

Contracting and subcontractors: tax, VAT and employment issues

Contractors who are subcontracting client work to other contractors should be aware that there are potential tax, VAT, employment and legal implications that could leave them out of pocket or even outside the law.

According to **James Abbott**, owner and head of tax at contractor accountant **Abbott Moore LLP**, contractors usually subcontract because they have too much work, want to make a premium by supplying other contractors or just prefer to benefit from work they've found for another contractor. "But," he says, "too often they don't consider the implications.

"Subcontracting can be a good option for a contractor to generate additional income, but, depending on their company circumstances, could actually have the reverse effect, leaving the contractor out of pocket and possibly even in breach of employment laws."

The VAT implications of subcontracting

The first pitfall is value added tax (**VAT**). "A contractor may be earning a contracting income that keeps them just below the VAT registration threshold of £77,000 [tax year 2013/2014]," continues Abbott. "But when they add a second contractor's income, this may drive their income above the threshold and force them to register for VAT."

Another VAT complication is when a contractor's limited company operates the **flat rate VAT scheme**. Abbott explains: "The combined income of the principal contractor and potentially several subcontractors could drive the total turnover of the business plus VAT to over £230,000, which could mean the contractor must de-register from the flat rate scheme."

The final VAT complication could leave a contractor seriously out of pocket. This is because, under the flat rate scheme, the principal contractor cannot claim back the VAT their subcontractor charges on fees and expenses. Nor, in the case of expenses, is it likely that they could recover these costs from the client.

"If the contractor doing the hiring uses the flat rate scheme, they must typically pay HMRC 14.5% of what they charge the client including VAT, but must pay their subcontractor the full 20% VAT," adds Abbott. "That means a subcontractor on a day rate of £375 could end up actually costing their principal contractor 'client' £75 a day!"

Companies under common control and corporation tax

Companies generating profits under £300,000 a year enjoy the small profits rate of 20% corporation tax. However, adding a team of subcontractors could result in a contractor's profits above the £300,000 threshold being taxed at 23%.

A contractor might start a new company to spread the income across more than one company, but companies under common control share the £300,000 small profits allowance: "If the same shareholders control more than one company, then HMRC considers them to be under common control, which means they must share out the £300,000 allowance equally," explains Abbott.

The same rules used also to apply to companies owned by spouses, but the 2011 Budget contained provisions that may allow independent companies owned and managed by each spouse to have their own full small profits rate allowance.

Hire limited company or umbrella contractors, not employees or sole traders

"How a contractor chooses to operate their subcontracting is crucial, as adopting the wrong model can have major implications for taxation and employment rights," says Abbott. "Contractors should always hire subcontractors via a **limited company** or **umbrella company**, I rarely recommend subcontracting to a sole trader or employee."

Any income tax or National Insurance liabilities arising from reclassification of employment status because of **IR35** must be paid by the subcontracted contractor. This is not true for sole traders or employees, where it is the hirer/employer's responsibility. In other words, the contractor doing the subcontracting could be saddled with huge income tax and National Insurance liabilities if they take on a sole trader and HMRC successfully argues that the hiring contractor should have deducted income and National Insurance.

"Contractors who started out subcontracting to earn a quick buck will come unstuck if they start employing workers," says Abbott. "They could end-up paying out for tax, National Insurance and other benefits as required under employment law. Not obeying the legal requirements to offer employment rights could even lead to a contractor breaking the law."

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Other factors: employees' expenses, contracts and the 'hassle factor'

Although there are no rules or restrictions over the charging and re-charging of expenses between two contractor limited companies engaged in

subcontracting, Abbott warns that there are different rules for employees, and these can add further complications to a contractor's payroll.

The contractual relationship should also be considered: "Many subcontracting arrangements start off as two mates helping each other out and there is frequently no written agreement. Putting a proper contract in place is essential. It should be prepared by a professional or based on a tried and tested template, such as those provided by [PCG](#)."

Abbott also challenges the value of some contractors going to the trouble and hassle of subcontracting: "Most contractors are very good at contracting, but spend a huge amount of time managing their subcontracting business for little return. I often suggest that contractors should consider whether they can earn more spending that time doing what they do best – contracting!"



James Abbott

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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.

Abbott Moore LLP are PCG Accredited Accountants and specialise in providing tax advice to freelancers as well as dealing with their year end accounts and tax returns. [Read Full Profile...](#)

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But despite all the pitfalls, there are some real positives. "Subcontracting can support a contractor's 'outside IR35' status, as it is direct evidence that a contractor is exercising their [right to substitution](#). And," Abbott concludes, "if properly run, a subcontracting business can be a profitable sideline for a contractor."

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