Financial impact of IR35 on contractors

For contractors looking to maximise their income the financial impact of getting caught by IR35 is significant – they will pay far more tax on their earnings. By understanding what those extra taxes are you can then determine how much you'll be able to save by staying outside IR35.

Let's look at both tax scenarios and then compare some actual income figures. You can compare figures for your own personal contractor earnings using the IR35 Taxes Calculator.

What taxes do contractors pay outside IR35?

Contractors outside IR35 typically use a limited company structure for their payments. They pay themselves a low salary with the rest paid in dividends.

This structure results in the following:

Employers N.I. of 12.8% avoided on all revenue.

Employees N.I. of 11% partially avoided, since upper bracket not reached.

Employees N.I. of 1% completely avoided on all revenue, since upper bracket not reached.

PAYE of 40% completely avoided, since higher rate tax bracket not reached.

Under this structure the contractor will also pay corporation tax of 22% on all profits, after expenditure.

> Contractors caught by IR35 pay significantly more tax

Finally, the contractor pays further taxation on their dividends if their total personal income (salary + dividends) falls within the higher rate bracket. In this case the contractor pays an extra 25% on the amount falling within the higher rate bracket, due to tax credits on dividends.

What taxes do contractors pay inside IR35?

Contractors inside IR35 typically use a contractor umbrella company, since it is cheaper than the limited company structure which provides no real benefits when caught by IR35. If the contractor still uses a limited company the tax calculations are the same.

The 'inside IR35' structure results in the following:

Employers N.I. of 12.% applied to all gross earnings*.

Employees N.I. of 11% paid on all earnings within lower bracket.

Employees N.I. of 1% paid on all earnings within upper bracket.

PAYE of 40% paid on all earnings within higher rate tax bracket.

* Gross Earnings = (Revenue – Expenses) * (1/(1+employers NI rate))

In this scenario all taxes are fully paid. The only way to minimise tax is to take full advantage of any available expenses benefits.

Comparing actual earnings figures for inside and outside IR35

Rate per hour	Change in tax burden	Take home pay per month
£20	Taxes increase 88%	Decreases 24% (£503)
£30	Taxes increase 63%	Decreases 23% (£711)
£40	Taxes increase 44%	Decreases 22% (£863)
£50	Taxes increase 35%	Decreases 21% (£1,015)

As you can see from the figures, the financial impact of IR35 on contractors is significant. Not all is lost, and avoiding IR35 is certainly possible...

Take action – What can contractors do to avoid the finacial impact of IR35

Contract Review: It is **important to take IR35 legal advice** to get your contract reviewed. Engage an IR35 expert before signing any new contract to ensure you have the maximum chance of passing IR35.

Pensions: You can **reduce the pain of IR35 with a contractor pension** by channelling pre taxed income straight into a pension, obtaining up to 50% tax relief. For each £100 invested your net pay reduces by only £50.

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