Comparing taxes: contractors versus employees

Compared with employees, contractors receive relatively modest tax advantages, especially considering the employment rights and security that they forego in order to work flexibly.

Yet, fuelled by Government rhetoric about 'levelling the playing field', the press often reports on the supposedly more favourable tax treatment that contractors enjoy, as well as perceived widespread tax avoidance amongst contingent workers.

The truth is that the tax advantages experienced by contractors are grossly exaggerated. In particular, the April 2016 dividend tax changes have helped to significantly narrow the comparative tax take from contractors and employees.

How tax from contracting and employment income compares

Let's consider this by taking a look at a contractor and an employee. Both are under starter's orders and ready to race to £100,000 of earnings, though there are some key markers that both will encounter along the way:

- £8,424 – the annual threshold before employee's National Insurance (NI) is due on salaries
- £11,850 – the amount of the tax-free personal allowance
- £13,850 – the personal allowance plus the dividend tax allowance (£2,000)
- £46,350 – end of the 20% basic rate tax band and beginning of the 40% higher rate.

Let's see how the contractor and the employee compare.

£0-£8,424: the contractor and employee are neck and neck

The employee pays no Pay As You Earn (PAYE) income tax and no employee's NI. The same goes for the contractor, whose company pays them a salary of £8,424.

£8,424-£11,850: the contractor pays more to HMRC

The employee is now paying employee's NI at 12% on earnings within this threshold, amounting to £411.

At this point, the contractor's company has paid corporation tax at 19% on earnings, amounting to £650. The dividends on the money distributed does not yet attract income tax, as it is still below the personal tax threshold.

£11,850-£13,850: the contractor edges into the lead

The employee is now paying basic rate tax at 20%, and employee's NI at 12%, resulting in a marginal tax rate of 32%. £639 is due on these earnings, taking the employee's total tax bill at this point to £1,050.

The contractor's company is still paying corporation tax at 19%, but the first £2,000 of dividends are subject to the dividend allowance and so attract no further tax. As a result, the contractor pays £380 in tax within this threshold, meaning they have paid £1,030 in tax - just £20 less than the employee.

£13,851-£46,350: the employee pays more to HMRC

On this long straight leading up to the basic rate limit, the employee continues to pay tax at a marginal rate of 32%. This amounts to £10,399, taking their total tax liability at this point to £11,450.

The contractor's company continues to pay corporation tax at 19% on everything. However, dividends are now taxed at 7.5%, meaning the contractor's effective marginal rate of tax is now 25.1%. As a result, the contractor pays £8,149 in tax on the long straight, meaning by the time they reach the higher rate threshold, they have paid £9,180 in total taxes.

Though at this point the contractor has paid £2,270 less tax than the employee, the costs of running a company – including accountancy fees – will have wiped out most of these gains. Effectively, the race is still a far closer run than it appears.

£46,351-£46,384: a tiny saving for the contractor

In this very short stretch, the employee pays tax at a marginal rate of 52%, made up of higher rate tax at 40% and employee's NI at 12%. The tax paid is £17.

The contractor continues to pay corporation tax at 19%, while the remaining dividend is now taxed at 32.5%, costing them £15 in tax.

£46,384-£100,000: the employee catches up with the contractor

The employee now enjoys an employee's NI reduction to 2%, though they are still paying income tax at the 40% higher rate. As a result, they experience a marginal tax rate of 42% all the way to £100,000.

The contractor's dividend distributions are now taxed at 32.5%. Combining that with corporation tax at 19% creates an effective marginal tax rate of 45.3% – 3.1% higher than that of the employee. This means that, for every £10,000 earned up until the £100,000 threshold, the employee pays £332 less in tax than the contractor.

Once the earnings exceed £100,000, the advantage that the contractor had built earlier in the race has completely disappeared. For any earnings past this point, the contractor will pay more in tax than the employee, both in terms of marginal tax rates and total amount paid. The comparative tables below illustrate this.

How contractors and employees compare: the tax tables

The tables below are the effective marginal tax rates for both employees and contractors, taking into account employees NI, income tax (PAYE), corporation taxes, and income taxes on dividends.

The lower limit for employees NI at 12% is £8,424 per year and the upper limit is £46,384, before it decreases to 2%. The personal allowance is £11,850. Then the basic rate band ends at £46,350.

These tables demonstrate that contractors make some moderate tax savings whilst basic rate tax is applied, but that once higher rate tax kicks in the contractor is paying higher rates of tax. And once contractors start earning over £100,000 per year they end up paying more tax than employees.

Employees tax rates:

From	To	Income tax	Employees NI	Effective rate
0	8424	0%	0%	0%
8425	11,850	0%	12%	12%
11,851	13,850	20%	12%	32%

13,851	46350	20%	12%	32%
46351	46384	40%	12%	52%
46385	150000	40%	2%	42%

Limited company contractors tax rates:

From	To	Corporation tax	Dividends	Effective rate
0	8424	0%	0.00%	0.0%
8425	11850	19%	0.00%	19.0%
11851	13850	19%	0.00%	19.0%
13851	46350	19%	7.50%	25.1%
46351	46384	19%	32.50%	45.3%
46385	150000	19%	32.50%	45.3%

Note: To calculate the effective rate for the contractor start with say £100, take off corporation tax at 19%, leaving £81, and then apply the dividend tax rate to the £81. The total amount of taxes deducted is the effective rate.

Why IR35 isn't the answer to HMRC's prayers

Though the difference in tax take from employees and contractors is negligible, contractors have long attracted unwanted attention from HMRC in the form of IR35. However, curiously, the elephant in the room is employer's NI.

Employer's NI is paid at a rate of 13.8% by the employer ***on top*** of the salary paid to an employee. Firms do not pay employer's NI when they hire contractors, which has resulted in what HMRC perceives to be a shortfall in contributions to the Exchequer.

The public sector IR35 reforms were introduced in a bid to claw back this money, by attempting to make hirers pay employer's NI on top of the money paid to contractors, whose earnings would be treated as employment income.

However, the reforms have proved to be a failure. Non-compliance has been rife, with numerous agencies and hirers choosing to pay their employment costs out of the contractors' earnings. This is potentially unlawful.

When we consider that many hirers are also avoiding apprenticeship levy contributions and withholding monies for holiday pay, which otherwise would be paid at 12.07%, this can result in an effective basic rate of tax of 52% and an effective higher rate of 62%. This has driven many, who are desperate and have no alternative, to consider aggressive tax avoidance schemes, which HMRC is struggling to shut down.

Many contractors have fled the public sector entirely, and others, are now leaving the UK for opportunities elsewhere. This is a particular problem in the healthcare sector, and is placing the NHS under considerable pressure.

Elsewhere, contractors working on key projects have received rate rises in the region of 30% to avoid them leaving, meaning the public sector is now paying far more to retain key skills.

So, what needs to happen?

Firms who hire individuals caught by IR35 should pay their employer's NI, and HMRC needs to clarify very quickly who should be paying these taxes.

The NHS needs to find funds to pay its employer's NI bill. This could prove a largely cash-neutral arrangement for Government, given the fact that the funds raised by tax circulates back to the public sector anyway. Ironically, the Chancellor could announce hundreds of millions in extra funding for NHS locums, and then claw back the entire amount in one go.

Why contractors pay more tax than employees

In truth, comparing the tax take from a contractor and an employee earning the same amount creates an inaccurate representation, because contractors typically charge considerably more than employees are paid.

This is due to free market forces which dictate rates of pay. Firms are willing to pay more for short-term access to essential skills, and contractors are entitled to accept nothing less, especially given that they are already surrendering employment rights and stability.

Contractors who earn significantly more than their permanent counterparts inevitably generate a considerable amount more in tax, which is, of course, more beneficial for the Treasury. Meanwhile, flexible working continues to stimulate and benefit the economy.

Unfortunately, HMRC and Government don't see things this way, and if MPs continue to overlook this, it will destroy the advantage that UK Plc has held over many other countries that don't promote flexible working.

Markets are changing, and there is a move towards more flexible working. But the more HMRC tries to swim against the tide, the more it will ruin the UK's chances of a prospering economy.

But you can help.

IR35 campaign – what contractors must do now!

Though the public sector IR35 reforms have proved disastrous, HMRC seems intent on extending the rules into the private sector. This would mean considerable damage to flexible working as we know it, which is why we need you to get behind our IR35 campaign to prevent these changes.

To get involved, join ContractorCalculator free today, and follow or connect with our CEO Dave Chaplin on LinkedIn for updates. Dave is fully embroiled in the campaign against the IR35 reforms, and his profile provides many useful updates for contractors affected by the changes.

The Government may have announced a consultation into the proposed changes, but it is not released yet, and HMRC is under significant pressure to reconsider, given the widespread evidence demonstrating the issues arising from the public sector reforms and its Check Employment Status for Tax (CEST) tool.

There is plenty that you can do to help protect the future of flexible working in the UK. We need as many contractors as possible to write to their MPs and alert them to the damage that the proposed changes will cause.

Avoid winding up in a contract that is clearly caught by IR35 by securing a comprehensive and free IR35 assessment from IR35Testing.co.uk.

If a private sector rollout does go ahead, you need to make sure that your client is well informed. We will soon be distributing material which our members can use to educate their clients and help to ensure that they are given a fair IR35 assessment. Please sign up to receive your copies.

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