

# Contractor's Playbook

The ultimate guide to contracting in the UK

broome 

# Introduction

Deciding to become an independent contractor is a massive decision. And not one to be taken lightly. Whatever the reason: to enjoy a higher income or to have the ability to have a more varied and flexible work portfolio, many professionals, even in the current economic climate are turning to independent contracting as a genuine alternative to the 9 to 5.

Generally independent contractors can command higher fees than their salaried counterparts but, as with most things in life, there are two sides to this particular coin: As a member of the “flexible workforce” your contract will generally be for a fixed period and there is no guarantee of work beyond that fixed period. Nor do independent contractors enjoy benefits such as paid holidays and sick leave which many employees are used to.

That’s the trade-off in becoming a contractor and as you progress through this guide you will see that, in most circumstances, the benefits are far greater than the downsides.

Contractors should be aware that while this guide provides a significant amount of information, it should not be used a substitute for advice and we strongly urge you to contact an accountant or other professional before acting on anything you read in this guide.

# Options

There are three main routes available to a professional looking to enter into the contracting market: Umbrella Company; Offshore Solution; and Personal Limited Company. Many clients in the financial and energy sectors are insisting on the flexibility of using contractors and will not use permanent staff where this is possible. Therefore the professional finds himself in the position of having to choose one of these options. This guide is designed for independent contractors who plan on using their own limited company but it is worthwhile exploring the other options available:

## **Umbrella Company**

An umbrella company is a halfway point between the agency employee and Limited Company routes. The Umbrella company is set up and run by a third party (often a firm of accountants). The contractor becomes an employee of the Umbrella company and all invoicing, VAT returns, tax administration, bookkeeping etc are handled outside the control of the contractor. The contractor is then paid a salary in line with their earnings – the tax treatment is exactly the same as a permanent staff member.

While not particularly financially attractive, contracting through an umbrella company does provide the flexibility craved by many contractors and can be particularly good for short term contracts.

## **Offshore Solutions / EBTs**

Many independent contractors are tempted by the high financial return promised by promoters of Offshore Solutions, who claim that you can retain around 85% to 90% of your earnings. The schemes vary in complexity and are often shrouded in secrecy but most work in a very similar fashion: A small salary is paid to the contractor, typically £10,000 per annum, and the contractor will pay a small amount of tax on this. The balance of the income which **YOU HAVE EARNED** is then loaned back to you on a non-repaying basis. Unsurprisingly, HMRC are not too keen on these arrangements and are actively taking steps to close down these schemes. The basis of their argument being that a loan that is not repayable is not a loan. A sentiment we find quite difficult to argue with.

## **Limited Company**

Trading through a limited company is an extremely popular contracting method due to its flexibility and tax efficiency.

There are of course disadvantages associated with running your own limited company such as the increased administration and responsibility but with the right adviser behind you, this shouldn't present too much of a problem.

# The Considerable Tax Advantages of the Limited Company

Owner-Directors of one man Limited Companies are in a unique position. Due to the flexibility of being able to manipulate payment types and timings, it is possible to pay an overall tax rate of around 20% on earnings of up to £100,000.

Despite HMRC's attempts to curtail the tax advantages of the way small companies and their owners are taxed, there are a few simple tax planning strategies that can be put in place to significantly enhance your take home pay:

## Low Salary / High Dividend

Under normal circumstances, salaries are taxed under the PAYE system and employer's and employee's NIC's are chargeable on them. Dividends however, are taxed differently and they do not attract any national insurance.

It is normally a fairly tax efficient process to set your salary level at £624 per month and take the rest of your income in the form of dividends.

If your contract income is around £50,000 per year, just applying this single strategy will save you around £5,000 every year.

## Spouse as Shareholder

If you are married, and your spouse or partner does not have income exceeding £42,475 per year, it is normally tax efficient to split the shareholding between you. For example, if you have income of £60,000 per year, there will typically be £18,000 taxed at the higher tax rate of 40%.

It is possible to avoid this higher rate tax by apportioning a percentage of the shareholding to your spouse so that £18,000 of the dividends is paid to her/him\*

This will equate roughly to a tax saving of £4,000 each year.

**\*before putting this strategy into place, it's important to ensure that the combined income of the spouse / partner does not exceed £42,475, otherwise they will be liable for higher rate tax and therefore the purpose of the exercise is defeated.**

## Income Deferral

The flexibility of a limited company allows a contractor to defer income from a tax year in which a high rate of tax would normally be payable until a tax year in which a lower rate is due. This could be because of a change in official tax rates or because of a change in individual circumstances.

If you were to defer income of £20,000 in this way, you could expect to save approximately £5,000 in higher rate tax.

## Tax efficient company closure

If you don't mind locking your income away in your company for a few years, there are considerable tax savings to be made. This is a natural extension of the above Income Deferral process: Once the company

has fulfilled its purpose, the director(s) can close it down via a Members' Voluntary Liquidation and the company. The funds in the company can then be distributed as capital and the shareholders can take advantage of the CGT annual exemption (currently £10,600) and the balance will be taxed at just 10%.

Sometimes, if the contractor is retiring, and the company has built up considerable funds, he can choose not to withdraw the funds as capital but continue to withdraw as dividends. If it is possible to do this and keep total income below the £42,475 level, then no further tax will be payable.

### Profit from the VAT Flat Rate Scheme

By voluntarily registering the company, you can take advantage of an anomaly in the current VAT system. Your company charges VAT to your client or agency at 20%, but only needs to pay a lower amount of between 12% and 15%, dependent on the type of business.

Typical savings from the VFRS are in the region of £2,000 to £5,000 per year.

Typically we will use a blend of all of these strategies to come up with the most tax efficient structure, similar to the one below:

	<b>Ltd</b>
Annual income (48 week cycle)	£ 100,000
VAT flat rate profit	£ 3,750
	£ 103,750
Salary	£ 7,500
Accounting fee	£ 1,188
	£ 8,688
Company profit	£ 95,062
Corporation tax	£ 19,012
Net dividend	£ 76,050
Add salary and expenses back in	£ 7,500
<b>NET TAKE HOME</b>	<b>£ 83,550</b>
Higher rate tax on dividend	£ 7,120
<b>ADJUSTED TAKE HOME</b>	<b>£ 76,430</b>
	76%

As you can see without too much effort, 76% retention on a £100,000 contract income is not unreasonable. This can be further enhanced with the use of income deferral or by making pension contributions.

# Starting Out

Once you've established that you want to start a limited company, we need you to complete a simple form telling us what the name of the company should be and who the directors and shareholder will be. The form is available on our website. If you are at all unsure about anything on the form, give your BroomeAffinity accountant or adviser a call.

We are then able to set the wheels in motion and the process normally happens pretty quickly from here. Typically

What	Who
<b>Incorporation</b>	BroomeAffinity
<b>VAT registration</b>	BroomeAffinity
<b>PAYE registration</b>	BroomeAffinity
<b>Corporation tax registration</b>	BroomeAffinity
<b>Arrange Insurance</b>	The contractor
<b>Arrange and sign contracts with agency</b>	The contractor / BroomeAffinity
<b>Register company for HMRC online services</b>	BroomeAffinity
<b>Open a company bank account</b>	The contractor

Once these steps have been completed, you can begin to trade. It is important to note that, while all other steps must be at least commenced **before** you start your contract, you will only need to have the bank account in place by the time your client or agency wants to pay the first invoice, which can be as little as two weeks and as much as two months from the start of the contract.

The bank account can often be the time consuming part of this process. Because of anti-money laundering regulations, we are unable to assist in opening a bank account. We recommend either HSBC or Santander but sometimes you might be as well to use the bank you are with personally. You should be aware though that Lloyds TSB and HBOS are both famously slow at opening business accounts. When setting up the bank account remember to sign up for internet banking as this will make your life much, much easier.

# Running your limited company

Once your Limited company is set up and you ready to start working then the process is very simple. All we ask is that on a weekly or monthly basis (depending on your billing cycle or preference), you complete our spreadsheet to report your income and expenditure which you can then upload to our system via our secure client area, along with your bank transactions for the period.

We will then prepare your weekly or monthly summary for you which will detail the amounts you can take out of the company for salary, expenses and dividend. The summary also details the amounts you need to provide for in the company for the various taxes which need to be paid.

## **Payroll**

On setting up your company we will also register it as an employer with HMRC. We recommend our contractors pay “themselves” an annual salary of £7,500 per year. There are no national insurance contributions or PAYE due on this salary as it is below the upper earnings threshold. However, because it is above the lower earnings threshold then the government will ensure you national insurance contributions are still continued thus protecting any future benefits or state pensions for yourself or spouse if applicable.

Annually in April, we will submit a return to HMRC on your behalf (a P35) which details all these payment you will have already made. This is a statutory obligation. We will then be able to generate a P60 which we will send to you.

## **Dividends**

Dividends are a distribution of profit from your limited company and do not affect how much corporation tax you will pay. These come with a 10% tax credit so there is no additional tax to pay unless your total income (wages plus dividends) exceeds the basic rate threshold which is currently £35,000 with a £7475 tax allowance.

## **Corporation Tax**

Corporation tax is a tax that is paid on the net company profits and is not concerned with any money you personally have withdrawn from the company. Simply, net sales less net expenses give taxable profit and tax is paid on this profit at 20%. Corporation tax must be paid to HMRC 9 months and 1 day after the company’s financial year end.

## **Annual Accounts**

At the end of your financial year, BroomeAffinity will prepare the company’s annual accounts. These final accounts are approved by you, and then copies are sent to Companies House and HMRC along with the corporation tax return. HMRC will then confirm the figures and send out a statement detailing how much is to be paid and by when.

## **VAT**

VAT registration is compulsory for businesses that have a turnover of £73,000 or more per year. However, 95% of companies can benefit from voluntarily registering for VAT and then applying to join the VAT flat rate scheme.

VAT returns are normally made quarterly. We will contact you on or around the day your VAT period ends to get any information from you that we may need, and then we will prepare the return. Once the return is ready we will upload this to your client area for you to complete online. Once the return has been submitted, HMRC will collect the VAT due by direct debit approximately six weeks after the end of the VAT period.

# The dreaded IR35

It's a very rare contractor that hasn't heard of IR35. But there are many, many contractors who are working in this grey area who have little or no knowledge of what it is and how it affects them.

## So, what is it?

IR35 is the term used to describe the tax legislation introduced in 1999 by HMRC in an attempt to tax people in "disguised employment" at a rate similar those in a staff position. If your contract is deemed to be inside IR35, then virtually all tax planning mentioned in the previous section are off the table, although as you are still able to benefit from the VAT flat rate scheme and are allowed up to 5% of your gross income for expenses so even "inside" IR35 is more tax efficient than an umbrella or permanent position.

Clearly then, it is in every contractor's interest to arrange their affairs so that they are outside IR35.

The key sensitive areas under IR35 fall into the following categories:

**Direction and Control:** The level of control over your method of work that your client can exert is extremely important. The less, the better.

**No mutuality of obligation:** Having a defined project with no future obligation or need from either side to provide further work or services. Immediate termination of contract is a good indicator

**Right of substitution:** Having the ability to substitute, sub contract or re-assign the project or your involvement within it. This is the wholly grail: If you have this right, and you have exercised it, then HMRC can have no argument: The ability to substitute is unquestionably only available to genuine contractors. **If you can do this, nothing else matters.**

**Commercial Risk:** Exposure to financial risks, error correction without reward, bad debts, and provision of insurances

**Being in business in your own right** with different rights and obligations to permanent staff, own web site, premises, own training programmes etc.

IR35 is an extremely complex area which is beyond the scope of this guide. If you are at all concerned about your status, we urge you to get in touch with your BroomeAffinity accountant or adviser to discuss this and to arrange a contract review.

## HMRC's Business Entity Tests

In May 2012, HMRC introduced a points-based system to determine whether contractors are at risk of falling within IR35.

In our opinion it's another ill thought out approach and asks questions which are less relevant than ones that aren't asked and therefore causes further confusion in an already murky area. More weight is given to a company's expenditure on marketing than on a contractor's degree of Direction and Control.

# Expenses

Man, do we get asked a lot about expenses. Every day, literally, someone asks if they can claim one thing or another.

We could write a book the length of a Tolstoy classic about expenses, and maybe one day we will. For the time being, you need to ask yourself a simple question to determine, under normal circumstances, whether the expense is allowable:

**“Is this expense incurred wholly and exclusively in the course of running my business?”**

If you can answer yes, then in all likelihood, it will be an allowable expense, if you can't then it probably won't be. Although, as with most tax matters, there are some exceptions, taking this approach will stand you in good stead.

So, no, you **can't** claim for:

- a 42" TV even although you use it as a PC monitor
- your DSLR camera even if you do use it to take some pics for your website
- a business suit
- a new pair of specs even if you do wear them to work
- a holiday to Vegas even if you plan on having your AGM there at the same time.

However, you **can** claim for:

- Ordinary travelling expenses to and from site including mileage (subject to the 24 month rule)
- Meals, depending on how long business takes you away from home
- Childcare costs up to £55 per week
- Mobile telephone
- Protective clothing and uniforms
- Computer equipment
- Business insurance (but not health insurance)
- Certain training costs
- Stationery and postage

Please refer to our Expenses Guide for more detailed information.

# Key dates

As a contractor (and director of a limited company) you have some legal obligations. Your BroomeAffinity accountant will help you fulfil these obligations and our systems ensure that you are compliant but it makes sense for you to know these dates:

Date	Details
6th April	First day of the tax year.
19th May	File P35 (Employed Annual Return) + P14.
31st May	The deadline for providing Form P60 to all your employees - for the previous tax year.
6th July	If applicable, the date by which you must return Forms P11D, P11D(b) and P9D to HMRC. The later two forms should also be provided to all relevant employees.
19th July	Transfer any liabilities for Class 1A National Insurance Contributions to HMRC - for the previous tax year.
31st July	Second payment on account to be paid for self assessment (if tax is owed).
31st October	Deadline for submission of paper self assessment tax return for previous tax year. HMRC will calculate your tax liability on your behalf.
31st January	1st payment on account to be made (if relevant). Balancing payment for previous tax year. Capital Gains Tax Payment. Final filing date for previous tax year's personal tax return (£100 penalty applied if return is made later than this date).
9 months after financial year end	Company accounts must be filed at Companies House. £150 penalty applied if accounts are filed late rising to £1,500 if more than 6 months late
9 months and 1 day after financial year end	Corporation tax is payable
12 months after financial year end	Accounts and Corporation Tax Return must be filed with HMRC. Various penalties are payable if the return is made late
Every 3 months	VAT period ends
One month and 7 days after VAT period ends	VAT return needs to be filed online

# Tax Rates and Allowances 2013-14

## Income tax personal allowances

Per year	2012-13	2013-14
Personal allowance (age under 65)	£8,105	£9,440
Personal allowance (age 65-75)	£10,500	£10,500
Personal allowance (age 75 and over)	£10,660	£10,660
Income limit for under 65 personal allowance	£100,000	£100,000
Blind person's allowance	£2,100	£2,160
<b>Capital gains tax annual exempt amount</b>		
Individuals etc.	£10,600	£11,000*
Most trustees	£5,300	£5,500*
<b>Individual inheritance tax allowance</b>	£325,000	£325,000
<b>Pension schemes allowances</b>		
Annual Allowance	£50,000	£50,000
Lifetime Allowance	£1,500,000	£1,500,000

\* Estimate - Awaiting confirmation that annual exempt amount will increase in line with CPI (then 1% in 2014-15)

## Income tax: Taxable bands

	2012-13	2013-14
Savings starting rate*: 10%	0-£2,710	0-£2,790
Basic rate: 20%	0-£34,370	0 - £32,010
Higher rate: 40%	£34,371 - £150,000	£32,011 - £150,000
Additional rate: (reduced 5% in 2013-14)	Over £150,000 (50%)	Over £150,000 (45%)

\* Only available if non savings income is less than this amount

### Capital gains tax rates

	2012-13	2013-14
Standard rate of CGT	18%	18%
Higher rate (for higher rate income tax payers)	28%	28%
Rate for Entrepreneurs	10%	10%

### Corporation tax on profits

£ per year (unless stated)	2012-13	2013-14
£0-£300,000	20%	20%
£300,001 - £1,500,000	Marginal rate	Marginal rate
£1,500,001 or more	24%	23%*

### National insurance contributions

per week (unless stated)	2012-13	2013-14
Lower earnings limit, primary Class 1	£107	£109
Upper earnings limit, primary Class 1	£817	£817
Upper Accruals point	£770	£770
Primary threshold	£146	£149
Secondary threshold	£144	£148

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