Umbrella companies: labour supply chains

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UK labour supply chains have evolved through layered tax rules, with new PAYE liability changes affecting umbrellas and agencies.

Key Points

What is the issue?
UK employment tax rules for labour supply chains have become highly complex, and from April 2026 unpaid PAYE and NICs can transfer beyond umbrella companies to agencies or recruiters higher up the chain.

What does it mean to me?
Even if you do not run payroll, you may become jointly liable for PAYE failures elsewhere in the supply chain, increasing risk for agencies, recruiters and advisers.

What can I take away?
From now on, labour supply chains need active scrutiny: understand deeming rules, assess SDC properly, and carry out stronger due diligence on umbrella arrangements.

Over the last 25 years, the UK's employment tax legislation has evolved largely in response to repeated attempts by successive governments to reduce PAYE and NICs avoidance in labour supply chains. What has emerged is a complex framework of 'deeming' rules that determine who is treated as the employer for tax purposes, often with results that are difficult to navigate even for experienced advisers.

Given the sheer volume of tax and employment rights legislation now in play, it is increasingly challenging for anyone new to the 'employment game' to engage workers with confidence that everything has been done correctly. Those who understand the issues tend to understand them very well; those who do not may remain blissfully unaware until something goes wrong.

From HMRC's perspective, tax administration would be simpler if all working individuals were employed and subject to PAYE and NICs. However, such an approach would sit uneasily with the need for labour market flexibility and global competitiveness. Businesses and workers alike often value flexibility just as highly as economists value efficiency in a capitalist market. When it comes to engaging workers, there is no single model that suits every situation.

Against this background, we consider why labour supply chains operate as they do and, in particular, the practical implications of recent and forthcoming changes affecting umbrella companies – most notably the introduction of joint and several liability for PAYE and NICs from 6 April 2026.

Why HMRC is targeting umbrella companies

An umbrella company is a business that employs workers who supply their personal services to end clients through contracts with one or more agencies. It operates payroll and accounts for PAYE and NICs on the workers' pay, without itself being treated as the employer under the agency, IR35, managed service company or other employment deeming rules. Umbrella companies have become a familiar feature of modern labour supply chains. In many cases, they perform a compliance function

that other parties in the chain – agencies, recruiters or clients – are unwilling or unable to fulfil, whether because of cost, volume, complexity or risk appetite.

However, umbrella companies have also been associated with significant non-compliance. A common abuse arises where an umbrella company deducts PAYE and NICs from workers' pay but fails to account for those deductions to HMRC. Although the umbrella company is legally liable for the tax debt, such entities – and often their directors – have a tendency to disappear before enforcement action can be effective.

There are additional reasons why HMRC is keen to reduce reliance on umbrella companies. Some have structured themselves as small agencies in order to claim the employment allowance or to benefit from the VAT flat rate scheme, while others have been linked to excessive expense claims or payslip fraud. From HMRC's perspective, these risks are compounded by the length and opacity of many labour supply chains.

The response has been legislative. From April 2026, where an umbrella company operates within a labour supply chain, new rules will allow liability for unpaid PAYE and NICs to move beyond the umbrella company itself.

The new joint and several liability rules from April 2026

The Finance (No.2) 2025 Bill introduces a new Chapter 11 into Income Tax (Earnings and Pensions) Act (ITEPA) 2003 Part 2. These provisions establish joint and several liability for unpaid PAYE and NICs arising in labour supply chains involving umbrella companies.

In broad terms, where an umbrella company fails to account for PAYE and NICs, liability will transfer to a 'relevant party' higher up the chain, starting with the next agency above the umbrella. Where there are overseas agencies or even overseas clients in the chain, liability will ultimately rest with the UK-based entity closest to the end client.

The policy aim is clear: to eradicate non-compliant umbrella companies by removing the ability for tax debts to die with them. The practical consequence, however, is that parties who do not operate payroll – including recruiters – may now find themselves exposed to PAYE and NICs liabilities arising elsewhere in the chain.

To understand how significant this shift is, it is necessary to revisit how labour supply chains operate and how the existing deeming rules interact.

A simple labour supply chain

In its simplest form, a labour supply chain involves a client engaging workers who supply personal services via an agency, with the work ranging from apprenticeships to senior management roles. The agency recruits the workers, supplies them to the client and is paid by the client, while the workers provide their services under the agency arrangement and the agency operates payroll, paying the workers and accounting for PAYE and NICs to HMRC.

In such straightforward arrangements, the agency must consider whether the agency rules in ITEPA 2003 Part 2 Chapter 7 apply. If they do, the agency is deemed to be the employer for tax purposes and is responsible for operating PAYE and NICs. If the agency rules do not apply, it may be because other deeming provisions apply instead. These deeming rules are central to understanding why labour supply chains – and umbrella companies – exist at all.

Deeming rules: who is treated as the employer?

An entity may be deemed to be the employer under a number of different legislative provisions, including:

- agency workers;
- employment intermediaries;
- managed service companies; and
- intermediaries to public authorities and medium or large business.

In addition (and for completeness), salaried members of LLPs are treated as employees subject to PAYE, which must be applied by the LLP (ITTOIA 2005 s 863A). Where there is no actual or deemed employer, the worker must be self-employed and may be paid gross, subject to employment status considerations.

However, the involvement of an agency brings additional obligations, including quarterly reporting under the Employment Intermediaries Regulations (The Income Tax (Pay As You Earn) (Amendment No. 2) Regulations 2015) – obligations that

agencies generally prefer to avoid. At the same time, the ultimate engager faces potential exposure if PAYE is not operated correctly.

Neither party is comfortable with this uncertainty, which creates a strong incentive to introduce a third party that will apply PAYE. This is the space in which umbrella companies operate.

Who operates PAYE when personal services are supplied?

- **Direct engagement by the client:** Where a worker is engaged directly by the client, this is actual employment. The client assesses employment status and operates PAYE and NICs (and/or CIS where relevant). Liability for PAYE rests with the employer.
- **Engagement via an agency (ITEPA 2003 Part 2 Chapter 7):** The agency must consider whether the worker is subject to supervision, direction or control (SDC) or is already paid under PAYE. If so, the agency is treated as the deemed employer and must operate PAYE. Where neither applies, the agency must report gross payments and liability for PAYE may rest with the agency or the client. An umbrella may be used to avoid this.
- **Engagement via the worker's own personal service company (PSC) (Chapters 8 or 10):** The PAYE position depends on the size of the ultimate engager. For small engagers, the PSC determines employment status and applies PAYE if IR35 applies. For medium or large engagers, the engager issues a Status Determination Statement and PAYE is operated by the engager or, where applicable, the agency. Liability for PAYE rests with the deemed employer.
- **Engagement via a managed service company (MSC) (Chapter 9):** The MSC operates PAYE and is treated as the deemed employer. Liability for PAYE rests with the MSC.
- **Engagement via an umbrella company (ITEPA 2003 Part 2 Chapter 11 – from April 2026):** The umbrella company acts as the employer and operates PAYE and NICs. Liability for PAYE initially rests with the umbrella, but from April 2026 joint and several liability may pass up the labour supply chain if the umbrella defaults.

Agency rules and the SDC test: why umbrellas are attractive

Under the agency rules at ITEPA 2003 s 44(2), an agency is deemed to be the employer unless it can show that:

- the worker is not subject to supervision, direction or control (SDC) as to the manner in which they provide their services; or
- the worker's remuneration already constitutes employment income.

The agency rules also do not apply where the worker always works from their own home or from premises not managed by the client (unless required by the nature of the work), or where the worker provides services as an entertainer or model.

The SDC test is a legislative shorthand derived from decades of employment status case law. However, it is a cut-down test that bears little resemblance to the courts' employment status tests, as it does not consider factors such as mutuality of obligation. Despite its apparent simplicity, SDC can be difficult to assess in practice, particularly for agencies dealing with high volumes of workers or highly skilled individuals. Crucially, s 44(2)(b) provides a practical escape route: if someone else is already applying PAYE, the agency rules do not apply. This is a key reason why umbrella companies are introduced into labour supply chains.

By employing the worker and operating PAYE, the umbrella company removes the need for the agency to conduct SDC assessments or to report gross payments. From a compliance perspective, this can appear to be an efficient solution.

Complex chains: multiple agencies and umbrellas

In reality, labour supply chains are rarely simple. A client may contract with a recruiter, who in turn contracts with one or more agencies. One agency may be content to supply workers subject to SDC, while another uses an umbrella company to employ workers where SDC is uncertain or difficult to assess.

In practice, chains can be considerably longer, involving multiple agencies and varied contractual arrangements depending on the engager's recruitment policies. In some cases, engagers may contract directly with umbrella companies (under ITEPA 2003 Chapter 10) to operate their own payrolls alongside outsourced arrangements.

The result is a patchwork of contractual and tax relationships in which responsibility for PAYE is often assumed rather than actively tested.

Defining an umbrella company

From April 2026, the legislation introduces a statutory definition of an umbrella company (and includes what is called ‘a purported umbrella company’). Broadly, an umbrella company exists where:

- A worker personally provides services to a client under a contract.
- The worker is employed by a third person (the umbrella company) who carries on a business of supplying labour.
- The worker does not have a material interest (5% or more) in that third person.
- The third person is not already deemed to be the employer under ITEPA 2003 Chapters 7 to 10 or ITTOIA 2005 s 863A.

A purported umbrella company is a deliberately wide anti-avoidance measure designed to capture any entity involved in ‘arrangements’ intended to circumvent the rules, including vehicles connected with the worker. If an entity falls within this definition, it is treated as an umbrella company for the purposes of the joint and several liability rules.

How liability moves up the chain

Where an umbrella company fails to account for PAYE and NICs, liability will pass to the relevant party immediately above it in the labour supply chain. If that party is overseas, liability moves further up until it reaches a UK-based entity.

This creates a fundamental shift in risk. Liability for PAYE debts can now rest with parties that neither employ the worker nor operate payroll – including recruiters and agencies whose role is largely commercial.

It is important to note that these rules sit alongside existing provisions under which agencies may already be liable for PAYE as deemed employers. The interaction of these regimes makes liability analysis more complex, not less.

There is also a critical caveat: if an umbrella company is found to have exercised, or had the right to exercise, SDC over a worker, it is then considered to be an agency

(falling within the agency rules in Chapter 7). In that case, the new Chapter 11 rules do not apply, and liability transfers under the existing agency debt transfer provisions.

What advisers should be doing now

The introduction of joint and several liability for PAYE in labour supply chains means that those chains must be analysed more carefully than ever before.

Key questions include:

- Do the agency rules apply at any point in the chain?
- Has anyone genuinely assessed SDC, or has it simply been assumed that is the case?
- What level of due diligence is realistically possible on other parties in the chain?

One apparent solution is to avoid umbrella companies altogether. In practice, this may be unrealistic. As we have seen, umbrella companies often form a vital link in labour supply chains, existing because the tax and employment rules have created a need for them.

A more pragmatic approach may be to limit relationships to businesses that are known and trusted. Even that is likely to be challenging for large organisations operating at scale.

Umbrella companies are umbrellas by choice: they exist for commercial reasons. They perform a compliance function that others in the chain would prefer not to fulfill. It is therefore worth reflecting on whether the underlying policy objective – improving PAYE compliance – might have been addressed more directly. For example, tax compliance conditionality for agencies or earlier collection mechanisms could, in theory, have achieved similar results.

What is clear is that from April 2026, PAYE risk in labour supply chains no longer stops with the payroll provider. Advisers will need to help clients understand where that risk sits – and how it can be managed – before HMRC comes calling.

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