

CONVERTING FROM A MSC TO A PSC

From April 2007 so called “Managed Service Company” arrangements lose their current tax privileges and become tax disadvantageous for contractors. For most contractors the answer is to set up a Personal Service Company. This is a guide to the terms, changes from April and what's involved.

WHATS CHANGING?

In the 2006 Pre Budget Speech the Chancellor indicated that from April 2007 a new tax regime was to apply to MSCs. Details of this are still to be worked out, but put simply it will force all MSC operators to apply IR35 / PAYE on all income to a contractor, bar some very limited tax free expenses. The scheme operator will be personally liable for tax if they fail to do this.

WHAT DOES THIS MEAN FOR A MSC USER?

For the user of a Umbrella Company, the expenses you can claim may well reduce. Other than that the tax and NI rates will be unchanged.

For the user of a Composite Company, or any MSC paying dividends, there will be two effects – a large increase in tax/NI rates as NI will have to apply to income previously paid NI free, and, secondly, your tax free expenses will decrease.

We've appended some financial illustrations at the end of this document.

So why the changes? The Government were concerned that (a) IR35 was not being applied in the sector, (b) expense rules were being abused by MSCs who were encouraging / allowing contractors to make expense claims which were not justified under Tax legislation, and (c) under current rules any attempt to recover back tax under (a) and (b) often failed as the companies would just go into liquidation.

DEFINITIONS

MSC	Managed Service Company – in essence any contracting arrangement like an Umbrella or Composite where a manager such as an accountant runs the affairs of a contractors company, with the contractor having little or no control over business matters.
PSC	Personal Service Company – a company owned by a contractor, and maybe a spouse/partner, which is used to provide the services of the contractor to clients and agents. In contrast to a MSC the Contractor will run most commercial aspects of the company.
Umbrella Company	A form of MSC which usually works on a PAYE basis only, which is for all practical purposes the same as being IR35 caught. A true Umbrella distributes funds by salary and expenses, and not dividend.
Composite Company	A form of MSC where a number of contractors share one company, run by an accountant or similar, and where the contractors receive dividends, salary and expenses
IR35	The so called “intermediaries legislation”. IR35 applies PAYE, outlawing the tax savings of dividends, where contracts constitute disguised employment. IR35 applies to MSCs and PSCs – an Umbrella company, in its truest sense, is already applying IR35.
S660a	A disputed piece of legislation, which has been subject to various court cases over recent years, with a further appeal hearing in 2007. It seeks to restrict the use of a spouses tax allowances.

NB the terms MSC, Umbrella and Composite are nebulous – the legislation is to be framed so as to be all embracing.

THE SOLUTION?

For most current MSC users, the solution is to move to a PSC. Staff at Garbetts have 20 years experience in setting up and running PSCs. Unlike some accountants, we don't do only PSCs – we are a full service firm with a diverse range of clients, and amongst are 25 staff, a wide range of experience.

So what are the differences between a PSC and a MSC?

	MSC	PSC
The legal form	Limited Company	Limited Company
Run by	Accountant / manager	Contractor [but normally uses an accountant to assist with tax returns, year end accounts and IR35 advice]
Who does:		
- invoicing	Accountant / Manger	Contractor [but can buy the service in]
- banking and cash management	Accountant / Manger	Contractor
- IR35 compliance	Accountant / Manger	Contractor [but can ask for advice / contract reviews]
- Annual accounts / tax returns	Accountant / Manger	Contractor [but normally engages an accountant]
- Payroll	Accountant / Manger	Contractor [but can ask accountant to do it]
- VAT	Accountant / Manger	Contractor [but can ask accountant to do it]
- bookkeeping and transaction recording	Accountant / Manger	Contractor
- expense claims	Accountant / Manger based on form supplied by contractor	Contractor
Tax regime – pre 5.4.07	PAYE [Umbrella] PAYE/dividend mix [Composite]	PAYE / dividend mix [if outside of IR35] PAYE only if caught by IR35
Tax regime – post 6.4.07	PAYE	PAYE / dividend mix [if outside of IR35] PAYE only if caught by IR35
Who is responsible for running the company	Accountant / Manager	Contractor [as director]
Directors of company	Supplied by Accountant / Manager	Contractor

HOW DO I SET UP A PSC AND WHAT DOES IT COST?

Garbetts can help you set up a PSC.

We have a simple downloadable questionnaire in excel at

<http://www.garbetts.com/download/formationquestionnaire.xls>

and some notes at <http://www.garbetts.com/download/forming.pdf>

A company can be formed almost instantly, but allow up to four weeks for opening bank accounts and vat registrations, so its best to give yourself plenty of time.

Costs:

- forming your company £100 + vat + £10 name change fee = £127.50, payable on application
[NB you can buy a company, supply only, for a lot less online. What we are charging for is not only supply of the company, but assistance with the myriad of Companies House, Tax and bank forms, as well as handholding to get you going]

- running costs £800 pa + vat, payable by monthly standing order of £78.33 per month

- recommended, but not compulsory, Tax Enquiry Insurance provided by Qdos at £130 pa. This covers professional fees of up to £50,000 for a tax enquiry, including IR35 disputes.

The running costs of £800pa + vat are comprehensive, specifically:

Included

Annual accounts
Payroll
Checking vat returns

Company tax returns
Personal tax returns
IR35 contract reviews and advice
Registered office service
Nominee secretary service
Routine tax queries and administration

Not included

Regular bookkeeping
Invoicing
Tax credit claims / support [working tax credit etc]
Tax enquiries / IR35 disputes

The full service specification is at <http://www.garbetts.com/download/pscservices.pdf>

TAX TRAPS

There are a couple of points tax wise to watch out for:

IR35 – IR35 applies where a contract has the characteristics of “disguised employment”. If a contract fails IR35 the all contract fees have to come out as PAYE, with full tax and NI, rather than achieving the tax / NI savings from dividends. The rules on IR35 are the same for PSCs and MSCs, and from 6 April 2007 MSCs are subject to a compulsory form of IR35 regardless of the nature of the contract.

It is unlikely that a compulsory form of IR35 could ever apply to a PSC because it would be impossible for tax legislation to target that precisely.

See <http://www.garbetts.com/download/pscservices.pdf> for more information.

S660a – this is an old piece of tax legislation which HMRC have recently dusted off and tried to use to prevent the owners of small companies, mainly, but not exclusively, PSCs, from utilising the tax allowances of a non working spouse. HMRCs use of the legislation has been challenged in the courts, and at present [January 2007] case law supports the tax payer and has ruled HMRCs use of S660a incorrect. There is a further appeal in the courts shortly [Arctic Systems].

See <http://www.garbetts.com/download/S660A.pdf> for more information.

EXPENSES

One of the Governments gripes with MSCs is that they have been operating expense regimes which don't meet with tax legislation, specifically on travel and subsistence.

Our guide to expenses is at <http://www.garbetts.com/download/expenses.pdf>

If you are currently using a MSC then some of what you are used to, eg daily allowances for travel and subsistence, meals away from home, and similar, will not be allowable. However in most cases genuine travel and subsistence costs will be allowable, and under the new rules post April 2007 the expense regime in a PSC is much more generous than in a new style MSC as after April 2007 it will be near to impossible to get home to work expenses or staying away from home costs in a MSC, whereas with a PSC these should be claimable subject to the so called 24 month rule.

HELP AND ADVICE

If you need help and advice, why not visit www.garbetts.com/psc where you will find a myriad of assistance and advice relating to PSCs.

Alternatively contact us at office@garbetts.com, or on 01983 400350 asking for Paul Garbett or Susan Albest.

APPENDIX TAX RATES FOR TYPICAL PSC AND MSC

2006/07 Tax rates

Income Band £		MSC after 6.4.07 and PSC caught by IR35	PSC - outside IR35 - without spouse allowances £	PSC - outside IR35 - with spouse allowances £ (see note 5)
20,000	Tax/NI	5,738	3,380	2,960
	Take home	14,262	16,620	17,040
	% take home	71.3%	83.1%	85.2%
25,000	Tax/NI	7,760	4,330	3,910
	Take home	17,240	20,670	21,090
	% take home	69.0%	82.7%	84.4%
30,000	Tax/NI	9,783	5,280	4,860
	Take home	20,217	24,720	25,140
	% take home	67.4%	82.4%	83.8%
35,000	Tax/NI	11,805	6,230	5,810
	Take home	23,195	28,770	29,190
	% take home	66.3%	82.2%	83.4%
40,000	Tax/NI	13,803	7,180	6,760
	Take home	26,197	32,820	33,240
	% take home	65.5%	82.1%	83.1%
45,000	Tax/NI	15,774	8,797	7,710
	Take home	29,226	36,203	37,290
	% take home	64.9%	80.5%	82.9%
50,000	Tax/NI	18,197	10,760	8,660
	Take home	31,803	39,240	41,340
	% take home	63.6%	78.5%	82.7%
60,000	Tax/NI	23,006	14,685	10,560
	Take home	36,994	45,315	49,440
	% take home	61.7%	75.5%	82.4%
70,000	Tax/NI	27,815	18,610	12,460
	Take home	42,185	51,390	57,540
	% take home	60.3%	73.4%	82.2%
80,000	Tax/NI	32,623	22,535	14,360
	Take home	47,377	57,465	65,640
	% take home	59.2%	71.8%	82.1%
90,000	Tax/NI	37,432	26,460	17,594
	Take home	52,568	63,540	72,406
	% take home	58.4%	70.6%	80.5%
100,000	Tax/NI	42,241	30,385	21,519
	Take home	57,759	69,615	78,481
	% take home	57.8%	69.6%	78.5%
120,000	Tax/NI	51,858	38,235	29,369
	Take home	68,142	81,765	90,631
	% take home	56.8%	68.1%	75.5%
140,000	Tax/NI	61,476	46,085	37,219
	Take home	78,524	93,915	102,781
	% take home	56.1%	67.1%	73.4%
160,000	Tax/NI	71,093	53,935	45,069
	Take home	88,907	106,065	114,931
	% take home	55.6%	66.3%	71.8%

2006/07 Tax rates

Income Band £		MSC after 6.4.07 and PSC caught by IR35	PSC - outside IR35 - without spouse allowances £	PSC - outside IR35 - with spouse allowances £ (see note 5)
180,000	Tax/NI	80,710	61,785	52,919
	Take home	99,290	118,215	127,081
	% take home	55.2%	65.7%	70.6%
200,000	Tax/NI	90,328	69,635	60,769
	Take home	109,672	130,365	139,231
	% take home	54.8%	65.2%	69.6%
220,000	Tax/NI	99,945	77,485	68,619
	Take home	120,055	142,515	151,381
	% take home	54.6%	64.8%	68.8%
240,000	Tax/NI	109,562	85,335	76,469
	Take home	130,438	154,665	163,531
	% take home	54.3%	64.4%	68.1%

Assumptions:

- 1 All income is drawn from the company
- 2 Income is after deductible expenses, and exclusive of vat
- 3 For the example with spouse allowances, spouse has no other income
- 4 Outside of IR35, salaries of £8k pa assumed.
- 5 In some cases S660A may prevent spouse allowances being used in this manner – see the separate section on S660A on our www site.