*

> *(a) benefits financially on an ongoing basis from the provision of the services of the individual,*
>
> *(b) influences or controls the provision of those services,*
>
> *(c) influences or controls the way in which payments to the individual (or associates of the individual) are made,*
>
> *(d) influences or controls the company's finances or any of its activities, or*
>
> *(e) gives or promotes an undertaking to make good any tax loss.*
>
> *(2) A person does not fall within subsection (1)(d) merely by virtue of providing legal or accountancy services in a professional capacity.*
>
> *(3) A person does not fall within subsection (1)(d) merely by virtue of carrying on a business consisting only of placing individuals with persons who wish to obtain their services (including by contracting with companies which provide their services).*
>
> *(5) Subsection (4) does not apply if the person or an associate of the person-*
>
> *(a) does anything within subsection (2)(c) or (e), or*
>
> *(b) does anything within subsection (2)(d) other than influencing the company's finances or activities by doing anything within subsection (2)(b).*

In this context, a company means a body corporate or a partnership.

It can be seen that in order to fall within the definition of managed service company several conditions must be satisfied.

> ***"...business consists wholly or mainly of providing (directly or indirectly) the services of an individual to other persons..."***

A question might arise as to what is meant by providing services of an individual indirectly to other persons. In particular, most business which involve the alteration or manufacture of products could be said to be indirectly providing the services of an individual.

For example, when I buy a suit, I can be said to be buying a suit, but I might also be said to have been provided in an indirect manner with the services of the tailor who made the suit, together with the cloth from which it was constructed. Since the former is likely to have been more significant, can the manufacture of clothing be said to be a business consisting mainly of providing (albeit indirectly) the services of an individual to another person?

It is unlikely this provision would be construed in this manner, and that the business in question must in fact (when properly considered) be the provision of the services of an individual rather than the services of individuals being a significant component in that business. That is, however, unlikely to be a simple question to determine in all circumstances.

> ***"payments are made (directly or indirectly) to the individual (or associates of the individual) of an amount equal to the greater part or all of the consideration for the provision of the services"***

It must be the case that there needs to be a link between the payments made to the individual and the services provided by him albeit that such link may not necessarily be a direct one.

The amount paid to the individual or his associates must be of an amount equal to the greater part of the consideration paid for the provision of services. That would seem to require over 50% of the consideration provided for the services. It would also seem to require some mechanism for identifying the consideration paid for the services.

In this respect it is noted that section 61D ITEPA 2003 (considered below) draws a distinction between payments and benefits. Query the position where the greater part of the value of what the individual is provided with is provided by means of benefits in kind?

An associate of an individual means (section 61I(2) ITEPA 2003):

(a) a member of the individual's family or household,

(b) a relative of the individual (meaning ancestor, lineal descendant, brother or sister),

(c) a partner of the individual, or

(d) the trustee of any settlement in relation to which the individual, or a relative of the individual or member of the individual's family (living or dead), is or was a settlor.

For these purposes, "relative" means ancestor, lineal descendant, brother or sister.

Additionally, it is provided that a man and woman living together as husband and wife are treated as if they were married to each other, and two persons of the same sex living together as if they were civil partners of each other are treated as if they were civil partners of each other (section 61I(7) ITEPA 2003). This would seem to be a test which is easier to state than to apply (see *Burden and Burden v. United Kingdom* (ECHR) (Application no. 13378/05)). Contrast also section 61(5) ITEPA 2003.

Additionally in the context of this provision, an associate of an individual includes "a person who, for the purpose of securing that the individual's services are provided by a company, acts in concert with P (or with P and other persons)" (section 61C(4) ITEPA 2003). This would seem to cover scheme providers.

> ***"the way in which those payments are made would result in the individual (or associates) receiving payments of an amount (net of tax and national insurance) exceeding that which would be received (net of tax and national insurance) if every payment in respect of the services were employment income of the individual"***

It is not clear whether the reference to "every payment in respect of the services" is a reference to the payment by the person receiving the services or a reference to the payment received by the individual and his associates. HMRC appear suggest that it is the latter in their guidance, although if that is correct there would seem to be an argument that since they derive from ownership of shares, dividend payments are not payments *in respect of services* (contrast section 61D(1)(b) ITEPA 2003 which refers to 'a payment or benefit which can reasonably be taken to be in respect of services').

In any event, query the position where the payment received by the individual is reduced by reason of his also receiving benefits in kind?

> ***"a person who carries on a business of promoting or facilitating the use of companies to provide the services of individuals ("an MSC provider")..."***

This is an astoundingly vague provision which can almost be as wide or as narrow as one wishes to argue for. This is probably deliberate, given that there does not appear to have been any clear principle as to where the line should be drawn, save that it should probably be drawn somewhere (excluding those genuinely in business on their own account), and it was felt that the condition originally proposed (that the company should not be under the control of the persons providing the service: see *Tackling Managed Service Companies, December 2006*) was too easily satisfied by giving the 'impression' of control (although once again, the concern appears to have been that HMRC would have to investigate the matter).

Some indication of what is intended to be meant by this provision was given by the Financial Secretary to the Treasury, John Healey, at the Finance Bill Committee on 15 May 2007:

> "The first element that must be satisfied is that a person is carrying on a business of promoting or facilitating companies to provide the services of individuals, not a business to promote or facilitate companies generally. For that reason, those promoting or facilitating companies generally—for example, company formation agents—are not MSC providers. The same would be true of training providers and a number of companies that may provide advice.
>
> Some have asked whether a person who promotes their business and who provides services to those working through service companies is an MSC provider. The answer is no. There is a clear distinction between a person who promotes themselves or their business and someone who is, as a business, promoting the use of companies to provide the services of individuals.
> ...
>
> Let me try and be clear about how HMRC will approach this. First and foremost, it will look at the nature of the product provided by an MSC provider. Where it is clearly a standardised product constituting the MSC being involved with client companies, it will take the starting view that all client companies are MSCs. The onus will then be on the individual companies to demonstrate no involvement.
>
> ... in determining whether a person is an MSC provider it is necessary to look at the nature of their business. Clearly, to do that it is necessary to look at the services provided by the clients more widely. There is the risk that an MSC provider would seek to challenge the assertion that it is carrying on a business of "promoting or facilitating" by arguing that in determining the nature of its business, HMRC could not consider the nature of the services offered widely. Clearly, that could constrain HMRC unduly and could undermine the effectiveness of the legislation.
>
> ... a tax adviser providing tax advice is not an MSC provider and therefore the tests set out in proposed section 61B(2) are not considered.
> ...
>
> Let me try to make this absolutely clear: even when the specific exclusion does not apply, the purpose of the legislation is not to include within the definition of MSC provider accountants, tax advisers, lawyers and company secretaries who provide advice or other professional services to companies in general. Those persons are not in the business of promoting or facilitating

the use of companies to provide the services of individuals, nor are they regarded as involved with the company in the way in which the legislation envisages.

When an individual asks a tax adviser for help or advice in setting up a business to provide that individual's services to end users, the tax adviser considers the individual's position and might recommend a corporate structure that includes the payment of dividends to the individual as a shareholder worker. The tax adviser is not acting as an MSC provider.".

In their guidance on Managed Service Companies, HMRC state the following:

"**Meaning of "promotion"**

In this context promotion does not mean a person who promotes their business (whatever that business might be), rather it means the promotion of a certain type of product, namely companies to provide the services of individuals. Promotion takes its general usage meaning and includes, amongst other things, such activities as marketing, encouraging, initiating, etc

Meaning of "facilitation"

In this context facilitation takes its ordinary meaning: amongst other things, helping, making easier, enabling etc.

Who is and who is not an MSC Provider

The legislation provides a specific exemption for persons being MSC Providers (involved with a company) merely by virtue of providing legal or accountant services in a professional capacity. This specific exemption applies only to persons professionally qualified (or training for a professional qualification) regulated by a regulatory body.

But simply because a person is not exempt merely by virtue of providing legal or accountancy services in a professional capacity, does not mean that they are an MSC Provider. Persons who promote or facilitate companies generally, as opposed to companies specifically to provide the services of individuals, are not MSC Providers.

The Financial Secretary to the Treasury, John Healey, said in Parliament on 15 May 2007: "The first element that must be satisfied is that a person is carrying on a business of promoting or facilitating companies to provide the services of individuals, not a business to promote or facilitate companies generally. For that reason, those promoting or facilitating companies

> generally—for example, company formation agents—are not MSC providers. The same would be true of training providers and a number of companies that may provide advice."
>
> An accountancy/tax adviser, whether or not professionally qualified, who provides advice to clients who are service companies is not an MSC Provider merely by virtue of their client base. The test is whether a person is carrying on a business (or a discernable part of their business) of promoting or facilitating the use of companies to provide the services of individuals.
> The Financial Secretary to the Treasury, John Healey, said in Parliament on 15 May 2007:" When an individual asks a tax adviser for help or advice in setting up a business to provide that individual's services to end users, the tax adviser considers the individual's position and might recommend a corporate structure that includes the payment of dividends to the individual as a shareholder worker. The tax adviser is not acting as an MSC provider."
> Simply because a person is a lawyer or accountant does not automatically exempt them from being an MSC Provider—the ultimate test is whether a person is carrying on a business (or a discernable part of their business) of promoting or facilitating the use of companies to provide the services of individuals.".

These extracts appear to suggest that a person must do more than promote or facilitate the use of personal service companies as part of their business, but must have such use or facilitation as their business. This is a very fine and subtle distinction which is unconvincing and likely to be unworkable in practice.

Any person who advises on the setting up or running of companies to provide personal services is at risk of being an MSC provider unless they are providing 'legal or accountancy services in a professional capacity' and as such are specifically excluded.

In respect of this latter point, HMRC appear to be taking a narrow view of what qualifies as legal or accountancy services provided in a professional capacity. In particular, there is no express requirement that the person be professionally qualified or regulated by a regulatory body whatever that may mean. In particular, there would seem to be a reasonable argument that most tax advice provided by a professional tax adviser will fall within this provision.

Further, the final paragraph is misleading, since a person could be carrying on a business of facilitating the use of companies to provide the services of individuals in the course of providing legal and accountancy business in a professional capacity and it would **not** be an MSC provider.

The guidance goes on to give some examples:

Examples:

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

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

The following are an MSC Provider

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

The first point to note is that these examples are the HMRC view of the legislation. They do not necessarily represent the law. As such, a Court is certainly not bound by them, while the extent to which HMRC are, or consider themselves to be, bound by them is likely to be questionable. Nevertheless, they may provide some comfort to those who can rely on them.

The second point is that it is difficult to discern the basis for the distinctions being drawn, other than that those who market and provide tax avoidance schemes are more likely to be targeted than those who simply provide them. In particular, the difference between an accountant whose entire client base is individuals operating through service companies (apparently not an MSC provider) and an accountant, a discernable part of whose business is to provide services to individuals providing services to end clients (apparently an MSC provider) is very difficult to see.

Further, why a firm of accountants providing corporate solutions and services to individuals providing their services to end clients is not providing legal or accountancy services in a professional capacity is not entirely clear.

The guidance goes on to consider 'back office service providers'

> "The term "Back Office Service Provider" is applied to a number of different types of operations. Whether or not such providers are MSC Providers, or possibly associates of MSC Providers, will depend on the precise nature of their business.
>
> A person who terms themselves a "Back Office Service Provider" and who is carrying on a business of, in addition to providing a range of accounting/bookkeeping services, providing structures (partnerships or bodies corporate) through which workers provide their services, is likely to be an MSC Provider because such a business model indicates that they are in fact promoting or facilitating the use of companies to provide the services of individuals. If this is the case the person must consider whether their business model constitutes being involved with their clients (see section 2.3.)
>
> A Back Office Service Provider who:
>
> - Provides accounting/bookkeeping services exclusively to clients in the service company sector, **is** an MSC Provider because they are carrying on a business of facilitating the use of companies to provide the services of individuals ;
>
> - Merely provides accounting/bookkeeping services to clients generally, and not exclusively in the service company sector, is **not** an MSC Provider;

- Merely provides accounting/bookkeeping services to Employment Businesses or Agencies carrying on their core business of placing work seekers with end clients, is **not** an MSC Provider; or

- Acts in concert with an MSC Provider for the purposes of securing that an individual's services are provided by a company, is an associate of an MSC Provider.

The approach to the examples here is inconsistent with earlier advice and with itself as well as once again being devoid of any discernible principle related to the terms of the legislation.

"... is involved in the company"

Subsection (2) defines what is meant by involved with the company, thereby limiting what might otherwise be considered a very general phrase.

This will include not only the MSC provider, but its associates, which include persons acting in concert with it to secure that the worker's services are provided by a company.

"...influences or controls..."

These terms are of significant relevance to the question of whether and MSC provider is involved in a company.

Once again, what are apparently wide terms are intended to have a narrower meaning which does not altogether make sense. The HMRC guidance states:

> In this context "influences" does not mean the provision of advice. The Financial Secretary to the Treasury said in Parliament on 15 May 2007: "there is a distinct difference…..between a person who provides independent, tailored advice to a client, who is then able to consider that advice before accepting it or rejecting it, and the person who simply supplies a client with a standard solution or product that the client accepts."
> The fact that an adviser advises a client to incorporate does not in itself constitute "influences". The advice to incorporate needs to be considered in the wider context of the advice to the client i.e. whether it comprises part of truly tailored advice or in reality constitutes part of a standard product.
> In determining whether an MSC Provider or their associate is exercising influence, HMRC will consider all factors in the Provider (or associate)/client relationship and will not accept solely documentation, statutory or otherwise, as definitive proof as to the true nature of the relationship between Provider (or associate) and client.

It might have been thought that specifically tailored advice is more likely to be influential than standard advice, being directly targeted at the individual's circumstances and as such, more likely to be followed.

In relation to control, HMRC have indicated that they will look beyond superficial matters 'including the level of understanding of all relevant parties'.

"...benefits financially on an ongoing basis from the provision of the services of the individual"

While an adviser to a company is likely to benefit on an ongoing basis from the provision of services by the individual, simply because he retains him as a client, this is likely to require that the MSC provider links their fee directly to the worker's income (rather than, for example by reference to time spent).

The HMRC guidance partly accepts this, but then goes on to contradict this, suggesting that where an increase in the worker's provision of services creates a greater demand for those of the MSC provider, then there is an indirect link between the two.

"... influences or controls the provision of those services"

This is apparently aimed at ensuring the provider of services negotiates the terms of the contract of service and/or remuneration. In many cases, however, these terms will be imposed by a client as a reflection of its much stronger negotiating position and will be on standard terms.

In these circumstances, it will be necessary to have regard to whether the client company might be said to be an associate of the MSC provider as it is acting in concert with it to secure that the individual's services are provided by a company.

"... influences or controls the way in which payments to the individual (or associates of the individual) are made"

This would seem to cover dividend policy as well as the manner in which the remuneration of the individual is calculated. Clearly the fact that a person is not an MSC provider merely by providing legal or accountancy advice in a professional capacity is important here.

"...influences or controls the company's finances or any of its activities"

Presumably this does not require the advice in relation to liabilities to HMRC and other creditors to be ignored, however, standard that advice may be.

"...gives or promotes an undertaking to make good any tax loss"

This apparently relates to the practice of guaranteeing a tax saving. Section 61C(5) ITEPA 2003 adds the explanation that an ""undertaking to make good any tax loss" means an undertaking (in any terms) to make good (in whole or in part, and by any means) any cost to the individual or an associate of the individual resulting from a relevant provision, or a particular kind of relevant provision, applying in relation to payments made to the individual or associate".

Agencies

Section 61B(4) ITEPA 2003 appears to give an exemption to agencies, although only those with no influence or control over the way in which workers are paid.

Effect of services being provided by a managed service company

Where services of an individual are supplied through a managed service company, then the individual is deemed to be in receipt of earnings. Section 61D provides:

> ***61D 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 be in respect of the services, and*
>
> *(c) the payment or benefit is not earnings (within Chapter 1 of Part 3) 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 61F supplements this section.

It must follow that where an amount is deemed to be the income of the worker from employment with the MSC, it cannot also be income of the employee from employment with any other person. Otherwise, there would be potential for double taxation.

Express provision is included so that regard is had to the deemed payment in calculating the profits of a trade profession or vocation and in calculating the charge to corporation tax (see 164A ITTOIA 2005 and paragraph 10, Schedule 3 FA 2007).

To the extent that distributions are made, there is express provision for relief against double taxation (section 61H ITEPA 2003).

The deemed charge would only seem to apply to payments or benefits received by the worker in respect of services provided by him while the company in question was a managed service company. Query the position where a greater part of the consideration for the provision of services is retained in the company (so that it never becomes a managed service company under section 61B(1)(b) ITEPA 2003) and the company is subsequently liquidated?

More simply, what if they are all paid at the end of the year in which they were paid. It is only after a greater part of the consideration is paid that the company becomes a managed service company. Further it is only in respect of the services provided *while the company is a managed service company* that the deemed employment charge applies. As such, by deferring payment of a dividend the charge under these provisions might be avoided.

Where the charge does apply, the deemed employment payment is calculated in the following manner:

61E 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 61F) the amount of the payment or benefit mentioned in section 61D(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.*

PAYE

The PAYE provisions are stated to operate on the deemed employment payment were a payment by the managed service company to provide the services and the deemed employment payment was a payment by the managed service company of earnings from the employment (see section 61G(2) ITEPA 2003).

Section 688A ITEPA 2003 and Chapter 4 of the Income Tax (PAYE) Regulations 2003 make provision for recovery "of any amount that an officer of Revenue and Customs considers should have been deducted by a managed service company from a payment of, or on account of, PAYE income of an individual".

The persons who can be potentially liable are as follows:

(a) a director or other office-holder, or an associate, of the MSC,

(b) an MSC provider,

(c) a person who (directly or indirectly) has encouraged or been actively involved in the provision by the MSC of the services of the individual, and

(d) a director or other office-holder, or an associate, of a person (other than an individual) who is within paragraph (b) or (c).

This would include a client who has contracted for and paid for the services of the individual through the MSC, although the Financial Secretary to the Treasury took a different view:

> "Both tests require the third party to have an active role, so those who simply use MSC workers will not be caught. If an end client did more than simply use MSC labour, for example by telling those who it employed that they must move to an MSC, it would fall within the scope of the measure as that would be regarded as encouragement—the hon. Lady asked about that point. That was the reason why we included the word "actively", which I am glad she welcomed. She asked for clarification of whether the tax clock is ticking from April".

Why employing an individual through a managed service company is not active involvement in the provision by that company of the services of an individual appears to involve the same type of subtle argument used in respect of the words

'influence' and 'facilitating'. Certainly, it is not plain on the face of the legislation.

An appeal against a notice transferring a PAYE debt is available under regulation 97G of the PAYE Regulations 2003.

Jones v Garnett [2007] UKHL 35 and the Settlements legislation

Assuming that the service company avoids the MSC provisions and the Intermediaries provisions, a question arises as to whether there is any possibility of ensuring a further tax saving by splitting the rights to income, typically by giving a spouse a right to dividend income.

It is of course possible to have a deemed splitting of income where property is in the joint names of spouses under section 836 ITA 2006. That will not, however apply to (see section 836(3) ITA 2006):

> income consisting of a distribution arising from property consisting of-
>
> (a) shares in or securities of a close company to which one of the individuals is beneficially entitled to the exclusion of the other, or
>
> (b) such shares or securities to which the individuals are beneficially entitled in equal or unequal shares,

and certain other classes of income.

It is of course possible to have an actual splitting of income where shares in a close company are concerned. The issue in this respect is whether the settlements legislation applies to deem the income to be that of the individual whose efforts have ultimately produced it. This of course was the point in dispute in *Jones v Garnett.*

In that case, the husband provided his services as a computer consultant through a company in which his wife offered some secretarial services. Each was paid a small wage directly from the company and the remaining profits were extracted by way of dividends. The question was whether the dividends paid to Mrs Jones in respect of the £1 ordinary share which she had acquired from the formation agents were to be deemed to accrue to Mr Jones under the Settlements legislation in section 660Aff ICTA 1988 (the relevant provisions are now to be found at sections 619ff ITTOIA 2005).

The first issue was whether there was an 'arrangement' such as to give rise to a settlement as defined in section 660G ICTA 1988. This required an element of bounty. This issue was decided in favour of HMRC. It was held that there was such an arrangement on the basis that although the original corporate settlement

constituted the arrangement, the purpose for which it was established was relevant in discerning an element of bounty.

Lord Hoffmann stated at paragraph 29):

> "The transfer of the share was in my opinion the essence of the arrangement. The expectation of other future events gave that transfer the necessary element of bounty but the events themselves did not form part of the arrangement."

Lord Walker of Gestingthorpe stated (at paragraphs 53 and 54):

> "Normally (there may be exceptions) the arrangement is to be identified by the constituent parts or components of the legal structure designed for a purpose, and not by what is done (sometimes months or even years later) in using the structure for its intended purpose.
> ...
> The establishment of the corporate set-up, together with the common intention that Mr and Mrs Jones would use it to minimise tax in accordance with their accountants' advice, was the essential arrangement. What happened afterwards was that the arrangement was put to its intended use".

Lord Neuberger of Abbotsbury stated (at paragraphs 79 and 82):

> "It seems to me clear that, when considering whether there was an "arrangement" within the meaning of the sections, i.e. an arrangement which involved an element of bounty, one should assess the position at the time that the alleged arrangement was made, but, in carrying out that exercise, one should not disregard what happened thereafter. In particular, if the parties intended an element of bounty to accrue, and that element of bounty does indeed eventuate, then, absent any other good reason to the contrary, there is indeed an "arrangement" within the meaning of section 660G (1).
> ... in considering whether the arrangement involved an element of bounty, one looks at the whole of the purpose of the arrangement, and, in that connection, one does not shut ones eye to whether that purpose was achieved."

The second issue, on which the taxpayer succeeded, was whether there was an outright gift of property which was not wholly or substantially a right to income. It was held that, although there had never actually been a gift of the share to Mrs Jones (she had acquired it from the formation agent) the element of bounty which gave rise to the arrangement was sufficient to give rise to a gift for the purposes of this provision. Further, as an ordinary share (as opposed to a preference share) the rights which it gave in the company could not be characterised as solely being a right to income. Finally, it could not be said that the 'settlement' did not constitute an

outright gift because it was more than simply a gift of a share. This was on the basis, that the agreement to work in the future at a modest salary, while giving the arrangement the necessary element of bounty, was not in itself a part of the arrangement.

Lord Hoffman stated (at paragraphs 28 and 30):

> "It was Mr Jones's consent to the transfer of a share with expectations of dividend to Mrs Jones for £1 which gave the transfer the "element of bounty" for the purposes of section 660A. By the same token, I think it made the transfer a "gift" for the purposes of subsection (6). And there is no dispute that, if it was a gift, it was outright.
> ...
> It is true that the value in the share arose from the expectation that it would generate income. But that is true of many shares, even in quoted companies. The share was not wholly or even substantially a right to income. It was an ordinary share conferring a right to vote, to participate in the distribution of assets on a winding up, to block a special resolution, to complain under section 459 of the Companies Act 1985. These are all rights over and above the right to income. The ordinary share is different from the preference shares in Young v Pearce (1996) 70 TC 331, which conferred nothing except the right to 30% of the net profits before distribution of any other dividend and repayment on winding up of the nominal amount subscribed for their shares. Those shares were substantially a right to share in the income of the company".

Lord Hope of Craighead stated (at paragraph 39):

> "The critical words are "a right to income". It is the rights attached to the asset comprised in the settlement, not the product of their exercise from time to time, now or in the future, that determine whether the exception applies to it".

Lord Walker of Gestingthorpe stated (at paragraph 55):

> "Mr Jones did not actually make a transfer by way of gift to his wife of one of the two issued shares in Arctic. She bought it at par from the company formation agents. But it was not the sort of arrangement that would have been made between strangers dealing with each other at arm's length. Arctic was the chosen vehicle through which Mr Jones was to offer his valuable services as an IT consultant, and it was an act of bounty on his part to permit his wife to acquire half its equity for the nominal sum of £1. In my opinion that amounted to an outright gift of the share within the meaning of section 660A(6)".

Lord Neuberger of Abbotsbury stated (at paragraphs 91 and 82):

> "The Revenue's first argument was that Mrs Jones paid £1 for her share, and that therefore there was no "outright gift", merely a purchase at an undervalue. In my opinion, that point will not do, and it was not strongly pressed by Mr Furness. A purchase at an undervalue involves, as a matter of ordinary language, an element of gift. There was a "settlement" in the present case because there was an "arrangement", and there was an "arrangement" because, for the reasons already explained, there was a substantial element of "bounty" when Mrs Jones acquired her share. It seems to me very difficult to contend that there was a substantial element of bounty without there having been a gift, albeit that the value of the gift must be diminished by £1 to take into account what Mrs Jones paid for her share. To describe the element of gift in the arrangement as substantial is, in my judgment, a positive understatement in the light of the virtually nominal payment of £1. Once one accepts that there is a gift, it seems to me that the word "outright" is of no assistance in connection with this point".

So far as it goes, the decision in *Jones v Garnett* is useful in the short term to taxpayers who are in a position to avoid both the MSC legislation and the Intermediaries legislation. It is to be noted, however, that on the day after the decision was handed down, the Exchequer Secretary to the Treasury, Angela Eagle made the following Written Statement to Parliament:

> "The Government acknowledges the judgement given by the House of Lords in the *Jones v Garnett (Arctic Systems)* case.
>
> The Government is committed to maintaining fairness in the tax system. The case has brought to light the need for the Government to ensure that there is greater clarity in the law regarding its position on the tax treatment of 'income splitting'.
>
> Some individuals use non commercial arrangements (arrangements that they would not reasonably enter into with an arms-length third party) to divert income (which would, in the absence of those arrangements have flowed to them) to others. That minimises their tax liability, and results in an unfair outcome, increasing the tax burden on other tax payers and putting businesses that compete with these individuals at a competitive disadvantage.
>
> It is the Government's view that individuals involved in these arrangements should pay tax on what is, in substance, their own income and that the legislation should clearly provide for this. The Government will therefore bring forward proposals for changes to legislation to ensure this is the case. In the meantime, HMRC will apply the law as elucidated by the House of

> Lords and will be providing guidance in due course.
>
> The Government would not want commercial arrangements to be caught by any change to legislation. Consultation should help to ensure this."

Nevertheless, this does not mean all possibilities for income splitting will be shut down, and much will depend upon the manner in which the legislation is sought to be amended.