

Umbrella contractors and emergency tax codes

For some contractors, emergency [tax codes](#) will revive memories of moving between past permanent jobs or to a new contract with a different trading vehicle. This can mean paying over the odds in tax for the first month or so, seriously reducing take-home pay.

According to Derek Kelly of contractor umbrella [Parasol](#), with a little planning and organisation, contractors can avoid the financial pain of an emergency tax code. And Kelly should know, because as technical director he is responsible for paying a whopping 20,000 contractors every year.

"With a little planning and filing paperwork safely between contracts," says Kelly, "contractors can start work with their [contractor umbrella company](#) on the correct tax code and nip the issue in the bud before it becomes a painful financial problem."

What is an emergency tax code?

Tax codes are based on our tax-free allowances and are designed to help HMRC with its cash flow. Everyone can earn up to a certain amount before paying tax, currently £6,039, although this figure tends to change every year with the Budget.

As most people are paid monthly or weekly, a contractor's tax-free allowance is spread over the year. So the contractor can earn one twelfth of their tax-free allowance every month (or 1/52 if paid weekly). They then pay income tax on the rest of their earnings that month via Pay As You Earn, (PAYE) deducted by their employer at source.

Tax codes are further complicated when an employee receives benefits, such as private health insurance, or a [company car](#). For example, if the health insurance was worth £500, this would be spread over the 12 months, and the tax code would be adjusted to accommodate the benefit.

"The key issue, and where many contractors come unstuck, is that PAYE is cumulative," explains Kelly. "That means if they don't have their P45 from a previous employer, they will automatically be placed on an emergency tax code, which is the same for everyone and is based on the tax-free earnings allowance."

An up-to-date P45 is essential

A contractor's P45 will show what earnings and income tax have been accumulated to date by the contractor, and also shows the contractor's previous tax code, which can be used by the new umbrella company.

"A P45 will be automatically issued to the contractor by their former employer when they leave that employment, with a copy also going to HMRC," continues Kelly. "But contractors can mislay their P45, or might have been working for an organisation that is perhaps not as rigorous as it should be in providing its ex-employees with correct paperwork."

And when a contractor [moves from their own limited company to contracting with an umbrella company](#), they or their accountant should still issue a P45, even if the only income has been [dividend income](#), meaning no PAYE has been accumulated.

Obtaining the correct tax code from HMRC

"When a contractor starts working for Parasol without a P45, they are placed on an emergency tax code, which generally results in them paying more tax than they should," says Kelly. "We immediately ask them to complete a P46, which we send to HMRC, who generate the new tax code, generally within three to four weeks."

Once the correct tax code is applied, the contractor will get a rebate, which according to Kelly is paid as a lump sum in the next payment period: "HMRC is very efficient at prioritising tax codes and resulting rebates, and the contractor receives the full amount as a single payment, rather than having their tax code adjusted."

So the initial pain of a lower net salary is soon followed up by a nice 'surprise' from the taxman in the form of a lump sum, although of course the money has always been the contractors!

New contractors who have never worked before in any capacity also have to apply for a tax code, because they will have no income tax history with HMRC. So they will find themselves on an emergency tax code for the first few weeks of their contract.

How contractors can avoid emergency tax codes

"It is possible for contractors with no P45 who have had a gap in their employment or who have been between contracts to apply for a tax code before they start work with their umbrella company," explains Kelly.

“In the weeks before they know they will be starting a new contract, the contractor can apply to HMRC directly for a tax code, and this will generally only take a few weeks to arrive.”

And, concludes Kelly, this forward planning will result in the contractor starting work with the correct tax code from day one, and not overpaying a penny in tax.

Published: Tuesday, February 03, 2009

[Tweet](#)

© 2011 All rights reserved. Reproduction in whole or in part without permission is prohibited. Please see our [copyright notice](#). If you want to use any content you have seen on this site then please [request our media pack](#) and ask for details of our Content Licencing Service.

Readers Comments...



Be the first to comment on this article

Also of interest...

Related Guides:

- [A guide to UK tax codes](#)
- [Joining a contractor umbrella scheme](#)
- [Is it worth contractors buying a company car?](#)
- [Moving from a limited company to an umbrella: reasons and practicalities.](#)
- [Dividends and contracting: calculation, payment and taxation](#)

Related Calculators:

- [Limited Company versus Umbrella Calculator](#)
- [Contractor Umbrella Calculator](#)

Related Internet Links:

- [HMRC](#)
- [Parasol](#)



ABCe verified website - last audit confirmed **130,682 monthly unique visitors**

© Copyright 2011 Byte-Vision Limited UK. All rights reserved [Copyright notice](#)