

Can umbrella companies deduct employer's NI lawfully?



Potentially unlawful practices among certain recruiters and umbrella companies, in response to the public sector IR35 reforms, have left many contractors unjustly funding the tax obligations of their recruiters and clients, including employer's national insurance (NI) contributions.

Since the April 2017 legislative changes, recruiters have increasingly been encouraging contractors to work through umbrella companies. Many of these recruiters are deceptively advertising contracts to contractors at the rate that they pay the umbrella company.

While the contractor rightly expects to receive the quoted rate, the employment costs, including employer's NI, must first be funded from the sum paid to the umbrella, leaving the contractor far short of their expected income. This could be construed as a legal misrepresentation, rendering the consequent deduction of the client's or recruiter's employment costs unlawful.

"The umbrella margin and employer's NI are overheads that need to be factored into the overall assignment rate - in addition to the advertised pay rate," comments Julia Kermode, chief executive of the [Freelancer and Contractor Services Association \(FCSA\)](#). "FCSA's position on this has always been very clear; people should not be charged for receiving their wages, nor should they be paying employer's NI."

The problem with non-compliant umbrellas

"We're seeing this all the time, and it's the reason why all umbrella companies are being tarred with the same brush," says Janet De-Havilland, commercial director of professional employment and payroll provider [Unitum Group](#). "Recruiters aren't accounting for the full uplift – also known as a limited rate - when they quote rates to contractors, and neither they nor the umbrella companies are making this clear, meaning contractors are being misled."

De-Havilland notes that, when a recruiter engages a contractor via an umbrella, it is required to uplift (increase) the Pay As You Earn (PAYE) rate, accounting for all of the employers tax obligations and costs:

- Holiday pay at 12.07%
- Employer's NI at 13.8%
- Apprenticeship levy at 0.5% (where applicable)
- Contributions into a pension scheme
- Umbrella company margin.

The remaining sum, not including the uplift, would then be treated as the contractor's earnings and subject to income tax and employee's NI. Unfortunately, in addition to quoting contractors the umbrella's invoice value, many recruiters are also pocketing a portion of the umbrella fee. This is known as a 'kick back', which many non-compliant umbrella companies with lower operating costs accept to avoid being frozen out by recruiters.

Why are contractors being forced into umbrella companies?

Following the public sector IR35 reforms, recruiters are often liable for employer's NI where a contractor is deemed caught by IR35. With many public-sector organisations imposing unlawful blanket rules, whereby all contractors are automatically deemed caught by IR35 and recruiters are often left to pick up a significant NI bill. To pass the buck, many organisations are encouraging contractors to use umbrella companies.

"Recruiters are pretty much unanimously shifting contractors into umbrella companies, because they are being told by their clients that everyone is inside IR35," says De-Havilland. "Unfortunately, what the client says, goes."

What does HMRC guidance say about employer's NI?

Section 7 of [HMRC guidance published online](#) in March 2017 states the following concerning NI payments: *'They [the fee payer] cannot lawfully deduct the secondary NICs from a fee that has been agreed, but could, depending on the contractual terms, negotiate a lower fee [with the intermediary].'*

This appears to simultaneously prohibit unlawful NI deductions while providing recruiters with an opportunity to circumvent the rule. In truth, HMRC intended the first part of the sentence to apply to fee payers negotiating new contracts with contractors.

The freedom to renegotiate a lower fee was only supposed to apply to existing contracts when the Off-Payroll rules came into play, with this stipulation providing fee payers with the chance to alleviate unforeseen employer's NI costs. However, a lack of clarification from HMRC appears to have caused unlawful activity on a broad scale.

HMRC example offers clarity to recruiters

How HMRC expects the reforms to work is explained more clearly in a [technical note](#), published online, which includes the following example:

'Each month, Rebecca IT Ltd invoices the Ministry £7200 which includes £1200 VAT.'

'The Ministry treats £6000 as Rebecca's earnings and deducts £1400 tax and £400 employee NICs which it pays to HMRC via RTI with £700 employer NICs.'

'Each month, the Ministry pays Rebecca IT Ltd a total of £5400, which is £4200 for the services provided plus £1200 VAT.'

HMRC reinforced this in its [response to a Freedom of Information \(FOI\) request from a contractor](#), who asked the taxman to clarify the rules regarding employer's NI. Dated 27 March 2018, HMRC's response states:

'The client or agency would pay secondary (employer) National Insurance contributions (NICs) related to the engagement, as it does for directly employed workers.'

ContractorCalculator CEO Dave Chaplin says: "After much contention, it is now crystal clear where this liability lies. Recruiters and clients need to stop the practice of advertising rates that include their own tax obligations, otherwise they could find themselves incurring significant losses at Tribunal."

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According to Martyn Valentine, director of [The Law Place](#), amendments to the Income Tax (Earnings and Pensions) Act 2003 following the [Finance Act 2017](#) suggest that the recruiter may be responsible for paying employer's NI irrespective of the presence of an umbrella company:

"Section 61N centres around 'fee payer', who is responsible for making a 'deemed direct payment' to the worker, which is to be treated as earnings from an employment," says Valentine.

"S61N(2) of the legislation states that the fee payer is the party in the chain immediately above the lowest. According to s61N(1), the lowest party in the chain is not the worker but the intermediary. Given that the contractor no longer engages via a limited company, the umbrella company is deemed to be the intermediary, meaning the recruiter is, by law, the fee payer."

Valentine points out that, as the payment is to be treated as earnings from employment, the fee payer is responsible for paying employer's NI, and issuing gross payments to the umbrella intermediary. By paying gross to the umbrella, the recruiter is in breach of s61N of the ITEPA 2003.

"Any contractor affected could claim that they suffered an unlawful deduction with reference to this," he adds. "Recruiters who have acted in this manner may find themselves liable to the contractor in respect of damages for misrepresentation. They also risk ruinous tax investigations and claims in the High Court for damages."

Valentine concludes: "Examples of malpractice of this nature underscore yet again the need for regular auditing of a recruiter's practices and actual supervision by a competent professional body. The present, virtually laissez-faire, regulatory environment is overdue for reform."

Payslips from compliant and non-compliant umbrellas

At first glance, there appears little in a payslip to determine whether an umbrella company is compliant, because the important calculations are made before the contractor receives payment. Below we compare basic payslips for two contractors on £200-day rates; one working via a compliant umbrella company, and the other paid via PAYE through the recruiter with no uplift.

Payments			Deductions		
	Period	YTD		Period	YTD
Basic Pay (NMW x Hours)	300.00	300.00	INCOME TAX	128.00	128.00
Holiday Pay Advance	92.83	92.83	NATIONAL INSURANCE CONTRIBUTION	84.59	84.59
Bonus	469.13	469.13			
Hours:	40.00				
Total Payments	£861.95	£861.95	Total Deductions	£212.59	£212.59

Net Pay this period:	£649.36
Expenses Reimbursed	£0.00
Total Pay	£649.36

	Period	YTD
Gross for Tax	£861.95	£861.95
Gross for NI	£861.95	£861.95

This payslip is showing an umbrella return on £200 per day

Based on an agency PAYE return using the same income, a worker would likely be paid a net amount of around £729.55 making them better off using in house agency payroll.

Above is a payslip from a compliant umbrella. Note that, though the contractor has worked five days at £200 per day, their gross pay is more than £1,000. Here, the umbrella company has uplifted the rate to account for employer's NI at 13.8% and holiday pay at 12.07%, bringing the total income up to £1,275.35, before fees are deducted for:

- Employer's NI
- Employer pension contribution
- Administration contribution.

Income tax and employee's NI are then deducted from the remaining £1,098.71, leaving the contractor with £787.02 following all tax deductions.

Payments	Period	YTD	Deductions	Period	YTD
Basic Pay (NMW x Hours)	300.00	300.00	INCOME TAX	221.96	221.96
Holiday Pay Advance	118.32	118.32	NATIONAL INSURANCE CONTRIBUTION	89.73	89.73
Bonus	680.39	680.39			
Hours: 40.00					
Total Payments	£1098.71	£1098.71	Total Deductions	£311.69	£311.69

Net Pay this period:	£787.02
Expenses Reimbursed	£0.00
Total Pay	£787.02

	Period	YTD
Gross for Tax	£1098.71	£1098.71
Gross for NI	£1098.71	£1098.71

This is an umbrella return where the rate has been uplifted from £200 per day. The uplift is typically 12.07% for holiday pay and a further 13.8% to cover the Employers NI

Now the rate has been fully uplifted, the worker is better off using the umbrella company. The benefit to the worker is one continuous employment for all their assignments. The benefit to the agency is a considerable reduction of in house administration and peace of mind that their workers are being paid correctly and compliantly.

The gross income displayed in the non-compliant umbrella payslip is significantly lower. As no uplift has been provided, all fees, including employer's NI amounting to £100.81, have been deducted from the contractor's flat rate. The contractor is left with £861.95, which becomes £649.36 following income tax and employee's NI payments.

In our example, the compliant umbrella company pays its contractor £137.66 more each week than the non-compliant umbrella, which equates to over £550 a month.

"This is why contractors need to be aware of their exact rate of pay," concludes De-Havilland. "They need to consider the recruiter PAYE rate, and what they are being paid. If the contractor's rate is not much higher than the recruiter PAYE rate, then the umbrella hasn't accounted for enough uplift to cover the cost."

How can recruiters stay compliant with the law?

To avoid legal risk, recruiters placing contractors in inside IR35 contracts must ensure that they quote rates after all employment deductions have been made. With recruiters placing hundreds of workers, the cost of failing to do so could be ruinous.

"We are already starting to see contractors heading to Tribunals via the [Advisory, Conciliation and Arbitration Service \(ACAS\)](#) after finding that employer taxes are being deducted unlawfully from their agreed rates," explains Chaplin.

"The message to recruiters and hirers is clear: make the calculations before advertising the position and quote the correct rate after the employer's deductions have been made."

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