Umbrella companies – why labour supply chain due diligence is essential

Tax voice

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Robert Woodward looks at umbrella companies and the risks for end clients of their non-compliance.

With the rise of flexible working, partly in response to changes in tax and employment law legislation, there have been changes in how organisations are resourcing their people. Consequentially, there has been a growth in more non-traditional worker models for organisations to contract with workers. This has meant the usual, well-established PAYE/NIC obligations for an organisation employing its employees have become more complicated.

Over recent years there has been a marked growth in alternative models and platforms as the gig economy has developed. This growth has been driven by business need for a flexible, immediate workforce to meet resourcing needs, but also by the workers themselves – often due to lifestyle choices. As a result of these developments, the lines sometimes appear blurred between what are the PAYE/NIC obligations of a traditional employer and those of an engager choosing alternative resourcing solutions to fill vacancies.

In particular, there has been an increase in the use of umbrella companies. While they have been a labour supply option since turn of the century, originating as they did from a response to the original intermediaries' legislation (IR35), it is apparent that they have become increasingly prevalent in light of the IR35 reforms in first the public sector (2017) and more recently in 2021 for organisations that are not considered "small".

Operation of an umbrella company

The term ‘umbrella company’ is something of a catch-all as there is no statutory definition of umbrella company and umbrella companies operate in different guises. Ultimately, businesses operating as umbrella companies will fall into three categories.

The first, and most common, category is that the umbrella company is an employer of a worker providing services to a third party under the terms of an agreement between that employer and either the third party or another organisation in the labour supply chain, such as an agency.

The second category is where the umbrella company is not the legal employer of the worker but acts as a payroll intermediary and processes payments for payroll purposes, operating PAYE and National Insurance as appropriate.

The third category is where the umbrella company is a payment facilitator, simply acting as a conduit for payment from the end client to the worker, without treating the worker as an employee for either tax or legal purposes (for example, engaging self-employed workers under the construction industry scheme).

Other models, such as Professional Employer Organisations (PEOs) and co-employment are becoming more popular and carry many of the same potential risks as placing workers with umbrellas even though they aren’t materially different and are often marketed as being fully compliant.

Typically, under an umbrella company structure, the client business will contract with an agency for a worker’s services. The agency will not pay the worker directly, instead contracting with an umbrella company. The agency will invoice the client to cover both its own fee for placing the worker with the client business and the costs of paying the worker – the latter portion will then be paid to the umbrella company. The umbrella company will

meet its costs out of the amount it has received from the agency. On the basis the umbrella company is treating the worker as an employee, these costs will include:

- payment of wages to the worker;
- administration costs (sometimes charged separately to the worker by the umbrella company);
- employer NICs (these cannot be deducted from the worker’s earnings because of statutory prohibitions);

- employer workplace pension contributions;
- holiday pay that the umbrella company is liable to pay to the worker;
- apprenticeship levy contributions; and
- (from 6 April 2023) employer contributions towards the new health and social care levy (with increased NICs for 2022/23).

The amount paid to the worker will often be referred to as the ‘contract rate’ or ‘pay rate’ and should be set out in the employment contract. This amount will be the gross amount. As the umbrella company is the worker’s employer, the umbrella company will be required to deduct any income tax or NICs that are due from the worker’s earnings under the PAYE system. Other deductions may also be made, for example, in respect of worker pension contributions.

Care needs to be taken to ensure that it is clear that any contract rate contains various employment costs that will be deducted before the worker receives their gross pay.

Are umbrella companies compliant?

The short answer is potentially yes – but it requires due diligence to understand what potential risks need to be considered and to what extent those risks are likely to manifest themselves in your circumstances.

Firstly, umbrella companies are often considered a “solution” to the challenges of IR35 but actually may just be moving the PAYE/NIC obligation along the labour supply chain. If a worker is engaged by an end client through what is understood to be an umbrella company, but the contractual arrangements are such that the engagement between the worker and the umbrella company is through a Personal Service Company (PSC), IR35 will still be relevant.

Organisations sourcing workers through an umbrella company must, therefore, exercise caution whenever PSCs are part of the labour supply chain even if a tax compliant umbrella company is another intermediary in the chain. This is because, while it is likely the umbrella company will be the ‘fee-payer’ for IR35 off-payroll purposes (as it will be the entity which makes payment to the PSC), the organisation will still be under an obligation to undertake an employment status assessment.

Furthermore, the organisation will also want to ensure it has the ability to communicate the conclusions of that assessment that to the worker (and the

umbrella company if the end client contracts directly with it) via a status determination statement (SDS). If the organisation has concluded that the arrangement falls within the IR35 off-payroll provisions, the umbrella company becomes required to operate PAYE and account for NICs on payments made to the PSC (see ITEPA 2003 section 61N(3)–(5), (8A)) but only when the SDS has been made and passed to the worker and umbrella company. Until that happens the organisation remains liable for any PAYE and NICs due and, potentially, remains liable if the umbrella company fails to operate PAYE and NICs correctly even if the SDS has been made and communicated.

Where IR35 is not in issue, other legislation that could still impact on the engagement with umbrella companies, for example because of:

- the managed service company legislation (ITEPA 2003 Part 2 Chapter 8);
- the changes to the employment intermediary regulations (ITEPA 2003 section 44);
- charges for travel and subsistence expenses for employment intermediary workers who are subject to supervision, direction or control (ITEPA 2003 section 339A);
- offshore intermediaries (ITEPA 2003 section 688);
- disguised remuneration (ITEPA 2003 Part 7A) through the use of contractor loan schemes.

All of these areas can result in significant liabilities if not handled correctly.

Due diligence is also important to gain comfort around ensuring fraudulent practices are not being undertaken in the supply chain: for example, the well-publicised cases of mini-umbrella companies set up to artificially claim the Employers' Allowance.

There is also a personal liability risk, most clearly demonstrated in the recent case of Umbrella Care v Nisa ([2022] EWHC 86 (Ch) where an umbrella company collapsed owing £36m to HMRC, in particular PAYE/NIC deducted from wages paid to workers (some of whom were actually being treated as self-employed) but not remitted to HMRC. The liquidators of the company were successful in reclaiming some of the unpaid debts from the directors who had extracted the funds for their personal benefit.

Whichever category the umbrella company falls into (and therefore the extent to which a PAYE/NIC risk exists), other considerations will apply regardless.

Organisations engaging with umbrella companies need to understand who is being paid, and what structures are involved in order to gain comfort that there is no tax evasion involved in the processes undertaken in engaging with the worker. If they don’t, there is a risk of failing to meet their obligations under the Criminal Finances Act 2017 and may fall within the strict liability corporate criminal offence of the failure to prevent the facilitation of tax evasion.

For larger businesses, that lack of due process and controls also brings into scope compliance failures under the Senior Accounting Officer legislation. However, businesses of all sizes need to be aware of the reputational, financial and even criminal risks at stake.

Future developments

The coming years are likely to see greater scrutiny and regulation of umbrella companies.

In 2021 the department for Business, Energy & Industrial Strategy brought the Gangmasters and Labour Abuse Authority, the Employment Agency Standards Inspectorate and HMRC’s National Minimum Wage together under a single enforcement body. Under the stewardship of Margaret Beels (the director of Labour Market Enforcement) the new body will review labour supply models. Labour supply chain due diligence will, therefore, be undertaken by a regulatory body and also feature as part of expected business strategy.

In addition, HMRC recently issued a call for evidence on umbrella companies, principally from businesses engaging with umbrella companies, asking questions around what labour supply chain due diligence is carried out by businesses. While we wait to see what changes come out of this consultation, it is clear that HMRC is paying attention and will continue to pay attention as they recognise that alternative labour supply models, from agencies to umbrella companies and platforms in the gig economy, have proliferated in recent years (especially since the IR35 reforms) increasing the risk of compliance failures.

Whether this leads to full regulation or a more formal basis for labour supply chain due diligence remains to be seen, but what is clear is the direction of travel towards greater scrutiny.