

Contractor tax: limited company and personal taxes explained

Introduction

If you decide to contract via your own [limited company](#) the amount of tax you will pay as a contractor will arise in two different forms, that which you pay through your company and that which you pay personally. This will in turn be determined by the IR35 status of your contract, such that if you are caught by [IR35](#), you will inevitably suffer higher tax. The [financial impact of being caught by IR35](#) on contractor's tax is severe and you should try to remain outside IR35 if you can.

Taxes Paid Through Your Limited company

Corporation Tax

All limited companies are subject to Corporation Tax at rates varying between 0% and 30%. Most computer contracting companies will pay at the small companies rate of 20%.

If your contract is not caught by IR35, then you will most likely take the traditional route of low salary combined with high [dividends](#). Since dividends can only be paid from company profits, you will need to pay corporation tax at 20% of your net company profit.

If your contract is caught by IR35, then your salary and expenses will be approximately equal to the company's income, such that the company will make very little net profit and consequently very little, if any, Corporation Tax will be payable.

Corporation Tax is payable 9 months after your year end.

“ If you are caught by IR35 you will inevitably suffer higher tax ”

David Colom

Employer's National Insurance Contributions

This is a company cost based on the amount of your gross salary at the rate of 12.8%.

If your contract is caught by IR35, then your salary will be substantially higher as result and consequently the amount of Employer's National Insurance will be based on the IR35 salary.

If your contract is not caught by IR35, then best advice would be to take a very low salary, potentially avoiding Employer's National Insurance contributions altogether. No National Insurance contributions are chargeable on company dividends.

Employer's National Insurance is paid monthly.

VAT (Value Added Tax)

If your company is registered for [VAT](#) (which the vast majority of contracting companies are), then you will need to charge VAT on your [invoices](#) to agencies/clients at the standard rate of 17.5%.

This money is collected by the company on behalf of HMRC and must be accounted to them on a quarterly basis. You will be able to make claims for input VAT (on your company purchases) by deduction when you make the payment to HMRC.

VAT does not affect your company profit, although it may be possible for the company to register for the "[flat rate VAT scheme](#) for small businesses", which can reduce payments of VAT in certain circumstances.

Personal Taxes

Income Tax

If you are working in an IR35 caught contract, your entire income from the company will be subject to PAYE and will be deducted at source.

If you are not caught by IR35, then only a very small amount of your Income Tax liability will be deducted through PAYE (on the low salary).

On IR35 exempt contracts, you will receive dividends, on which there will be tax credits covering your basic rate tax liability. If your taxable income is less than the higher rate threshold, then you will not have any further income tax liability. Any income in excess of the higher rate tax threshold will be subject to the difference between the higher rate (currently 40%) and the basic rate (currently 22%).

Income Tax is paid monthly.

Employee's National Insurance Contribution

If your contract is caught by IR35, then you will suffer Employee's National Insurance contributions on your salary. These are currently 11% up to £670 per week and 1% thereafter.

If your contract is not caught by IR35, then you will pay very little, if any, Employee's National Insurance contributions, since the bulk of your income will be taken by dividends, which do not attract National Insurance contributions of any kind.

Employee's National Insurance Contributions are paid monthly.



Capital Gains Tax

You may be subject to Capital Gains Tax when you close your company and make a capital distribution to yourself as shareholder. Exemptions and reliefs are available through which it may be possible to reduce a substantial capital gain.

[Note: All tax rates quoted from 2007 Budget]

Published: Wednesday, February 08, 2006

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David Colom qualified as a Chartered Accountant in the City of London in 1981 and is the founder and principal of D J Colom & Co Chartered Accountants established in 1989.

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