Managed service companies: what exemptions apply?

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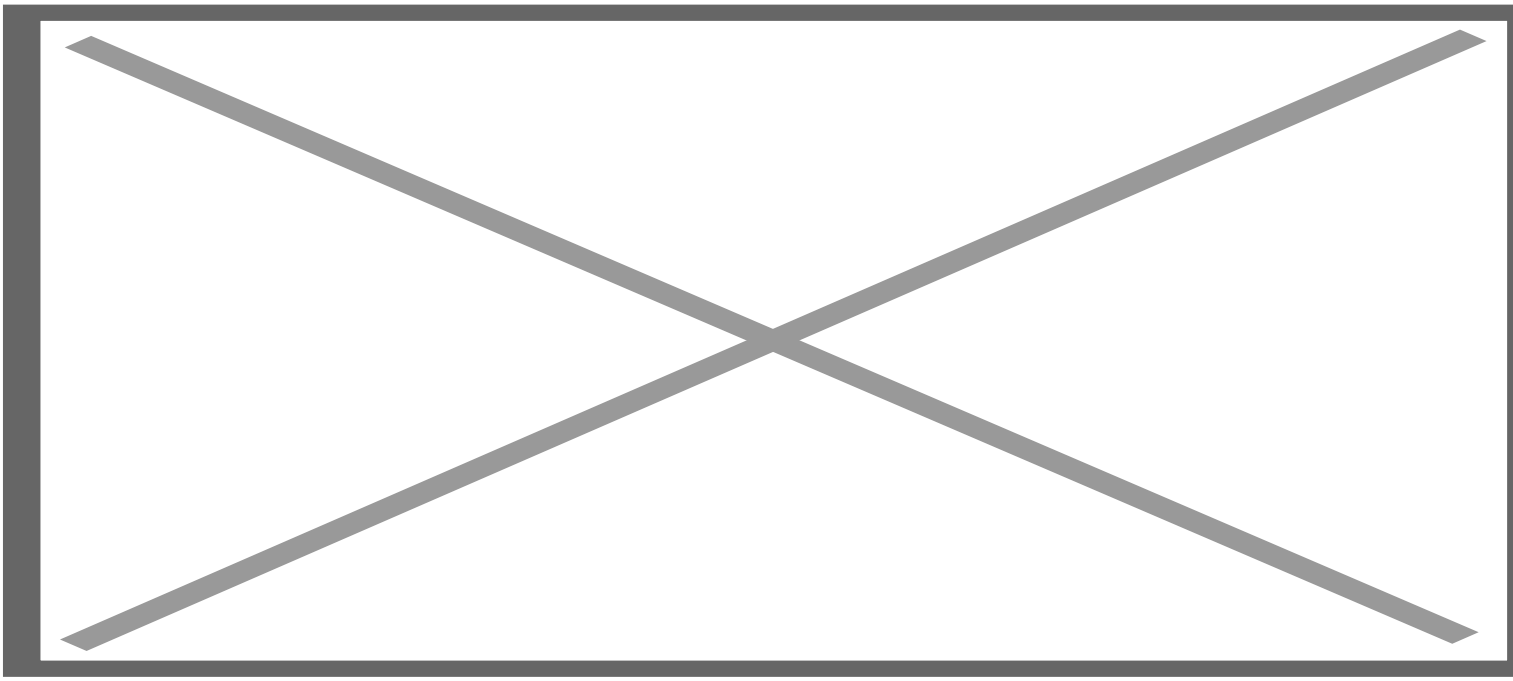

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As HMRC increases the number of assessments made under the managed service company legislation, we consider what exemptions can apply to those offering advice and services to contractors.

Key Points

What is the issue?

For the managed service company legislation to apply, there first needs to be a managed service company provider involved in any arrangements.

What does it mean for me?

There are exemptions where the purported managed service company provider is providing legal or accountancy services in a professional capacity, in which case the managed service company legislation cannot apply.

What can I take away?

It’s not unusual to find isolated errors which, if they become part of ‘normal practice’, could change the managed service company outcome, and seeking professional advice is recommended.

There has been a significant amount of coverage in accountancy and contractor press and forums recently on managed service companies. This has largely been prompted by HMRC activity before the end of the 2021/22 tax year, which could be a major issue for the contracting sector if HMRC succeed.

As a starting point, it is useful to have a reminder of the legislation, especially the 'mischief' it purports to address. The legislation was introduced on 6 April 2007 as a response to the government perceiving a significant growth in arrangements to avoid PAYE, NIC and the existing IR35 legislation by providers setting up personal service companies for contractors who might otherwise have been taxed as employees.

The government noted that a whole industry had developed whereby providers were forcing contractors into managed personal service companies by taking on contractors and 'churning out' personal service companies simply to save tax.

How the legislation works

The aim of the legislation was not to focus on the contractors or their personal service companies. (The IR35 legislation already did that and was a time consuming and often fruitless process for HMRC). Instead, it focused on the providers (and any associates) putting the contractors through what HMRC felt was the personal service company 'sausage machine'.

For the managed service company legislation to apply, there first needs to be a managed service company provider involved in any arrangements. This is an organisation or person that 'carries on a business of promoting or facilitating the use of companies to provide the services of individuals'. The managed service company provider can:

- benefit financially on an ongoing basis from the provisions of services of the worker;
- influence or control those services;
- influence or control the way in which payments are made;
- influence or control the personal service company's finances or activities; or
- underwrite any tax loss suffered by the personal service company.

Within the legislation, there are exemptions where the potential managed service company provider is merely providing legal or accountancy services in a professional capacity, or is merely placing individuals at third parties (for example, employment businesses acting as an introductory agent). Where the exemptions apply, that business will not be considered a managed service company provider, such that the managed service company legislation would not apply.

Another key concept is that where the managed service company legislation applies, the assessment of income tax and NIC due will be raised by HMRC on the contractor. However, if the contractor is unable to settle the income tax and NIC due, then HMRC can transfer the debt to other parties, including the managed service company provider. There are limited grounds for the provider to appeal against the transfer of debt. In practice, the most effective appeal would be in tandem with the contractor's appeal that the tax and NIC was not due in the first place – something that will require careful management.

What has changed?

As far as the legislation itself, nothing has changed. However, there have been two important developments since 2007.

The first is the digitisation of accountancy services. Increasingly, accountants and their clients interact electronically, often via information uploaded through portals for the generation of electronic returns. Much of this has been driven by government requirements to file electronically; for example, iXBRL tagging, Real Time Information payroll filing and Making Tax Digital. This means that some accountancy practices operate differently to how they did in 2007.

The second development is that in 2016 HMRC won *Christianuyi Ltd & Others v HMRC*, the first managed service company case to appear before the tribunals. HMRC was also successful in subsequent appeals before the Upper Tribunal and Court of Appeal. Consequentially, HMRC started opening enquiries on the back of its success.

In early 2022, HMRC issued a number of tax assessments resulting from these enquiries. These were seemingly as a result of time limits for assessments needing to be issued by HMRC to protect its chance to collect tax if it was due, rather than necessarily being confirmation that tax was due. As the assessments under the managed service company legislation are raised on the contractors rather than the managed service company providers, the enquiries burst into the public arena when contractors started commenting in public forums about the assessments.

Does HMRC have a case?

Clearly, every case needs to be judged on its merits, which limits the value of some of the general comments made. However, it appears there are two key themes affecting HMRC thinking:

1. HMRC is trying to apply the judgment in *Christianuyi Ltd* more widely.

2. HMRC is seeking to argue that businesses relying on the exemption to being a managed service company provider by providing legal or accountancy services in a professional capacity cannot readily rely on that exemption.

On the first point, clearly no two cases are the same. Indeed, no two contractors or their relationships with their advisors are the same. In taking *Christianuyi Ltd* to the tribunal as the first managed service company case, HMRC clearly picked a case it was highly likely to win. In our view, the facts of that case are not a reflection of wider trends and, importantly, at no point did the purported managed service company provider in question seek to rely on the legal or accountancy services exemption.

The bigger concern relates to the legal and accountancy services exemption. In the run up to April 2007, many organisations undertook assessments to gauge their readiness for the managed service company legislation coming into force and took appropriate corrective action. This resulted in a number of organisations becoming or rebadging themselves as accountants (with, of course, adjustments to their operating model). Many of those providers hired and trained accountants and joined accountancy professional bodies, which included signing up to their codes of conduct and regulatory regimes. In other words, they operated as specialist accountancy firms, not businesses churning out personal service companies for no other reason than potential tax savings.

It has now been 15 years since the legislation went live and the way in which a typical accountancy provider operates is a world away from the mischief envisaged by the legislation.

There does appear to be a misunderstanding from HMRC on how accountants operate, particularly when the client is a contractor. Most contractors' accountants have a model that involves the accountant advising on appropriate models of operation and due to general accepted practice, most (but not all) contractors incorporate their business to both take advantage of potential tax breaks but also to ring-fence risks.

HMRC's rather narrow view is that by incorporating, and the contractor's accountant assisting with incorporation, then the accountant is influencing or controlling the way the worker is paid. It does not recognise that a well-run accountants will advise based on the client's position and, where circumstances are more appropriate, advise to not incorporate. Does this sound like a 'sausage machine'?

HMRC seems to have interpreted the standard operating model of contractors' accountants as something driven by tax rather than client service. The standard approach is that the contractor signs up for the services, which are paid for monthly in instalments via direct debit, in anticipation of the accountant filing their tax returns, annual accounts, running payroll, etc. The business rationale for this is to smooth out the costs to ease cashflow – there would be monthly payroll running costs but certain months (for example, January when tax returns are filed) would see larger fees if this smoothing didn't take place.

In HMRC's opinion, monthly billing is 'benefiting financially on an ongoing basis from the provision of services'. A key finding in *Christianuyi* was that flat rate fees in that case meant that the company fell within that provision, which no doubt is why HMRC is taking this position more widely. However, where the service provider is simply spreading the cost over a year, as may be modern commercial practices, our view is that the test is not met.

Another worrying position taken by HMRC emerges where access to the managed company services is via a portal. This allows the provider to receive the relevant information in electronic form to link in with relevant software to enable online filing of returns and perhaps reflects modern preference as well. HMRC's view is that this means the provider is controlling the personal service company's activities. Perhaps this is rooted in the Dickensian view of Bob Cratchit-like accountants on high backed chairs poring over paper ledgers!

HMRC's position is a concern because, if such views are ingrained, it may take a while to reappraise them. As assessment windows are closing, this means there could be further assessments each year until the matter is resolved. These assessments are particularly concerning because the target is the contractor's accountant; however, the assessments are made on the contractor with a subsequent transfer of debt but with no scope for the purported managed service company provider to appeal against the managed service company legislation applying.

What should contractors' accountants and contractors be doing?

The main point is to be vigilant and not rely on historic practice. Instead, accountants should review their position and take advice as necessary to ensure that they aren't getting close to HMRC's view of a managed service company provider. Contractors should ensure that their accountant looks and acts like an advisor and that the contractor makes all relevant decisions – albeit based on best practice advice received.

Changes made in 2007 intended to avoid the accountant being deemed as a managed service company provider may have evolved without the necessary reflection as to whether they undermine their case currently that they are not a managed service company provider. This is both a reminder and a good opportunity to reassess practices to determine whether the organisation is considered a managed service company provider.

Of course, if assessments are received by contractors, they should take advice and appeal within the 30-day time limit if they don't agree with the tax liability requested. Contractors' accountants should react accordingly, taking note of the fact that it will be the client who needs to appeal. However, due to the transfer of debt risk the accountant has a vested interest in those appeals being made in a timely manner and on sensible technical grounds.

Another key message is to keep abreast of developments. This is a current live issue and evolving rapidly (in tax terms anyway) so being flexible and adaptable is important to avoid getting into hot water.

For a contractor, the best question they can ask themselves is: ‘Does it feel like I’m dealing with an accountant providing tailored advice to my individual circumstances or does it feel like I’m being sold a set product and expected to fit into their way of doing business?’

If contractors’ accountants don’t feel certain that they can answer this question comfortably or withstand any HMRC review, they should review the current arrangements to determine whether this presents a risk under the managed service company legislation. It’s not unusual to find isolated errors which, if they become part of ‘normal practice’, could change the managed service company outcome, and seeking professional advice is recommended.

For businesses that have already received notification from HMRC that they are under enquiry, this should be taken extremely seriously. We’ve defended a number of these cases over the years. None of them are simple but the common theme was that early advice always helped. Contractors should not delay in asking for help if HMRC get in touch!