Temp
Labour
Initiative

Labour Market Compliance: Challenges, Myths, and Sustainable Solutions

Insights into Labour Market Compliance and Policy Impacts on Recruitment.

March 2025

Executive Summary

The temporary labour market plays a crucial role in the UK economy, but misconceptions around regulation and tax compliance often obscure the real challenges facing the industry. A widely held but incorrect belief is that the presence—or absence—of regulation is the primary driver of fraud in the temporary labour supply chain. In reality, the risk of non-compliance is tied not to the type of organisation but to the function it performs—specifically, the responsibility of employing and paying workers.

Understanding the True Compliance Risk

The compliance risk within the temporary labour market does not originate from umbrella companies themselves but from any entity responsible for payroll processing. If umbrella companies were removed from the supply chain, non-compliance risks would not be eliminated—they would simply shift to recruitment agencies or other payroll processors. Recruitment agencies, for example, could establish mini companies to reduce employment tax liabilities or engage in tax avoidance schemes such as disguised remuneration schemes. This demonstrates that the risk is tied to payroll processing, not to whether an umbrella company or a recruitment agency is responsible for it.

The Role of Umbrella Companies in Ensuring Compliance

Compliant umbrella companies serve as compliance hubs, financial stabilisers, and advisory partners to recruitment agencies and end clients. When operating correctly, they act as a key line of defence against fraud and tax non-compliance, supporting HMRC's broader mission of creating a fairer and more transparent tax system.

However, misleading narratives have wrongly positioned umbrella companies as the primary drivers of non-compliance, shifting focus away from the deeper structural issues affecting tax compliance. In particular, a pervasive myth suggests that umbrella workers unfairly bear both Employer's and Employee's National Insurance Contributions (NICs). This misconception has been widely spread by lobbying organisations and trade unions, despite clear evidence to the contrary. The reality is that assignment rates—agreed upon between workers and agencies—already account for employer costs, making it inaccurate to claim that workers are unfairly burdened.

The Risks of Over-Reliance on the Tax Gap

The UK government's tax enforcement strategy has been heavily influenced by tax gap estimates, which were prominently used to justify new measures in the Autumn Budget 2024. While closing the tax gap is a reasonable objective, relying on highly uncertain estimates poses risks of resource misallocation and ineffective enforcement. If enforcement efforts disproportionately target umbrella companies without addressing fundamental compliance challenges—such as enforcement inefficiencies and loopholes exploited by all payroll processors—these measures may fail to achieve the intended compliance improvements.

Option 3: The Right and Wrong Approaches

HMRC's Option 3 seeks to address compliance challenges by shifting PAYE responsibilities from umbrella companies to recruitment agencies or end clients. However, one version of Option 3 (Chapter 4 of this report), where recruitment agencies are forced to use their own PAYE reference numbers, poses a severe risk to the stability of the labour supply chain.

A better solution would be a version of Option 3 where the umbrella company's PAYE reference number remains in use. This approach would:

- Solve non-compliance issues while maintaining operational stability.
- Retain the commercial advantages of umbrella companies, such as payroll efficiency and financial support for agencies.
- Ensure HMRC oversight without disrupting compliant businesses.
- Avoid unnecessary market destabilisation, preserving a trusted and transparent employment structure.

Preserving Market Stability While Enhancing Compliance

Maintaining the use of the Umbrella PAYE reference model would ensure compliance without damaging the contingent labour market. Rather than dismantling a working system, this approach would:

- Reinforce tax compliance by ensuring that payroll remains within regulated and monitored umbrella companies.
- Prevent recruitment agencies from facing unmanageable payroll responsibilities, maintaining cashflow stability.
- Continue providing workers with full employment protections, safeguarding their rights.
- Reduce unnecessary complexity, ensuring a smoother transition for all stakeholders.
- Prevent alternative non-compliant models from emerging and becoming more prevalent
- Remove the risks and administrative burden of 20,000 recruitment agencies becoming responsible for operating PAYE on their own PAYE scheme.

Conclusion

Compliance risks in the temporary labour market do not stem from umbrella companies but from how payroll is processed. Targeting the umbrella company sector as a whole without distinguishing between compliant and non-compliant operators risks destabilising a functional system and harming workers, agencies, and HMRC alike.

With the timescales of April 2026, it is imperative that a solution is settled on that is the least impactful for the sector in order to avoid unintended consequences for workers and supply chain. Some of those unintended consequences are detailed in this report and some will remain unknown. With contracting so ubiquitous throughout the economy and used in the majority of sectors, the risks of destabilisation could be impactful for the economy at large.

The most effective solution is a version of Option 3 where the PAYE reference of the umbrella company remains in use. This would allow for better enforcement, greater transparency, and continued stability, while ensuring that non-compliant payroll schemes—not compliant umbrella companies—are held accountable.

Rather than disrupting a compliant industry, HMRC should focus on stronger enforcement against tax avoidance schemes while preserving the vital role of umbrella companies in maintaining compliance across the labour supply chain.

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1. Introduction and Purpose of the Report

This Report is designed to provide HMRC, government stakeholders and industry leaders with an objective analysis of tax non-compliance, particularly within the temporary labour market. It is presented by the Temp Labour Initiative, an independent movement set up with the purpose of gathering insights from various stakeholders within the temporary labour supply chain such that a greater understanding of the industry can prevail. The Temp Labour Initiative uses a data driven approach to enhancing understanding of the facts of how the market operates.

There has been a disparity between the insights from data and the anecdotal narratives that dominate discussions around the industry. The aim is to present a comprehensive overview whilst identifying potential pitfalls in hastily implemented measures. Specifically, we will highlight how recent policy proposals such as enforcing the transfer of PAYE responsibility to recruitment agencies could inadvertently exacerbate non-compliance and undermine the labour markets stability.

Our findings are intended to foster informed dialogue and propose actionable solutions to enhance compliance whilst supporting the governments broader economic objectives.

Through our work with industries stakeholders, we have developed an unparalleled data-driven perspective on the challenges facing the temporary labour market. However, we frequently observe a gap between the insights gleaned from our macro-level data and anecdotal narratives that dominate industry discussions. This discrepancy underscores the need for an evidence-based approach to policymaking and compliance enforcement.

This report is designed to provide HMRC, government stakeholders, and industry leaders with an objective analysis of tax non-compliance, particularly within the temporary labour market. Our aim is to present a comprehensive overview grounded in facts and data, while also identifying potential pitfalls in hastily implemented measures. Specifically, we will highlight how recent policy proposals, such as enforcing the transfer of PAYE responsibility to recruitment agencies, could inadvertently exacerbate tax non-compliance and undermine the labour market's stability.

Our findings are intended to foster informed dialogue and propose actionable solutions to enhance compliance while supporting the government's broader economic objectives. This introductory section provides a foundation for understanding the challenges and opportunities explored throughout the report and introduce The Temp Labour Initiative.

1.1. The Temp Labour Initiative: A Collective for Truth, Transparency, and Evidence-Based Policy

The Temp Labour Initiative (TLI) is a unified platform bringing together stakeholders across the temporary labour supply chain—including umbrella companies, recruitment agencies, workers, and end clients—to champion accuracy, transparency, and truth in industry discussions and policymaking.

At a time when anecdotal evidence and misinformation often shape regulatory debates, the TLI stands as a collective voice committed to ensuring that government decisions are grounded in facts, not narratives driven by self-interest. Our mission is to provide policymakers with accurate, data-backed insights that reflect the realities of the temporary labour market.

Unlike many organisations that engage in industry discussions primarily for self-promotion or commercial gain, the TLI is not here to serve individual agendas. Instead, we prioritise unbiased, collective advocacy—an approach that is particularly crucial when addressing contentious issues such as the regulation of umbrella companies. Too often, these debates are dominated by those who seek to influence the market to their own advantage, rather than focusing on solutions that genuinely benefit workers, agencies, and businesses alike.

Through research, data analysis, and direct engagement with policymakers, we challenge misconceptions, highlight compliance challenges, and push for enforcement mechanisms that are effective, fair, and practical. By fostering collaboration between all key stakeholders, we create a space where truth prevails over speculation, ensuring that industry reforms serve the interests of the entire supply chain rather than just a select few.

Ultimately, the Temp Labour Initiative exists to build a credible, evidence-driven foundation for the future of temporary work—one where workers, businesses, and the government can rely on clarity, fairness, and well-informed regulation.

1.2. Objective of the Report

This report is intended to provide a comprehensive analysis emphasising the critical role of umbrella companies within the contingent labour sector and assessing the implications of recent HMRC policy proposals.

Through a detailed and data-driven approach, the report seeks to:

- Highlight the essential functions of umbrella companies.
- Address and dispel common misconceptions about their operations.
- Offer evidence-based alternatives that balance compliance with operational efficiency and market stability.

By presenting objective insights, we aim to contribute to a fairer and more transparent labour market while fostering solutions that protect workers and ensure the smooth functioning of supply chains.

1.2.1. Rationale for the Report

The UK's contingent labour market employs approximately 1.5 million temporary workers annually[1], forming a cornerstone of the economy. Umbrella companies are pivotal to this system, acting as compliance hubs and ensuring workers are paid correctly, while agencies can operate efficiently. Despite their vital role, umbrella companies often face misrepresentation and criticism, including inaccuracies shared by some worker advocacy groups and unions. Such narratives can obscure the benefits of compliant umbrella companies as they exist today and their contributions to the labour market's stability.

This report challenges such misconceptions by providing evidence-based insights into:

- How compliant umbrella companies safeguard workers and ensure tax compliance.

[1] EMP07: Temporary employees – 18th February 2025
https://www.ons.gov.uk/employmentandlabourmarket/peopleinwork/employmentandemployeetypes/datasets/temporaryemployeesemp07?utm_source=chatgpt.com

- Why they are indispensable to recruitment agencies, many of which rely on umbrella companies to secure jobs for UK citizens daily.

Ultimately, this report demonstrates that compliant umbrella companies are not only essential but also critical to preserving the integrity of the UK's temporary labour ecosystem.

1.2.2. Target Audience

The report is designed to cater to a broad audience of stakeholders, including:

- **Policymakers and HMRC Officials:** To provide a nuanced understanding of the umbrella company market and inform balanced decision-making.

- **MPs and all stakeholders:** To clarify the roles and responsibilities of Recruitment Agencies and Umbrella Companies within the labour supply chain.

- **Trade Unions and Worker Advocacy Groups:** To highlight the protections and benefits that compliant umbrella companies offer to workers, aiming to address and correct misconceptions.

This report goes beyond presenting data; it is a **call for informed and balanced policymaking**, advocating for collaboration between stakeholders. By combining robust evidence, diverse perspectives, and actionable recommendations, it seeks to align with HMRC's goals of fairness, compliance, and economic growth.

2. The Temporary Labour Market and tax compliance

The temporary labour market is a cornerstone of the UK economy, characterised by its flexibility and dynamic nature. However, this sector is not without its challenges, particularly when it comes to ensuring tax compliance. This section seeks to examine the contingent labour market through the lens of tax compliance, adopting a **holistic perspective** that considers the interplay of various pressures influencing the market.

Tax compliance in this context cannot be understood in isolation. Both industry dynamics and governmental policies create conditions that can either incentivise or inadvertently push non-compliance. For businesses operating in a highly competitive environment, the pressure to minimise costs and maintain operations can sometimes lead to compliance risks. Similarly, regulatory frameworks, while well-intentioned, can occasionally place burdens on stakeholders that make compliance more difficult to achieve.

Before delving into the sources of non-compliance, it is essential to explore the broader context in which the contingent labour market operates. This includes understanding the economic pressures on supply chain stakeholders, the role of temporary workers, and the impact of government interventions. By first establishing this foundation, we can more effectively assess the origins of non-compliance and propose targeted solutions that balance regulatory goals with market realities.

2.1. Industries Dynamics

The recruitment industry plays a pivotal role as an intermediary for nearly every sector of the economy. Its operations create complex and diverse relationships between workers, recruitment agencies, and end clients. Each recruitment agency inherits the specific characteristics and complexities of the industry in which it operates, requiring adaptability to sector-specific challenges.

This interconnectedness gives rise to varying compliance risks and operational challenges, particularly in adhering to tax and employment regulations. The dynamics of these relationships—shaped by the sectors involved, the roles being filled, the pay rates offered, the nature of the work, and the expectations of stakeholders—differ significantly. These variations influence how compliance is managed and respected across industries.

While each sector and job type have unique nuances, the recruitment industry can often be understood through the lens of two overarching trends: Candidate-Driven Markets and Job-Driven Markets. **These are not rigid categories but represent two extremes on a continuum**, providing a simplified framework for understanding industry dynamics.

- **Candidate-Driven Markets**: In such markets, skilled workers are in high demand, and the competition among employers is for talent. Recruitment agencies must navigate pressures to find candidates and manage compliance risks in scenarios where candidates have significant bargaining power.

- **Job-Driven Markets**: Here, the availability of roles outweighs the supply of candidates. Recruitment agencies in these markets face challenges related to cost management, client expectations, and ensuring compliance amidst tight margins and high competition for contracts.

Understanding these dynamics is essential to comprehending how recruitment agencies adapt to sector-specific pressures and how these pressures can influence compliance behaviours. This foundation sets the stage for examining how tax and employment laws interact with recruitment practices and their impact on the broader contingent labour market.

2.1.1. Candidate Driven Market: Explanation and Examples

A candidate-driven market arises when the demand for skilled workers exceeds the available supply, giving candidates significant leverage in determining their terms of engagement. This dynamic is particularly evident in sectors where urgency and societal impact play a critical role, such as healthcare.

Healthcare Sector Example:

The healthcare industry represents one of the clearest examples of a candidate-driven market. The demand for essential workers, such as nurses, doctors, etc, is consistently high, and during periods of crisis or staff shortages, the urgency to fill these roles becomes critical.

- **Leverage and Payment Models**: Some Healthcare workers are acutely aware of their indispensable role and frequently leverage the competition among recruitment agencies to their advantage. If an agency insists on compliance with stricter tax or payment models, some workers may threaten to approach a competing agency willing to accommodate their preferred intermediary or payment structure.

- **Urgency Over Compliance**: For end clients, such as hospitals and care facilities, the immediate need to fill positions often outweighs concerns about compliance. Faced with critical staffing shortages that could directly affect patient care, end clients are frequently willing to overlook tax compliance issues in favour of securing the workers they urgently need.

- **Agency Challenges**: Recruitment agencies operating in this environment face significant pressure. On one hand, they strive to maintain compliance with tax and employment laws; on the other, they risk losing candidates to competitors or failing to meet client demands if they enforce stricter rules. This creates a difficult balancing act, where regulatory adherence is often deprioritised in the face of market realities.

The healthcare sector illustrates the unique dynamics of candidate-driven markets, where the urgency of needs and the high value of skilled workers can drive behaviours that challenge compliance efforts. This underscores the importance of developing frameworks that address both the immediate demands of the sector and long-term regulatory obligations.

2.1.2. Job-Driven Market: Explanation and Examples

A job-driven market is characterised by an oversupply of candidates relative to the demand for roles. In this environment, end clients hold greater bargaining power as workers face significant competition for limited opportunities. These markets are common in industries with lower-skilled roles, where wages are close to the National Minimum Wage (NMW), and the financial margins for agencies are tight.

Example: Retail and Warehousing Sector

The retail and warehousing sector is a prime example of a job-driven market, particularly in roles involving tasks such as shelf-stocking, packing, and order fulfilment.

- **Low Wages and Tight Margins**: Many workers in these roles are paid at or near the National Minimum Wage. Recruitment agencies supplying workers to these industries often struggle to remain profitable due to the low margins dictated by client budgets and competitive pressures.

- **Impact of NMW Increases**: When the NMW increases, agencies are under significant pressure to negotiate new rates with end clients. This is especially challenging in markets where clients are unwilling to adjust their budgets, leaving agencies with limited options to balance rising wage costs with operational profitability.

- **Compliance Risks**: To mitigate these pressures, some agencies may unintentionally or deliberately cut corners, such as misclassifying workers, or engaging with less transparent intermediaries to offset rising expenses. These actions can lead to non-compliance with tax and employment regulations.

- **Client Demands**: End clients in the job driven sectors often prioritise cost savings and rapid onboarding over compliance. This creates an environment where agencies are pressured to deliver at the lowest possible cost, further exacerbating challenges tied to compliance.

- **Worker Vulnerability**: Workers in job-driven markets are often in a vulnerable position. With limited negotiating power, they may accept conditions that offer minimal benefits or unclear payment models, just to secure employment. This dynamic place greater responsibility on agencies and clients to ensure compliance and protect workers' rights.

This example highlights the delicate balance that recruitment agencies must maintain in job-driven markets. The need to remain competitive and manage costs, especially during regulatory changes like NMW increases, can inadvertently create an environment ripe for compliance risks. Addressing these challenges requires collaboration between agencies, end clients, and regulators to create sustainable solutions that prioritise compliance while considering economic realities.

2.1.3. How Market Dynamics influence Non-Compliance Risks

The impact of market dynamics on compliance risks in the temporary labour market is significant, shaping how tax compliance is approached across industries. The unique pressures in candidate-driven and job-driven markets influence the behaviours of workers, agencies, and end clients, often in ways that unintentionally foster non-compliance. This section introduces these dynamics.

2.1.3.1. Compliance in Candidate-Driven Markets:

As we have seen, in candidate-driven markets, where skilled workers hold substantial leverage, tax non-compliance often originates from workers themselves. These individuals are aware of their value and frequently use this bargaining power to dictate the terms of their engagement, including the choice of engagement type and often using model that are not operated by umbrella companies.

2.1.3.1.1. Worker-Driven Non-Compliance:

Workers in sectors like healthcare often prefer to engage through companies that maximise their take-home pay, even if those arrangements fall into non-compliant practices. Agencies attempting to enforce stricter compliance face significant pushback from workers, who may threaten to switch to competitor agencies willing to accommodate their preferences.

2.1.3.1.2. Case Study in Healthcare:

Several of our healthcare clients collectively employing over 7,500 workers have shared a common challenge: managing the sheer volume of umbrella companies engaged each week. Before partnering with us, several of these clients reported paying, on average, over 50 pay intermediaries weekly, not by choice but due to intense market pressures. Workers often demand specific companies to facilitate their payments, leaving agencies with little control over the process.

2.1.3.1.3. Preferred Supplier Lists (PSL):

While agencies typically aim to establish a PSL of compliant umbrella companies—often limited to five or fewer—market pressures force them to accommodate far more. Contrary to claims that agencies allow this to receive kickbacks or rebates from umbrellas, a properly managed PSL would give agencies greater negotiating power for rebates if that were their true objective. Instead, the high number of companies reflects the lack of control agencies have in candidate-driven markets dominated by worker preferences.

2.1.3.2. Compliance in Job-Driven Markets:

Job-driven markets present the opposite challenge, where tax non-compliance is more likely to originate from agencies struggling to survive in highly competitive environments. In these markets, end clients often hold significant leverage in commercial relationships, placing agencies under intense pressure to minimise costs and maintain slim profit margins.

2.1.3.2.1. Agency-Driven Non-Compliance:

When regulatory changes occur—such as increases to the National Minimum Wage (NMW)—agencies must absorb the additional costs while remaining competitive. This often leads to partnerships with umbrella companies offering the lowest assignment rates to workers.

2.1.3.2.2. Low Assignment Rates and Tax Avoidance:

Umbrella companies offering the lowest rates are frequently able to do so because they engage in tax avoidance schemes or others, including the Elective Deduction Model. Agencies, desperate to meet client demands and stay afloat, may inadvertently or knowingly partner with such companies, creating systemic non-compliance risks.

2.1.3.2.3. End Client Leverage:

In job-driven markets, end clients often prioritise cost efficiency above all else, putting downward pressure on agencies to deliver the cheapest possible labour solutions. This economic reality compels agencies to prioritise affordability over compliance, further entrenching non-compliant practices in the labour supply chain.

2.1.3.3. Dynamic Effects on Compliance:

The interplay of these market forces demonstrates how compliance risks are not uniform across industries but are deeply influenced by market dynamics:

- In candidate-driven markets, workers often dictate the terms, leading to fragmented compliance efforts and agencies forced to accommodate non-compliant umbrellas.
- In job-driven markets, agencies bear the burden of compliance challenges as they prioritise cost minimisation and survival over adherence to regulations.

These dynamics reveal the systemic challenges inherent in balancing compliance with the economic realities of the contingent labour market. Addressing these issues requires collaborative efforts across stakeholders and a deeper understanding of the pressures driving non-compliance, which will be further detailed in Section 5.

2.2. Impact of Policy Changes on the Contingent Labour Market

Recent policy changes, including the increase in the National Minimum Wage (NMW) and rising Employer National Insurance Contributions (NICs), aim to enhance worker welfare and fund public services. While these measures are well-intentioned, their implementation places significant financial and operational pressures on stakeholders within the contingent labour market. These pressures can inadvertently drive non-compliance as recruitment agencies, end clients, and umbrella companies grapple with the challenges of adapting to these regulatory shifts.

2.2.1. Impact on Recruitment Agencies

Recruitment agencies, particularly those in job-driven markets like retail, warehousing, and hospitality, are disproportionately affected by these policy changes.

Tight Margins: Agencies in these sectors often operate with razor-thin margins, leaving little room to absorb the increased costs of NMW hikes and higher NICs. These changes intensify financial strain and force agencies to make difficult decisions about cost management.

Cost Absorption or Passing On: Agencies must either absorb the additional costs, which reduces profitability, or pass them on to end clients. However, end clients often resist fee increases, placing agencies in a precarious position.

Compliance Risks: To remain competitive, some agencies may resort to partnering with non-compliant umbrella companies that offer lower assignment rates, often achieved through models such as elective deduction models or loan arrangements.

2.2.2. Challenges for Umbrella Companies

Umbrella companies encounter distinct and significant challenges in adapting to evolving policy changes while striving to maintain full regulatory compliance.

- **Uneven Competitive Landscape**: Compliant umbrella companies, which adhere to strict obligations for paying PAYE, National Insurance Contributions (NICs) and meeting other regulatory requirements, frequently face disadvantages. Non-compliant operators often lure business by offering artificially low rates, creating an uneven playing field and undermining market integrity. This unfair competition not only threatens compliant businesses but also contributes to significant tax gaps, as highlighted in recent HMRC reports.

- **Market Pressures and Cost-Driven Choices**: Agencies and workers often prioritise cost reduction and higher take-home pay, leading some to engage with non-compliant umbrellas. This not only exacerbates compliance challenges but also perpetuates practices that erode trust and fairness within the labour supply chain. Such trends create a ripple effect, where responsible operators are marginalised, and workers are exposed to increased risk, including unexpected tax liabilities.

- **Fraudulent Practices by Rogue Operators**: The proliferation of "mini umbrella companies" and tax avoidance schemes continues to tarnish the reputation of the entire sector. HMRC's recent proposed policy changes aim to address these issues, but the ease with which non-compliant structures can reappear undermines enforcement efforts and can prevent legitimate businesses from operating in the sector.

The challenges faced by umbrella companies underscore the need for a balanced and collaborative approach to policy development and enforcement. While stringent compliance requirements are crucial to safeguarding workers and reducing tax losses, they must be paired with robust enforcement measures targeting non-compliant entities. Additionally, fostering clearer regulations and providing practical support to compliant operators can help level the playing field, ensuring a fair and transparent labour market that benefits all stakeholders.

2.2.3. Illustrating the Challenges with NMW and NIC Changes:

Recent policy changes, particularly those announced in the Autumn Budget 2024, have introduced significant cost pressures for labour market intermediaries, including recruitment agencies and umbrella companies. These changes, while aimed at protecting workers and ensuring fair pay, have created a complex environment for agencies and employers operating in already challenging economic conditions.

- **Impact of National Minimum Wage (NMW) Increases**: The increase in the National Minimum Wage (NMW) has a direct and immediate impact on wage costs, particularly for agencies and umbrella companies providing services to industries where workers are frequently employed near the minimum wage threshold. In a job-driven market, where client demand determines worker allocation, this increase adds financial strain to agencies already operating on tight margins. Many agencies must either absorb these costs, reducing profitability, or pass them on to clients, potentially losing business in an already competitive market.

- **Compounding Challenges from Employer National Insurance Contributions (NICs)**: The Autumn Budget 2024 also introduced a change in Employer NIC rates with an increase of percentage and a threshold reduction. This change imposes an additional cost layer on every worker employed through an agency or umbrella company. For businesses operating at scale, where hundreds or even thousands of workers are employed, the cumulative financial burden is substantial. Agencies often struggle to balance these costs without compromising their compliance obligations or reducing worker benefits, such as holiday pay or pensions.

- **Cascading Effect on Profitability and Compliance**: When combined, the increases in NMW and Employer NICs intensify the financial pressures on agencies, particularly those working within tight cost parameters. Non-compliant umbrella companies may attempt to sidestep these costs by leveraging tax avoidance schemes or illegal deductions, further undercutting compliant operators. For compliant businesses, these pressures risk reducing the viability of operations, especially in industries where cost sensitivity is high.

- **Additional Strain in a High-Inflation Economy**: These changes come amidst broader economic pressures, including high inflation and interest rates, which already squeeze agency margins. The costs of compliance, such as maintaining robust payroll systems and adhering to increasingly stringent regulatory requirements, add to the burden. For smaller or regional operators, this environment makes it difficult to remain competitive while adhering to the law.

The combined effects of NMW increases and Employer NIC hikes illustrate the mounting challenges faced by agencies and umbrella companies. These changes, while aligned with the government's goals of reducing tax gaps and protecting workers, risk exacerbating non-compliance trends and reducing access to fair employment opportunities for workers. To mitigate these risks, a balanced approach that includes targeted financial support for compliant operators, clearer regulatory guidance, and robust enforcement against rogue operators is essential. Without such measures, the labour market could face greater instability and reduced fairness for all stakeholders.

These dynamics illustrate the external impact of policy decisions on compliance levels within the contingent labour market. While policies like the NMW and NIC increases are designed to improve worker welfare, they also amplify financial pressures that force stakeholders to prioritise cost management over regulatory adherence. Addressing these challenges requires a collaborative and balanced approach that aligns regulatory goals with the economic realities of the contingent labour market, ensuring compliance is maintained without undermining the sustainability of the industry.

2.3. Recruitment Agencies and Umbrella Companies: A Comparative Overview

The contingent labour market is characterised by its complexity, with multiple intermediaries playing crucial roles in ensuring the supply chain operates smoothly. Two key players in this ecosystem are recruitment agencies and umbrella companies, which often face misconceptions about their responsibilities and regulatory frameworks. This section addresses these misconceptions and clarifies the financial and operational roles of these intermediaries within the temporary supply chain.

2.3.1. Regulation and Misconception about Umbrella Companies

There is a widespread misconception that umbrella companies are unregulated. While it is true that they are not governed by a specific entity dedicated solely to their oversight, umbrella companies are still subject to the same tax laws and employment regulations as all other employers in the UK.

Misunderstanding Regulation in the Industry

The narrative often portrays umbrella companies as operating without oversight, implying they can act without limits. However, this is fundamentally incorrect.

Tax Law: Umbrella companies like any other businesses, are required to comply with UK tax laws, including corporation tax, VAT, and PAYE (Pay As You Earn) for employees. HMRC is responsible for ensuring that taxes are correctly calculated, reported, and paid.

Employment Law: They are subject to the employment tribunal system and, in some cases, oversight by the GLAA (Gangmasters and Labour Abuse Authority) for industries under its jurisdiction.

To illustrate this point, consider the banking sector, often regarded as one of the most heavily regulated industries in the UK. Banks are regulated by the FCA (Financial Conduct Authority) for their financial conduct and banking activities, but their compliance with tax laws is overseen by HMRC, and employment law by the employment tribunal system—just like any other business, including umbrella companies.

Similarly, recruitment agencies are regulated by the EAS (Employment Agency Standards Inspectorate) for their agency-specific activities[2], but they are not overseen by the EAS for their tax compliance or employment law adherence.

Regulatory Parity Across the Supply Chain

Umbrella companies are, therefore, subject to the same regulatory framework as recruitment agencies or any other organisation responsible for paying temporary workers.

- **Tax Compliance:** Any organisation in the supply chain, whether a recruitment agency, umbrella company, or other entity, can potentially engage in non-compliant practices, such as mini-company schemes, tax credit abuse, or disguised remuneration (DR) schemes.

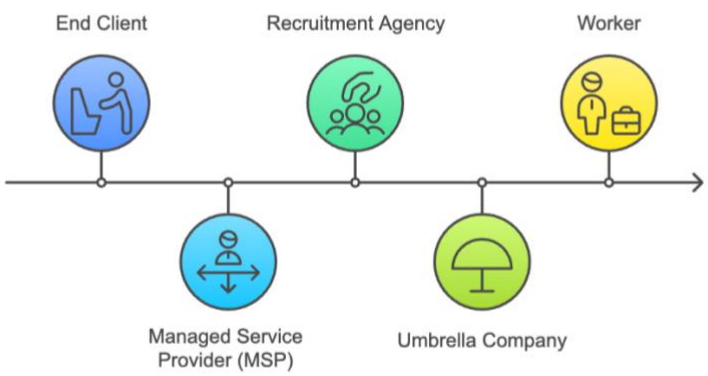
- **Employment Compliance:** The legal obligations regarding worker rights, holiday pay, and workplace protections apply equally to all employers, regardless of their role in the supply chain.

This misconception that regulation—or the lack thereof—is the root cause of fraud in the temporary labour market distracts from the underlying issues. The reality is that non-compliance is equally a risk for any organisation tasked with employing and paying temporary workers, not just umbrella companies.

2.3.2. Financial and Operational Roles in the Supply Chain

Recruitment agencies and umbrella companies serve distinct yet interconnected functions in the temporary labour supply chain. While some argue that removing umbrella companies would improve compliance, this logic fails to account for the operational roles these intermediaries perform.

Temporary Supply Chain



[2] The Conduct of Employment Agencies and Employment Businesses Regulations 2003 - https://www.legislation.gov.uk/uksi/2003/3319/contents

Functional Overview of the Supply Chain

Breaking down the supply chain by function rather than intermediary level provides clarity:

> **Recruitment Agencies:** Their primary role is to source talent, match workers to client needs, manage contracts and timesheets. However, when agencies also process payroll, the compliance risk lies directly with them.
>
> **Umbrella Companies:** These entities act as employers, handling payroll processing, tax deductions, and employment rights for temporary workers. When an umbrella company processes payroll, the compliance risk shifts to them.

The key compliance risk in the temporary labour supply chain arises not from the nature of the organisation but from the function it performs—specifically, the responsibility of employing and paying workers.

The Reality of Compliance Risk

Assuming that tax non-compliance stems inherently from umbrella companies is a flawed perspective. Any organisation fulfilling the role of payroll processor in the supply chain can engage in non-compliant practices.

For example: Recruitment agencies could create mini companies to reduce employment tax liabilities or utilise tax avoidance schemes like disguised remuneration schemes. The compliance risk lies with the entity processing payroll, regardless of whether it is an umbrella company or a recruitment agency. If there is no Umbrella Companies in a supply chain it does not eliminate the compliance risk; it merely shifts it to another party.

Understanding the financial and operational roles in the supply chain is essential for addressing compliance challenges in the temporary labour market. Compliance risks are tied to the function of employing and paying workers, not the type of organisation performing that function. A focus on collaboration and accountability across all intermediaries is key to creating a compliant and sustainable labour supply chain.

2.4. Role of Umbrella Companies in Ensuring Compliance

Compliant Umbrella companies have become an integral part of the UK's temporary labour market, evolving over the years to address complexities in employment and tax compliance. Their role has grown significantly, not only as employers but also as compliance hubs that simplify payroll processing, enhance financial stability for workers and agencies, and act as key partners for HMRC as efficient tax collectors.

The rise of umbrella companies in the UK's contingent labour market was driven by the increasing complexity of employment and tax regulations. Historically, recruitment agencies managed payroll and employment for temporary workers directly. However, with the introduction of legislation such as IR35 and the rising administrative burden of tax compliance, umbrella companies emerged to fill a gap: providing a structured and compliant solution for managing payroll and employment in the supply chain.

Umbrella companies allow workers to be employed directly while supporting agencies in focusing on their core activities—sourcing and placing talent. Over time, they have become pivotal in ensuring compliance and mitigating risks in the labour supply chain.

2.4.1. Operational Functions as Compliance Hubs

Umbrella companies perform key operational functions that contribute to compliance across the supply chain:

- **Tax Compliance:**
  Umbrella companies handle all aspects of PAYE (Pay-As-You-Earn) and NICs (National Insurance Contributions) on behalf of workers, ensuring accurate and timely tax submissions to HMRC.

- **Payroll Processing:**
  They streamline payroll for temporary workers, managing holiday pay, pensions, and other statutory benefits, ensuring workers are compensated in full compliance with employment laws.

- **Operational Efficiency for Agencies:**
  By taking on employment responsibilities, umbrella companies enable recruitment agencies to focus on their core activities—sourcing candidates and managing client relationships—while reducing their administrative burdens.

- **Scalability:**
  Umbrella companies offer a scalable solution for agencies and clients managing large volumes of temporary workers, providing the infrastructure to handle rapid fluctuations in workforce size without compromising compliance.

2.4.2. Financial Support for Agencies and Workers

Compliant Umbrella companies play a crucial role in stabilising the financial ecosystem of the contingent labour market.

- **Helping Temporary Agencies with Cashflow:**
  Umbrella companies reduce cashflow pressure on recruitment agencies by handling payroll obligations and often offering payment terms. Agencies must pay workers on a weekly basis, but they are rarely paid each week. Umbrella Companies in many cases allow recruitment agencies with payment terms allowing these agencies to exist.

- **Commercial Advantages for Workers:**
  Workers get advances from Umbrella Companies. When workers need money or when timesheet have been approved too late by the line managers most of the Umbrella Companies don’t hesitate to step in and advance money to workers and support them financially.

- **Providing More Rights to Temporary Workers:**
  Umbrella companies ensure that temporary workers are treated as employees, giving them better legal protections and access to rights. This is more than what individual receive when engage directly by recruitment agencies. With recruitment agencies, individual often have a

status of “worker” unlike the status of “employee” they have with Umbrella Companies, the latter providing additional rights.

2.4.3. Advisory Contributions to Agencies and Clients

In addition to their operational and financial roles, compliant umbrella companies also act as advisors, helping agencies and clients navigate the complexities of compliance.

- **Support in Compliance:**
  Umbrella companies educate agencies about tax laws and employment regulations, minimising risks in the supply chain.

- **Example: KID Information Document:**
  Umbrella companies assist agencies in understanding regulation like the Key Information Document (KID), ensuring transparency about pay and deductions, a legal requirement.

- **Example: SDC Rules:**
  They provide clarity on Supervision, Direction, and Control (SDC) rules, which determine the applicability of certain tax reliefs.[3]

- **Support on Tax Regulations and Governmental Decisions:**
  Umbrella companies keep agencies informed of changes in tax laws, such as updates to IR35, NMW increases, and NIC adjustments, helping them adapt quickly.

- **Guidance on National Minimum Wage Compliance:**
  Umbrella companies ensure that all workers are paid in accordance with NMW laws, protecting agencies and clients from inadvertent non-compliance.

- **2.4.4. Role for HMRC**

Compliant Umbrella companies are valuable partners for HMRC, playing a key role in ensuring tax compliance across the temporary labour market.

- **Centralisation of Tax Collections:**
  By acting as employers for large numbers of temporary workers, umbrella companies centralise tax collection, making it easier for HMRC to monitor and enforce compliance.

- **Efficient Tax Collection:**
  Umbrella companies ensure timely and accurate submission of taxes, reducing the administrative burden on HMRC.

- **Combatting Fraud:**
  Compliant umbrella companies help identify and expose fraudulent practices in the supply chain, educating agencies about the risks of engaging with non-compliant models. This contributes to a healthier and more transparent labour market.

Umbrella companies play a vital role in the contingent labour market, serving as compliance hubs, financial stabilisers, and advisory partners for agencies and clients. When operating compliantly, they not only ensure the smooth functioning of the supply chain but also act as a critical line of

[3] Travelling and subsistence expenses (480: Chapter 8) - https://www.gov.uk/guidance/travelling-and-subsistence-expenses-480-chapter-8?utm_source=chatgpt.com

defence against fraud and non-compliance, supporting HMRC in its mission to create a fairer and more transparent tax system.

3. Tax Non-Compliance: Issues and Misconceptions

Tax non-compliance in the temporary labour market is a complex issue, often misunderstood and misrepresented by stakeholders with limited knowledge of the supply chain's intricacies. Some organisations, such as the Trades Union Congress (TUC), have been vocal in their campaigns to abolish umbrella companies. However, these calls are frequently rooted in political motivations or a lack of understanding about how umbrella companies operate and their role in ensuring compliance.

This section aims to address and debunk common misconceptions perpetuated by workers, unions, and other stakeholders. Misguided narratives, such as claims that umbrella companies are unregulated or that they are the sole source of non-compliance, often shift the focus away from the actual structural and behavioural causes of tax non-compliance within the supply chain.

By examining these misconceptions and providing clarity on how umbrella companies function, this section will shed light on the real sources of non-compliance and explain why these issues occur across the supply chain—not just at the umbrella company level. The goal is to foster a more informed discussion that moves beyond political rhetoric and helps stakeholders work collaboratively to address non-compliance effectively.

3.1. Misunderstandings about Umbrella Companies

3.1.1. Non-Compliance: Myths and Realities

3.1.1.1. Myth 1: Non-Compliance in the Labour Supply Chain Comes Exclusively from Umbrella Companies

One of the most persistent misconceptions is that tax non-compliance in the temporary labour market is primarily driven by umbrella companies. This narrative oversimplifies the issue and fails to acknowledge the inherent risks tied to any organisation tasked with calculating and paying taxes in the supply chain.

Reality: Tax non-compliance is not a consequence of the type of entity managing payroll but rather of the function it performs. Any organisation responsible for payroll—whether a recruitment agency, an umbrella company, or another intermediary—is inherently exposed to risks of engaging workers in tax avoidance schemes.

This risk is a structural characteristic of the temporary labour supply chain and is not specific to umbrella companies.

Inherent Risks in the Temporary Supply Chain:
The temporary labour market operates under unique pressures, including fluctuating demand, tight profit margins, and complex tax laws. These factors create an environment where non-compliance can arise anywhere in the supply chain, especially at the point where taxes are calculated and paid.

Blaming umbrella companies exclusively for tax non-compliance ignores the broader systemic risks present across the supply chain. Addressing non-compliance requires a focus on compliance practices, regardless of which organisation performs them. It is a structural issue, not an organisational one.

3.1.2. Myth 2: Workers Are Always Victims of Tax Avoidance Schemes

Another common narrative is that workers are solely victims of tax avoidance schemes, portrayed as being unwittingly caught in fraudulent arrangements orchestrated by other actors in the supply chain.

Reality:
While workers can indeed be victimised, particularly when they are unknowingly enrolled in tax avoidance schemes, they are not always passive participants. In some cases, especially in candidate-driven markets, workers actively seek out payment models that maximise their take-home pay, even if those models involve non-compliance with tax regulations.

High-demand sectors like healthcare, where skilled workers are scarce, workers frequently leverage their bargaining power to dictate intermediaries. This includes pushing recruitment agencies and umbrella companies to accommodate tax avoidance schemes to meet their preferences for higher take-home pay.

Example: The DUCAS Ltd Case. A recent case involving DUCAS Ltd, where a freezing order was issued, highlights this issue. Workers in the healthcare sector actively sought engagement through tax avoidance arrangements offered by non-compliant intermediaries.

The narrative that workers are always victims oversimplifies the reality of tax non-compliance in the temporary labour market. While victimisation does occur, workers in candidate-driven markets often wield significant influence and can contribute to the proliferation of non-compliant models. Acknowledging this shared responsibility is crucial for developing effective solutions to address tax non-compliance.

3.1.3. Myth 3: Umbrella Companies Are Not Transparent

A widespread myth is that umbrella companies lack transparency, particularly in how they calculate and process worker pay. This narrative often stems from a misunderstanding of the assignment rate and its conversion into a PAYE rate, which forms the basis of workers' gross pay.

Reality: Historically, workers in the temporary labour market have always negotiated their pay based on the assignment rate, which has become their "currency."

Assignment Rate as Currency: Similar to how someone knows the value of their skills in pounds but not necessarily in yen, workers are familiar with the assignment rate because it has been communicated to them for decades by recruitment agencies. This is the figure they negotiate, understand, and use to assess the value of their work.

Complex Conversion to PAYE: Unlike a straightforward currency conversion, converting an assignment rate to a PAYE rate involves several variables, including employer costs like National Insurance Contributions (NICs), the apprenticeship levy, pension contributions, and holiday pay.

Umbrella Companies' Role in Transparency: Umbrella companies are the only organisations in the UK that provide workers with a reconciliation statement, which details every deduction from the assignment rate to calculate their salary.

This reconciliation includes:

- Employer NICs.
- Holiday pay.
- Pension contributions.
- Umbrella company margin.

Contrast with Other Models: When workers are employed directly by recruitment agencies or through other PAYE models (PEO), they typically only receive a standard payslip. This lacks the detailed breakdown of deductions, leaving workers unclear about how their salary was calculated from the assignment rate they negotiated.

Umbrella companies offer the most transparent PAYE model in the UK, giving workers visibility into the total cost of their employment (assignment rate) and the employer costs incurred on their behalf. By comparison, other PAYE engagement models obscure these details, leaving workers with less information about how their pay is derived.

The belief that umbrella companies lack transparency is unfounded. In reality, compliant umbrella companies provide unparalleled clarity through reconciliation statements, empowering workers to understand every aspect of their pay. Far from being opaque, umbrella companies set the standard for transparency in the temporary labour market, offering workers insights that are unavailable in other PAYE engagement models.

3.1.4. Myth 4: Temporary Workers Have No Rights When Engaged by Umbrella Companies

A common misconception about umbrella companies is that temporary workers don't have any employment rights when they are engaged by them. This belief fundamentally misrepresents the reality of the UK's employment framework and the enhanced protections that umbrella companies provide to workers.

In the UK, individuals fall into one of three employment statuses: self-employed, worker, or employee. Each status comes with distinct rights and obligations under employment law. Workers generally receive fewer rights than employees, while employees benefit from the most comprehensive set of legal protections.

Workers, for example, are entitled to basic rights such as the National Minimum Wage, paid holiday leave, and protection against unlawful deductions from wages. They are also protected under anti-discrimination laws and are subject to working time regulations that govern rest breaks and working hours. However, their employment arrangements tend to be more flexible, and they do not receive benefits like redundancy pay, or maternity and paternity leave.

In contrast, employees work under a formal contract of employment, which places mutual obligations on both the employer and employee. Their working arrangements tend to be more structured.

When temporary workers are engaged directly by recruitment agencies, they are usually classified as workers rather than employees, which limits their rights. However, when these same individuals are engaged by compliant umbrella companies, they are typically employed as full employees. This transition gives them access to fundamental protections, such maternity or paternity leave, which they might not have otherwise received.

Without umbrella companies, many temporary workers would remain in worker status under recruitment agencies, thereby losing access to these additional protections. Instead of improving conditions, this shift would reduce the security and benefits available to temporary workers.

The claim that workers don't have rights when employed by umbrella companies is therefore unfounded. On the contrary, umbrella companies play a critical role in elevating temporary workers to employee status, providing them with a broader set of statutory rights and protections.

3.1.5. Perceived Tax Burden on Umbrella Workers

The belief that umbrella workers bear both the Employer's National Insurance Contributions (NICs) and Employee's NICs is one of the most pervasive misconceptions in discussions surrounding umbrella companies. This narrative has been propagated for years by lobbying organisations, including trade unions, and has contributed to significant misinformation.

For instance, Unite the Union, the second-largest trade union in the UK with over 1.24 million members, still claims on its website that "under an umbrella company, the worker has to pay both the employer's and employee's national insurance contributions"[4]. This assertion, however, misrepresents how umbrella companies operate and how pay is calculated.

Understanding the Assignment Rate

To clarify this misunderstanding, it is essential to distinguish between the assignment rate and the PAYE rate, two key concepts that govern contractor compensation under umbrella arrangements.

The assignment rate represents the total cost that the end client or agency agrees to pay for the worker's services. This figure includes not only the worker's gross pay but also the employment costs that an employer typically covers. These employment costs include:

- Employer's National Insurance Contributions.
- The Apprenticeship Levy.
- Employer pension contributions (if applicable).
- Holiday pay, which is usually calculated at 12.07% of the gross pay.
- The margin charged by the umbrella company for its services.

The assignment rate is often communicated to the worker upfront and is commonly referred to as the "Ltd rate" because it mirrors the rate typically offered to contractors operating through their own limited companies. However, it is critical to understand that the assignment rate is not equivalent to the worker's gross pay; rather, it is the total cost of employing the worker.

Understanding the PAYE Rate

The PAYE rate, on the other hand, is the worker's gross pay (excluding holiday pay) after the employer costs have been deducted from the assignment rate. This is the figure that appears on the worker's payslip and forms the basis for calculating the worker's tax and NICs.

This distinction is vital because it demonstrates that the worker is not paying the employer's NICs directly. Rather, these costs are deducted from the assignment rate, which includes all components of the employment cost.

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[4] Government 'washes hands' on umbrella company misery, says Unite - https://www.unitetheunion.org/news-events/news/2018/august/government-washes-hands-on-umbrella-company-misery-says-unite

Debunking the Myth

The misconception that umbrella workers pay both the employer's and employee's NICs likely stems from the fact that the assignment rate is presented as a total cost that includes all employment expenses. Workers who are unfamiliar with this structure may mistakenly believe that employer costs are being unfairly passed onto them.

However, this belief does not account for the fact that the assignment rate is a gross figure, not the salary amount. In any PAYE arrangement—whether through a recruitment agency, umbrella company, or direct employment—employer costs are always deducted before the worker's gross pay is calculated. Umbrella companies are no different in this respect.

Furthermore, umbrella companies add a layer of transparency by providing workers with a reconciliation statement. This statement breaks down the assignment rate into its individual components, showing the worker exactly how their salary is derived. No other employment model in the UK offers this level of visibility into the calculation of gross pay.

Why This Matters

The distinction between the assignment rate and salary is crucial for combating misinformation and ensuring that workers fully understand their financial arrangements. By conflating these terms, lobbying organisations perpetuate the false narrative that umbrella companies impose an undue tax burden on workers. In reality, umbrella companies simply structure pay in a way that provides greater clarity about the costs involved in temporary employment.

The claim that umbrella workers pay both the employer's and employee's NICs is not only inaccurate but also misleading. The assignment rate includes all costs associated with employing the worker, and these costs are deducted before arriving at the PAYE rate. Umbrella companies enhance transparency by providing detailed reconciliation statements that clarify these calculations, empowering workers to understand their pay in a way that other PAYE models do not.

This distinction is fundamental for stakeholders, including trade unions and workers, to accurately evaluate the role of umbrella companies and to dispel the myths that have long distorted public discourse on the subject.

3.2. Enforcement Challenges and Opportunities

3.2.1. Lack of Effective Enforcement as the Core Issue

The central issue underlying tax avoidance in the UK, particularly in the context of umbrella companies and pay intermediaries, is not rooted in ambiguity or lack of regulatory frameworks but in the inefficiency of enforcement mechanisms. It is well accepted across the industry and all stakeholders that if enforcement were 100% effective and efficient, tax avoidance problems would be resolved in the temporary labour market. This highlights that enforcement, rather than additional legislative clarifications, is the key to tackling non-compliance.

The narrative often portrays umbrella companies as operating in unregulated grey areas, creating a perception that the sector's challenges stem from unclear responsibilities. However, the roles of umbrella companies and agencies as employers are explicitly defined. Both entities are bound by the same fundamental responsibilities to their workers under the law, including ensuring proper payment of wages, deduction of taxes, and provision of employment rights. The lack of enforcement, not the lack of clarity, allows unscrupulous actors to exploit the system.

3.2.1.1. The Cost of Inaction

HMRC has already acknowledged the financial and social damage caused by rogue companies, which often don't act as PAYE Umbrella Companies. The autumn budget 2024 highlighted the alleged £500 million lost to disguised remuneration schemes facilitated through non-compliant operators. This is compounded by mini-company fraud schemes and other evasion tactics that funnel taxpayers' money into non-compliant businesses, undermining compliant businesses and eroding trust in the tax system.

The government's recent actions, such as publishing lists of tax avoidance promoters, enablers, and schemes, demonstrate an awareness of the need for robust enforcement. However, these measures are reactive rather than preventative. A more comprehensive and proactive enforcement strategy is essential to dismantle the mechanisms enabling tax avoidance within the temporary labour market.

3.2.1.2. Understanding the Industry to Enforce Effectively

To enforce efficiently, it is critical to understand the complexities of the umbrella company market and its interactions with recruitment agencies and end clients. HMRC's reliance on the "tax gap" as a decision-making tool underlines this necessity. The autumn budget 2024 referred to an ambitious plan to raise £6.5 billion annually by closing the tax gap by 2029-30. This initiative relies heavily on the information from the tax gap to quantify non-compliance which is far from being accurate as you can see below in "*3.2.2 - Understanding the Tax Gap and Its implication*".

The lack of effective enforcement is the cornerstone of the tax avoidance problem in the UK. Addressing this through a combination of proactive oversight, targeted interventions, and industry collaboration can transform the current landscape. Enforcement is not a supplementary measure; it is the critical path to achieving compliance, protecting taxpayers, and restoring fairness in the labour market.

3.2.2. Understanding the Tax Gap and its implication

The tax gap, defined as the difference between the tax theoretically due and what is actually collected, is a critical indicator used by HMRC to shape tax policy and enforcement priorities. However, the tax gap is not merely a technical measure—it is a tool that drives decision-making, sets government objectives, and underscores the systemic challenges in tax compliance. A refined understanding of its origins, methodology, and limitations highlights both its utility and the risks of over-reliance.

3.2.2.1. Deconstructing the Tax Gap: Methodology and Accuracy

HMRC's tax gap estimates are built on complex methodologies, incorporating data from audits, economic modelling, and administrative sources. To address the inherent uncertainties in this process, HMRC assigns uncertainty ratings to its tax gap components. These ratings evaluate the reliability of the data, methodology, and the scope of the models used. This transparent approach ensures a better understanding of the data's strengths and weaknesses.

For instance, in assessing non-compliance among umbrella companies, the tax gap estimates rely on **assumptions** about labour market intermediaries and payroll structures. The methodologies, while comprehensive, struggle to capture the evolving complexity of disguised remuneration schemes and the cascading effects of multi-layered supply chains. These limitations can, and we argue they do, result in misrepresentation of specific sectors' contribution to the tax gap.

The table below exemplifies the challenges in accurately estimating the tax gap, focusing on "income tax, NICs, and CGT – avoidance":

S3.2.2.1

HMRC Tax Gap Uncertainty Rating	Scope Uncertainty	Methodology Uncertainty	Data Uncertainty	Overall uncertainty rating
Income Tax, NICs, CGT - avoidance	**High**: Missing some of the tax base and population. Some forms of non-compliance are risks not being accounted for. Some potential for overlap with other estimates.	**Very high**: Assumption based sensitive model, most of which are unverifiable. Many risks with no strong mitigation.	**Very high**: No suitable data, what is available is not well understood and is of low quality.	**Very high**: Very low confidence in the estimate – the actual is likely to be markedly different

The wording used in this table is HMRC wording.[5]

The "Scope Uncertainty" column illustrates that the model omits significant elements of the tax base and population, leading to an incomplete picture of non-compliance. HMRC also explain that forms of tax avoidance or evasion may overlap with other tax categories, further distorting the overall estimate.

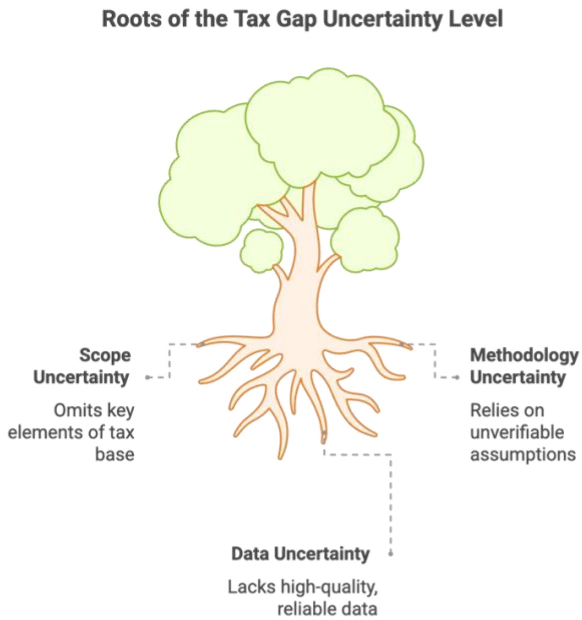
"Methodology Uncertainty" highlights a reliance on sensitive assumptions, many of which are unverifiable. These assumptions pose a substantial risk of error as there are limited measures in place to mitigate inaccuracies. For example, the methodology could depend on outdated or incomplete models that fail to reflect the dynamic and evolving nature of tax avoidance schemes.

"Data Uncertainty" points to the lack of suitable, high-quality data. The available data are often fragmented, poorly understood, or low in reliability, making it challenging to draw accurate conclusions. This is particularly problematic in areas like disguised remuneration schemes and mini-company fraud, where non-compliance is both sophisticated and difficult to quantify.

The "Overall Uncertainty Rating" for income tax, NICs, and CGT avoidance is marked as "Very High." This reflects a lack of confidence in the estimates, with actual figures potentially differing significantly from HMRC's reported values. Such high uncertainty undermines the reliability of the tax gap as a policymaking tool.

While the tax gap serves as a useful indicator for highlighting trends in tax compliance and non-compliance, it fundamentally lacks the accuracy required for high-stakes decision-making. As acknowledged by HMRC, the significant uncertainties in scope, methodology, and data quality make the tax gap an inherently unreliable measure. While it can guide initial enforcement priorities, its limitations mean it should not be overly relied upon as a definitive or precise representation of the problem.

[5] Tax Gaps: Methodological Annex - https://www.gov.uk/government/statistics/measuring-tax-gaps/methodological-annex#chapter-a-introduction



3.2.2.2. Influence on Policy and Strategic Direction

Despite its acknowledged inaccuracies, the tax gap remains a central reference point for shaping tax enforcement strategies. The autumn budget 2024, for instance, heavily relied on tax gap estimates to justify an ambitious plan to close the gap and raise £6.5 billion annually by 2029-30. While such objectives are laudable, basing them on highly uncertain data risks misallocating resources and focusing enforcement efforts on less critical areas.

Furthermore, over-reliance on the tax gap metric can obscure the nuanced realities of non-compliance. For example, targeting umbrella companies without addressing the structural causes of non-compliance, such as enforcement inefficiencies, may fail to yield the desired outcomes.

3.2.2.3. Broader Implications for Stakeholders

The limitations in the tax gap's accuracy have tangible consequences for businesses, workers, and public trust. For compliant businesses, inaccuracies in the tax gap figures may lead to disproportionate enforcement actions or misdirected compliance initiatives. Workers in sectors prone to non-compliance, such as the temporary labour market, face greater risks of exploitation due to inadequate targeting of rogue operators.

Public trust in the tax system is also at stake. Persistent uncertainty and inaccuracies in tax gap reporting can erode confidence in HMRC's ability to enforce tax compliance effectively. To restore trust, HMRC must not only refine its methodologies but also communicate the limitations of the tax gap transparently beyond the annex.

The tax gap is an essential but imperfect tool for understanding and addressing non-compliance. The example of income tax, NICs, and CGT avoidance underscores the significant uncertainties inherent in its calculation. For the tax gap to remain a credible guide for policymaking, HMRC must address its methodological weaknesses and supplement it with sector-specific analyses that provide deeper insights into non-compliance dynamics.

HMRC Tax Gap Uncertainty Rating

SafeRec. 3.2.2

HMRC Tax Gap Uncertainty Rating	Scope Uncertainty	Methodology Uncertainty	Data Uncertainty	Overall uncertainty rating
Income Tax, NICs, CGT - avoidance	**High**: Missing some of the tax base and population. Some forms of non-compliance are risks not being accounted for. Some potential for overlap with other estimates.	**Very high**: Assumption based sensitive model, most of which are unverifiable. Many risks with no strong mitigation.	**Very high**: No suitable data, what is available is not well understood and is of low quality.	**Very high:** Very low confidence in the estimate – the actual is likely to be markedly different
PAYE - mid-sized business	**High**: Missing some of the tax base and population. Some forms of non-compliance are risks not being accounted for. Some potential for overlap with other estimates.	**Medium**: Some sensitive assumptions and challenges. The model is analytically complex with multiple stages. Some external risks with most unlikely and with good risk mitigation	**Medium**: Not complete data (a lot of assumptions but all logical and verifiable). Some data not fully understood but still acceptable for use in tax gaps with some caveats.	**Medium**: The estimate is likely to be close to the actual but there is a possibility that it is different
PAYE - small business	**Medium**: Accounts for most of the tax base and population. Accounts for most potential forms of non-compliance. No overlap with other estimates.	**Medium**: Some sensitive assumptions and challenges. The model is analytically complex with multiple stages. Some external risks with most unlikely and with good risk mitigation	**Low**: High quality data (small amount of unsensitive projecting/non-detection multiplier uplifts). Mostly understood data and suitable for use in tax gaps.	**Medium**: The estimate is likely to be close to the actual but there is a possibility that it is different
PAYE - large business	**High**: Missing some of the tax base and population. Some forms of non-compliance are risks not being accounted for. Some potential for overlap with other estimates.	**Very high**: Assumption based sensitive model, most of which are unverifiable. Many risks with no strong mitigation.	**Very high**: No suitable data, what is available is not well understood and is of low quality.	**Very high**: Very low confidence in the estimate – the actual is likely to be markedly different
Income Tax, NICs, CGT hidden economy - moonlighters	**High**: Missing some of the tax base and population. Some forms of non-compliance are risks not being accounted for. Some potential for overlap with other estimates.	**High**: Multiple sensitive and unverifiable assumptions. Model may be too analytically complex or simplistic. Many risks, some of which have weak mitigation in place.	**High**: Little suitable data and of poor quality. Most of the data is not properly understood, many caveats but no alternative.	**High**: Low confidence that the estimate is close to the actual
Income Tax, NICs, CGT hidden economy - ghosts	**Very high**: Almost all the tax base and population are missing and almost no risks are being accounted for. Likely overlap with other estimates.	**High**: Multiple sensitive and unverifiable assumptions. Model may be too analytically complex or simplistic. Many risks, some of which have weak mitigation in place.	**Very high**: No suitable data, what is available is not well understood and is of low quality.	**Very high**: Very low confidence in the estimate – the actual is likely to be markedly different

Source: .Gov.UK - "Tax Gaps: Methodological annex" - [*https://www.gov.uk/government/statistics/measuring-tax-gaps/methodological-annex#chapter-a-introduction*](https://www.gov.uk/government/statistics/measuring-tax-gaps/methodological-annex#chapter-a-introduction)

4. HMRC’s Proposals and Their Implications

4.1. Interpretation & Impacts of HMRC Proposals on Key Stakeholders

HMRC’s adoption of Option 3, as outlined in the Autumn Budget 2024, marks a significant shift in the taxation framework for temporary labour supply chains. The proposed changes, scheduled for implementation in April 2026, aim to address non-compliance issues by transferring the responsibility for Pay As You Earn (PAYE) and National Insurance Contributions (NICs) from umbrella companies to recruitment agencies or end clients in the absence of an agency. While the policy targets unscrupulous practices that have contributed to substantial tax revenue losses, its introduction has created widespread uncertainty and misunderstanding within the industry.

Two interpretations of the proposal have emerged, adding to the confusion:

- PAYE Reference Enforcement: Under this interpretation, recruitment agencies would be required to use their own PAYE reference numbers for workers engaged via umbrella companies, fundamentally altering the operational role of umbrellas and the flow of the supply chain.

- Modified Liability Model: In this scenario, umbrella companies would continue to process taxes under their PAYE reference numbers, but the recruitment agency or end client would bear ultimate liability for PAYE and NIC compliance.

The second interpretation retains operational alignment with the current umbrella model while introducing a layer of liability for agencies, which would strengthen compliance without significantly disrupting labour market practices. However, the first interpretation—mandating the use of agencies’ PAYE references—poses profound challenges. It risks destabilising contingent labour markets operationally and financially, particularly by eroding the efficiencies provided by umbrellas, complicating payroll management, and introducing legal ambiguities across industries.

This section explores the implications of these proposals, emphasising the potential for disruption under the first interpretation. By analysing these impacts, we aim to provide HMRC with actionable insights to refine its approach, minimise unintended consequences, and uphold its objectives of fairness, compliance, and tax integrity.

4.1.1. Potential Implications for the Compliance Market

The UK government’s 2024 policy paper proposes a significant shift in responsibilities within the labour supply chain, aiming to address tax non-compliance in the temporary labour market. However, a critical flaw in this proposal lies in its potential broad-brush approach, which risks disrupting the operational integrity of 60% of the market—deemed compliant by HMRC itself. If the proposal effectively renders the current model non-compliant, it will force widespread and unnecessary changes on compliant businesses that collectively contribute billions of pounds in taxes annually.

4.1.1.1. Key Observations:

- **Disrupting a Functioning Model**: HMRC’s own analysis acknowledges that 60% of the umbrella company market operates within compliance. Mandating such entities to overhaul their operations despite their adherence to existing regulations is not just unnecessary but counterproductive. It risks destabilising a significant portion of the labour market without clear evidence that these changes would improve compliance.

- **Flawed Data Underpinning the Policy**: The policy is grounded in assumptions about non-compliance that are highly speculative. The Autumn Budget Policy Costings document[6] admits significant uncertainty surrounding the size of the tax base and the behavioural responses to the proposed measures. Such uncertainty undermines the rationale for enforcing a change that impacts a largely compliant sector.

- **Counterproductive Compliance Strategy**: Rather than targeting non-compliant actors directly, Option 3 where the PAYE reference number of the employment business punishes compliant businesses by forcing them to restructure their operations entirely. This approach paradoxically shifts the focus away from tackling bad actors, making enforcement against genuine tax avoidance more difficult.

- **Risks to Tax Revenue and Market Stability**: The compliant portion of the umbrella company sector plays a vital role in ensuring timely and accurate tax collection. Forcing them to adopt new, untested models jeopardises their operational efficiency and could lead to payroll disruptions, increased non-compliance, and reduced tax revenue.

It is unfathomable to enforce Option 3 if it results in using the PAYE reference of the recruitment agency instead of using the umbrella company's one, which would effectively dismantle a functioning compliance framework, destabilising a critical component of the labour market. HMRC's proposal, based on uncertain and incomplete data, risks creating chaos for 60% of the compliant market while failing to address the root causes of non-compliance. A more measured and targeted approach is needed—one that focuses on bolstering enforcement against non-compliance rather than penalising those who adhere to the rules.

4.1.1.2. Concerns on Data Accuracy and Market Implications

Cross-referencing HMRC's tax gap reports reveals that these estimates heavily depend on experimental methodologies, which often combine statistical models with unverified assumptions. This approach casts doubt on the reliability of conclusions drawn about the scale of non-compliance. Moreover, umbrella companies constitute an integral part of a largely compliant sector that contributes billions in taxes annually. If, as HMRC estimates, 60% of this market is compliant, disrupting their operations through a sweeping policy shift risks destabilising a significant revenue source.

Key Observations:

Unclear Tax Base and Data Assumptions: HMRC's broad-brush assumptions about non-compliance inflate concerns, which are not substantiated by transparent data or methodological clarity. The policy's basis on such speculative figures undermines its validity.

Risk to Compliance Ecosystem: Forcing operational changes upon 60% of the umbrella company sector—acknowledged to be compliant—may inadvertently dismantle well-functioning systems, impairing payroll efficiency and tax collection consistency.

[6] Autumn Budget 2024 Policy Costings - https://assets.publishing.service.gov.uk/media/6721d2c54da1c0d41942a8d2/Policy_Costing_Document_-_Autumn_Budget_2024.pdf

Economic Ripple Effects: These disruptions could have profound implications for the recruitment market, including diminished worker rights protections, financial instability, and strained recruitment agency operations, as seen in previous regulatory shifts like IR35.

Given the policy's reliance on uncertain figures and its broad implications, it seems questionable whether such measures will result in a net benefit to tax compliance or the wider economy. A more calibrated approach, focusing on enhancing enforcement mechanisms against proven bad actors while safeguarding compliant entities, could yield more equitable and sustainable outcomes.

4.1.2. Threats to the Financial Stability of Labour Market

The proposed shift in PAYE responsibilities from umbrella companies to recruitment agencies or end-client threatens to destabilise the financial foundation of the temporary labour market. Umbrella companies currently provide essential support to agencies, not only by managing payroll operations but also by offering credit terms that help agencies maintain cashflow while awaiting client payments. This financial buffer is critical for agencies operating in low-margin sectors or handling high volumes of temporary workers, enabling them to meet payroll obligations and other operational costs without disruption.

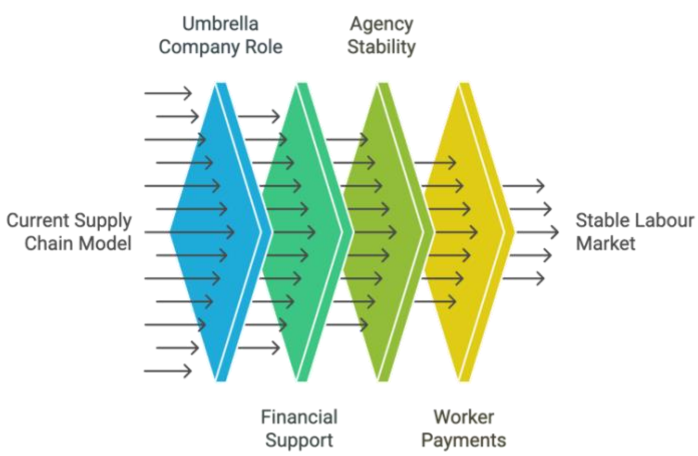
If agencies or end clients are required to absorb payroll costs upfront, the resulting financial strain could lead to significant challenges, particularly for smaller and mid-sized agencies. These challenges include reduced liquidity, increased operational costs, and potential market consolidation as smaller players struggle to remain viable. Moreover, the introduction of the 'deemed model,' which would require agencies to calculate payroll themselves, further undermines the value of engaging with umbrella companies and adds substantial administrative burdens.

This section explores how these changes could weaken competition, reduce financial stability, and destabilise the contingent labour market, ultimately impacting workers, agencies, and clients alike.

4.1.2.1. The Role of Umbrella Companies in Sustaining Supply Chain Cashflow

The financial stability of the contingent labour market hinges on the effective flow of cash across its supply chain. Recruitment agencies, end clients, umbrella companies, and workers are interdependent, and any disruption to this balance could have far-reaching consequences. Umbrella companies play a critical role in this ecosystem by not only managing payroll and compliance but also supporting agencies and workers financially through efficient cashflow management.

Current Model



In the current structure, the financial flow across the supply chain is built as followed:

- **Assignment Rate and Agency Margin**: End clients pay recruitment agencies a combined amount that includes the assignment rate (e.g., £32.50/hour for a social worker) to cover the worker's pay and associated costs, alongside the agency's margin (e.g., £2.50/hour) for their services.

- **Umbrella Companies as Intermediaries**: Agencies transfer the assignment rate (minus their margin) to umbrella companies, which employ the worker, process payroll, and manage PAYE and National Insurance deductions. Crucially, umbrella companies retain the tax funds before passing them to HMRC, enabling them to manage cashflow effectively.

Shifting PAYE responsibility to recruitment agencies or end clients would fundamentally alter this cashflow model, with severe consequences for the supply chain that we will cover in the following parts.

4.1.2.2. Credit Terms and Cashflow Management

Umbrella companies currently provide recruitment agencies with critical credit terms that enable them to defer payroll costs while waiting for client payments. This arrangement allows agencies to:

- ***Smooth Cashflow***: Agencies can continue paying workers promptly, even when there are delays in receiving payments from clients, ensuring the continuity of operations without financial strain.

- ***Operate in Low-Margin Sectors***: Many recruitment agencies work in industries with slim profit margins, such as logistics. The cashflow flexibility provided by umbrella companies is essential for maintaining financial stability in these sectors.

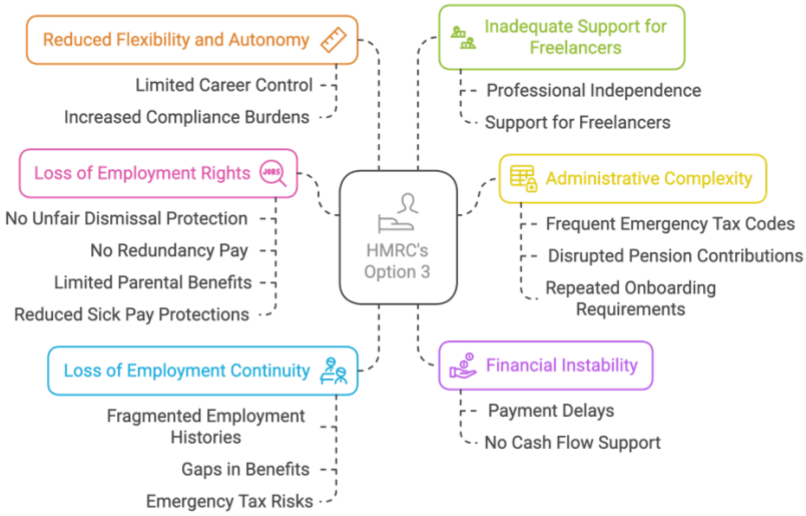
- ***Support High-Volume Operations***: Agencies dealing with large numbers of temporary workers benefit from the ability to defer payroll costs, as managing significant upfront payments would otherwise require substantial financial reserves.

If PAYE responsibilities are enforced to be shifted entirely to agencies, Umbrella Companies won't receive the necessary cashflow and therefore this vital support would disappear, creating cashflow bottlenecks that could severely impact smaller and mid-sized agencies. Without these credit terms, agencies may struggle to pay workers on time.

4.1.3. Risks to Worker's Rights and their Financial Stability

The shift in responsibility proposed by HMRC's Option 3, which would push recruitment agencies to directly engage workers under PAYE rather than relying on umbrella companies, poses substantial risks to the rights and financial stability of workers in the contingent labour market. Umbrella companies currently play a critical role in safeguarding employment protections, providing financial stability, and streamlining administrative processes for workers. However, influencing agencies to engage workers directly could undermine these benefits, leaving workers more vulnerable and financially insecure.

This section examines the specific risks associated with the proposed changes, including the erosion of statutory employment rights, increased financial instability due to inconsistent payments, and the administrative fragmentation likely to arise from agency PAYE engagement. It also explores the operational strain on agencies and the broader destabilising effects on the contingent labour market, making the case for the continued use of umbrella companies as a critical element of worker support and compliance.



4.1.3.1. Loss of Employment Rights

If agencies were required to directly engage workers instead of using umbrella companies, the majority of workers would lose their employee status and instead be classified as "workers." This reclassification would result in diminished statutory protections, including:

- **No Unfair Dismissal Protection**: Workers under agency PAYE would not qualify for unfair dismissal claims, leaving them vulnerable to abrupt terminations without recourse.
- **No Redundancy Pay**: Agency PAYE workers would lose access to redundancy payments, which can provide vital financial security during economic downturns or job shortages.
- **Limited Parental Benefits**: Agency PAYE workers typically have no right to statutory maternity or paternity leave, only pay (if they qualify). This creates confusion and reduces protections for those needing time off for family reasons.
- **Reduced Sick Pay Protections**: Eligibility for statutory sick pay (SSP) could become harder to meet under agency PAYE due to fragmented work patterns or lower earnings thresholds.

For workers currently employed via umbrella companies, these rights are guaranteed under their employee status. Shifting to agency PAYE would strip workers of these benefits, leaving them in a significantly more precarious position.

4.1.3.2. Financial Instability Due to Inconsistent Payments

Umbrella companies often provide critical financial support to workers by advancing wages based on hours worked but not yet paid by the agency. If agencies were forced to engage workers directly, this vital service would be likely lost, leading to:

- **Payment Delays:** Agencies typically rely on client payments before compensating workers. Without wage advances, workers would face delays in receiving their pay, creating financial strain, for example in cases where their time sheets have not been signed by their line manager on time.

- **No Cash Flow Support**: Workers often depend on the timely wage advances provided by umbrella companies to cover immediate expenses like rent, bills, and transport. Agencies rarely have the infrastructure or cashflow to offer such support.

The removal of wage advances and consistent payment systems provided by umbrella companies could create severe cash flow challenges for workers, potentially forcing them into financial hardship.

4.1.3.3. Administrative Complexity and Fragmentation

Under the current model, umbrella companies provide a seamless administrative service, handling payroll, tax deductions, and compliance. If agencies were pushed to engage workers directly, it would result in:

- **Frequent Emergency Tax Codes**: Workers moving between assignments under agency PAYE are likely to encounter emergency tax codes or inaccurate deductions, creating financial and administrative headaches.

- **Disrupted Pension Contributions**: Agencies often postpone or fail to auto-enrol workers into pension schemes, resulting in gaps or delays in contributions that reduce long-term financial security.

- **Repeated Onboarding Requirements**: Each assignment under agency PAYE would require new contracts, onboarding, and payroll setup, increasing administrative burdens for both workers and agencies.

- **Increased risk of inaccurate liabilities being calculated**: the current tax system is unlikely to keep up with the fast changing assignments being worked under multiple agencies. Tax codes not being accurate or issued in time to the correct PAYE scheme could lead to inadvertent under/over collection of tax from a contractor.

This fragmentation would significantly increase the complexity of managing contingent labour, leaving workers exposed to errors and delays in receiving entitlements.

4.1.3.4. Loss of Employment Continuity

Umbrella companies provide workers with a continuous employment record, even during gaps between assignments. If agencies were pushed to engage workers directly:

- **Fragmented Employment Histories**: Workers would lose the continuity of having a single employer, which is critical for credit checks, mortgage applications, and financial stability.

- **Gaps in Benefits**: Continuous employment ensures uninterrupted access to entitlements like sick pay and pensions. Under agency PAYE, workers could face lapses in these benefits between assignments.

- **Emergency Tax Risks**: Switching agencies frequently under PAYE increases the likelihood of being placed on emergency tax codes, further complicating workers' financial situations.

The removal of employment continuity would undermine workers' financial security and access to critical benefits, particularly for those relying on temporary work for long-term career stability.

4.1.3.5. Reduced Flexibility and Autonomy

Many workers value the flexibility and autonomy provided by the umbrella model, as it allows them to work on their own terms without being tied directly to agencies or clients. If agencies were required to engage workers directly:

- **Limited Career Control**: Workers would have less independence in choosing assignments, as agencies often impose stricter conditions on direct hires.

- **Increased Compliance Burdens for Workers**: Workers who lose the option of umbrella employment would lose advise on managing tax filings, insurance, and compliance themselves.

This reduced flexibility could deter workers from participating in the contingent labour market altogether, exacerbating talent shortages in key industries.

4.1.3.6. Inadequate Support for Freelancers and Itinerant Workers

Umbrella companies allow workers to retain their autonomy while benefiting from the protections of employment, a balance rarely achieved under agency PAYE:

- **Professional Independence**: Workers maintain control over their career paths, choosing assignments that suit their skills and preferences. Under agency PAYE, workers are often more constrained by the agency's policies and practices.

- **Support for Freelancers**: Many workers prefer the umbrella model as it allows them to avoid the administrative burden of running a limited company while still operating independently. Agency PAYE or end clients offers no such flexibility.

4.1.3.7. Confusion for Workers

The implementation of Option 3 introduces significant ambiguity in employment relationships, leaving workers uncertain about their roles and responsibilities. This confusion presents several challenges:

- **Unclear Employment Relationship**: Workers may struggle to understand whether their employer for tax purposes is the recruitment agency or the umbrella company. This uncertainty can lead to misunderstandings about who is responsible for statutory payments, benefits, and compliance.

- **Reduced Trust**: If professionals in the industry are already expressing confusion about these changes, workers—who often rely on clear communication—are likely to feel alienated and mistrustful. This erosion of trust could reduce their confidence in both their employers and the wider contingent labour market.

4.1.3.8. Less Visibility on Deductions Made from Assignment Rate to Calculate PAYE Rate

One of the strengths of the umbrella company model is the transparency it provides to workers about the deductions taken from their assignment rate to calculate the PAYE rate. Shifting responsibility to recruitment agencies under Option 3 would likely reduce this visibility for workers, leading to:

- **Uncertainty in Pay Calculations**: Without clear communication and standardised processes, workers may struggle to understand how their PAYE rate has been calculated. This could result in disputes and dissatisfaction.

- **Increased Errors**: Agencies, especially smaller ones with less experience in payroll, may inadvertently miscalculate deductions, leaving workers short-changed or overtaxed, further complicating their financial stability.

If agencies or end clients were forced to directly engage workers instead of using umbrella companies, the impact on workers' rights, financial stability, and the overall efficiency of the contingent labour market would be severe. Workers would face reduced protections, increased financial insecurity, and greater administrative burdens, while agencies would struggle with higher costs and operational inefficiencies. Preserving the option for workers to engage through umbrella companies is essential to maintaining a stable and equitable labour market.

4.1.4. Consequences for Umbrella Companies

An aggressive version of Option 3 where the PAYE reference of the employment business is used will fundamentally undermine the role of umbrella companies, placing their very existence at risk. By shifting PAYE and NIC responsibilities to agencies or end clients, umbrella companies will lose their core function of managing payroll and compliance for temporary workers. This section outlines the specific risks faced by umbrella companies under the proposed changes.

4.1.4.1. Loss of Relevance in the Labour Market

The central role of umbrella companies as intermediaries in the contingent labour market could severely diminished if the employment business' PAYE Reference number is used:

- **Disruption of Payroll Operations**: The responsibility for PAYE would transfer to agencies or end clients, leaving umbrella companies with little operational value.

- **Limited Role in Joint Employment Models**: While some suggest umbrella companies could remain relevant in a joint employment model—where agencies or clients handle tax compliance and umbrellas manage employment law—this arrangement is fraught with inefficiencies and complexities.

- **Fragmented Responsibilities**: Statutory payments like Statutory Maternity Pay (SMP) would require agencies to act as secondary contributors for tax purposes, while umbrellas would oversee employment rights. This fragmented setup would strain coordination between parties and render umbrella companies less practical for agencies.

- **Unclear Financial Processes**: In such a model, it is unclear how agencies would structure assignment rates or pass funds to umbrellas, further complicating workflows and diminishing the appeal of umbrellas.

This erosion of relevance leaves umbrella companies at significant risk of being pushed out of the labour market entirely.

4.1.4.2. Financial Fragility and Market Exit

Without their payroll function and the ability to manage retained taxes, umbrella companies would lose a critical source of cashflow. This has severe financial implications:

- **Loss of Cashflow Buffer**: Currently, umbrella companies retain taxes before remitting them to HMRC, allowing them to maintain liquidity and provide credit terms to agencies. Removing this function would strip umbrellas of their ability to sustain their own operations.

- **Inability to Support Recruitment Agencies**: Umbrella companies play a key role in financially supporting smaller agencies by offering credit terms. The loss of this capability would destabilise smaller recruitment agencies, creating a ripple effect across the market and further reducing demand for umbrellas.

- **Closure of Smaller Umbrella Companies**: Smaller, specialist umbrella companies are especially at risk. Without a clear role or cashflow, they would likely exit the market, further reducing competition and innovation.

The financial fragility introduced by Option 3 would make it almost impossible for umbrella companies to remain viable, pushing the majority out of the market.

4.1.4.3. Exacerbation of Financial and Legal Risks

The erosion of umbrella companies could lead to broader financial and legal risks within the labour market:

- **Loss of Compliance Frameworks**: Umbrella companies currently act as centralised compliance hubs, ensuring proper tax deductions and adherence to employment laws. Without their oversight, agencies may struggle to fill this gap, increasing the risk of non-compliance with tax regulations.

- **Erosion of Tax Revenue Integrity**: With fewer umbrella companies to enforce compliance, the risk of tax avoidance and worker misclassification will rise, undermining the government's efforts to address non-compliance.

Option 3 represents an existential threat to umbrella companies. By stripping them of their primary role in managing payroll and compliance, the proposed changes would financially destabilise these organisations and render them largely irrelevant in the labour market. The inefficiencies and confusion introduced by fragmented roles in a joint employment model would further diminish the appeal of umbrella companies, leading to widespread closures. This erosion of the umbrella company model would have cascading consequences for workers, agencies, and the broader contingent labour market, making its preservation crucial for industry stability.

4.1.5. Impact on Recruitment Agencies

4.1.5.1. Impact of Option 3: the 'Deemed Employer Model'

Under the deemed employer model, recruitment agencies and end clients would be required to handle payroll directly, calculating tax and National Insurance deductions before passing the net amount to umbrella companies. This shift carries several destabilising consequences:

- **Loss of Payroll Outsourcing Benefits**: Recruitment agencies have historically relied on umbrella companies to streamline payroll management. By shifting payroll responsibility to agencies, HMRC is removing one of the primary advantages of using umbrella companies, leaving agencies to absorb significant administrative burdens.

- **Increased Costs and Complexity**: Payroll processing requires sophisticated systems and compliance expertise. Many small and medium-sized agencies lack the necessary infrastructure, meaning they would need to invest heavily in payroll software, tax advisory services, and additional staff. A survey of recruitment businesses found that 64% [7]were already reducing operational costs due to inflation. Adding payroll responsibilities – even if outsourced - will further strain their financial stability.

- **Disruption of Industry Dynamics**: Agencies may seek alternative models to avoid these additional obligations, mirroring the responses seen following IR35 reforms. A 2017 survey found that 80% of contractors planned to leave the public sector following IR35 changes[8], leading to staffing shortages and project delays. Similar shifts in response to Option 3 could further fragment the labour supply chain and introduce inconsistencies in compliance.

- **Impact on Specialist Recruitment Sectors**: Niche recruitment firms, such as those supplying healthcare professionals, logistics workers, and IT contractors, rely on the flexibility and efficiency of umbrella companies. Removing this support could lead to supply chain disruptions, longer hiring times, and increased costs, ultimately affecting industries that depend on rapid workforce deployment.

By eliminating the operational efficiencies offered by umbrella companies, Option 3 introduces financial, administrative, and compliance risks that could undermine the ability of recruitment agencies to function effectively.

4.1.5.2. Operational Strain on Agencies

Forcing agencies or end clients to engage workers directly introduces significant operational challenges, making workforce management more complex and financially unsustainable. Key issues include:

- **Higher Administrative Costs**: Agencies will need to expand payroll, HR, and compliance teams to handle tax deductions and payments. For smaller agencies (which represent over 70% of the sector), these costs could be unsustainable, leading to business closures.

- **Delays in Onboarding Workers**: Longer processing times due to increased payroll and compliance burdens will slow down the hiring cycle. This will be especially problematic in industries that depend on flexible, short-notice staffing, such as retail, hospitality, and

[7] UK Recruitment Status Report 2023
[8] https://www.contractorcalculator.co.uk/docs/ContractorCalculator-IR35-Survey-Report.pdf

construction. Even a few days' delay in payroll processing could result in serious staffing shortages.

- **Increased Risk of Non-Compliance**: Many agencies lack the expertise to navigate complex tax laws and employment regulations. As a result, shifting PAYE responsibilities to agencies increases the likelihood of payroll errors, misclassifications, and late payments, leading to higher audit risks, penalties, and reputational damage.

- **Cashflow Instability**: Umbrella companies help smooth out cashflow fluctuations by providing credit terms to recruitment agencies. If agencies must now cover payroll upfront, they will need to pay workers before receiving funds from clients—potentially waiting 30 to 60 days for reimbursement. This creates cashflow problems that many agencies cannot absorb, increasing the risk of delayed payments to workers and financial collapse

4.1.5.3. Payment Terms and the Survival of Low-Margin Agencies

Long Payment Terms Could Drive Agencies Out of Business

Recruitment agencies typically operate with long payment terms, meaning they invoice clients after placing a worker but often wait 30 or 60 days for payment. However, payroll obligations require immediate cash outflows, creating a significant funding gap.

- Large agencies may have sufficient reserves or credit facilities to cover payroll in the interim, but small and mid-sized agencies—especially those with low margins—simply cannot afford to operate under these conditions.

- Umbrella companies currently absorb this financial risk by handling payroll and providing a buffer between agency invoicing and contractor payments. Without umbrellas, agencies must finance payroll themselves, leading to liquidity crises.

Low-Margin Agencies Are at Greatest Risk

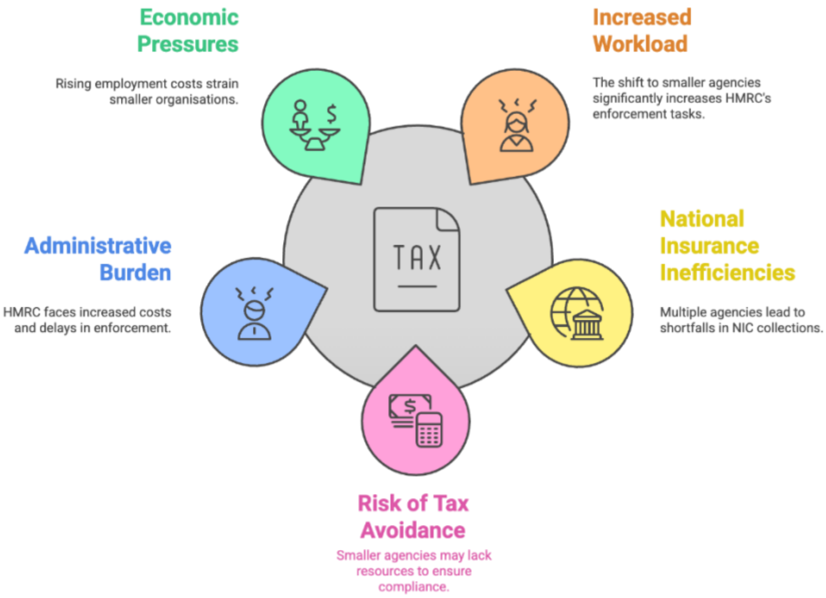
The recruitment industry operates on tight margins, particularly in sectors like hospitality, manufacturing, and social care**,** where client budgets are constrained**.** Agencies in these fields rely on umbrella companies to keep operations viable**.**

- If agencies must now fund payroll upfront, many will lack the working capital to sustain their business. This could lead to widespread business closures, consolidating the industry into the hands of larger agencies with greater financial resources.

- This shift would reduce competition, making the industry less dynamic and increasing hiring costs for businesses.

4.1.6. Effect for HMRC and Tax Collection

The shift in PAYE responsibility proposed under Option 3 introduces significant challenges for HMRC in enforcing tax compliance across the recruitment industry. Currently, umbrella companies serve as centralised and effective tax collectors, simplifying the process and ensuring accountability. By transferring this responsibility to thousands of smaller organisations, the complexity of tax collection will increase dramatically, straining HMRC's resources and potentially leading to inefficiencies, revenue loss, and higher rates of non-compliance. With many recruitment agencies being small or micro-organisations, the added administrative and financial pressures could destabilise the system, placing greater burdens on HMRC and jeopardising the integrity of tax collection in the temporary labour market.



4.1.6.1. Exponential Increase in Compliance Oversight

The recruitment industry consists of approximately 30,000 temporary recruitment businesses and around 500 umbrella companies. At present, umbrella companies consolidate tax collection by acting as employers for workers, simplifying enforcement for HMRC. Shifting the responsibility to agencies would:

- **Multiply HMRC's Workload by Over 5,000%:** HMRC would need to monitor and enforce compliance across over 30,000 smaller organisations, compared to the current 500 umbrella companies. This dramatic increase in workload would strain HMRC's resources and increase the likelihood of non-compliance slipping through the cracks.

- **Target High-Risk Micro Organisations**: Over 70% of recruitment agencies are micro-organisations with fewer than 10 employees. Many of these businesses lack the administrative capacity to manage payroll and tax compliance effectively. The risk of error or deliberate non-compliance would grow exponentially, adding further strain on HMRC.

- **Increased Business Shutdowns**: Just as some payroll intermediaries occasionally shut down due to financial challenges, small agencies could also fold under the weight of new responsibilities. This creates further instability in tax collection, as HMRC would need to pursue arrears or unpaid taxes from closed businesses.

Shifting tax responsibility to 30,000 smaller organisations will overwhelm HMRC's enforcement capacity, making tax compliance significantly harder to monitor and enforce.

4.1.6.2. Loss in National Insurance Collection

The umbrella company model ensures that workers' National Insurance Contributions (NICs) are managed efficiently under a single employer and therefore one threshold. If responsibility shifts to multiple agencies, significant inefficiencies will arise:

- **No Mechanism for Multiple NIC Thresholds**: Unlike income tax, where HMRC has mechanisms like BR, D0, or D1 codes for workers with multiple employers, there are no equivalent mechanisms for NICs.

- **Excessive NIC Thresholds for Workers with Multiple Agencies**: For example, a supply teacher working with three schools through three different agencies would receive an Employee NIC threshold of £242/week per employer, effectively tripling the tax-free allowance and reducing the amount of NICs collected by HMRC.

- **Revenue Loss**: This inefficiency could result in significant shortfalls in NIC revenue, undermining the government's tax collection goals.

4.1.6.3. Increased Risk of Tax Avoidance

Umbrella companies currently provide a robust compliance framework, ensuring accurate and timely tax deductions. Moving to a decentralised system of 30,000 smaller organisations would increase the risk of:

- **Non-Compliance**: Smaller agencies may lack the expertise or resources to comply fully with complex tax laws, leading to errors or intentional avoidance.

- **Corner-Cutting to Survive**: With rising employment costs and financial pressures planned in 2025, smaller agencies may resort to non-compliant practices to reduce costs and remain competitive.

- **Growth of Tax Avoidance Schemes**: The absence of umbrella companies as centralised tax collectors could create opportunities for new schemes that exploit the fragmented system.

- False self-employment becomes more attractive: Agencies prioritising cost reductions may encourage workers to adopt false self-employment or operate through a limited company where they would be inside IR35

Decentralising tax collection will heighten the risk of non-compliance and tax avoidance, especially among smaller agencies struggling to manage rising employment costs.

4.1.6.4. Administrative Burden on HMRC

The added complexity of enforcing tax compliance across a decentralised system would place a massive administrative burden on HMRC:

- **Increased Enforcement Costs**: Monitoring and auditing 30,000 agencies would require a significant expansion of HMRC's enforcement teams and resources.

- **Delays and Inefficiencies**: With limited capacity, HMRC could face delays in identifying and addressing non-compliance, further increasing revenue risks.

- **Disruption from Business Closures**: Many smaller agencies may close due to financial and administrative pressures, requiring HMRC to chase unpaid taxes and compliance issues post-closure, further complicating enforcement efforts.

The increased workload for HMRC to monitor and enforce compliance across a fragmented system will stretch resources, delay enforcement actions, and undermine tax revenue integrity.

4.1.6.5. Timing and Economic Risks

Implementing Option 3 after a year of risen employment costs would exacerbate financial pressures on smaller organisations, leading to:

- **Widespread Cost-Cutting**: Smaller agencies are likely to reduce spending on compliance, payroll systems, and professional advice to manage rising costs, increasing the likelihood of errors and non-compliance.

- **Industry Instability**: The combination of rising costs and additional responsibilities could destabilise the recruitment industry, leading to significant disruptions in the temporary labour market and translated in less tax collection for HMRC.

Shifting PAYE responsibility from umbrella companies to agencies will significantly complicate tax collection for HMRC, increasing their workload by over 5,000% and introducing inefficiencies in National Insurance contributions. The reliance on 30,000 smaller organisations, many of which are micro-businesses with limited capacity, will lead to increased non-compliance, tax avoidance, and revenue shortfalls. Furthermore, the economic pressures of rising employment costs will push smaller organisations to cut corners, exacerbating enforcement challenges for HMRC. Maintaining the umbrella company model is essential to preserving an efficient and effective tax collection system.

4.1.7. Effect on the Contingent Labour Market

The contingent labour market is built on flexibility, efficiency, and collaboration across multiple stakeholders, including workers, agencies, clients, and umbrella companies. However, the removal or significant reduction of umbrella companies under Option 3 would destabilise this delicate balance, introducing severe risks that could diminish the effectiveness and competitiveness of this market.

4.1.7.1. Talent Shortages

The proposed changes risk creating widespread dissatisfaction among workers, leading to:

- **Exodus of Workers**: Workers may leave the contingent labour market altogether due to reduced rights, delayed payments, and increased administrative burdens.

- **Sector-Specific Labour Gaps**: Industries that rely heavily on temporary workers, such as healthcare, logistics, and construction, would struggle to fill critical roles, exacerbating existing labour shortages.

- **Reduced Appeal of Temporary Work**: The erosion of financial stability and employment protections, currently provided by umbrella companies, would make temporary work less attractive to skilled workers, further shrinking the talent pool.

Talent shortages would severely impact industries reliant on contingent workers, compromising their ability to meet demand and deliver essential services.

4.1.7.2. Higher Costs for Businesses

If agencies are required to take on additional administrative and payroll responsibilities, the resulting costs will cascade through the supply chain:

- **Increased Client Costs**: Agencies will pass their rising operational expenses to clients, making temporary labour significantly more expensive for businesses.

- **Reduced Use of Temporary Labour**: Higher costs could deter businesses from using contingent workers as a staffing solution, disrupting their operational flexibility.

- **Competitive Disadvantages**: Businesses relying on temporary labour would face higher costs compared to competitors in other jurisdictions with more efficient systems.

Increased costs will reduce the affordability and attractiveness of temporary labour, undermining the flexibility that defines the contingent labour market.

4.1.7.3. Reduced Access to Innovation and Niche Expertise

Specialist umbrella companies have developed tailored solutions for niche industries such as IT, healthcare, and engineering, enabling these sectors to operate efficiently:

- **Customised Support**: Smaller, niche umbrella companies create innovative payroll, compliance, and workforce management systems to address unique industry challenges.

- **Enabling Smaller Agencies**: These umbrella companies allow smaller agencies to compete with larger firms by handling complex workforce arrangements on their behalf.

If smaller umbrella companies are driven out of the market due to reduced engagement, the following risks emerge:

- **Loss of Innovation**: The disappearance of specialist umbrella companies would limit the availability of custom solutions that enhance overall market efficiency.

- **Weakened Niche Industries**: Smaller agencies and their workers, particularly in specialised sectors, would lose vital support, reducing their ability to thrive in a competitive market.

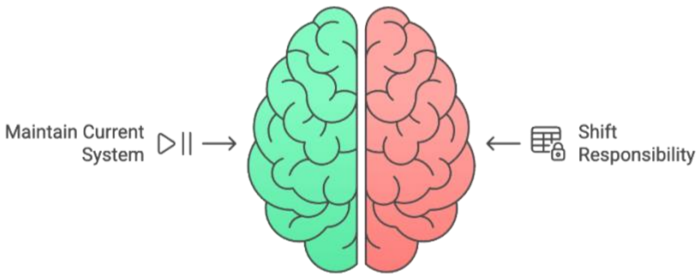
The loss of niche expertise and innovation would further destabilise the contingent labour market, reducing its ability to adapt and evolve.

Overall, the removal of umbrella companies would lead to a less efficient and less competitive labour market, creating significant challenges for industries that rely on temporary labour. From talent shortages and higher costs to weakened worker protections and reduced innovation, the cumulative effect of these destabilising factors would hinder the contingent labour market's ability to meet the needs of modern industries and businesses.

4.2. Comparative Analysis between option 3 and current model

The current umbrella company model serves as the backbone of the contingent labour market, offering centralised payroll management, compliance assurance, and vital financial and administrative support. Option 3, which shifts PAYE and NIC responsibilities to agencies or end clients, represents a drastic departure from this system. While it aims to address perceived gaps in compliance, it introduces significant risks that could destabilise the market and weaken its efficiency.

Below is a detailed comparison of the two systems, highlighting the critical advantages of the current model and the potential downsides of Option 3.



4.2.1. Tax Compliance and Enforcement

Current Model:

- Umbrella companies act as centralised tax collectors, ensuring accurate and timely PAYE and NIC deductions while managing compliance with employment law.
- With only 500 umbrella companies in operation, HMRC's oversight is streamlined, enabling efficient enforcement and monitoring of tax compliance.
- Umbrella companies provide a robust framework to ensure workers' taxes and National Insurance contributions are correctly deducted and remitted to HMRC, minimising tax avoidance.

Option 3:

- Shifting PAYE responsibilities to 30,000 smaller recruitment agencies would increase HMRC's oversight workload by over 5,000%, making compliance enforcement significantly more challenging.

- Smaller agencies often lack the expertise or resources to handle complex tax regulations, leading to a higher likelihood of errors or intentional tax avoidance.

- The absence of a mechanism for handling multiple NIC thresholds could result in workers unintentionally benefiting from duplicate thresholds when employed by multiple agencies. For example, a supply teacher working through three agencies could avoid a significant portion of NIC payments, reducing HMRC's tax revenue.

- Increased decentralisation also risks the proliferation of tax avoidance schemes, as unregulated intermediaries could exploit gaps in the system.

The current model centralises tax compliance, making enforcement more efficient for HMRC. Option 3, by contrast, decentralises responsibility, creating significant enforcement challenges and increasing the risk of non-compliance.

4.2.2. Financial and Administrative Stability

Current Model:

- Umbrella companies provide essential cashflow management by retaining taxes before remitting them to HMRC. This enables them to offer credit terms to smaller agencies, allowing these agencies to defer payroll costs until client payments are received.

- Agencies rely on umbrella companies to handle complex payroll calculations, statutory payments, and compliance tasks, enabling them to focus on recruitment and client relationships.

- Umbrella companies ensure that workers are paid promptly, even in cases of client payment delays, creating financial stability across the supply chain.

Option 3:

- Agencies would need to absorb the responsibility for payroll, tax compliance, and statutory payment administration, significantly increasing their operational burdens.

- Smaller agencies, particularly those with fewer than 10 employees (which represent over 70% of recruitment agencies), may lack the financial or administrative capacity to manage these tasks effectively, risking insolvency.

- The absence of umbrella companies would disrupt cashflow management across the supply chain, leading to delayed payments for workers and increased financial strain on agencies.

- Agencies would also face additional costs for payroll systems, tax expertise, and compliance staff, further straining their operations and reducing profitability.

The current model provides financial and administrative stability, particularly for smaller agencies. Option 3 introduces significant risks of disruption, financial strain, and operational inefficiency.

4.2.3. Worker Protections and Satisfaction

Current Model:

- Workers employed through umbrella companies are classified as employees, granting them full statutory protections such as maternity and paternity leave.

- Umbrella companies offer transparent and consistent payroll practices, ensuring workers understand their deductions and net pay.

- The support provided by umbrella companies enhances worker satisfaction and trust, encouraging continued participation in the contingent labour market.

Option 3:

- Many workers would lose employee status and instead be classified as "workers" under agency PAYE. This would strip them of critical protections, including redundancy pay, maternity leave, and unfair dismissal claims.

- Fragmented responsibilities between agencies and workers would create confusion regarding statutory benefits, leading to dissatisfaction and disputes.

- Workers would have less visibility on deductions from their assignment rates, increasing the risk of mistrust and payroll disputes.

- Payment delays caused by agency inefficiencies could result in financial hardship for workers, further eroding their trust in the system.

The current model prioritises worker protections and ensures financial stability. Option 3 risks alienating workers by reducing rights, transparency, and reliability.

4.2.4. Industry Innovation and Efficiency

Current Model:

- Umbrella companies drive innovation in payroll and compliance processes, improving efficiency across the contingent labour market.

- Smaller recruitment agencies rely on umbrella companies' expertise to compete with larger firms, enabling a more diverse and competitive market.

Option 3:

- Smaller and specialist umbrella companies would likely be forced out of the market, reducing innovation and leaving agencies and workers without tailored support.

- Agencies and end clients would face increased operational complexity, as they would need to replicate the efficiencies currently provided by umbrella companies.

- The lack of innovation and expertise would weaken the overall market, making it less competitive and less adaptable to future challenges.

The current model fosters innovation and efficiency, while Option 3 threatens to erode these benefits, reducing the market's ability to adapt and thrive.

4.2.5. Implications for HMRC and Tax Revenue

Current Model:

- Umbrella companies centralise tax collection, ensuring that PAYE and NIC deductions are accurate and compliant with HMRC regulations.

- HMRC benefits from a manageable enforcement system, with only 500 umbrella companies to oversee.

Option 3:

- Decentralising tax collection to 30,000 agencies would overwhelm HMRC's resources, increasing enforcement costs and delays.

- Inefficiencies in NIC collection, such as multiple thresholds for workers with multiple employers, would reduce revenue and complicate compliance.

- The increased risk of tax avoidance and non-compliance would undermine HMRC's efforts to maximise tax revenue.

The current model supports effective tax collection and revenue protection, while Option 3 introduces inefficiencies and risks that would weaken HMRC's ability to enforce compliance.

This analysis demonstrates that the current umbrella company model provides significant benefits for all stakeholders, including workers, agencies, clients, and HMRC. Option 3, while addressing some concerns, introduces far greater risks and inefficiencies that threaten to destabilise the contingent labour market.

Part 5 will propose enforcement solutions and recommendations that enhance the existing model's strengths while addressing areas of concern. These recommendations aim to improve compliance, reduce risks, and preserve the stability and efficiency of the contingent labour market. Instead of adopting a disruptive structural change, targeted enforcement measures offer a more effective way forward for HMRC and the industry as a whole.

4.2.6. Promoting a Competitive and Compliant Industry

The umbrella model contributes to a competitive and compliant labour market by levelling the playing field for businesses and discouraging exploitative or fraudulent practices. By centralising compliance functions, umbrella companies help to ensure adherence to tax and employment laws, reducing opportunities for non-compliance and tax evasion.

Additionally, preserving the current model helps to sustain smaller recruitment agencies that might otherwise struggle to meet the additional administrative demands of direct PAYE operations. This prevents market consolidation, where only larger players can afford the resources required, which could lead to monopolistic practices and reduced choices for both workers and clients.

A vibrant and diverse recruitment industry, supported by compliant umbrella companies, ensures healthy competition and innovation. This environment benefits all stakeholders and promotes long-term sustainability in the temporary labour market.

Preserving the current umbrella model delivers strategic advantages for the temporary labour market, fostering flexibility, safeguarding workers' rights, and maintaining a competitive industry. By retaining this structure, the labour market can continue to evolve in a way that benefits businesses, workers, and regulators, while preventing consolidation that could harm smaller agencies and limit choices.

5. Recommendations for Sustainable Compliance

The recommendations outlined in this section aim to provide HMRC with practical, sustainable solutions to ensure compliance while addressing the complexities of the temporary labour market. Given the significant role umbrella companies play in the employment ecosystem, especially for temporary and agency workers, it is essential to adopt strategies that balance regulatory enforcement with the operational realities of the sector.

The measures proposed in this section are structured to achieve three core objectives:

- **Operational Sustainability**: Retaining the current PAYE framework within umbrella companies ensures minimal disruption to labour supply chains and payroll operations.

- **Regulatory Strengthening**: Enhanced oversight and accountability mechanisms will help mitigate risks of tax non-compliance and fraudulent practices, bolstering HMRC's efforts to close the tax gap.

- **Market Responsiveness**: Recognising and adapting to emerging trends, such as technological advancements and the growth of the gig economy, ensures that regulatory approaches remain effective and forward-looking.

These recommendations are designed to address the unintended consequences associated with enforcing shifting PAYE responsibilities to recruitment agencies. They focus on preserving the integrity of existing payroll systems, maintaining worker protections, and promoting a competitive, compliant labour market. The section also highlights the importance of fostering shared accountability across the supply chain and leveraging technology to enhance transparency and compliance.

By adopting a balanced and evidence-based approach, these recommendations aim to support HMRC's objectives while mitigating risks to businesses, workers, and the broader labour market.

5.1. Retaining PAYE Operations within Umbrella Companies' Scope

The decision to retain PAYE operations within umbrella companies under the PAYE reference number of the umbrella company is pivotal to the continued efficiency, compliance, and stability of the UK's temporary labour market. This section explores how preserving the existing PAYE framework ensures operational efficiency, maintains accurate income tax and National Insurance Contributions (NICs) calculations, and mitigates risks of payroll disruptions in labour supply chains.

5.1.1. Preserving Operational Efficiency

Retaining PAYE operations within umbrella companies ensures the smooth running of payroll systems, which is critical for the temporary labour market's fluid and dynamic nature. Umbrella companies specialise in managing the administrative complexities of temporary employment, such as processing payments for workers who may have varying assignments, hours, and contracts. Their centralised approach simplifies payroll management, saving time and resources for recruitment agencies and end clients.

By maintaining the current model, recruitment agencies can focus on their core functions of sourcing talent and supporting clients, rather than being burdened with the additional administrative overhead of payroll processing. This specialisation avoids inefficiencies that could arise if agencies—

particularly smaller ones—were forced to scale up their operations to meet these demands. Additionally, umbrella companies' well-established systems reduce the risk of delays or errors in processing, ensuring workers receive timely payments.

The operational efficiency of umbrella companies contributes directly to the productivity and reliability of the temporary labour supply chain. This efficiency strengthens the market's competitiveness, particularly in sectors with high turnover or short-term contracts, where swift and accurate payroll processes are essential.

5.1.2. Ensuring Accurate Income Tax and NICs Calculations

The expertise of umbrella companies in payroll management is key to ensuring precise calculations of income tax and National Insurance Contributions (NICs). Their systems are purpose-built to handle the complexities of the UK tax regime, including deductions for student loans, pensions, and other statutory requirements, which may vary widely across individual workers.

By retaining PAYE operations within umbrella companies, recruitment agencies and workers benefit from the accuracy and reliability these companies provide. Miscalculations—whether underpayments or overpayments—not only affect workers but also lead to costly and time-consuming rectifications for agencies. Umbrella companies minimise these risks, ensuring that deductions are processed correctly from the outset.

This model also reduces HMRC's administrative burden by consolidating payroll reporting. Instead of receiving fragmented submissions from multiple recruitment agencies, HMRC benefits from centralised, standardised reports from umbrella companies, improving oversight and supporting compliance. This streamlined approach ensures that taxes are paid correctly and on time, closing potential gaps in tax collection while reducing errors that could undermine trust in the system.

5.1.3. Mitigating Risks of Payroll Disruptions in Labour Supply Chains

Umbrella companies act as a stabilising force within the labour supply chain by ensuring the consistent and reliable processing of payroll. In the fast-moving temporary labour market, disruptions to payroll can have significant consequences, including delays in worker payments and a loss of trust between agencies, clients, and workers.

The established infrastructure of umbrella companies allows them to adapt quickly to changes in worker circumstances, employment contracts, or regulatory requirements. Their systems are designed to handle the complexities of processing payments for a transient workforce, minimising the risk of disruptions. Recruitment agencies, in contrast, may lack the capacity and expertise to handle such challenges efficiently, especially during periods of high demand or regulatory change.

Maintaining this stability is essential for worker satisfaction and retention. Timely and accurate payments ensure that workers remain financially secure and motivated, which in turn supports the productivity of the temporary labour market. This benefit extends to end clients, who can rely on a steady supply of engaged workers to meet their operational needs.

The advantages of retaining PAYE operations within umbrella companies are clear and far-reaching. This model preserves operational efficiency, supports accurate and compliant tax deductions, and mitigates risks of payroll disruptions, all of which are critical for the stability of the temporary labour market. By maintaining the current system, HMRC, recruitment agencies, end clients, and workers all benefit from a streamlined and effective approach to payroll management. Protecting this framework is essential for sustaining the competitiveness and integrity of the UK's labour market.

5.2. Enhancing Regulatory Oversight and Accountability

Enhancing regulatory oversight and accountability in the labour market is essential for ensuring compliance, reducing risks of non-compliance, and maintaining the integrity of supply chains. This section examines how strengthening due diligence mechanisms, establishing formal accountability measures, and leveraging advanced oversight technologies can help address regulatory gaps and improve overall transparency.

5.2.1. Strengthening Due Diligence Mechanisms

Due diligence mechanisms are the first line of defence in identifying and mitigating risks associated with non-compliance and fraud in labour supply chains. Enhancing these mechanisms ensures that businesses and umbrella companies operate within legal and ethical frameworks, safeguarding both workers and stakeholders.

Effective due diligence mechanisms involve a comprehensive assessment of compliance risks within supply chains. For umbrella companies and agencies, this includes verifying the legitimacy of entities within the chain, ensuring accurate payment of taxes and NICs, and monitoring adherence to employment standards. A robust due diligence framework also helps identify unscrupulous practices, such as the use of disguised remuneration schemes or mini-umbrella company fraud, which have historically caused significant losses to the Treasury.

Strengthened due diligence mechanisms provide critical safeguards for the labour market. By implementing rigorous checks and promoting compliance, HMRC and businesses can mitigate risks, improve compliance, and create a fairer operating environment for all participants.

5.2.2. Establishing Formal Accountability Measures for Supply Chains

Accountability within labour supply chains is crucial to ensuring that all stakeholders—agencies, umbrella companies, and end clients—fulfil their legal obligations. Formalising accountability measures fosters transparency and clarity, reducing opportunities for evasion or malpractice.

One of the key benefits of formal accountability measures is the clear delineation of responsibilities among supply chain participants. For example, holding umbrella companies and recruitment agencies accountable for payroll compliance ensures that taxes and deductions are processed correctly. At the same time, end clients must also play a role by verifying that the intermediaries they engage comply with HMRC regulations.

Formal accountability measures bring clarity to labour supply chains, ensuring that all parties meet their obligations. This approach not only reduces the likelihood of non-compliance but also protects workers and ensures fair competition in the market.

5.2.3. Liability for Unpaid Tax and the Role of the Supply Chain

Shifting PAYE responsibility from umbrella companies to recruitment agencies does not address the root cause of non-compliance in the labour market. Instead, the most effective approach is to place liability for unpaid tax on recruitment agencies and end clients while ensuring that umbrella companies remain the employer for both tax and employment law purposes, using their own PAYE reference numbers.

Why Liability Should Be Assigned to Recruitment Agencies and End Clients

Several countries have successfully tackled non-compliance by holding agencies and end clients accountable for tax obligations. In the Netherlands, the "ketenaansprakelijkheid" (chain liability) model ensures all parties in the supply chain share responsibility for unpaid taxes and social security contributions. Similarly, Germany's liability framework for subcontracted labour places direct accountability on end clients, preventing fraud through intermediary companies. These models discourage non-compliant entities from operating while ensuring tax obligations are met.

Why Shifting the PAYE Reference Number Won't Work

Requiring recruitment agencies to use their own PAYE references does not eliminate the risk of tax evasion. Non-compliant agencies could still establish short-lived entities to avoid liability. Furthermore, most agencies do not have the payroll expertise or compliance infrastructure that established umbrella companies provide.

A more practical and immediate solution is to:

- **Make Recruitment Agencies and End Clients Jointly Liable for PAYE Compliance** – This ensures that those benefiting from temporary labour have a direct financial incentive to engage only with compliant payroll providers.

- **Retain Umbrella Companies' PAYE Reference Numbers** – This maintains payroll stability and allows for existing compliance measures to remain effective.

- **Strengthen Due Diligence Obligations for Agencies and End Clients** – HMRC can implement stricter requirements today, such as mandatory checks on umbrella companies before engagement and penalties for failing to verify compliance.

This approach ensures HMRC can take immediate action without disrupting the stability of the labour supply chain.

5.3. Strengthening Compliance Through Legislative Adjustments and Supply Chain Responsibility

The temporary labour market requires a pragmatic regulatory framework that ensures compliance without creating unnecessary administrative burdens. The most effective solution is to retain the existing umbrella company PAYE reference number while clarifying legal responsibilities across the supply chain. By adjusting Section 44 of the Income Tax (Earnings and Pensions) Act 2003 (ITEPA 2003) and extending liability provisions, HMRC can strengthen enforcement while maintaining the operational stability of the sector.

5.3.1. Retaining the Umbrella Company PAYE Reference and Strengthening Legal Liabilities

The core issue with HMRC's current proposal under Option 3 is that merely shifting the PAYE responsibility to recruitment agencies does not eliminate the risk of tax evasion. Instead, the law should be updated to:

- Ensure that umbrella companies remain the employer for tax and employment law purposes by explicitly recognising them as employment businesses under existing regulations.

- Amend Section 44 of ITEPA 2003 to confirm that whenever an umbrella company is involved in a supply chain, the umbrella as well as the recruitment are liable for PAYE and NIC obligations.

- Extend liability provisions to the rest of the supply chain, ensuring that they are held accountable for engaging non-compliant payroll providers. This would prevent deliberate non-compliance through fraudulent models while protecting legitimate businesses.

This approach mirrors successful models in other countries, such as Germany's liability framework for subcontracted labour and the Netherlands' "ketenaansprakelijkheid" (chain liability) model, which hold all parties in the supply chain responsible for tax compliance.

5.3.2. Implementing Practical Enforcement Measures Without Overhauling Systems

To ensure immediate enforceability, HMRC should introduce:

- **Mandatory due diligence obligations** for recruitment agencies and end clients, requiring them to verify that umbrella companies are operating in full compliance with PAYE regulations.

- **Liability provisions** similar to the UK's existing IR35 rules, where failure to conduct due diligence results in the end client or agency becoming liable for unpaid taxes.

- **Keep on building the great work HMRC has already conducted** in term of targeted enforcement campaigns focused on known areas of non-compliance, rather than disrupting compliant umbrella companies.

This approach ensures that HMRC can continue to act today using existing mechanisms rather than relying on complex future technological solutions.

5.3.3. Ensuring Long-Term Stability and Compliance in the Labour Market

By codifying the role of umbrella companies within Section 44 and introducing clear liability measures for agencies and end clients, HMRC can achieve the following:

- **Preserve the efficiency of the current payroll system** by maintaining the use of the umbrella company's PAYE reference.

- **Close regulatory loopholes** that allow non-compliant intermediaries to avoid detection.

- **Enhance compliance without disrupting the legitimate temporary labour market**, ensuring that agencies and end clients have a vested interest in working with fully compliant payroll providers.

This proposal provides HMRC with a practical, immediately implementable solution that strengthens tax enforcement while maintaining operational stability in the sector.

6. Conclusion and Closing Statement

The temporary labour market is a cornerstone of the UK economy, providing businesses with flexibility and workers with diverse employment opportunities. However, ensuring tax compliance and market stability requires pragmatic, enforceable solutions rather than disruptive structural changes. This report has demonstrated that the most effective approach is to retain the umbrella company's PAYE reference number while reinforcing accountability throughout the supply chain.

Key findings indicate that shifting PAYE responsibilities away from umbrella companies would introduce significant risks, including increased administrative burdens on recruitment agencies, payroll inefficiencies, and a rise in non-compliant models. Instead, maintaining the umbrella PAYE framework while strengthening legal obligations for recruitment agencies and end clients provides a practical and immediately implementable solution.

Recommendations for HMRC and Policymakers:

- Amending Section 44 of ITEPA 2003 to confirm that umbrella companies—soon formally defined as employment businesses—are first responsible for PAYE compliance when operating within a labour supply chain.

- Extending liability provisions to recruitment agencies and end clients, ensuring they are responsible alongside the Umbrella companies if taxes are not accurately calculated and paid to HMRC.

- Implementing mandatory due diligence obligations for agencies and end clients, preventing engagement with non-compliant umbrella companies (Option 3, coupled with Option 1).

- Focusing enforcement efforts on fraudulent supply chain practices rather than disrupting compliant umbrella companies.

- Ensuring that the PAYE reference number of the umbrella company remains in use, maintaining payroll stability while closing compliance loopholes.

Closing Statement

The decision to retain PAYE operations within umbrella companies is not just a technical adjustment—it is a strategic necessity to protect workers, maintain business efficiency, and uphold tax compliance. By refining regulatory oversight rather than overhauling payroll structures, HMRC can create a fair, enforceable, and stable framework that benefits all stakeholders.

Collaboration between HMRC, umbrella companies, recruitment agencies, and end clients is key to ensuring shared accountability. Through the implementation of these targeted legislative and enforcement measures, the UK's temporary labour market can continue to thrive, delivering value to businesses, workers, and the broader economy.