

## STARTER GUIDE TO CONTRACTING/FREELANCING

This guide has been developed by the Partners of Forbes Young and is meant to be used as an informative and useful resource for people new to contracting or freelancing (for the purposes of this guide contracting and freelancing mean the same thing). It is a guide up to the point in time when the business owner actually appoints an Accountant.

There is a minefield of information already available from different forums throughout the internet. We feel strongly that every prospective contractor should understand the world they are about to enter and not just “jump in” to a contract without considering every possible angle.

Please note - this is an actual guide and not based on rumour or misinformation. It is set out in the form of a series of questions and answers. If you want clarification regarding any part of this guide or have any other questions then please feel free to ask us any questions you have.

### 1. Why Do It?

Some advantages of contracting can be summarised as follows:

- Increase the amount of money you earn.

This comes from both the increased rates of pay you can expect get via contracting coupled with being able to reduce your tax liabilities by not receiving all your remuneration as a standard salary and offsetting certain expenses against your income.

- Increased flexibility over when you work and where you work.

Some contractors take long periods of time away from work, if they can afford it, whilst Others work all the hours they can to accumulate as much as they can to enable them to retire early.

- Be your own boss

Focusing on doing the sort of work that you want to do and are good at.

- To get away from things you don't currently like

Such as unappreciative management, meetings, office politics etc.

But there are also some risks to contracting, including:

- May have to move/travel significant distances to get work

- Reduced job/financial security

The norm is for contracts to initially be drawn up to last for months not years, although they can be renewed. This uncertainty puts some people off. There is also less security in that contractors are not protected in the same way as permanent employees e.g. contractors don't get sick pay, holiday pay, redundancy pay etc.

- Being a director of your own company

You have to take on the responsibility of running your own business and only get paid when you do work.

## 2.How Do You Find Contracts?

Broadly speaking there are two main methods:

- Via Recruitment Agencies – this is the most common way of finding work. There are many agencies throughout the UK, with some specialising in particular skills and/or industry sectors. Typically they will ask you to send in your CV which they will send out to clients who might be interested in your skills.
- Going direct to a client – if you can do this it obviously saves on the agency commission but relatively few contractors are fortunate enough to find significant periods of work this way.

## 3.How Should You Set Up Your Business?

So you've decided to take the plunge and have or are close to getting your first contract. The next step is to set up an appropriate trading vehicle so that you can get paid and ensure you are working within the law. Additionally, as your choice of vehicle will affect how much tax you pay, there is much scope for maximising your earnings by choosing a set up that will minimise your tax bill. The main ways of operating are:

- As an employee of an agency

This is a simple option but isn't really about running your own business as you are still an employee. You might do this as a very short term option, particularly if on a relatively low rate of pay.

- Sole Trader

This is the simplest and cheapest way of being your own boss. There are only a few formalities to setting up and trading this way, the most important of which is informing HMRC (HMRC = the taxman). You are required to prepare accounts each year and they will form the basis of your tax and National Insurance Contribution (NIC) calculations. Any profits generated are automatically yours. The business of a sole trader is not distinguished

from the proprietor's personal affairs so that if there are any business debts, you are legally liable to pay those debts.

**KEYPOINT** - Agencies and clients will rarely sign a contract with a sole trader because there is a significant risk that the contractor could be considered an employee of the agency or client with full employment rights. Also, if sole trader does not pay their full tax and NICs the agency or client could be liable to HMRC for these costs.

- Partnership

A partnership is an extension of being a sole trader. Here, a group of two or more people will come together. It is advisable to draw up a Partnership Agreement which sets the rules of how the partners will work together, how they will share out the business profits etc. Partners are taxed in the same way as sole traders, but only on their own share of the partnership profits. There is a variation of the partnership format called a limited liability partnership (LLP) which limits the liability of partners for debts incurred by the business if things go wrong, but LLPs are mostly suitable for larger accounting and legal firms.

It is fairly rare for a contractor to supply their services via a partnership.

- Your Own Limited Company

A limited company is an "artificial" person that can trade, sign contracts, own assets and incur liabilities in its own right. Your ownership of the company is recognised by owning shares in that company but it is still a separate legal entity from its owners.

It is termed a "limited" company because the personal liability of the owners is limited to the share capital that has been invested, which can be as little as £1.

If you also work for the company, you are both the owner and an employee of that company. When a company generates profits, they are the company's property. Should you wish to extract money from the company, you must either pay yourself a dividend, as an owner, or a salary, as an employee. The advantage to you is that you can have a balance of these two to minimise your overall tax and national insurance liability. Companies themselves pay corporation tax on their profits after paying your salary but before your dividend distribution.

Effective tax planning requires profits, salary and dividends to be considered together.

**KEY POINT** - for many contractors, including those just starting up, a limited company is the best solution to maximise those benefits that led them to contracting in the first place such as more net income, more control, flexibility etc.

KJM Accountancy can assist you to set up your limited company in 24 hours.

- Umbrella Company

Umbrella companies are limited companies operated by a specialist provider that groups a number of contractors under one company. Contractors using this structure become employees of the umbrella company and then submit regular timesheets and expenses (normally online) and then leave the rest up to the umbrella company. The umbrella company will generate and send invoices to the agency or client, chase payment when it's due and then upon receipt of payment calculate your tax and national insurance and transfer your net pay direct to your bank account. The umbrella company provider will take care of all accountancy and taxation matters and also deal with the bulk of the administration.

**KEYPOINT** - The advantage of this arrangement is that it is relatively simple from the contractor's point of view. However the downside is that your income is treated as salary which gives you a relatively high tax bill. So probably more suited to someone contracting for only a very short term or on a relatively low rate of pay or if caught by IR35 (more on this later).

- Offshore Company

Offshore arrangements come in a variety of schemes. They seek to avoid a large chunk of UK tax being deducted from your earnings by channelling your income through a company or partnership or trust based outside the UK tax jurisdiction e.g. in the Isle of Man, Jersey etc. However, we would caution anyone thinking of using such schemes as HMRC are taking an increasingly aggressive stance towards them. Unusually, HMRC have the powers to retrospectively apply the current rules to past income. Thus you could end up being personally liable for unpaid tax, penalties and interest if a particular scheme you get involved in is subsequently investigated and falls foul of current legislation.

**KEYPOINT** - Our advice is that if you live and work in the UK then using one of these schemes is a high risk strategy to save tax.

#### 4. What's involved in Setting Up Your Own Limited Company?

Forming a limited company (sometimes referred to as "incorporation") is a quick and cost-effective process. You need to decide on the company's name, its owners and officers. As a minimum one owner (also called shareholder) and one officer (a director) are required, although these can be the same person. So normally the contractor becomes both a director and shareholder of the company and if the contractor has a spouse they sometimes also become a shareholder. Whilst a shareholder and a director may be physically the same person each role has different responsibilities set out in law. In essence, a director is responsible for the proper running of the company on behalf of the shareholders and these responsibilities must be taken seriously.

Once the company is formed, which should take no more than 24 hours, it can trade i.e. sign contracts, issue invoices etc. However, to make it fully functioning the following need to be done:

- I) Setup a company bank account (NB: you cannot use a personal bank account)
- II) register for VAT
- III) register for Pay As You Earn (PAYE)
- IV) register for corporation tax
- V) arrange some business insurance – typically buried in a contract with an agency or client will be a requirement to have the likes of public liability and professional indemnity cover, which can be quickly obtained.

Obviously until the bank account is open you cannot get paid but there is no requirement to register for VAT, PAYE or corporation tax the instant you commence trading. However, it is usual to obtain these registrations without undue delay and indeed through a scheme such as the flat rate VAT scheme it is financially advantageous to get registered early. Your accountant will handle the registration processes.

## 5. What's Involved In Running A Limited Company?

Once the company is operational there will be a certain amount of ongoing paperwork and administration to attend to, which is best done on a regular basis rather than leaving it until a crisis occurs. In particular, it is vital to regularly invoice the agency or client for your work and to ensure that those invoices are promptly settled i.e. cash is king! Many accountants offer online systems to assist this cycle. It is most important that you keep records of your business income and expenses and regularly update your accountant with this information via their online system or spreadsheet they will give you. Largely based on this data your accountant will be able to produce the various tax returns and accounts that the law requires, which are:

- Annual accounts and an Annual Return must be filed at Companies House each year.
- VAT returns (quarterly)
- Personal tax return (annually)
- Company profits return (annually)
- PAYE must be operated for anyone employed by the Company

## 6. How Does Having Your Own Limited Company Save Tax?

**KEYPOINT** – From a tax point of view the major difference between a permanent employee and a contractor being paid through their own limited company is that the contractor can take the majority of their payments by way of dividends. Dividends do attract income tax but do not attract NICs (National Insurance Contributions). This avoidance of NICs is the major part of the tax saving.

Things do get a bit complicated here because your company is a separate legal entity from yourself and it has to pay tax on its profits in addition to you suffering tax on the dividends and salary you take out of the company. However, when you take all the taxes into account it is not uncommon for a contractor to keep up to 25% more of their gross contract rate than they would do if they received the same gross rate in the form of a permanent staff member's salary.

In addition, note that a limited company pays tax on profits not its gross income, which is a much more advantageous compared to the rules applying to permanent employees. Within a limited company many expenses such as travel, accountancy fees, insurances, contractors pension contribution etc. are deductible from the businesses income in arriving at the profit figure on which tax is charged.

## 7. What Is The Issue With IR35?

The "IR35" rules were introduced in April 2000 because HMRC/Government believed that many contractors were effectively very much like permanent employees of their client but by working through their own limited company were able to save (avoid) a large amount of tax. Hence the introduction of this so called anti-avoidance legislation.

Effectively it seeks to determine what the relationship would be if you were engaged directly by the end client i.e. if your limited company and the agency were removed from the picture. Would this hypothetical contract with the end client be a Contract of Service or a Contract for Services?

- If a contract of service exists, then you are caught by IR35 (also known as "inside IR35")
- If it can be shown that a contract for services exists, then you are regarded as genuinely self employed.

One way of understanding the difference is to think about what is being supplied. Under a contract for services there will be a list of objectives required by your client and your company will supply the personnel/equipment to ensure the objectives are met. By comparison a contract of services suggests you are supplying yourself as the service in much the same way as a permanent member of the client's staff.

In order to find out whether you are caught by IR35 it is probably best to discuss your situation with us but note that the two areas to be evaluated are:

- 1) Your actual written contract, often with an agency
- 2) Your actual working practices at the end client's site

## 8. What Is the Consequence Of Being Caught By IR35?

Essentially, you will be deemed to be an employee and so the majority of the income received by your company has to be taxed according to the IR35 deemed salary calculation. **KEYPOINT** - This means that, whilst some allowance is given for expenses, the majority of the income received by your company is taxed as though it were salary and thus both income tax plus employees and employers NICs must be paid. So instead of taking the bulk of your payments from your company as dividends and so avoiding NICs you are forced to take them as salary and suffer NICs.

## 9. What Other Financial Matters Need Consideration?

One important factor to note about having your own limited company is that the money coming into the company is received without any tax deductions. This is in stark contrast to a regular salary where the tax has already been deducted and you just receive a net pay. Consequently you must be disciplined and ensure that you retain enough money within your company to pay all the relevant taxes as they become due.

In addition to being mindful of future tax bills, you should also consider building up a buffer of funds for a “rainy day”. There may be times when you want to take a break between contracts or you may be unable to immediately find a new contract or you may fall ill etc. Despite these occurrences you will still have business and personal costs to meet.

Also as you move into the world of self employment from a permanent position, many of the benefits that your previous employer may have provided now fall away and you may need to reconsider arrangements for:

**Pensions** - as well as providing for your future there are also tax advantages to be had as your company can make payments directly into a scheme set up for you. Such payments are tax deductible and hence of great help in reducing your tax bill.

**Income Protection** – to maintain your income in the event that you are unable to work through illness or injury.

**Critical Illness Cover** - will pay out on diagnosis of a range of medical conditions so that you can continue to enjoy your current lifestyle.

**Life Cover** – particularly important if you have a family.

**Private Medical Insurance.**

**Mortgages** – it can be harder to take out a mortgage as a contractor, particularly if a new contractor as your business has very little history.

However, we can put you in touch with an Independent Financial Adviser for full advice on these issues.



## 10. How much “take home pay” will I receive?

To summarise, to form a limited company and operate outside of IR35 is in most cases the best way to maximise your take home remuneration, whether the take-home total after tax is 80%, 75% or 70%. This all depends on how much income your company generates and how many expenses the company incurs and the timing of when you take your dividends.

Beware of Accountancy firms claiming you will take home over 80% if you go with them as this is very misleading. From a logical viewpoint, if the corporation tax rate is 20% and your company's income is over £ 40k, your normal take home remuneration is extremely unlikely to be over 80%.

As a rough guide, a typical client of ours earns around £ 70k per year and the take home remuneration is typically around 75% operating with a limited company outside of IR35.

## 11. Conclusion

There are both advantages and disadvantages to contracting. If you can obtain contracts at a reasonable rate (a guide would be to earn at least £ 20k per annum) and if you are outside IR35 then the best way of working is likely to be through your own limited company. Whilst initially this sounds daunting, the mechanics of setting up and running a company can be relatively easily handled with the help of an experienced accountant.

This guide is not designed to cover everything in detail and so please feel free to contact us with any questions you have.

Why do we do what we do? We provide a premium quality relationship, so that our clients feel:

- Comfortable
- Confident
- Reassured
- They are always travelling First Class

If you signed up with us, you would be looked after by a Partner who is a qualified/experienced accountant, as opposed to the inexperienced “Account Manager” provided by many of our competitors.