

IMPLICATIONS OF UMBRELLA COMPANIES FOR TAX ADMINISTRATION

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1. INTRODUCTION

Umbrella companies play an increasingly important role in the U.K. labour market. They permit employment businesses (temporary work agencies) to outsource their pay, employment rights, and tax functions to them (albeit at a cost to the agency and, often, the worker). It appears that the recent rapid expansion in the number of umbrella companies has created a concerning number of non-compliant operators. Two forms of tax non-compliance are observed:

- tax evasion, through the use of mini-umbrella companies (MUCs)²; and
- tax avoidance, through the use of disguised remuneration (DR) schemes.

In response, the government needs to take action to protect the rights of workers and protect exchequer revenues. This note focuses on these behaviours but also comments briefly on the role of umbrella companies and the information that should be conveyed to workers.

2. THE ROLE OF UMBRELLA COMPANIES IN THE LABOUR MARKET

While umbrella companies are not currently defined in U.K. legislation, their place in the temporary work supply chain is well defined—an umbrella company is a labour market intermediary within a supply chain that sits below the end client (the ultimate recipient of the worker's services) and the temporary work agency (or agencies) supplying the worker to the end client, and just above the worker that is performing the services for the end client. Similarly, the role of umbrella companies is also well defined—they take on the obligations relating to employment rights and employment taxes that either the end client (as an employer) or the temporary work agency (as an employment business) would be responsible for had the worker been engaged by either of those parties directly.

The U.K. government has already committed to expanding “state enforcement to umbrella companies by bringing these companies within scope of the new enforcement body [the Employment Agency Standards Inspectorate]”.³ This is to be expected given the increasing role that umbrella companies play in the temporary labour market. It is important that this body not only regulates employment rights for workers engaged by umbrella companies, but also assists His Majesty's Revenue and Customs (HMRC) in tackling tax non-compliance by such businesses.

¹ This comment is adapted by Gareth D. Myles from the full text of “Umbrella Company Market”, the Chartered Institute of Taxation (CIOT)'s response (<https://ciotmktgprodeun.azureedge.net/ref885>) to His Majesty's Treasury's call for evidence on the umbrella company market (<https://www.gov.uk/government/consultations/call-for-evidence-umbrella-company-market>).

² Mini umbrella company fraud. <https://www.gov.uk/guidance/mini-umbrella-company-fraud>

³ Ibid.

Whether employment businesses and end clients have been influenced to use umbrella companies by the introduction of the IR35/Off-Payroll Working (OPW) rules is an open question. These rules first applied for the public sector in April 2017 and were extended to medium/larger businesses in the private and third sectors in April 2021. Anecdotal evidence suggests that there was increasing use of umbrella companies in labour supply chains after the April 2017 OPW changes were implemented and that there was a further, and significant, increase in the use of such companies after the April 2021 changes were introduced. This increase is acknowledged in the recent House of Lords Economic Affairs' Finance Sub-Committee report⁴ and the National Audit Office's Investigation into the implementation of IR35 tax reforms in the public sector.⁵ These changes have significantly contributed to the increased use of MUCs and umbrella-company-DR avoidance schemes. This suggests that research is required to determine whether pressure to keep down amounts paid to temporary work agencies for the labour they provide has led to an increased use of non-compliant umbrella companies.

More broadly, the underlying challenges that businesses face in determining employment status have played a key part. This has particularly been the case where workers have multiple roles for one/other business and no set hours of work—something which is commonplace in today's world of work. The Taylor review discussed these difficulties and suggested that the delineation between employment and self-employment should be clarified.⁶ The government's response indicated, with particular reference to gig economy workers, that “we should make it easier for individuals and businesses to distinguish workers from those who are legitimately self-employed”.⁷ Unfortunately, in many situations, whether an individual is employed or self-employed for the purposes of either employment law or tax law is not clear, and clarifying the distinction should be a priority.

3. PROVISION OF INFORMATION TO WORKERS

As noted above, the U.K. government has committed to bring umbrella companies within the scope of the new single enforcement body for agency workers. The government has already introduced the “Key information document” (KID)⁸, which requires any employment business to provide every worker registered with them with a range of pay-related information. In addition, HMRC has provided guidance to umbrella company workers on how to check their payslip and understand whether the umbrella company is meeting tax obligations.⁹

⁴ “Off-payroll working rules have resulted in an increased use of umbrella companies”. <https://committees.parliament.uk/committee/230/finance-bill-subcommittee/news/160935/offpayroll-working-rules-have-resulted-in-an-increased-use-of-umbrella-companies/>

⁵ “Investigation into the implementation of IR35 tax reforms” - National Audit Office (NAO) Report. <https://www.nao.org.uk/reports/investigation-into-the-implementation-of-ir35-tax-reforms/>

⁶ Independent report overview: “Good work: the Taylor review of modern working practices”. <https://www.gov.uk/government/publications/good-work-the-taylor-review-of-modern-working-practices>

⁷ “Government response to the Taylor review of modern working practices”. - <https://www.gov.uk/government/publications/government-response-to-the-taylor-review-of-modern-working-practices>

⁸ “Providing a key information document for agency workers: guidance for employment businesses”. <https://www.gov.uk/government/publications/providing-a-key-information-document-for-agency-workers-guidance-for-employment-businesses>

⁹ “Check your payslip if you work through an umbrella company”. <https://www.gov.uk/guidance/check-your-payslip-if-you-work-through-an-umbrella-company>

It is important that this guidance, and the requirement to provide a KID, is well publicised. In addition, the employment business should also be required to either direct workers to HMRC's net pay calculator¹⁰ to check the umbrella company's payslip, or illustrate typical gross and net pay based on certain assumptions to enable workers to compare their actual gross to net pay using these examples.

In addition, when developing policy to better protect umbrella company workers, the government should recognise the differences between umbrella companies and service companies within a group of companies. It is a relatively common practice for groups of companies to "own" a service company that directly engages the employees of that group of companies. These service companies are not umbrella companies.

4. TAX NON-COMPLIANCE IN THE UMBRELLA COMPANY MARKET

Concerns have been raised that umbrella companies are being used to facilitate tax non-compliance, with the key concerns being the promotion and marketing of tax avoidance schemes (DR avoidance schemes), and fraudulent attacks exploiting generous employer tax reliefs using MUCs to claim the National Insurance Employment Allowance and to avoid value added tax (VAT) registration.

In responding to the 2020 call for evidence into DR¹¹, the CIOT raised its concerns about the misuse of umbrella companies that use DR avoidance schemes.¹² In particular, the CIOT noted that "taking on board the Finance Act 2011 legislation on DR", the General Anti-Abuse Rule "and the attitude of the courts to tax avoidance, DR schemes of the sort described in the call for evidence, it is difficult to see how such schemes can succeed".¹³ The key points of the 2020 response were that HMRC should be targeting the promoters of DR schemes by making it clear that DR schemes do not work, and that these schemes often involve sham arrangements, evasion, and fraud. In addition, HMRC should use existing powers to pursue sanctions and penalties, and, in appropriate cases, criminal prosecutions against promoters, enablers and associated parties. They should also require onshore engagers to do more due diligence on the party with whom they are contracting and introduce more rigorous compliance activity as regards umbrella companies. Several of these suggestions have been acted upon.

However, the U.K. government reports that 99.8% of taxpayers have never used a DR avoidance scheme¹⁴, which suggests that the use of such schemes is not widespread and there are relatively few rogue operators. It would be beneficial to conduct research into the 0.2% of taxpayers that have used such schemes in order to ascertain why they used the scheme, how they came to be involved with the scheme, their knowledge of the scheme, and whether they would be involved in such an arrangement in the future now that they know the consequences of being involved with such schemes. The experiences of this 0.2% should inform a targeted,

¹⁰ "PAYE tax calculator". <http://payecalculator.hmrc.gov.uk/PAYE0.aspx>

¹¹ "Call for evidence: tackling disguised remuneration tax avoidance". <https://www.gov.uk/government/consultations/call-for-evidence-tackling-disguised-remuneration-tax-avoidance>. DR schemes are defined in section 1.9 of this call as "contrived arrangements that pay people amounts that purport to be non-taxable in place of a salary; these amounts are often described as a loan, annuities, shares or another payment that is said to be 'non-taxable'".

¹² The CIOT's response to the call for evidence: <https://ciotmktgprodeun.azureedge.net/ref885>

¹³ Ibid.

¹⁴ Call for Evidence: umbrella company market". www.gov.uk/government/consultations/call-for-evidence-umbrella-company-market

robust, and proportionate response to the problem of umbrella companies using DR avoidance schemes that are almost certain to fail.

A way to improve awareness of umbrella company DR avoidance schemes is to require appropriate messaging—for example, on checking Pay As You Earn (PAYE) and National Insurance contributions (NIC) deductions—both (i) in the KID that temporary work agencies are obliged to give temporary workers and (ii) on the payslips that umbrella companies should issue to workers. Umbrella companies may be favoured as a tax avoidance vehicle because these companies can be established and subsequently liquidated with relative ease. This suggests that part of the response to tackling such arrangements may be to (a) impose a regulatory framework on umbrella companies and (b) make the directors/shadow directors of those companies, their promoters, and associates personally liable for breaches of those regulatory obligations (including those related to unpaid taxes). Indeed, since much non-compliance in this area essentially relies on misrepresentation and concealment, targeting those responsible, rather than penalising often lower paid workers for being placed into non-compliant umbrella companies by temporary work agencies, is an appropriate response.

In the typical DR avoidance scheme scenario there is commonly an offshore promoter. The U.K. government has already clamped down on U.K. promoters and introduced an additional penalty for U.K. entities who facilitate avoidance schemes using offshore promoters. This should make U.K.-based umbrella companies and temporary work agencies that facilitate DR avoidance schemes promoted by offshore promoters more wary, as the government could go further. In cases where PAYE and NIC is not accounted for by the deemed employer, the OPW rules place liability on the end client or first temporary work agency in the supply chain. Similarly, the agency worker rules—and section 688 of the Income Tax (Earnings and Pensions) Act (ITEPA) 2003—place liability on temporary work agencies to account for PAYE and NIC but, in certain cases (for example, where the intermediary is offshore), that liability can be transferred to another party in the supply chain. If it is considered that a temporary work agency or, indeed, the end client has facilitated the use of an umbrella company DR avoidance scheme, why not make that entity liable for the unpaid PAYE and NIC, in a similar way as currently applies under the OPW and agency worker rules? Certainly, the extension of the transfer of debt provisions to managed service company providers effectively ended that market (see section 688A, ITEPA, 2003).

When non-taxable loans are routed via an offshore trust or other intermediary, DR anti-avoidance provisions should apply. However, where these payments are paid directly from the umbrella company to the worker, the DR provisions do not apply. Instead, normal employment tax rules apply and, unless there is an expectation that the “loan” will be repaid (in which case the usual loan benefit rules apply), it would be expected that the “loan” is not a loan but pay for PAYE and NIC. Failure to deduct PAYE and NIC in such circumstances would be an automatic failure on the part of the umbrella company employer, and HMRC can use existing provisions to issue assessments on the umbrella company and transfer liability in appropriate cases. There is an evidential issue here, in that HMRC has to demonstrate that “loans” are not, in fact, intended to be repaid. This difficulty is what led to the enactment of the Finance Act, 2011, DR rules, and the requirement to apply PAYE and NIC to loans from third parties unless the loans fell within certain exceptions.

MUCs are used to facilitate NIC Employment Allowance and VAT fraud by seeking to disaggregate larger umbrella companies into a series of smaller MUCs that qualify for the NIC

Employment Allowance and fall below the VAT registration turnover threshold. This fraud is perpetrated by organised criminals and HMRC's Fraud Investigation Service is investigating and prosecuting those involved. HMRC is using its civil and criminal powers to challenge this fraud and a number of arrests have been made. While HMRC has published guidance on MUC fraud (and how to report it)¹⁵, HMRC could do more to publicise the robust action that they are taking against such fraud. This includes the severe sanctions that can be imposed on any temporary work agencies that facilitate this type of fraud and the encouragement to compliant agencies to report others they come across who are, or appear to be, involved in it.

Another risk associated with umbrella companies is "payroll fraud", whereby PAYE and NIC deductions (and other required payroll deductions) are calculated and deducted from gross wages, and the worker is correctly paid their net pay, but the deductions are not paid to HMRC. When the payroll company is an employer based overseas, section 689, ITEPA 2003 would apply to transfer liability for these payroll deductions to the client for whom they work in the United Kingdom. or, where a U.K. agency is involved, that agency (further to section 689(1B)(1C), ITEPA 2003). This provision needs to be given more publicity, as it clearly represents a real risk to U.K. clients and U.K. agencies engaging with agencies where employees are sourced via a non-U.K.-based payroll/employing company. In addition, if the payroll company is U.K.-based, as it would appear that nothing less than fraud is involved, it is appropriate that the directors/shadow directors and officers of the payroll company are properly held to account for the fraud that has been perpetrated.

5. SUPPLY CHAIN ISSUES

Whilst many end clients and temporary work agencies already take steps to ensure tax compliance in the supply chain, it would be helpful if HMRC were to publicise best practice in this respect. For example, (i) checking for any non-U.K. entities in the supply chain (noting the potential transfer of liability consequences that could then arise), (ii) seeking contractual warranties that the umbrella company is tax-compliant, U.K. resident, and properly accounts for all taxes and NIC, (iii) obtaining indemnities from the umbrella company in case the temporary work agency or end client is found to be liable for tax and NICs, and (iv) obtaining references from other companies that use that umbrella (and noting how long they have been using it for). However, if the umbrella company is setting out to deceive (for example, commit payroll fraud, use a DR avoidance scheme, etc.), the likelihood is that they will not disclose this to the temporary work agency or end client. Consequently, it is particularly important to follow up references.

More could be done by HMRC to assist end clients and temporary work agencies to assess the bona fides of their labour supply chain where an umbrella company is involved. In particular, umbrella companies could be required to register with HMRC, so that HMRC is able to establish in more detail who they employ, the PAYE and NIC they collect, and whether they appear to be operating in a compliant fashion. End clients and temporary work agencies would then be able to approach HMRC in order to validate any umbrella company that is or may be involved in their labour supply chain. This could work along similar lines to the Construction Industry Scheme, which has operated since the 1970s and was established because of concerns over pervasive fraud in the construction industry.¹⁶ A validation scheme would certainly

¹⁵ "Mini umbrella company fraud". <https://www.gov.uk/guidance/mini-umbrella-company-fraud>

¹⁶ "Construction industry scheme". <https://www.gov.uk/what-is-the-construction-industry-scheme>

provide welcome assurances to end clients and employment businesses that workers are being paid by “known” and tax compliant entities. It would also allow HMRC to proactively monitor the umbrella companies, to withdraw validation to non-compliant umbrellas, and to publicise this accordingly.

In addition, there should be more rigorous policing of PAYE and NIC compliance by umbrella companies and the temporary work sector by HMRC, and naming and shaming of the bad apples and those facilitating fraudulent activity. ITEPA 2003 provides for the transfer of PAYE liability to a U.K. entity where an offshore entity is paying an employee. Greater awareness of this provision and how it might apply to a U.K. end client, or temporary work agency, where an offshore umbrella company is engaged should discourage the use of offshore entities. HMRC should also include labour supply chain due diligence higher up its agenda when conducting “business risk reviews” to assign risk assessment ratings to large businesses—and it should publicise that it intends to do so.

Furthermore, real-time pay and tax information could be included in an individual’s personal tax account (PTA) by HMRC through a feed from the Real Time Information PAYE reporting system. This would allow workers to check that their payslips match the information being reported to HMRC by umbrella companies (and other employers). The PTA could include signposting on what to do if the worker believes that the umbrella company is not accounting for PAYE and NIC on the full amount of pay they receive.

6. CONCLUSIONS

The best approach for dealing with DR schemes involves tackling the “rogues” head-on through the active identification, targeting, investigation, and prosecution of promoters of tax avoidance schemes and criminals engaged in tax fraud. Naming and shaming is the best way to prevent and tackle the non-compliant umbrella companies. By using the legislation to tackle tax abuses promptly and with publicity, and by providing adequate resources for HMRC to continue to do so, there will be a clear deterrent effect to stop new entrants entering into non-compliant or fraudulent payroll activity. As evidenced by the old IR35 rules, if the rules are not adequately policed, they do not act as a deterrent and are only as effective as the ability to enforce them.

The issue that would then remain is to tackle those criminals who ignore any legislation, however tough or onerous, and the few remaining promoters of tax avoidance schemes. This can only be done if there are adequate resources to investigate and prosecute such persons. The government should consider making these people, and those that knowingly facilitate tax evasion and tax avoidance, jointly and severally liable for the PAYE and NIC that is unaccounted for.