

## Service Companies question on self assessment returns

### Guidance for CIOT/ICAEW Members

*Guidance to members of the Chartered Institute of Taxation (CIOT) and Institute of Chartered Accountants in England and Wales (ICAEW).*

Members involved in completing 2007/08 income tax self assessment returns for clients will have seen the new question on the fourth page of the standard return regarding service companies. This prompted a significant number of practitioners to contact CIOT and ICAEW expressing concern about the question. We have previously advised that we were actively discussing this with HMRC.

CIOT and ICAEW met recently with HMRC and had constructive discussions about the objectives of the question and how the box is intended to be completed. In consequence, HMRC has announced that it is revising the wording accompanying the box for the 2008/09 tax return and has published revised guidance to apply both to the current and future years for this issue.

The revised guidance explains and amplifies what is meant by 'service company' and explains when you can ignore the box:

**Complete this box** if you provided your services through a service company.  
*You provided your services through a service company if:*

1. *you performed services (intellectual, manual or a mixture of the two) for a client (or clients); and*
2. *the services were provided under a contract between the client(s) and a company of which you were, at any time during the tax year, a shareholder; and*
3. *the company's income was, at any time during the tax year, derived wholly or mainly (that is, more than half of it) from services performed by the shareholders personally.*

**Do not complete this box** if all the income you derived from the company was employment income.

The CIOT and ICAEW have anticipated some of the questions which may be asked by our members, which are answered below.

### Frequently asked questions

#### **Q What is the purpose of the question?**

A HMRC stresses that its objective in asking for information about service companies is to improve the way that it risk assesses situations that might fall within the ambit of the IR35 or Managed Service Company legislation.

We are assured that the question is not related to information gathering about owner managed companies more generally, nor to income shifting in particular.

The purpose is to identify the population which should contain all potential IR35 companies and Managed Service Companies.

**Q Surely this will be a very large population?**

A Yes. HMRC intends to draw the net wider than just companies that are subject to IR35 or MSC legislation – the question is intended to pick up all cases where services are provided personally *by* an individual *through* a company *to* a third party. The important criterion is not whether a company is in the IR35 net, but whether the 50% test is passed (i.e. whether 50% of the company's income comes from services provided by shareholders personally).

Very many of these companies will be outside the IR35 legislation, for example, because the individual is in business on his own account and his relationship with the client is therefore not a quasi-employed one: the income should nevertheless be declared.

**Q Is the question related to similar questions being asked of companies on their employers' Form P35?**

A Yes. This question is intended to parallel, as far as possible, the *first* of the two questions posed on the P35 which asks 'Is the company a service company?'

The P35 guidance will be amended next year to reflect this.

**Q Why does the question not also state specifically that it targets shareholders? That is only made clear in the Guidance Notes.**

A The revised wording of the question had to be as concise as possible. Also, the format of the 2009 Tax Return had already been finalised and only minor changes were possible by the time of our discussions. The decision was therefore taken to put the detailed explanation in the Guidance Notes instead.

**Q Does the question apply only to service companies?**

A From the wording of the revised guidance and discussions with HMRC, it is clear that the phrase 'service company' is something of a distraction. The word 'service' could be dropped altogether without changing the nature of the question. Anyone who works through an owner managed company in a service industry may need to complete the box if more than half of the company's income derives from the services of the shareholders.

The third condition in HMRC's guidance requires the box to be completed if more than half the company's income came from services performed by the shareholders 'at any time during the tax year'. We understand that this has been widely drafted to ensure that taxpayers cannot avoid completing the box by manipulating the company's income and the days during the year on which they work so that they do not coincide.

**Q Why aren't very small shareholdings excluded?**

A HMRC is concerned that to exclude shareholders owning less than, say, 2% of the company shares would simply encourage umbrella type companies to be set up such that shareholders owned just under the limit in order to remain below the risk

assessment radar. This does mean that, depending on the company's business, employee shareholders of some quoted companies may need to complete the box.

**Q Deciding whether more than half of a company's income comes from services provided by the shareholders could take hours. What about the administrative burden?**

A We have explained to HMRC that this will give rise to an administrative burden for businesses which may be unsure about whether more than half of the company's income comes 'from services performed by the shareholders personally'. For example, in a father and son plumbing business where the father owns the company and both work full time, the father would need to calculate whether more than half of the company income derives from his work. However, HMRC insists that it needs the information and that it has the power to ask the question. It has nevertheless confirmed that no individual or company need keep records purely for the purpose of answering this question.

In most cases it will be obvious whether the 50% limit has been exceeded or not. However, if an adviser is unsure about whether the limit is exceeded 'at any time' then to save the effort of lengthy calculations and valuations, apply reasonable judgement to arrive at an answer to the question. If in doubt we would suggest that completing the box would minimise the risk of any subsequent penalty for failure to complete this part of the return and as any borderline case is unlikely to be a company within IR35 or MSC legislation this is unlikely to provide HMRC with any particularly useful information.

The figure which should be entered is dividends including the tax credit plus gross salary. This will be made clear in the 2008/09 question. Benefits in kind, other employment income and other income (e.g. rent and interest derived) from the company may be ignored.

**Q Will individuals who have completed the box be more likely to be selected for an enquiry?**

A HMRC has said that it is using this information to identify IR35 and MSC cases which are underpaying tax. If the taxpayer is one of these, or is perhaps a marginal IR35 case, then the answer is possibly yes. It is, however, difficult to see how individual cases will stand out with so many business owners completing this box.

The CIOT and ICAEW will be monitoring members' experiences of this in the future and would welcome feedback on this.

**Q Do returns which have already been submitted need to be changed?**

A The revised wording and guidance is intended to apply to 2007/08 returns as well as to 2008/09 returns. However, HMRC makes it clear in its own announcement that any tax returns already submitted do not need to be revised.

**Q How would HMRC penalise a taxpayer who completes this question incorrectly in the future?**

HMRC has confirmed that 'there will be no adverse consequences' for taxpayers who have already submitted a 2007/08 tax return in which this box has been incorrectly completed.

If in the future a person failed to complete the box and was not an IR35 or MSC case, then there would have been no underpayment of tax and hence there will not be a penalty.

If tax was due under the IR35/MSC rules and was not properly reported, then a penalty would be due under those provisions.

**Q Is HMRC actually entitled to ask for this information in a tax return?**

A We put forward the argument that the information being sought is more in the nature of an enquiry, involving judgement, rather than factual data gathering. However, HMRC is adamant that the Taxes Management Act gives it the power to ask for such information and also justify the request in practical terms. As noted in the first of these Qs & As, HMRC's objective is to target its risk assessment better; thus it argues that gathering this information will lead to better-targeted enquiries.

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