



CHARTERED ACCOUNTANTS



Maximising Net Income as a Contractor

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The decision to become a contractor, to leave the “safe” world of permanent employment, is often driven by money – to maximize income – at least in the short term. It is therefore vital that the contractor understands how net income (take-home pay) can be maximized since comparisons of gross pay alone are insufficient.

The way in which the contractor operates has to be considered very carefully since the effects of taxation can totally alter the net income position. The options available are explained in the following pages.



Option 1: PAYE

Most recruitment agencies do not want to administer their own payroll, or deal with potential employment issues, and so simply do not run a payroll service. If they do, the contractor pays full tax and employees national insurance (NI) contributions on all earnings. No business expenses, which would help to reduce tax and NI liabilities, can be claimed. Hence, although the most straight forward option this will invariably give the contractor the least take home pay.



Option 2: Self Employment

“Self employment” is where a person is *genuinely in business on their own account and not* working through any form of limited company or other type of incorporated entity. Whilst this way of working is beneficial to the contractor it is not accepted by HM Revenue and Customs (HMRC) as applicable to recruitment agencies and is therefore effectively unavailable to most contractors.



Option 3: Limited Company

Historically, the majority of contractors have worked through their own Limited Companies since the tax advantages of working this way are usually far greater than other compliant methods. The introduction of IR35 in 2000 attempted to remove these advantages but does so only for contracts falling within IR35. Very simply, IR35 states that if, other than for the existence of an intermediary company, you would have been an employee of the end user then you will be treated as an employee for tax purposes regardless of how you organise your affairs. As a general rule, if you genuinely fall outside of the IR35 rules then you are invariably better off using a Limited Company.



Option 4: Umbrella Company

An Umbrella Company provides the same legal structure of a personal Limited Company but removes the administrative burden normally associated with contracting by providing a ready made solution available to a large number of unconnected contractors. The Umbrella Company normally issues invoices on the contractor's behalf, collects payments from clients/agencies, calculates tax and NI contributions and pays the contractor their net pay direct to their personal bank account.



Option 4: Umbrella Company Continued

In order to be tax compliant, the contractor must be an employee of the Umbrella Company and have all remuneration paid out in the form of employment income. In practice the contractor is usually paid via a combination of salary, “bonus” and tax free expenses. The Umbrella is the most favoured option for contractors falling within IR35, those not expecting to be contracting in the longer term and those who want the “simplest life”.



Other Options

There have been a plethora of other “creative solutions” offered in the market place, covering Employee Benefit Trusts, Foreign Currencies and Loans, to name but three. Inevitably an offshore administrator is involved. Having looked closely at all of these schemes the writer is of the opinion that some are simply non-compliant, most are highly aggressive and simply rely on that the fact that HMRC haven’t yet caught up with them, and all subject the contractor to a risk far greater than the potential reward.



Minimizing Tax to Maximize Pay

Tax is reduced as follows:

PAYE

Pay is subject to full tax and employees NI. No tax reduction is achievable other than by way of personal pension contributions, which is also available under all the other options.



Minimizing Tax: Umbrella Company

The Umbrella Company has to pay Employers NI as well as tax deductions from the employee and as a consequence the agency/end user will compensate for this in the hourly rate paid under the contract. However once this “plus and minus” is taken account of the Umbrella employee is usually permitted to claim a range of business expenses to offset tax. The general rule for the tax free payment of expenses is that they are incurred “wholly, necessarily and exclusively” for the purpose of the business. It is not easy to comply with all 3 criteria and invariably most claimable business expenses revolve around travel, and its associated costs (accommodation, subsistence etc).



Minimizing Tax: Umbrella Company Continued

There are in fact special rules applicable to travel under which the contractor has to be a “site based worker” in order to ensure that the travel costs are not those of *ordinary commuting*, which are not allowable for tax. Many Umbrella Companies disingenuously suggest that more generous expense claims can be made because of the existence of a *dispensation with HMRC*. *This is not the case*, a dispensation merely absolves the Umbrella Company from the need to complete and submit certain year end returns (P11D’s) to HMRC.



Minimizing Tax: Limited Company

Provided contracts performed via the Limited Company are not subject to IR35, and the Limited Company itself is a genuine Personal Services Company and not a Managed Service Company, the Limited Company reduces tax via:

1. The ability to claim all the same expenses of the Umbrella Company
2. The possibility of claiming a more generous range of administrative expenses covering the costs of running the company, since costs must be incurred only “wholly and exclusively “ for the benefit of the company, the necessarily test is omitted.



Minimizing Tax: Limited Company Continued

3. The possibility to pay dividends to the shareholder/director in lieu of salary. Indeed with good tax planning a tax free salary can be paid, topped up solely by dividends on which no NI is paid (neither employees or employers), a 24% NI saving.

4. If a longer term strategy is taken the contractor can also reduce taxes further by retaining profits within the company, “sheltered” at the lower corporation tax rates and then (under current legislation) distributing them on the closure of the company at 10% capital gains tax rates.



Conclusion:

The personal Limited Company remains far and away the best vehicle for maximizing net income for a contractor. Where the use of the Limited Company is ruled out by IR35 then the Umbrella comes in as second choice, often conferring good increases in take home pay. The PAYE option is really only for those with no choice. As always, professional advice should be sought before making any decisions on what option to take. Regulated professionals will give you the best advice based on your personal circumstances.

To identify the best solution for your requirements, please contact us and one of our knowledgeable consultants will be able to guide you through the options.



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**Contact us for a free no-obligation
consultation**



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