

Limited company or umbrella - deciding on a payment structure

Introduction

First time contractors have two options for setting up a payment structure: [limited company](#), or [umbrella company](#). This article discusses the differences between the two and gives practical advice on which option to choose.

Payment Structure Options

Computer consultants and other agency contractors are faced with two tried and tested forms of company/payment structure:

1. One person limited company.
2. Umbrella company.

Option 1 is a well established route, whereas option 2 is a more recent innovation.

IR35 and Financial Considerations

It is important to emphasise at the outset that the choice does not in any way influence the [IR35](#) status of the contract or modus operandi of the working arrangements. The choice would also not influence any HMRC review or decision as to whether the contract falls within the regulations of IR35.

However, since the [Managed Service Company Legislation](#) was introduced in the 2007 Budget, the only viable umbrella option is to use a PAYE Umbrella, which effectively means all income is paid as though the contractor is caught by IR35. This is a key point, since the [financial impact of being caught by IR35](#) is considerable. You can find out how this effects you personally using the [IR35 Calculator](#).

A further point to make, in light of the MSC legislation, is that if you go via company route then you must [run your limited company yourself](#), rather than delegate control and key decisions to a third party supplier.

For contractors operating outside of the IR35 legislation, they are far better off financially by using a Limited Company vehicle.

For contractors inside IR35, the two options will not materially affect your net pay, although the administration costs of running an umbrella company are likely to be a little higher, since you are delegating all director and company responsibilities to a third party. It is bit like deciding between the cheaper option of owning a car which comes with the extra hassle of running it, or using a taxi which you pay more for, but has a reduced hassle factor.

“ Choosing between the two options will not materially affect your net pay. ”

David Colom

Differences Between a Limited Company and an Umbrella Company

With a one person limited company structure

- o The contractor is the director of the company and in full control of all company transactions.
- o As director they are responsible for compliance with all company and other statutory issues, including company law requirements to file accounts and returns to Companies House, calculation and payment of corporation tax liabilities, payroll calculations and returns and various other statutory and other Government requirements.
- o As director they raise all company invoices, run a simple accounting system to record transactions and appoint an accountant to deal with accounts, taxation and payroll matters.

With an umbrella company solution:

- o The contractor would not be a director or the responsibilities associated with running a limited company.
- o The umbrella company provider would take care of all accountancy and taxation matters and also deal with all administration matters.
- o The contractor completes a timesheet and forwards it to the umbrella company, who then invoices the agent.
- o Following payment by the agent to the umbrella company, a payment is made by the umbrella company to the contractor.

Advantages and Disadvantages of Each Solution

Limited Company - Advantages

- o Complete control of all transactions and company matters.
- o Contractor can be seen to be "representing" the company and "running a business" with its own trading name.
- o Full control of revenue. Paid directly into the company bank account, rather than passing via an umbrella company bank account.
- o Faster payment and administration process due to direct control, assuming the contractor deals efficiently with all transactions.
- o Smaller tax burden (higher percentage net pay) for contract revenue earned outside of the IR35 legislation.

Limited Company - Disadvantages

- o Main disadvantage is the amount of administration/paperwork arising, particularly in the late filing/payment penalty culture.
- o Responsible for day to day issues as invoicing, keeping a simple accounting system and fully liaising with their accountant, to ensure all forms, returns and accounts are filed by the due dates.

Many contractors, particularly first timers do struggle with these responsibilities.

Umbrella Company- Advantages

- o Avoids time and trouble of running a limited company. After a simple set up, the contractor completes timesheets and forwards to the umbrella company.
- o Knowledge that money is lodged into their bank account and documents are sent to them explaining how the payment is calculated. No need to be involved with running a spreadsheet, VAT returns, payroll matters, company accounts, taxation, etc.
- o For short term contractors, a main advantage is not having the costly process of forming a company and then arranging for it to be dissolved.

Umbrella Company- Disadvantages

- o The contractor will by definition not be running the company and will therefore be using it simply as a service to process transactions.
- o The contractor cannot represent themselves as running their own independent business, through which they can make policy decisions, take risks or act as company director.
- o There is inevitably some delay in the contractor receiving their money, since it needs to pass through a third party account before reaching them. This is down to the efficiency of the umbrella company.
- o There is an element of trust on the part of the contractor, since their money will be passing through the third party umbrella company bank account.
- o For contracts earning revenue outside IR35 there is a significantly higher tax burden than using a Limited Company - due to the Managed Service Company legislation (introduced in 2007 Budget).

Summary of Criteria for Making a Choice

In making a decision, the contractor should consider the following criteria:

1. IR35 status: If the majority of the contracts are likely to be outside IR35 then from an tax point of view the Limited Company is the sensible option for long term contractors.
2. Company Control: How important is it to control the company? – if important, take the one person company director route.
3. Presentation/Status: How important is it to be a company director for presentation/status with third parties? – if it is important, then the one person company should be taken.
4. Administration: Attitude to administration, including dealing with forms, returns, correspondence with accountants and other third parties, spreadsheets, VAT returns etc. – if it is no problem, then take the own company route but if it is likely to be a problem, then the umbrella route would be preferable.
5. Length of contracting: – if it is a long term contract, a one person company may be preferable. If it is short term or dependent on factors which may change in the short term, then an umbrella company solution may be preferable.
6. Borderline case: – if the decision to go "own company" or umbrella is a difficult one for a first time contract, then it would be best to go with the umbrella company solution for at least the short term. The reason for this is that it is very simple to leave an umbrella company and start up your own company but very much harder in terms of administration and expense to go from your own company to an umbrella.

Making the Right Choice

Making the right choice will always depend on your consideration of the above criteria.

Making the right decision based on your own circumstances and requirements will achieve the most efficient result. There is no "always right" or "always wrong" solution - both methods will work for you and achieve a similar result but with different working arrangements.

Your choice is similar to owning a car or using a hire car or taxi/bus service.

With car ownership, you are fully responsible for the purchase, running costs and eventual sale of

“ Your choice is similar to owning a car or using a hire

the car (just like your own limited company). It works well as a long term solution where you will need the car for a minimum of one year.

Compare this with a holiday situation, where you would hire a car or use taxis - much better for a short term solution where you do not want or need the benefits of ownership and do not wish to be concerned with the running costs of the taxi/bus - you just want a simple solution to get you to your destination (just like an umbrella company would do for you).

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David Colom
Principal
D J Colom & Co Chartered Accountants

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.

Started specialising in serving IT contractors in 1993 and is now one of the longest standing suppliers of accountancy services to computer contractors. [Read Full Profile...](#)

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car or taxis/bus service


David Colom

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