THE INSTITUTE OF CHARTERED ACCOUNTANTS IN ENGLAND AND WALES

Parliamentary Briefing

Finance Bill 2007

Committee Stage Briefing, Schedule 3 and Clause 26/ Schedule 4

1. Managed Service Companies (Schedule 3)

Effect of clause and Schedule

Clause 25 and Schedule 3 are designed to tackle the avoidance of income tax (and, through associated legislation, national insurance contributions) through the use of managed service companies (MSCs). Under the provisions, payments and earnings of workers from the MSC which can reasonably be taken to be in respect of services but which are not currently treated as earnings are treated as deemed employment payments by the MSC. The result is that such payments will be liable to PAYE in the same way as normal employment income.

Paragraph 4 of Schedule 3 inserts new section 61A to 61J into ITEPA 2003. New section 61B defines a managed service company. Section 61B(1)(d) states that a person carrying on a business of promoting of facilitating the use of companies to provide the services of individuals is an MSC provider, but section 61B(3) then excludes from this definition a person providing such services merely by virtue of providing legal or accountancy services in a professional capacity.

In addition, where the MSC did not make the necessary PAYE deductions or subsequent payments, these amounts may be recovered from certain persons connected to the MSC (the so-called 'debt-transfer rules'). This provision is set out in Paragraph 6 of Schedule 3, which inserts a new section 688A into ITEPA 2003.

ICAEW Issues

(i) Definition of an MSC provider

We support the principle and purpose of the legislation. However, we think that the legislation needs further amendment so as to ensure that it is properly targeted and does not catch professional firms who provide similar services to MSCs. The legislation is ambiguous as to whether firms of chartered accountants and tax and business advisers who, as part of their other services, advise clients about the best structure through which to trade and provide the necessary company secretarial services to enable them to do so, are within the definition of 'an MSC provider'. We understand that HMRC do not consider that such firms are within the definition (on the basis that their business extends beyond that defined in the legislation). We therefore consider that the legislation should be clarified to make this clear and to accommodate niche accountancy firms.

For example, many professional accountants will, on detailed consideration of the circumstances, recommend a corporate structure to a client and then provide the client with an off-the-shelf company for that purpose. It would appear to us that a professional accountant who advises his client to incorporate in this way is 'promoting' the use of companies (to use the wording in new section 61B(1)(d)) and, if he provides an off-the-shelf company for this purpose, he is 'facilitating' the use of companies (also to use the wording in new section 61B(1)(d)). However, these activities are an incidental part of a professional accountant's business of providing the best all-round service to his client.

Whilst HMRC has said in meetings that they will explain in guidance where they intend to draw the line between firms of accountants and tax advisers referred to above and others who carry on business of actively promoting and facilitating the use of companies to provide the services of individuals, that is no substitute for having a legal definition.

This is because, if the definition is not incorporated into the law, the courts cannot consider the point in cases of dispute and so taxpayers cannot be certain of their rights and obligations.

We are concerned that without clarification the purpose of this legislation will be misunderstood and many traditional accountants and advisers will inadvertently be brought within the remit of this legislation, when we believe the aim of Government is to have a very targeted measure.

The legislation does appear to give rise to the problem of 'tainting' so that if an accountant's involvement with one company makes him a MSC Provider then he or she is also a MSC Provider for all personal service companies (PSCs) for which he or she acts, even if those actions are only accountancy services. Being categorised as an MSC Provider (ie, tainted) for one client, denies access to the accountancy and legal services exemption to all other clients. We understand from discussions with HMRC that they do not believe this to be the case and we would welcome confirmation of that point and to see it included in any accompanying guidance.

Suggested amendments

1. In order to clarify the legislation and provide certainty to taxpayers we recommend the following two amendments in para 4 of Schedule 3 to new section 61B(d) ITEPA 2003:

in line 21

- after 'business' insert 'wholly or mainly'

and

- after 'promoting' substitute 'and' for 'or'

so the sub-clause will read as follows

'(d) a person who carries on a business wholly or mainly of promoting and facilitating the use of companies to provide the services of individuals ('an MSC provider') is involved with the company.' (changes underlined).

Another possibility is to draw a distinction between the adviser who offers advice on appropriate structures dependent on the facts (i.e. the bespoke business adviser) and the promoter who has a packaged solution which is the only or main 'product' which they are actively encouraging clients into.

2. In order that a 'good business advisor' will be protected by the exclusion for accountancy services we propose the following amendment to Schedule 3 to new section 61B ITEPA 2003. This amendment is a probing amendment and the definition of accountancy services is the one that we are currently using for a member consultation:

Insert new subsection (5)

- '(5) For the purpose of subsection (3) above, accountancy services include the preparation or provision of records, returns, financial statements, reports, financial information or advice concerning accounting, auditing, insolvency or taxation matters; or the representation of a client to/before third parties in matters concerning accounting, auditing, insolvency or taxation.'

3. In order to apply the exemption for accountancy and legal services to all personal service companies, and avoid 'tainting', we recommend the following amendment in para 4 of Schedule 3 to new section 61B(3) ITEPA 2003:

in line 35

- replace 'subsection' with 'subsections'

and

- after '(1)(d)' insert 'or (2)'

so that the sub-clause will read as follows

'A person does not fall within subsections (1)(d) or (2) merely by virtue of providing legal and accountancy services in a professional capacity,'

(ii) Debt transfer rules

We are concerned about how widely the debt transfer rules could be applied and more clarity is needed as to who the debts could be transferred to if the MSC closes down and tax is left outstanding. Third parties, like recruitment agencies, could be potentially exposed to a liability whilst having limited ability to avoid such an exposure. Recruitment companies are excluded from the provisions which categorise companies as MSC Providers but do not have a similar exemption from the debt transfer rules. It should be clear that the provisions are only targeted at those who were involved with promoting the MSC.

Technically, non-shareholding ordinary employees of a MSC could be caught by the third party liability rules. We understand this is not the intention of the legislation and this may be included in guidance but this is an item that should be clarified in the legislation.

Interest is due on the debt even if becomes payable by a third party. Interest is perceived by HMRC as restitution for the loss of the use of the money but there is a significant difference between transferred debt to other parties and the normal circumstance of ordinary late payment. In the former case the third party may have no previous knowledge that there was a debt outstanding. Hence, the interest charge looks like a penalty in these circumstances.

Another possibility is to draw a distinction between the adviser who offers advice on appropriate structures dependent on the facts (i.e. the bespoke business adviser) and the promoter who has a packaged solution which is the only or main 'product' which they are actively encouraging clients into.

A further confusion is that the exemption for accountancy and legal services used for the definition of an MSC Provider differs from the exemption from the debt transfer rules.

Suggested amendments

Six amendments are required as follows:

1. To clarify that non-shareholding ordinary employees of a MSC are not caught by the third party liability rules, we suggest the following amendment to Schedule 3 to new section 688A ITEPA 2003:

Insert new subclause (9)

- ‘(9) A person does not fall within subsection (2)(d) merely by being an employee but not a director.’

2. That interest does not run on debts transferred to a third party unless that person was involved in promoting the MSC and knew, or should have known, that the debt had not been paid

3. In order to apply the exemption for employment businesses to the debt transfer rules, we recommend the following amendment in para 6 of Schedule 3 to new section 688A ITEPA 2003:

Insert new subclause 3A:

- ‘(3A) A person does not fall within subsection (2)(c) 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); but this subsection does not apply if the person, or an associate of the person, does anything within any of paragraphs (c) to (e) of subsection (2) of clause 61B(2).’

4. In order to maintain consistency between the exemption for accountancy and legal services for the definition of an MSC Provider and the exemption from the debt transfer rules, we recommend the following amendment in para 6 of Schedule 3 to new section 688A ITEPA 2003:

in line 22

- replace ‘advice’ with ‘services’

so that the sub-clause will read as follows

‘A person does not fall within subsections (2)(c) merely by virtue of providing legal and accountancy services in a professional capacity,’

5. In order to ensure that the debt transfer rules do not apply to those who might otherwise be loosely connected with a managed service company, we recommend the following amendment in para 6 of Schedule 3 to new section 688A ITEPA 2003:

in line 17

- after 'encouraged,' insert 'actively'

so that the sub-clause will read as follows

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

6. New section 688A(7) gives the Treasury the power to amend by way of regulations section 688A (1) to (6), subject to the need to lay the regulations and have them approved by Parliament (as set out in section 688A(8). This gives Treasury is a very wide-ranging power to, in affect, completely rewrite section 688A. We do not think Treasury should be given such an unfettered power. We think that this power should be amended and made more targeted.

We propose that the power of Treasury should be limited only to adding to the list of persons under section 688A(2).

in line 35

- delete 'this section' and insert 'the list of persons set out in subsection (2) above'
- delete the words in brackets at the end of section 688A(7)

so that subclause 7 will read as follows:

- 'The Treasury may by order amend the list of persons set out in sub-section (2).

2. Restriction on loss relief available to partners (Clause 26, Schedule 4)

Effect of clause

The clause and schedule restricts tax relief for losses arising to non-active or limited partners. Tax relief is limited in the following two circumstances:

- where capital contributions are made by a non-active partner where the main purpose, or one of the main purposes, is for the partner to obtain a tax deduction by way of sideways loss relief; and, additionally

- the amount of trading losses sustained as a non-active partner that can be claimed as sideways loss relief or capital gains tax relief is limited to a maximum limit of £25,000 a tax year (referred to as a 'cap').

ICAEW Issues

The measure is being introduced in respect of concerns over certain marketed tax avoidance schemes. The Treasury is rightly concerned about such schemes and the first of the above two measures (set out in paragraph 2 of Schedule 4) is a suitably targeted measure that appears to address the issue.

However, the second of the two measures, namely the overall £25,000 limit on sideways loss relief and capital gains tax relief for non-active partners (set out in paragraph 1 of Schedule 4), is a cause for concern. The limit applies regardless of whether the sole or main purpose of the investment was to generate a tax loss. The key condition is that the investment was made by a non-active partner. The measure is not targeted solely at tax avoidance schemes and is therefore much more widely targeted. The result is that the measure will impact upon many small businesses being set up with substantial investment in the early years.

It is very usual for new businesses starting up to source finance from family and friends which can be injected either by way of loan or by the person putting in the money becoming a sleeping partner. If the sleeping partner has other taxable income and the business suffers a loss, then loss relief against this other income is available immediately. In many cases, any tax repayment will be reinvested into the business. However, if the sleeping partner's investment is treated as a loan, relief is only available if the loan itself eventually proves irrecoverable. We attach as an appendix some case studies showing possible scenarios of how this measure will apply in practice and the problems that might result.

We have not seen a justification for the general imposition of a £25,000 limit on non-active partners, but the proposed limit looks too low. Investment in growing businesses is inevitably risky, and this measure increases further the potential risk. The result of this measure and the increased risk profile will be an increased reluctance of potential investors to provide finance as sleeping partners. They may be unwilling to now provide finance, even if it could be provided by way of loan capital. The measure is likely to make it much more difficult for growing businesses to obtain finance in a flexible and cost-effective way.

Suggested amendments

1. As the first of the two measures mentioned above appears to achieve the primary objective in tackling tax avoidance schemes, we think that the second measure should be dropped from the Bill. Accordingly, we propose that paragraph 1 of Schedule 4 should be deleted from the Bill, with consequential renumbering of the following sections.

2. If this amendment is not accepted, then the cap should be raised to a more reasonable level. We suggest a cap of £100,000. Accordingly, our suggested amendment is:

- In line 11 on page 99, substitute '£25,000 for '£100,000'

3. Future Public Bill Committee briefings

The ICAEW will be providing committee briefings for Clauses 27, 35, 50 and 96/ Schedule 24.

Further information

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Appendix One

Clause 26- case studies to demonstrate impact

Case Study 1 – Hairdressing Salon

A hairdressing salon and nail bar was set up by a brother and sister. The brother is a sleeping partner and the sister received a prior share of profits for working in the business. As with many new businesses, there are losses in the first year as turnover is very low. The turnover is £25,000 with tax adjusted expenses of £60,000. As a result, there is a loss in the first year of £35,000 which is wholly attributable to the sleeping partner because of the prior share of profits due to the sister. The second year of the business shows a much higher level of turnover and so a small profit, but because of the prior share, not much of this is attributable to the sleeping partner. It would therefore be a considerable period of time before he utilises his losses if he was restricted from claiming them against other income or by carrying them back to previous years as opening year losses.

Case Study 2 – Kennels

Mr Smith is the manager of a supermarket. His wife decides to open a kennels and they incur substantial expenditure in converting part of their property to be a kennels. The business is structured as a husband and wife partnership. The decision to set up the business will in part be financed a substantial tax repayment due to Mr Smith in the first year which will help to reduce the significant capital cost of building the kennels. The proposed changes would restrict this relief.

Case Study 3 – Public House

A pub was purchased by a husband and wife. The wife was a full time school teacher and the husband ran the pub. The couple had four children and had sold the family home to finance the purchase of the pub. It would clearly be difficult for the wife to commit to spending a significant amount of time working in the pub, but as it happened the family home had been hers before the couple met. It was reasonable that the couple would be equal partners in the new business. The rental payments proved onerous and the business suffered severe losses in the early years. The ability to claim loss relief against the wife's income was essential in keeping the business trading. The proposed changes would restrict this.

Case Study 4 – Management Consultancy

Two firms of management consultants operating in Bristol and Birmingham, Bristol LLP and Birmingham LLP decide to merge. It would be possible to do this by transferring all activities to one LLP or, alternatively, to reduce liability risks, by admitting the Bristol partners into Birmingham LLP and admitting the Birmingham partners into Bristol LLP, with all partners sharing profits (and losses) from both Bristol LLP and Birmingham LLP.

If a loss was made by, say, Birmingham LLP, and that this was funded by the Bristol and Birmingham partners all injecting part of their Bristol LLP profits into Birmingham LLP given that:

- management consultancy is, arguably, not a profession, and
- that the Bristol partners wouldn't be working 10 hours a week for the Birmingham LLP

following the proposed changes the Bristol partners would get minimal relief for the losses even where they have suffered substantial economic losses. This appears wholly unreasonable.

Case Study 5 – Farming

A husband and wife buy a small run-down farm. The husband works in the City. They live on the farm and the husband has a lengthy commute. The husband is a high-earner but expects his career in the City to be short-lived. The aim is to upgrade the farm and develop it into a profitable business. They are able to upgrade and maintain the farm to a high standard, by repairing fences, ditches and outbuildings, investing in decent machinery and employing more staff. They are able to do this even if the farm itself does not generate much income because of the employment income.

Farmers already face a restriction on loss relief for their losses in year 6 if they have sustained 5 years of losses in order to prevent hobby farming. However, this is not a hobby. The partners are used to making money in the City/business and want to do so in their farm activities too. They are also providing important local employment as well as helping to preserve the countryside and the environment.