Employer provided nursery care: material financial responsibility

Indirect Tax | Employment Tax

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We examine when employer supported workplace nurseries qualify for tax exemption.

Key Points

What is the issue?

In August 2024, HMRC provided updated guidance on commercially marketed workplace nursery schemes and the income tax exemption available for qualifying schemes. However, HMRC remains concerned that many schemes do not qualify for the exemption and has issued further detailed guidance.

What does it mean for me?

HMRC's updated guidance states that to meet the partnership requirements employers must assume 'material financial responsibility'. This goes beyond merely paying for places at a commercial nursery and making a notional contribution to fixed costs.

What can I take away?

Employers with an existing scheme in place should consider whether they urgently need to review them, if they haven't already, against the exemption criteria and most up to date HMRC guidance to see if their scheme meets the requirements for claiming the tax exemption.

In recent years, there has been a growing interest in schemes that offer employer provided nursery places through arrangements between employers, nurseries, a scheme provider and employees (who are also parents). These arrangements claim to provide nursery childcare free from tax and NICs by utilising a tax exemption. However, the exemption for employer provided childcare, within Income Tax (Earnings and Pensions) Act (ITEPA) 2003 s 318, includes several qualifying conditions that must be met for the exemption to apply.

This growing interest perhaps arises because the costs of childcare have increased and the Tax-Free Childcare scheme introduced from 6 April 2017 does not provide sufficient help for working parents. Meanwhile, other established and well used childcare schemes (the employer-contracted scheme and the childcare vouchers scheme) were closed to new entrants from 4 October 2018 by the then Chief Secretary to the Treasury Elizabeth Truss.

In 2022, HMRC provided updated guidance on commercially marketed workplace nursery schemes and the income tax exemption available for qualifying schemes in its manuals (updated in August 2024 – see tinyurl.com/ed3rtf3h). However, HMRC remains concerned that many schemes do not qualify for the exemption and has issued further detailed guidance in its July 2024 Agent Update issue 121 (see tinyurl.com/9x65r8u4).

What are the exemption criteria for workplace nurseries?

Section 318 of ITEPA 2003 provides an exemption from tax for certain employer-provided childcare, for a qualifying child under the age of 16, where all the qualifying conditions below are met:

- **Condition A:** The child is a child or stepchild that the employee either lives with or for whom the employee has parental responsibility.
- **Condition B:** The premises on which the care is provided must meet registration requirements (as defined in the legislation) and must not be used wholly or mainly as a private dwelling.
- **Condition C:** The premises on which the care is provided are made available by the scheme employer alone, or the partnership requirements are met.

- **Condition D:** The arrangement under which care is provided must be open to all employees generally or, if the scheme employer has premises at more than one location, the scheme must be open to employees generally at the particular location at which the scheme operates. Nurseries may also be available to other workers on the site, such as contractors or employees of other employers based at the premises.

Further information on the above conditions can be found in HMRC's Employment Income Manual at EIM22002 (Condition A), EIM22003 (Condition B), EIM22004 (Condition C) and EIM22005 (Condition D).

Where a workplace nursery scheme is provided under a salary sacrifice arrangement and qualifies for the exemption at ITEPA 2003 s 318, it is also specifically excluded from the optional remuneration arrangement rules (the 'OpRA' rules) in ITEPA 2003 ss 69A and 69B. In addition, under the Social Security Contributions and Benefits Act (SSCBA) 1992 s 10(1)(a), there will be no Class 1A NICs liability where the tax exemption applies. This is because a Class 1A NICs liability can only arise where the benefit provided to the employee is general earnings on which the earner is chargeable to income tax under ITEPA 2003.

However, if the benefit is taxable as earnings within ITEPA 2003 s 62, the question of exemption under ITEPA 2003 s 318 does not arise.

In general, s 62 will apply to a benefit in kind if it is 'money's worth'. This includes anything of direct monetary value to the employee. Examples of this include arrangements where:

- the contract for a nursery place is between the employee and the nursery, so that when the employer pays the nursery they are satisfying the employee's pecuniary liability (see EIM00580); and
- the employee can at any time give up a nursery place and revert to their original salary, a principle established in the case of *Heaton v Bell* [1969] 46 TC 211 (see EIM00570).

The major scheme promoters generally manage to avoid these situations, but the points are worth bearing in mind if you are dealing with a one-off arrangement.

Commercially marketed schemes

Many of the commercially marketed schemes which HMRC believes fail to comply with the statutory provisions follow a similar model. They may have some or all of the following features or variants of them:

- The employee enters into a salary sacrifice, giving up an amount of pay equal to the cost of the nursery place which is to be provided.
- The employer pays for a nursery place for the employee's child, which may be at a nursery run by the scheme promoter or at an independent nursery, depending on the scheme.
- In addition to paying the nursery fee, the employer pays the nursery an additional sum, typically £100 per month per place.
- The employer appoints the scheme promoter to act as their 'agent' at meetings of the nursery management committee, though in practice the employer has no real say at all in the way the nursery is run.

It is generally Condition C that is problematic for such arrangements.

What are the requirements of Condition C?

HMRC's concern is primarily around employers entering into partnership arrangements with commercial nursery providers where the parties do not engage in such a way that the employer is wholly or partly responsible for financing and managing the provision of care.

Condition C allows employers who do not make a workplace nursery available on their own premises to jointly run a childcare facility with other employers. The partnership requirements must then be met for the exemption to apply, the conditions being that:

- the employer must be included in the arrangements for providing the care;
- the premises where the care is provided must be on one of the employer's sites or on the premises of a commercial childcare provider involved in the partnership; and
- the employer must, at least in part, contribute to both the financial and management elements of the care provision.

There is little case law in this area. In *Lotus Group Ltd v HMRC* (TC/2010/5155), the First-tier Tribunal considered the following significant facts and ruled in favour of the taxpayer:

- The employer had committed to maintaining, improving and redecorating the nursery in question, as well as paying an annual fee of £500 per child (in addition to the ongoing fees for the provision of a childcare place), thereby demonstrating a clear financial commitment, rather than a mere 'token gesture' as described in HMRC's guidance.
- A third-party agent, rather than the employee, met with the nursery on behalf of the employer.

However, these facts limit the ruling's applicability to many of the current schemes. Specifically, the employer was directly funding the nursery places, rather than merely passing on funds collected from employees through salary sacrifice. Additionally, the management circumstances differ, highlighting an employer-focused involvement and financial commitment to the nursery, as opposed to the employee-focused approach seen in many current marketed schemes.

Material financial responsibility

HMRC's updated guidance states that, to meet the partnership requirements, employers must assume 'material financial responsibility'. This goes beyond merely paying for places at a commercial nursery and making a notional contribution to fixed costs. It involves accepting the financial risks associated with operating a nursery, including sharing responsibility for any potential losses.

There must be a financial responsibility by the employer to fund the childcare facility, such as a significant contribution of capital or a specific undertaking to make good losses (where fees fall short of costs and contractor's profits).

HMRC also asserts that for employers to effectively manage the provision of childcare, they must have significant input and influence over management decisions and the way childcare is delivered. This could involve overseeing the performance of childcare staff and determining the conditions under which care is provided. Simply being consulted occasionally by the nursery provider on broad policies or having infrequent calls for general updates does not suffice.

If an employee is appointed to the nursery's management board, HMRC expects clear evidence that the employee is fully empowered to act on behalf of their employer, actively does so, and is involved in managing

the delivery of childcare as described above.

HMRC is aware that some workplace nursery scheme operators have advertised their services as having been approved by HMRC. It says that it ‘will never give approval for a business to advertise that a scheme is tax compliant’. It is the responsibility of the employer to make sure they only claim the tax exemption for any qualifying scheme they join, and employers are required to file forms P11D or payroll the benefit to employees if the exemption does not apply.

However, it should be remembered that HMRC guidance does not have the same standing as the underlying legislation; it is only its view of the law and has yet to be really tested through the courts. With that in mind, the question for employers is: are they comfortable that they know the correct tax treatment of their arrangements? Furthermore, do they understand the implications of getting it wrong and do they want to take that risk?

What should employers with such arrangements do now?

Employers with an existing scheme in place should consider whether they urgently need to review them, if they haven’t already, against the exemption criteria and most up to date HMRC guidance to see if their scheme meets the requirements for claiming the tax exemption.

Some arrangements will qualify for the exemption. If there is any ambiguity regarding eligibility in the first instance, the employer might want to discuss this with the workplace nursery provider to obtain their thoughts, though ultimately if it does not qualify it’s the employer that will suffer the consequences of a challenge by HMRC.

If the conditions of the workplace nursery exemption aren’t met, generally the benefit should be reported to HMRC on an employee’s Form P11D or through the payroll (if payrolling benefits has been agreed) and subject to Class 1A NIC.

If the exemption has been incorrectly claimed for earlier tax years, employers should consider making a voluntary disclosure to HMRC and settling the outstanding liabilities arising.

Where an arrangement has been treated as exempt in the past, but it is concluded that the exemption does not apply, HMRC can go back six tax years to collect any underpaid Class 1A NICs and charge interest on late payment and penalties. HMRC may also invite the employer to settle any underpaid tax due from employees on a grossed-up basis, normally for the previous four tax years.