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Service contracts attacked by HMRC

Over the last decade or so a number of tax-efficient business structures have arisen, some of which have been directly attacked by HMRC via legislation, and others which have been attacked by more general use of the law. A recent case has now highlighted the dangers of using 'consultancy arrangements.

The issue in this case was whether the taxpayer was liable to income tax under PAYE and NIC on payments made by the taxpayer to a company and a partnership ('the consultancy vehicles') where:

- the taxpayer had no staff, officers or employees other than the two directors;
- each of the directors was named as a consultant alongside his consultancy vehicle under a contract entered into with the taxpayer in 1999; and
- the directors actually carried out all the activities necessary to conduct the taxpayer's business.

For the tax years ending 5 April 2012 to 2015 determinations were issued under Reg 80 The Income Tax (PAYE) Regulations and s8 SSCA 1999. Income tax amounted to £116,771 and NIC amounted to £70,625.

The taxpayer carried on a business of running a petrol station business and the directors were not paid any remuneration directly by the taxpayer. The directors and their spouses owned between them all of the shares equally. There were no written contracts other than the 1999 agreements between the taxpayer and the consultancy vehicles which specified the fees and consultancy duties to be supplied to the taxpayer.

The directors visited the petrol stations together two or three times a week, checking the takings and the site to ensure that it was clean and there were no breaches of insurance conditions. Each director worked between 20 and 40 hours a week and provided such equipment as was needed to perform their services.

HMRC claimed that the payments made by the taxpayer were remuneration and that the 1999 agreements should be re-characterised as contracts of services rather than contracts for services. HMRC asked a number of third parties about identifying the party and capacity the person was acting in. None of the responses showed that the directors were operating in their capacity as consultants.

The taxpayer argued that there were no contracts of service in existence and that accepting the role of director did not automatically give rise to such a contract. There was a contract for services in existence in the form of the 1999 agreement, the directors were non-executive directors and the services required under the agreement were not those that one would expect a non-executive director to perform. Furthermore, there was no requirement under the Companies Act 2006 that a non-executive director should be remunerated and there was no pre-existing employment relationship before the consultancy arrangements were in place.

The taxpayer argued that the consultants could decline work and take breaks of their choosing which was completely incompatible with the master-servant relationship.

HMRC argued that:

- the omission of a precise description of the services to be provided was indicative that the contract was one of service and that the directors were under the complete control of the company. Furthermore, the number of hours actually worked were in fact indicators that they were actually engaged as directors;

- the directors were exposed to the risk and reward by virtue of being shareholders and not by virtue of being consultants. The taxpayer argued that if the consultants failed the company would become insolvent and the consultants would not be paid;
- the contractors existed only to provide services to the taxpayer. The taxpayer argued that this was not the case and the consultancy vehicles did in fact carry on other activities and had other customers;
- the fact that contracts had been rolled over for a decade was evidence of a contract of service but the taxpayer thought this was irrelevant; and
- that the consultants were part and parcel of the taxpayer's organisation which was consistent with them being held out as directors in communications with third parties. The taxpayer disagreed with this assertion.

The Tribunal reviewed the agreements and considered that they were contracts of service and did not accept the services provided were not the sort provided by non-executive directors.

The Tribunal concluded that when viewed realistically, as no services were provided by the consultants other than those provided by the directors, the payments should be regarded as having been awarded for the services as a director of the taxpayer.

The Tribunal decided that the arrangements were very tax efficient and that the tax collected would have been less than the tax paid as a director.

The Tribunal dismissed the appeals in full.

In addition to this case, Mercia has recently encountered a number of cases where HMRC are attacking the use of management charges, so it may be time to discuss with some of your clients the use of such arrangements.

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To help you keep your clients up to date with relevant announcements, we produce a concise, easy to understand summary in printed and digital formats. Our summary will also include a review of key aspects of the tax system, for individuals and businesses, in the run up to the end of the tax year. We will also focus on changes that take effect from April 2019.

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