# Workplace nursery schemes: the parent trap

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Misunderstanding the tax-free exemption for employer-provided childcare can lead to unexpected tax, NICs and penalties.

## Key Points

**What is the issue?**
HMRC is increasingly challenging workplace nursery schemes, making it clear that many fail to meet the statutory conditions for the childcare exemption under ITEPA 2003 s 318.

**What does it mean to me?**
Where the exemption is incorrectly applied, employers face significant income tax and NIC liabilities, potential penalties, and scrutiny of associated salary sacrifice and

OpRA arrangements.

**What can I take away?**
Workplace nursery schemes should be continually reviewed to establish who the scheme employer is and whether there is real financial risk and management involvement in substance, not just on paper.

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For many years, employer-supported childcare in the UK was closely associated with childcare vouchers. These arrangements were widely used, relatively well understood and provided a straightforward mechanism for employers to support working parents in a tax-efficient manner. Employers also benefited from employer NIC savings, making vouchers a familiar component of reward strategies.

That landscape changed permanently in October 2018, when childcare voucher schemes were closed to new entrants and replaced by the government's Tax-Free Childcare scheme. While existing participants were able to remain in voucher schemes, the closure marked the end of a longstanding and visible form of employer involvement in childcare support.

Since then, options for employers wishing to support working parents have become more limited. Tax-Free Childcare provides government support directly to parents, but it sits outside the employment relationship: childcare is arranged by the parent, not the employer, and no employer NIC savings arise. For many employers, this has reduced both the incentive to provide childcare support and its prominence within reward packages.

Against this backdrop, attention has returned to the exemption for employer-provided childcare under s 318 of the Income Tax (Earnings and Pensions) Act (ITEPA) 2003 (the 'childcare exemption'). Although this exemption has existed since 1990, it has taken on renewed significance in a post-voucher environment.

The exemption is primarily intended to apply to childcare facilities provided by an employer on its own premises for its own employees – the traditional 'workplace nursery'. In recent years, however, it has increasingly been relied upon in more complex arrangements involving commercial childcare providers and third-party scheme operators and, frequently, salary sacrifice.

These commercially marketed workplace nursery schemes are often promoted as modern, flexible solutions that replicate the tax efficiency of childcare vouchers without requiring employers to operate a nursery themselves. However, HMRC has made clear that many such arrangements do not meet the statutory conditions for exemption. Updated guidance issued in 2022 and again in 2024 confirms that HMRC is scrutinising these schemes closely and that employers may face significant tax and NIC exposure where the exemption has been incorrectly applied.

This article examines HMRC's concerns, the key technical risks for employers, and what advisers should be encouraging clients to do now.

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## The childcare exemption: scope and limits

The childcare exemption applies where an employer provides care for an employee's child and specific statutory conditions are met. Where it applies, the value of the childcare provided is exempt from income tax and NICs.

Broadly, the exemption applies where all of the following conditions are satisfied:

- **Condition A**: The care is provided for a qualifying child of the employee.
- **Condition B**: The childcare premises meet relevant registration requirements and are not used wholly or mainly as a private dwelling.
- **Condition C**: The premises on which the care is provided are made available by the employer alone, or the partnership requirements are met.
- **Condition D**: The arrangement is open to all employees generally (or where the scheme employer has multiple sites, the scheme is open to all employees at the relevant location).

Conditions A and B are usually straightforward and rarely controversial. In practice, the technical difficulty almost always arises in relation to Condition C, and to a lesser extent Condition D, particularly where employers seek to rely on partnership arrangements involving commercial providers.

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## HMRC's renewed focus on commercially marketed schemes

HMRC's concerns regarding workplace nursery schemes are not new, but they have been articulated with increasing clarity in recent years. Updated guidance in HMRC's

Employment Income Manual (EIM 21972), together with commentary in Agent Update 121 (July 2024), places particular emphasis on arrangements involving commercially marketed workplace nursery schemes.

HMRC has highlighted several recurring features of these arrangements. In particular, some scheme operators have historically promoted their services as ‘HMRC approved’. HMRC has been explicit that it does not approve workplace nursery schemes and does not endorse any arrangement as tax compliant. While some providers have adjusted their marketing language (for example, referring to the schemes as ‘HMRC friendly’), HMRC’s position remains unchanged.

A central concern is whether the statutory conditions for exemption are met in substance. Section 318 requires that, under the arrangements, the employer is ‘wholly or partly responsible for financing and managing the provision of the care’. HMRC has observed that, in many commercially marketed schemes, employers have little or no substantive involvement in either financing or management, notwithstanding contractual assertions to the contrary.

HMRC has also drawn attention to a recurring misunderstanding as to what it means for an employer to be ‘providing’ childcare for the purposes of the exemption. Where the employer’s role is limited to facilitating access to a third-party provider operating at arm’s length, the exemption is unlikely to apply.

Responsibility for applying the exemption correctly rests squarely with the employer. Where the statutory conditions are not met, the employer must not apply the exemption and must correctly report and account for any resulting taxable benefit, including consideration of the optional remuneration arrangement (OpRA) rules where salary sacrifice is involved.

Taken together, HMRC’s guidance signals a materially increased risk of challenge for workplace nursery arrangements involving commercial providers. Employers and advisers should assume that such schemes are firmly within HMRC’s compliance spotlight.

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## What is the employer actually providing?

Before considering the statutory conditions in detail, it is worth stepping back and asking a fundamental question: what is the employer actually providing?

The childcare exemption applies to the ‘provision for an employee of care for a child’. This is a critical concept and one that is often misunderstood in practice.

Where the employer provides childcare – for example, by operating a nursery itself or jointly operating a facility with other employers – the exemption may apply, subject to the statutory conditions. By contrast, where the employer simply meets or reimburses an employee’s childcare costs, the employer is not providing childcare but settling the employee’s pecuniary liability.

Where the contract for childcare exists between the employee and the nursery, payments made by the employer (whether directly to the nursery or by reimbursing the employee) are likely to be treated as taxable remuneration under Income Tax (Earnings and Pensions) Act 2003 s 62, rather than exempt childcare provision. This risk arises even where payments are made directly to the nursery, if they are made on the employee’s behalf.

Some workplace nursery schemes rely on the employee entering into a direct contract with the nursery, with the employer paying the nursery under a parallel arrangement. Whether the exemption can apply in such cases will depend on the precise contractual structure, including whether there is a genuine tripartite agreement and whether the employer can properly be said to be providing the childcare.

Although HMRC’s published guidance has focused primarily on partnership requirements, employers should not assume that the distinction between provision and reimbursement will remain unchallenged.

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## Condition C: partnership requirements

Condition C requires that either the employer alone makes the childcare premises available, or the partnership requirements are met. Most commercially marketed workplace nursery schemes seek to rely on the partnership route.

To qualify, the employer must be wholly or partly responsible for both financing and managing the provision of childcare. HMRC’s guidance makes it clear that these requirements must be satisfied in substance, not merely by contractual form. Token involvement or purely contractual participation will not be sufficient to meet the partnership test.

**Financing requirements**

To meet the partnership requirements, employers must assume material financial responsibility for the provision of childcare.

In assessing whether this requirement is met, HMRC will examine how the employer's financial contributions are structured and whether the employer bears any genuine financial risk. Arrangements where the employer's payments are determined solely by reference to the nursery's standard fee rates for individual children, with no wider financial exposure, are unlikely to demonstrate material financial responsibility.

Arrangements that do not take account of the nursery's broader operating costs – such as business rates, staff salaries, utilities and maintenance – may indicate that the employer is insulated from the financial realities of running the childcare provision.

Indicators of material financial responsibility may include the employer:

- providing capital funding or start-up finance;
- underwriting operating losses or guaranteeing a minimum level of income;
- contributing to fixed costs such as rent, rates, utilities or maintenance; and
- entering into financial guarantees or other commitments that are not directly linked to the number of children attending.

The common feature of these indicators is the assumption of financial risk and long-term commitment by the employer. Where an employer's financial exposure rises and falls solely by reference to the number of employee children attending the nursery, HMRC is likely to conclude that the financing limb of the partnership requirements is not satisfied.

**Management requirements**

The management requirement presents an equally significant challenge. HMRC expects employers to have genuine and substantive involvement in the management of childcare provision.

HMRC will consider the nature and substance of employer involvement, including whether there are regular management or review meetings, whether those meetings

are meaningful, and whether the employer has the ability to influence outcomes rather than merely receiving updates.

The role of employer representatives is also relevant. Where an employee is appointed to a management or oversight body, HMRC expects clear evidence that the individual is empowered to act on behalf of the employer and does so in practice.

Indicators of meaningful involvement may include the employer having influence over:

- operational policies or standards;
- how childcare is delivered across the nursery population;
- staffing matters, including training standards; and
- the allocation or prioritisation of childcare places.

Mere consultation, or attendance at meetings without real influence, is unlikely to be sufficient.

#### Joint childcare provision

Condition C also permits joint provision with other employers. In such cases, the employer must still be involved in the arrangements, contribute to both financing and management, and ensure that the statutory requirements are met in relation to the particular scheme.

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## The scheme employer

The legislation refers to the ‘scheme employer’ – the employer operating the childcare scheme. The scheme employer must be party to the arrangements, make the premises available, and meet the financing and management requirements.

In practice, many workplace nursery arrangements fail to identify clearly who the scheme employer is. Where a commercial provider enters into arrangements with multiple employers to provide childcare at the same premises, each arrangement may constitute a separate scheme, each with its own scheme employer.

Alternatively, HMRC may argue that only one employer can be the scheme employer at a particular facility. If that is the case, other participating employers may fail to

meet the statutory conditions, even if they believe they are part of a joint arrangement. This risk is often overlooked but may be decisive.

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## Condition D: availability

Condition D requires the childcare arrangement to be open to all employees generally, or where the employer has multiple sites, to all employees at the relevant location. Nurseries may also be available to other workers on the site, such as contractors or employees of other employers.

While usually less contentious than Condition C, advisers should still ensure that eligibility criteria are consistent with the statutory requirements and do not inadvertently restrict access.

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## Salary sacrifice and OpRA considerations

Many workplace nursery schemes are offered in conjunction with a salary sacrifice arrangement.

Where the appropriate processes and controls are in place, a salary sacrifice scheme can be effective regardless of whether the childcare exemption ultimately applies. While salary sacrifice can be effective in principle, a HMRC review of a workplace nursery scheme is likely to extend to the effectiveness of the salary sacrifice itself.

HMRC may consider whether:

- the employee genuinely agreed to a change to contractual terms of their employment;
- the arrangement can be reversed at will;
- the salary sacrifice was applied retrospectively; and
- cash pay was reduced below the national minimum or living wage.

Where the childcare exemption applies, workplace nursery provision is specifically excluded from the Optional Remuneration Arrangement (OpRA) rules, as set out at ITEPA 2003 ss 69A and 69B. Where it does not apply, however, OpRA will generally result in a fully taxable benefit.

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## Consequences where the exemption does not apply

Where the childcare exemption is incorrectly claimed, the consequences of a challenge by HMRC can be significant. The benefit may need to be reported through payroll or on Form P11D and may be subject to income tax and Class 1A NIC.

HMRC can initially assess income tax for up to four years and Class 1A NIC for up to six years. Interest will be due on any underpaid amounts, and penalties may apply, particularly where HMRC considers that reasonable care was not taken. Employers should consider whether voluntary disclosure is appropriate and, in some cases, whether settling employees' tax liabilities is desirable, recognising that this step will itself give rise to additional tax and NIC costs.

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## Key questions for employers to ask

### Contracts and structure

- Who is the designated scheme employer?
- What contracts are in place and who are the parties?
- Is the employee party to any contract with the nursery?
- Is the employee required to make any payments directly?

### Financial responsibility

- How are fees calculated?
- Does the employer contribute beyond standard nursery fees?
- Who bears the risk of fee increases or operating losses?
- Has the employer provided any guarantees or underwriting?

### Management involvement

- What level of management input does the employer have?
- Are there regular meetings and who attends them?
- Does the employer have genuine influence over childcare delivery?
- Is the employer represented on a management or oversight body?

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## What should employers do now?

Employers operating workplace nursery schemes should continually review their arrangements in light of HMRC’s updated guidance.

As a first step, employers should understand how their scheme operates in practice, including reviewing contracts, identifying the scheme employer and assessing their actual role in financing and managing childcare provision. Salary sacrifice arrangements should also be reviewed.

Where there is any uncertainty, employers should seek independent advice. Early identification of issues may allow employers to restructure arrangements or make voluntary disclosures to HMRC, potentially mitigating penalties.

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