Contractors who take long breaks between contracts should be aware of likely pitfalls

Contractors can take long breaks away from their contracting for many reasons – everything from taking an extended holiday, through taking time off to care for a family member, to returning to permanent work for a spell when contracts are thin on the ground. This freedom to take time out is viewed as one of the perks of the riskier contracting lifestyle, but it can have its pitfalls.

Taking breaks for a few weeks holiday won't cause any problems but, according to **James Abbott** of contractor accountant **Abbott Moore LLP**, limited company contractors who spend many months or even years away from their contracting risk attracting unwelcome attention from **HMRC**.

"**Limited company contractors** can continue to draw a salary and claim **valid expenses** for as long as they can justify that these costs are in the pursuit of trade," explains Abbott. "But as soon as it's clear a contractor is taking more than just a short break from trading, company costs can no longer receive corporation tax deductions. And, if the contractor has built up assets in their company, the business runs the risk of becoming a **Close Investment Company**, which would result in a higher rate of corporation tax on any profits.

How long is long?

As Abbott explains, each contractor's individual circumstances will dictate how they manage their tax affairs, so there is no definitive point at which a contractor on a break should stop paying themselves. But for breaks of a few months, many contractors could justify some ongoing salary and expenses.

He says: "If a contractor decided to spend six months trekking in the African bush, they might be able to justify paying the basic tax-free allowance as salary for keeping the business ticking over, but would have difficulty convincing HMRC that their limited company should continue to pay for a large use of home charge."

However, three months spent on a series of training courses and short breaks in-between a contract, with ongoing monitoring of emails and calls to agents, demonstrates that the contractor continues to incur costs in the pursuit of trade and is intent on picking up the business after the lull.

Dividends limited only by profits

"A contractor can continue to pay themselves potentially unlimited **dividends** out of the retained profits and cash left in the business, as long as there is the profit to do so," continues Abbott.

"Just because a limited company has no income, it does not mean that it is automatically classed as non-trading. Declaring a business as non-trading is a judgement call that also relies on intent, so if a contractor is intent on resuming trade, for example after a nine-month career break on maternity leave, then the company may retain its trading status." However, it would still be difficult to justify significant expenses during this period.

Warning signs for HMRC

According to Abbott, contractors will fall foul of HMRC if they forget that all business expenses that are to be off set against corporation tax must be incurred 'wholly and exclusively' for the purposes of trade. "What could happen is that during a routine employer's PAYE inspection or Corporation Tax Enquiry, a tax inspector will spot a period of low trading activity, representing a long break by the contractor," says Abbott.

"Plenty of companies have low levels of trading for quite long periods. However, if there is no corresponding drop in business expenses during the same period, the inspector is likely to ask why. The contractor could have to pay additional corporation tax, which will have been underpaid because of the expenses claimed during the contractor's break, not to mention interest on the underpayment and possibly penalties, too."

Long-term commitments

Where the contractor's limited company has made a longer-term commitment, for example to a motor vehicle lease, then Abbott confirms the payments could be justified, although the contractor should speak to their accountant to ensure the lease payments are accounted for correctly. "Other long-term commitments, such as insurances, should always be maintained as long as the company is 'open', even if the contractor is away," he says.

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> James Abbott, Abbott Moore LLP

James Abbott

Owner

Abbott Moore LLP

James Abbott is the owner of Abbott Moore LLP and often speaks on freelancer / contractor tax matters. He has his own growing portfolio of contractor clients.

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Abbott concludes: “Contractors should enjoy the unique benefits that their contracting lifestyle brings by taking career breaks for reasons that suit their lifestyle. But to stay within the rules, they should ensure they work with their accountant to create and implement a proper tax-planning strategy that allows them to do this.”

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