

What is a PAYE umbrella company?

Introduction

When [deciding on a payment structure](#) contractors can either choose to [run a limited company](#) themselves or use an [umbrella company](#).

How does a PAYE Umbrella work?

With a PAYE umbrella company you become an employee of the company. Each week or month you instruct them to invoice the agency/client based on your time sheet. They then pay you a net salary after deducting national insurance contributions and income tax on all your earnings.

After securing a contract you instruct your agent to send a contract to the umbrella company for signing. You do not sign the contract yourself. Instead there will be a contract in place between you and the umbrella company.

[Joining an umbrella scheme](#) is very quick. If you do not currently have one then you can wait until you have a firm offer before deciding which one to join. In any case, you should [have your contract reviewed for IR35](#) before [deciding which payment structure to use](#).

IR35 and Umbrellas?

The [IR35 legislation](#) is used to determine whether you are considered a 'deemed employee' for tax purposes. Your IR35 status for each contract will either be 'inside IR35' or 'outside IR35' and depends on your contract and working arrangements with each of your clients.

In the 2007 Budget the [Managed Service Company Legislation](#) was introduced, which effectively put an end to 'composite umbrella companies'. Composite schemes were effective for contractors outside the IR35 legislation, since all income could be taken as a combination of salary and dividends. Now however, the only viable umbrella option is the PAYE Umbrella, where all income is paid via PAYE.

You will need to [determine whether you are caught by IR35](#) before deciding which payment scheme to use (umbrella or Limited Company).

If you are inside (caught by IR35) then you are forced to take all your income as salary only, and using a PAYE umbrella is a sensible option.

If you are outside (not caught by IR35) then you will be able to take advantage of a salary plus dividends route available by [setting up your own limited company](#). This significantly minimises your tax burden. You can calculate the difference using the [IR35 Tax Calculator](#).

Note that your IR35 status is not something that is personal to you. It depends on each contract you take and thus needs to be re-examined each time you move to a new client.

If after having a contract reviewed you discover it is within IR35 you can certainly [negotiate your contract for IR35 compliance](#) and get the contract terms changed so that it becomes outside IR35.

Expenses and Dispensation

If you are caught by IR35 and are using a limited company scheme then the legislation caps the amount of **administration expenses** you can take using the [5% IR35 Expenses Rule](#).

Under an umbrella scheme this does not apply since administration costs are likely to be low apart from the administration fee for using the umbrella.

Note that all other section 198 expenses like travel, computer costs, training etc are outside of the 5% rule can be claimed.

Some umbrella companies have dispensation agreements with HMRC. These are issued so companies can reduce paperwork at month and year end. They certainly do not give permission for contractors to claim expenses for which they have not incurred. See ['Dispensation and Why Contractors Cannot Claim Expenses Without Receipts'](#).

In Summary

There are many factors which Contractors should consider when [choosing an umbrella company](#). Financial considerations tend to be the primary one, so initially determining your IR35 status and ensuring you remain outside IR35 is key.

If the status of your contracts switches between inside and outside IR35 then choosing a company which offers both types of schemes will reduce the minor hassle of switching companies at a later date.

In addition to the IR35 issue there are other factors you should consider which are discussed in the article [Choosing an Umbrella Company](#).

Published: Tuesday, May 20, 2008

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