Contracting mindset tips: contractors are not paid the same as employees

As a **limited company contractor** you manage your own tax affairs and, unlike employees, pay corporation tax, income tax and National Insurance Contributions (NICs) yourself. That means you can't directly compare **hourly or daily contract rates** with employee salaries.

Do you know how much it costs to employ someone?

Say you had your own business and decided to hire an employee on a salary of £50,000 a year. Do you know how much it would actually cost your company to employ this person?

If you're a permanent employee earning a gross salary of £52,000 a year, or £1,000 a week, do you know how you would calculate what contracting day rate you need to secure the equivalent take-home pay after taxes are paid?

As a limited company contractor, if you invoiced your client for the same amount of money in fees as your gross annual salary as a permanent employee, would you expect to pay a greater or lesser amount of tax?

Contractors factor tax, holidays and other 'employment costs' into day rates

The cost to your ex-employer of hiring you was much more than the just the cost of your salary. For starters, they had to pay employers National Insurance Contributions (NICs). If you were earning a £50,000 annual salary, this added an extra cost of £5,667 for your employer. Then they also had to pay you when you didn't work (holidays or sickness), plus other benefits like insurances, pension, and so on. The overall cost to hire you was much more than your annual salary.

What this means practically is that you cannot simply translate an annual salary to a daily contract rate by dividing by 52 weeks to get a weekly rate, and then dividing by 5 to get a daily rate. That's because out of your revenue your limited company has to pay corporation tax, income tax, NICs, and most importantly you have to take into account time off for holiday and possible sickness, money towards a pension and the expenses of running your company.

However, by working through your own **limited company**, you are able to pay yourself very tax efficiently, with a **low salary** and high **dividends**. The effect is that you pay less tax than an employee, which is your reward for taking the risk of being in business, rather than being employed.

Contractors are not employees and get paid differently

To work out your day rate, start by working backwards from your desired net income – for many contractors, this is probably close to or more than what they paid after taxes when they were employed. Then add in taxes, allowances for time off, pensions and expenses, and you will reach your desired minimum day rate. You can use one of the interactive **online financial calculators** on this website to calculate your desired income and day rate.

After taking advice from your accountant or contracting advisor, you can minimise employment costs by paying yourself a small salary and the balance in dividends. In that way, you reduce employer's NICs and may claim all the expenses you are entitled to, so you can offset them against your company's corporation tax. You can also invest in a pension, paid directly from your company, to further reduce your corporation tax liability and to provide for your retirement.

Don't forget to factor in direct and indirect taxes, costs of employment, holidays, bank holidays, sickness, pensions and operating expenses when comparing a permanent employee gross salary with contracting fees.

Contractor mindset tip:

Contractors pay for their own tax, benefits and time off, so you can't directly compare employee salaries and contracting rates.

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