PLANNING CONSIDERATIONS FOR IT CONTRACTORS

INITIAL JOBS DATA RELATING ENTIRELY TO THE PERIOD IMMEDIATELY AFTER THE EU REFERENDUM VOTE INDICATES A MARKED INCREASE IN IT ROLES. FIGURES FROM REED SHOW THAT ALMOST 12,000 IT JOBS WERE ADDED TO THE RECRUITER'S WEBSITE IN THE THREE WEEKS FOLLOWING 24 JUNE.

This represents a 14% jump on the same period in 2015 when approximately 10,500 new IT jobs were added to the site, according to figures obtained by Contractor UK*.

We take a look at a few of the planning considerations impacting IT contractors, using a case study.

HARRY

Harry had been employed by an insurance company for twenty years, before he was made redundant in September 2014. Harry's redundancy payment was £50,000, after tax. He's in his mid forties, and is married with two children aged ten and twelve. After six months he was offered work as an IT contractor, with Computing Personnel Ltd, and started 1 April 2015.

As a contractor he had to consider whether to establish his business as a limited company or whether to join the umbrella structure offered by Computing Personnel Ltd.

An umbrella structure lends itself well to someone on short term contracts, as it's very easy to use. The individual would simply enter their timesheet and expense details and wait to be paid. The umbrella will invoice the client, and if necessary, chase up payment. All tax and national insurance (NI) would be deducted before the individual receives their money, so they wouldn't normally have any further tax to pay. However, umbrella structures normally charge a fee to be used.

A limited company structure involves set up costs and more paperwork. However, as Harry intends to work as a contractor for a number of years he decided it would be worthwhile to set up his business as a limited company. He named his company Harry H Ltd.

A limited company is the most tax efficient structure, because of the ability to decide how much to pay yourself, a combination of salary and dividends, effectively avoiding NI.

Recently introduced restrictions on the ability to deduct travel and subsistence expenditure can impact both structures. Nevertheless, Harry can potentially claim a wider range of expenses than allowed under an umbrella scheme, and he gets to keep complete control of his financial affairs meaning he doesn't have to risk his money with any third party administrator. The types of expenses that could be deducted for tax purposes include: travel and subsistence, hardware and software, training, professional subscriptions, business telephone, accountancy fees and so on.

As Harry chose the limited company route he will need to be careful not to fall foul of IR35.

WHAT'S IR35?

It's tax legislation that's aimed at identifying individuals who, in the view of HMRC, are avoiding paying tax and NI by supplying their services to clients via a structure such as their own company, when the individual is acting like and is being treated like an employee of the end client.

Its effect is to severely restrict the tax breaks, ensuring that individuals cannot avoid PAYE by remunerating themselves by dividend. If caught by IR35, the individual is required to deduct PAYE and NI from any of their company's income that they haven't already drawn out as salary. This deemed payment of salary is a special calculation that allows tax relief for certain expenses.

However, since 6 April 2016, the cost of travel from home to and from affected workplaces** is no longer an allowable deduction.

The first things Harry had to do after forming the limited company and opening a business bank account, were to ensure that he had covered himself and his company against potential liabilities, for example by taking out suitable professional indemnity, public liability and employer liability insurance.

Harry's had a number of different contracts, paying £300 per day. He works for 200 days a year, so that's the equivalent of £60,000 a year.

He's been so busy that he hasn't reviewed his financial affairs for some time and now feels that he urgently needs to replace the benefits he was used to having provided by his former employer: cover for death in service and contributions to his pension.

Let's look at these in turn.

COVER FOR DEATH IN SERVICE

His previous employer provided him with a death in service benefit via a group life scheme on a registered pension scheme basis. However, pension legislation applies to registered group life schemes which means that when benefits become payable, they are assessed against the lifetime allowance with the employee's pension funds. A tax charge of up to 55% will apply if the limit is breached, significantly depleting the funds available to the employee's dependants.

The good news for Harry is that he can now set up his own death in service cover, using a type of policy known as 'Relevant Life' that won't impact his lifetime allowance (LTA). Consequently only his pension would be assessable against the LTA in the event of his death, avoiding a tax liability.

The policy would have to be set up by his limited company Harry H Ltd. Employer contributions will be deductible against corporation tax. They are also tax efficient for Harry as the employee, because the employer's contributions aren't treated as benefits in kind, nor are they assessable for employer or employee NI.

A relevant life policy (RLP) provides an alternative way for an employer to set up life cover for its employees which is still tax efficient, but without the possibility of triggering an LTA tax charge.

To be eligible, the life assured must be an employee of the business, including directors taxed on an employment income basis. Employees of LLPs, partnerships and sole traders are also eligible but not the business principals themselves.

How do they work?

- The employer takes out an RLP on the life of an employee.
- The policy is issued from the outset under a relevant life policy trust for the benefit of the employee and their family and other named individual beneficiaries.
- The initial trustee will normally be the employer but other trustees may be appointed.
- Premiums are paid by the employer.
- In the event of a claim the benefits will be payable to the trustees.

An RLP must also meet certain conditions:

- The policy can only pay out on death or upon diagnosis of a terminal illness.
- The policy cannot provide a surrender value.
- The scheme cannot run past the employee's 75 birthday
- It can only pay benefits to an individual or to a charity.
- The main purpose of the policy cannot be tax avoidance.

The further good news for employees like Harry, who run their own company and take low salary and high dividends for tax planning reasons, is that the life cover under an RLP doesn't have to be based on the low salary figure, it can be based on a fixed amount.

However, a single person business structure like Harry's can have implications for the shape of their business protection advice and cover needs, as summarised in the table below:

Limited company

A one-person limited company is a separate legal entity. It's a legal person in the same way as a living individual.
In their capacity as sole shareholder, the individual is the sole owner of the limited company.
In their capacity as sole director, the individual is an employee of the limited company.

Harry H Ltd is a limited company where Harry is the sole shareholding director.
Harry is the sole owner of this business.

Relevant life cover

It is possible to set up relevant life cover for the director of a limited company, as they have employee status.
Note that with relevant life cover the limited company (not the director) would be the applicant for the relevant life policy and the settlor of the relevant life policy trust. The director would be the life assured.

Family protection – other

The sole owner of a business is likely to have significant personal and family protection needs. A family trust can be used where relevant in respect of any personal term or whole of life insurance cover.
For example, Harry should consider what happens if his wife dies or becomes seriously ill. As a contractor, taking time off work for school holidays, doctors/dentists and so on is going to come straight out of his daily rate – he's given up on paid holidays. So reviewing her life assurance cover and setting up an ordinary level term assurance policy in trust while the children are likely to be dependant might be a priority.

Business trust

A business trust is not suitable as there are no shareholder or partnership protection needs because there are no co-owners in this business structure.
If Harry H Ltd operates an overdraft or has other borrowing, the lender might require it to set up life cover on Harry's life to ensure the lending could be repaid in the event of his death. If so, the policy should be set up on a life of another basis, with Harry H Ltd as the applicant and Harry as the life assured. No trust is required.
The lender provides its own mortgage assignment, which is completed once the policy is in force, and it is the lender which gives notice of its interest in the policy to the provider.

PENSION FUNDING

Harry has already built up £600,000 in a money purchase pension scheme with his previous employer and he wants to continue to build additional pension benefits. He'll have a £40,000 pension annual allowance, provided he keeps his income below the £150,000 threshold at which tapering of the annual allowances kicks in.

Harry is an employee of Harry H Ltd. Any employer contributions from his company Harry H Ltd should benefit from corporation tax relief. Personal contributions can benefit from tax relief up to the greater of £3,600 gross or his relevant UK earnings.

Harry and his accountant worked out how best to remunerate him from his company, and in 2015/2016 he took £8,060 as salary and £34,940 as dividends.

It's important that Harry doesn't take more dividends than is allowed. He mustn't take more than Harry H Ltd's distributable profit. To do this he has to consider how much his company's expenses will be. He can top up his income with further dividends later once he is certain how much distributable profit is available.

The taxation of dividends changed from 2016/2017. Are they still tax efficient for Harry? Can pension funding be more tax efficient?

Dividend tax

The introduction of a tax-free dividend allowance, the removal of the 10% dividend tax credit and an increase in the dividend tax rate can make dividends more expensive.

The dividend allowance exempts the first £5,000 of dividends from income tax, irrespective of what tax band they fall in. The exempted dividends, however, will still use up part of the relevant tax band. The removal of the tax credit means there is now no distinction between net and gross dividends – so all dividends are paid and received gross and it is this amount that must be entered into the self-assessment tax return.

The previous dividend tax rates of 10%, 32.5% and 37.5% have now become 7.5%, 32.5% and 38.1% for basic, higher and additional rate taxpayers. This represents an increase of 7.5% in the effective rate of tax as the previous rates were applied to the grossed up dividend not the actual dividend received.

The previous effective rates of tax were: 0%, 25% and 30.6%. Adding 7.5% to each of these gives you the new rates. It is, therefore, the £5,000 dividend allowance not the new tax rates that results in many taxpayers being better off since 6 April 2016.

Dividends below £5,000 per year will now suffer no tax even though the dividend will be included in the income tax calculation. Dividends of any amount received in previous years could have been taxed at 10%, 32.5% or 37.5%, so the new rules are an improvement for those in receipt of low levels of dividends. If those dividends would previously have been taxed at 10% and covered entirely by the tax credit, then there is no improvement in the tax liability but their position has improved marginally as the dividend now uses up less of their tax band as it is not grossed up.

Higher and additional rate taxpayers can receive moderate levels of dividends and still be better off under the new rules. The point at which the new dividend rules result in more tax will be usually be specific for each client, but a useful guide for higher and additional rate taxpayers with dividends that sit entirely in those tax bands is that the crossover point will be reached at the following dividend levels:

Higher rate taxpayers: £21,667

Additional rate taxpayers: £25,250

An increase in tax is much more likely to apply to those who own their own companies and have decided to pay themselves in dividends rather than salary. If the new dividend tax rules are less favourable they may want to consider paying the maximum employer pension contribution instead of a part (or all) of the dividend. If the new rules are more favourable, then swapping any salary they receive for dividends might appeal more.

Let's look at a comparison between the old rules and the new for Harry.

Harry's company pays him a salary of £8,060, so that he can avoid paying NI, but will still qualify for NI based benefits, and dividends of £34,940. He has no other sources of income. What is his tax liability under the new dividend taxation regime compared with the previous tax year?

The calculation for this year and last year, keeping the income level constant, is:

2015/2016		2016/2017	
Salary	£8,060	Salary	£8,060
Dividends	(£34,940/0.9) £38,822	Dividends	£34,940
Total income	**£46,882**	**Total income**	**£43,000**
Full personal allowance available:	£10,600	Full personal allowance available:	£11,000

Earned Income:		**Dividends:**		**Earned Income:**		**Dividends:**	
Salary	£8,060	Dividend	£38,822	Salary	£8,060	Dividend	£34,940
Deduct PA	(£8,060)	Deduct PA	(£2,540)	Deduct PA	(£8,060)	Deduct PA	(£2,940)
Taxable	**£0**	**Taxable**	**£36,282**	**Taxable**	**£0**	Divi allowance	(£5,000)
		Basic rate tax:				**Taxable**	**£27,000**
		£31,785 x 10% = £3,179				Basic rate tax:	
		Higher rate tax:				£27,000 x 7.5% = £2,025	
		£4,497 x 32.5% = £1,461				**Tax due**	**£2,025**
		Total tax	**£4,640**				
		Less tax credit	(£3,628)				
		Tax due	**£1,012**				

The pension solution

The increased tax bill should motivate Harry to consider the most tax-efficient way to remunerate himself. The clearest way to do this is to consider the total cost to the company of his remuneration package and the net benefit to himself, which can be expressed through an 'extraction rate'.

The total cost to the company of Harry's current package is £51,735, which is made up of £8,060 salary and the £34,940 dividend grossed up at the rate of 20% to include the corporation tax due against the dividend.

Switching to 100% salary wouldn't improve his position because employer NI of £5,290: ([£51,735 - £8,112] x 13.8%/113.8%) reduces the amount that can be distributed as salary whilst keeping the overall cost to the company constant. The personal tax bill – made up of income tax and employee NI – would be £12,040. This results in a total income tax and NI bill of £17,330, leaving £34,405 net, which is significantly less in pure tax terms than the net amount available through Harry's dividend-based remuneration package.

		Salary	Dividend
Contract		£60,000	£60,000
Expenses		(£8,265)	(£8,265)
		£51,735	£51,735
Salary		£46,445	£8,060
Employer NI @ 13.8% on £46,445 - £8,112 = £38,333		£5,290	
Income tax @ 20% on £32,000	£6,400		
Income tax @ 40% on £3,445	£1,378		
		(£7,778)	
Employee NI @ 12% on £34,940	£4,193		
Employee NI @ 2% on £3,445	£69		
		(£4,262)	
Net income / Profit		£34,405	£43,675
Corporation tax @ 20% on £43,675			(£8,735)
Distributable profit			£34,940
Dividend			£34,940
Income tax on dividend			(£2,025)
Net income		**£34,405**	**£40,975**

Switching to employer pension contributions of £51,735 – assuming at least £11,735 of carry forward is available – will not result in any immediate tax, but the potential tax to extract the funds from the pension has to be incorporated for a fair comparison. In other words, the potential future tax in retirement is brought forward to the present day and notionally applied to the contribution.

Assuming basic rate tax in retirement the potential tax charge is £7,760: 20% x (£51,735 x 75%). This would leave Harry with £43,975 net, which is more than the net amount available under the current strategy, but the trade-off is a potentially higher than expected tax bill (if income in retirement is higher than anticipated) and no immediate access to funds due to his age.

As Harry has an immediate need for income, then such a high employer contribution may not be suitable. However if he could supplement his income from his remaining redundancy money then a large employer contribution would be the most tax efficient solution for Harry. And as he becomes more experienced and his contract earnings rise he will be able to increase employer contributions year on year. He should consider paying as much in employer pension contributions as possible for retirement planning purposes, always being mindful of the lifetime allowance of course.

Otherwise, Harry is in a position where he potentially has the best remuneration strategy from a tax perspective, even though his position has worsened because of the new rates. In which case, he should continue to receive the small amount of salary and the dividends and suffer the slight increase in income tax.

The best outcome will be less clear cut for individuals with higher levels of income.

(This example is simplified slightly as in reality certain adjustments have to be made to the profit when calculating corporation tax.)

The Scottish Widows salary dividend pension calculator can be accessed from the Adviser website under
www.scottishwidows.co.uk/extranet/tools

IT contractors have quite particular support needs and a potential boom in this industry could lead to a big increase in opportunities to provide good quality advice, for anyone who is willing to specialise in this area.

* Source: www.contractoruk.com Job News & Guides Jul 22, 2016

**Normally, tax relief is available for travel and subsistence expenses for travel to and from a worker's home to a temporary workplace, but not for ordinary commuting, eg from home to a permanent workplace. From 6 April 2016, each assignment for a worker who is caught by IR35, or who is otherwise under the supervision, direction or control of the client, is considered to be a separate employment, ie a permanent workplace.

Every care has been taken to ensure that this information is correct and in accordance with our understanding of the law and HM Revenue & Customs practice, which may change. However, independent confirmation should be obtained before acting or refraining from acting in reliance upon the information given.

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