PROFESSIONAL PASSPORT
SETTING THE STANDARDS

CONTRACTOR INTELL™

Volume 3 – Issue 3 – February 2010 www.professionalpassport.com/contractors Essential reading for professional contractors

Financial Security; risk assessment and risk management

There has been a wide range of articles hitting the headlines recently around the issue of financial risks relating to providers, recruitment companies and their contractors.

Rather than focus on the headlines, many of which are misleading or inaccurate, we thought it would be more useful to our readers if we examine the trends that are emerging across the sector and what actions contractors should take to minimise their risks of financial loss.

We have separated the newsletter in to three main sections:

- Providers Retaining Contractors Money
- Umbrella Companies - Assessing the Risks
- Invoice Discounting and Factoring Arrangements

Providers Retaining Contractors Money

One recent story relates to a number of contractors whose provider retained monies to meet future tax liabilities, on the understanding that these would be paid on to HMRC once a self assessment return had been completed.

What has emerged is that the company has now ceased and the funds held to meet these liabilities have disappeared; leaving the contractors in a position where they now have to find additional funds to meet these liabilities.

This is not the first time that contractors have lost money held on their behalf by a provider.

So how can we identify where these increased risks are present?

The first important point is that any tax liability is held by the individual tax payer. If that individual agrees that a third party can hold these funds for them, this represents a significant increase in their risk if something goes wrong with the third party holding that money.

As the most recent example demonstrates, this leaves the individual tax payer still holding the liability; and in effect, from their perspective, that they have had to pay the tax twice.

The majority of examples in this area relate to self employed or limited liability partnership arrangements offered by providers; some of these arrangements are offshore but this is not always the case.

We suggest that contractors always retain their own monies to meet these liabilities as this is the only way they can control the risk.

Umbrella Providers

The first point to highlight here is that the guidance relates to a compliant umbrella, with appropriate contracts and procedures in place to support overarching employment, as well as all payments made to the worker, over and above those allowable expenses, being paid and taxed fully through the PAYE tax system.

continued on page 2 >

Support our Work

Become a member of Professional Passport

Membership starts at just £25.00 (+VAT) per annum and provides a wide range of benefits.

Membership fees support our work with government and future developments of our services and website.

Got an issue and need to talk to a real person?

Our members helpline provides one to one support covering a wide range of issues. This service is available to our Professional Members

Umbrella or Limited?

Our assessment reports will help you decide on the most appropriate route for you; providing a bespoke report based on your circumstances.

Contractors should be aware that many provider offerings are now described as an umbrella; this cannot be relied upon as a confirmation that they would in fact meet HMRC's definition of an umbrella.

Umbrella providers that fail to meet the requirements of operating a compliant umbrella pose a significantly higher degree of risk to contractors.

With the complex layers of legislation in this area there are some key points to be aware of in relation to non compliant umbrella offerings:

- Non compliant umbrellas could represent a risk to both the contractors and recruitment companies under the MSC legislation and Debt Transfer rules.
- In the case of offshore umbrellas much of the protection afforded to contractors falls away; this can significantly increase the risk of assessed liabilities falling directly back to the contractor. This aspect was covered in our Contractor Intell newsletter article that examined the key differences between onshore and offshore umbrellas.

Compliant umbrellas typically do not hold any significant amounts of contractors money at any given time; therefore the risks of financial loss are dramatically reduced.

In the majority of cases an umbrella provider makes their payments to their employees as soon as funds are received from the recruitment company; either weekly or monthly. This effectively caps any risk of financial loss to a period between payments, ie one week or a month.

If your umbrella operates a system where they receive monies weekly but run the payroll monthly this can represent a slightly higher risk if issues arise.

Contractors should also ensure their recruitment companies follow our guidance, and that of the many experts; in that all contracts between the recruitment company and an umbrella should contain clauses allowing for immediate termination if the umbrella company enters in to liquidation or administration.

This allows a recruitment company and the contractor, to immediately end the contract at the first signs of trouble. The recruitment company and contractor could then move instantly to a new provider and submit any time sheets and invoices for outstanding work through the new provider resulting in little, if any, financial risk or loss to either the recruitment company or the contractor.

Some umbrella providers retain the holiday pay deductions, rather than paying out automatically with each pay run. Whilst this is technically the correct position for an umbrella to adopt, it can present a slight increase in risk if the umbrella provider had problems.

In the majority of cases umbrella providers offer contractors the option of either having holiday pay paid automatically with each pay run or held with a process to request the payments during breaks. Paying the holiday pay automatically does not represent any increased risk to the umbrella; where the holiday pay is correctly highlighted through the payslips. This area relates to employment laws and therefore is not typically considered by HMRC on any compliance visit.

Where contractors are risk adverse they should request the payment of holiday pay automatically with each pay run.

In most instances an umbrella operating the typical compliant model represents a low risk to a contractor as few funds are held and contracts can be immediately terminated.

PROFESSIONAL PASSPORT
SETTING THE STANDARDS

CONTRACTOR INTELL™

Volume 3 – Issue 3 – February 2010 www.professionalpassport.com/contractors Essential reading for professional contractors

Umbrella Companies - Assessing Risks

As we have already highlighted; the risk of financial loss when using a compliant umbrella should be at a minimum as typically little, if any, money is retained by the umbrella provider.

The two main threats to an umbrella company's stability come from:

- A HMRC enquiry
- Financial management and reporting

It is also important to understand the corporate structure and make up of the umbrella; being clear on exactly which company the legal relationship exists with.

Many umbrella companies are part of a group of companies, often as a wholly owned subsidiary of a group.

The company that employs the contractors will typically only have contractor employees within that company with service contracts to other companies within the group for the provision of services required to run the umbrella; eg payroll and administration.

These companies rarely have any assets on their books and often the financials demonstrate that monies held are typically no more than future monies due to cover items such as PAYE, NI and VAT liabilities.

This has become the normal structure for many umbrella providers as it can provide protection to both the umbrella and the contractors.

Two relationships exist:

- An employer - employee relationship between the contractor and the umbrella
- A legal contractual relationship between the umbrella and recruitment company

Where a contractor uses an umbrella provider they do not have any legal relationship directly with the recruitment company. In the majority of cases this is not an issue but when things go wrong it can prove slightly more difficult. If a dispute arises between a contractor, who uses an umbrella, and the recruitment company the contractor has to rely on the umbrella to resolve this as it is the umbrella that holds the legal contract with the recruitment company.

This can, in extreme situations, present a conflict of interest as the umbrella will not want to disturb any commercial relationship it has with a recruitment company.

The legal relationship between the recruitment company and the umbrella is typically through this wholly owned subsidiary, as this is the company that holds the contracts.

Whilst it is entirely appropriate that the financial strength of the group be used as part of an overall financial assessment it must be remembered that the contract is not held with the group but the individual subsidiary. For this reason it is important that the assessment of umbrella companies is centred around the two main threats faced by umbrellas; a HMRC enquiry and financial management and reporting.

HMRC Enquiry

The first of the main threats faced by umbrella providers comes from a HMRC enquiry.

If during a HMRC enquiry HMRC felt that either the contracts or processes and procedures did not meet the requirements for demonstrating overarching employment then this could result in a significant tax assessment being raised; often at a level that could not be met by the company.

continued on page 4 >

> continued from page 3

Overarching employment is achieved by an umbrella having an appropriate contract of employment in place with its contractors supported by the relevant processes and procedures.

This allows the umbrella to assess each of the contractors workplaces as temporary; subject to meeting the requirements of the other tests of workplace status. Where a workplace is assessed as temporary the umbrella is then able to allow the contractors to claim travel and subsistence expenses. Many umbrella providers have agreed dispensations with HMRC for the levels of these expenses where the workplace qualifies as temporary.

It is important to remember that having a dispensation does not in itself demonstrate or confirm that HMRC accepts that the umbrella provider is compliant.

Where HMRC successfully challenges the overarching status of an umbrella providers relationship with its contractors, this results in each workplace being classed as a series of permanent workplaces. Where a workplace is assessed as permanent, no travel and subsistence expenses are allowed in relation to that workplace.

This reassessment of the workplace status will result in a significant tax liability for the umbrella. PAYE and NI would become payable on all the expenses disallowed, and in the case of an onshore provider, this liability rests with the provider.

This is the main reason why so many umbrella companies are structured as we described previously. Under current rules this would allow the umbrella to move their contractors to a new structure, relatively easily, leaving a shell company behind holding the liabilities. In the fullness of time these shell companies are then often liquidated resulting in the loss only being experienced by HMRC on the additional assessed liabilities.

This structure offers both contractors and recruitment companies further protection against financial loss.

The early warning sign to a contractor that there could be an investigation which may result in HMRC raising such assessments is where a sudden change to the expenses policy of the umbrella provider is communicated to the contractors.

Where HMRC carry out an investigation and question the overarching relationship, the first action taken is the removal of the dispensation. This results in the umbrella having to amend their expenses procedures typically changing the amounts that can be claimed and requiring receipts to support all claims.

Financial Management and Reporting

This is another key area for umbrella companies.

Umbrella companies hold significant amounts of money that must be paid in relation to PAYE, NI and VAT liabilities.

If an umbrella uses any of this money to support the growth and development of the business this could result in the company failing as it is unable to meet these liabilities.

As we highlighted earlier; the typical current corporate structure of umbrella companies means that should this happen, the main risk of loss is to HMRC and not usually the contractor or recruitment company.

It must also be remembered that a compliant umbrella does not represent any risk to contractors or recruitment companies in relation to MSC legislation or debt transfer.

continued on page 5 >

PROFESSIONAL PASSPORT
SETTING THE STANDARDS

CONTRACTOR INTELL™

Volume 3 – Issue 3 – February 2010 www.professionalpassport.com/contractors Essential reading for professional contractors

Looking for a compliant provider?

All ours have passed the Professional Passport audit; the toughest assesment of compliance in the market.

Want to read more articles?

Our newsletter archive gives you access to our past editions covering a wide range of topics.

What returns can you expect?

Use our earnings calculators to get a true comparison across the operating options available to you.

Useful Links

www.hmrc.gov.uk

www.icaew.co.uk

www.lawsociety.org.uk

www.shout99.com

www.contracteye.co.uk

< continued from page 4

Where an umbrella provider has its overarching status challenged successfully by HMRC resulting in a significant tax assessment or where an umbrella provider fails to meet their PAYE, NI or VAT liabilities, these are unlikely to fall back on to the contractors or recruitment companies as MSC legislation and debt transfer does not apply. This is only true where the provider meets HMRC's definition of an umbrella and the situation could be very different where the underlying offering fails to meet this definition or where the provider is based offshore.

Invoice Discounting and Factoring Arrangements

These arrangements are widely used by managed service providers [MSP's], recruitment process outsourcing companies [RPO's] as well as many recruitment companies; in some rare instances these arrangements may also be used by some umbrella providers.

Often companies operating with these arrangements were assumed to be relatively safe to deal with, as the financial due diligence carried out by the provider of the arrangement was more in depth and detailed than could be reasonably carried out by any other third party. Recent events may have changed this.

One of the stories featured across many headlines recently highlights the risks when these arrangements are withdrawn or amended.

The signs are that some of these lenders are now applying a higher risk rating to the recruitment sector which could lead to new terms for many of the existing arrangements. Where this happens it will put the companies under extreme financial and cashflow pressure and, as was seen recently, could, in extreme cases, result in the failure of the company.

Where any provider fails, the knock on effect is dramatic with many companies, and potentially individuals, facing significant losses.

The issue for most contractors is that it is almost impossible to know in advance that arrangements are under renegotiation or threat of withdrawal; only finding out once the final outcome is decided by which time it is too late to react.

The changing shape of the recruitment and supply model has been a major factor in the lenders review of the sector. Where a RPO, recruitment company and umbrella all use funding arrangements this can mean that the lenders are effectively financing the same piece of work three times. In these circumstances, if one of the parties had their funding withdrawn it can result in a house of cards effect across all other parties in the chain. If the worker suffers non payment as a result then they are likely to seek recompense from either the end client or recruitment company creating a greater problem for those in the chain.

There are no simple answers to this problem although contractors must ensure they assess their risks by becoming fully aware of companies within their supply chain that utilise funding arrangements.

We will be watching developments in this area closely and keep our members informed of any updated guidance.

We also ensure that our audit standards are continually updated to reflect any changes in the market and to successfully identify where increased risks are present.