

GUIDE TO FREELANCING

for freelance consultants and contractors

Edition 5.0

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The purpose of this guide is to provide a useful source of information to new and established freelancers and small business owners, offering a wealth of helpful advice about running and nurturing a successful business .

With a growing number of people looking for alternative ways of working outside the corporate umbrella, and few of them knowing where to go for information and advice, PCG clearly has an important role to play.



PCG members are a diverse group of freelance consultants and contractors who represent a wide range of disciplines and market sectors throughout the UK.

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SECTION ONE: INTRODUCTION

1. Introduction

This guide has been written by freelancers for freelancers and is aimed at anyone thinking about or interested in freelancing. It attempts to explain the procedures you will have to go through to set up a freelancing business, how to go about obtaining work and, finally, how to maintain a viable business. Links are given to sites and documents containing fuller information on certain topics.

The Professional Contractors Group (PCG) would like to thank Abbey Tax, Wealth Matters and Contractor Financials for reviewing this document and recommending refinements and amendments where appropriate, in some cases to reflect changes in legislation since the previous edition was published in August 2006.

1.1 Disclaimer

This document is for general guidance only and is not a substitute for professional advice where specific circumstances can be considered. Whilst every effort has been made to ensure the information contained within this publication is correct, PCG does not accept any liability for any errors or omissions contained herein or any action taken or not taken in reliance upon the information provided in these articles.

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It is strongly recommended that you consult the appropriate legal and accounting professionals for advice about your specific circumstances before making important decisions.

1.2 Updates

This Guide to Freelancing is updated from time to time, and you should visit the PCG website www.pcg.org.uk regularly to make sure that you have the latest version, or, better still, join PCG as member.

Whilst every effort is made to ensure that the information herein is correct at the time of publication, it is inevitable that certain information may be superseded very quickly.

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SECTION TWO: SETTING UP YOUR BUSINESS

2. Choosing the right structure for you

Whichever way you choose to operate it is important to appreciate that running a business is not simply working in a different way.

Once you set up a business you enter a whole new realm of laws and regulations. It is essential that you begin to think and act as a business, not just as a worker who is operating through a business set up for convenience. For example, by law, if you form a limited company you will need a company nameplate at your registered office, although we have not found any instance of this rule being enforced.

You should have letterheads, business cards, a business name and identity. You need to start thinking in terms of the business, not you as an individual. You should think about having a business telephone line installed separate from your private line. If you already possess a desk, computers, fax machine, photocopier, etc., you should consider "selling" these to your business, initially recording the value as a personal loan to the business from you, in the form of set-up expenses. You may also consider putting some of your own personal money into the business as a loan from you to the business. These can be repaid later as the business begins to generate income. It is worth investing a small amount in a good book on Company Law for the business person.

At the outset, you need to decide which form of business is most appropriate for you, and the aim of this section is to give you some information about the various options available to you, to assist you in making a choice about which is most suitable for your circumstances. These are some of the vehicles through which you can operate:

- limited company
- limited liability partnership (LLP)
- partnership
- sole trader
- umbrella company
- PAYE agency

3. Forming a limited company

3.1 Do I need a limited company?

Technically, you do not actually need to set up a limited company to be a freelancer. In law, you can work as a self-employed sole trader or partner, as an employee of an "umbrella" company or as a PAYE employee to an agent. Throughout this document we shall use the generic term "freelancer" to cover all self-employed workers, including consultants, contractors, interim managers and others.

You may wonder why you cannot be just self-employed.

- a) You can work as a self-employed sole trader if your clients and agents are prepared to engage you on that basis. However, most are reluctant because if your tax status is challenged then it is the client that becomes liable for any additional tax and NIC due. Furthermore, the Income Tax (Earnings and Pensions) Act 2003 Section 44 effectively prevents individuals from being self-employed where an agency is involved, as it obliges the agency to treat the individual as if they were an employee by deducting PAYE and NI from the payments due. Important note: One cannot determine one's own status nor do so by agreement with the client; status is determined by the nature of the engagement i.e. contractual terms and working practices.

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- b) A limited company also offers the owners (i.e. the shareholders) protection against liability for the company's debts. So, if the company were to become insolvent, as a shareholder, you would lose only the value of your shares. As a director you would not be liable for the company debts either, unless it were proved that you had acted fraudulently or improperly under company law. Also, HM Revenue & Customs (HMRC) is likely to pursue directors for any outstanding tax liabilities, especially those in respect of PAYE deductions from salaries paid to directors (see Regulation 42 Determination).

There is no reason why you cannot operate as self-employed or within a partnership other than that you will be restricted to finding clients directly. An alternative form of company was introduced in April 2001, that of a limited liability partnership (LLP), details of which are included within this document.

3.2 How do I set up a limited company?

The quickest and easiest way to set up a limited company is to go to an accountant or company formation bureau and buy an "off-the-shelf" company. The name and the Articles of Association of this company can be very easily modified to your requirements.

An off-the-shelf company usually costs between £100 and £150, although some accountants will set one up for you for free. You will need to notify any changes to the company name, directors, company secretary and the Registered Office of the company to the Registrars at Companies House on the correct forms. You can find out more about this in the guidance booklets available via the Companies House website www.companieshouse.gov.uk.

Alternatively, incorporate the company yourself. This is actually quite straightforward and can be quite a bit cheaper, around £20 or £80 for a same-day service, than using a third party formation service. Guidance is, once again, available from Companies House.

PCG can provide assistance via PCG OneStop www.pcgonestop.org.uk. PCG OneStop enables a contractor to set up a limited company, apply for accountancy support, have their contract reviewed and obtain professional indemnity insurance with the resources to make sure everything complies with the law and the tax authorities.

3.3 What are the legal requirements for limited companies?

A limited company must have at least one director and a registered office, and must have "Limited" or "Ltd" after its name. It must currently also have a company secretary, but this requirement will be removed as of April 6th 2008, under the Companies Act 2006. The company secretary can also be a director but a sole director cannot be the company secretary.

Many freelancers choose their spouse or partner to act as company secretary but your accountant may be prepared to undertake the task. The company secretary's job is to ensure that the company is run according to company law, but this responsibility is shared with the directors.

Ownership in terms of the split of shares in the company is up to you but, normally, 100 per cent of the shares would be issued to you as managing director. Alternatively, many freelancers split the shares with their spouses. In the latter case, be prepared to defend the split of interest in the company should HMRC ever question it. In general, it is considered best to make the split when the company is first formed.

The registered office is where the company resides for official purposes. This could be your accountant's office, your own office premises or your home office. In case of a home office, do check the terms of any lease or mortgage agreement to make sure there are no restrictions regarding commercial operations.

The registered office must be within the jurisdiction in which the company was incorporated. To put it simply, a company formed in Scotland must have a registered office in Scotland, a company formed in England or Wales must have its registered office in England or Wales. Legally, a plaque or sign must be displayed outside the building to show that this is the company registered office,

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although PCG does not know of any freelancers who have been prosecuted or investigated for failing to comply.

A limited company must file annual accounts with Companies House and also a Corporation Tax return to HMRC. The limited company must also complete an annual return to Companies House. This confirms who owns and who runs the company.

Finally, any company with an annual turnover in excess of £64,000 from April 2007 must register for VAT. More information on the requirement to register is given in the VAT section.

3.4 What does a director do?

The post of director is not easy to define in a few words. Basically, the directors must make sure the company is run properly, according to the law and in the interests of the shareholders. Companies House produces a leaflet (GBA1) explaining the basics about being a director or secretary of a company. There are also many books available that explain the legal requirements of company officers.

The directors and company secretary are legally responsible for ensuring that the limited company meets these obligations and is run according to the Companies Act - the statute that governs the running of limited companies.

3.5 Will I be employed by my company?

A director of a limited company is not strictly an employee of that company unless he/she has a contract of employment. Many freelancers do indeed draw up such a contract. This would specify the expected duties of that individual and the compensation they would enjoy, such as salary, holiday entitlement and so forth. The existence of such a contract *may* be a pointer to the director's work for the company being indicative of non-employment with client companies for IR35 purposes. However, bear in mind that 'employment' leads to such responsibilities as the provision of the minimum wage and other statutory benefits.

If you wish to set up formal contracts of employment between yourself (and other directors) and your company, it is advisable to get these drawn up by an employment specialist. Some have pre-created standard contracts that you can then tailor to your specific needs.

3.6 What can a limited company do?

A limited company is actually a distinct legal entity in its own right. You are not the same as the "company"; the law sees the limited company as a separate "person". It has rights and responsibilities. A limited company can own property or equipment, such as computers. The company may have a business account with a supplier, can have its own bank accounts and can hold shares in other companies.

3.7 Useful links and resources

Companies House Directors and Secretaries Guide:

www.companieshouse.gov.uk/about/gbhtml/gba1.shtml

Companies House guidance booklets: www.companieshouse.gov.uk/about/guidance.shtml

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4. Limited Liability Partnerships

4.1 What is a Limited Liability Partnership (LLP)?

An LLP is an alternative corporate business vehicle, introduced on 6 April 2001, which gives the benefits of limited liability but allows its members the flexibility of organising their internal structure as a traditional partnership.

An LLP is different from a traditional partnership in that it is a legal person separate from its members. In many ways it is a partnership in name only. It has “members” rather than partners and must be formally incorporated to exist. Because an LLP is a legal person it is subject to some parts of the Companies Act 1985.

4.2 Why would I want to set up an LLP?

An LLP provides more flexibility than a traditional partnership. Because it exists independently of the members that formed it, it has the legal capacity to do everything that a person or company could do, such as opening bank accounts, entering into contracts and owning property.

It is also easier to join or leave an LLP than to join or leave a partnership. If a partner leaves a partnership, the partnership will automatically be dissolved unless there is a partnership agreement, which provides for it to continue between the remaining partners. Members of an LLP can join and leave at any time (subject to any agreement between them which provides otherwise) without the LLP being dissolved.

When business owners wanted to limit their personal liability in the past, they normally set up companies, and any profits made by those companies would have been subject to corporation tax. Dividends paid by the companies could then be taken as income of the shareholders. LLPs are taxed quite differently in that the profits are treated as the personal income of the members as if they had run their business as a partnership.

An LLP has to produce and publish financial accounts with a similar level of detail to a similar sized limited company and submit accounts and an annual return to the Registrar of Companies each year. This publication requirement is far more demanding than the position for normal partnerships and specific accounting rules may lead to different profits from those of a normal partnership.

4.3 How do I set up an LLP?

An LLP is set up by a legal incorporation process which involves sending certain documents to the Registrar of Companies and a fee of £20 (or £50 for same day registration). Although it is not legally necessary, every LLP should have a thorough and comprehensive members agreement (currently known as a partnership agreement) in place and needs to have taken legal or professional advice about the issues that should be covered by this agreement.

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4.4 What are the legal requirements for LLPs?

Any new or existing firm of two or more persons is able to incorporate as an LLP in England, Scotland or Wales. It is not possible to convert a company to an LLP or vice versa. LLPs are not available to charities, as there must be a view to profit.

LLPs are similar to companies in the respect that they are required to provide financial information equivalent to that of companies, including the filing of annual accounts. They must also notify any changes to the LLP membership, members' names and addresses, and the registered office.

At least two members of the LLP must be "designated members" who perform duties a little like those of a company secretary. In addition, they may perform duties such as signing off the LLP's accounts.

4.5 What do members do?

The designated members, who have a similar responsibility to a director and secretary of a limited company, together with the other members, control the business. They provide the capital for the business, and LLPs are similar to partnerships and sole traders in this respect.

Incomes derived by the members are more similar to those derived within a partnership than to dividends paid by companies.

4.6 How are members taxed?

Provided an LLP carries on a trade or a profession and is not simply an investment vehicle, it is tax transparent - that is, the LLP itself is not taxed on its income or capital gains at all. Instead the members are taxed on their respective shares of the LLP's profits and gains, just as partners in a partnership are taxed.

This means that the LLP may be more tax efficient than a limited company. This is because ordinarily a limited company is taxed on its income and capital gains and the company's shareholders are taxed on distributions from the company to them, giving rise to potential double taxation.

4.7 Will I be employed by the LLP?

As a member of an LLP, you are self-employed and must register with the HMRC within three months; otherwise you may be liable to a penalty of £100. You can register by calling the helpline for the newly self-employed on 08459 154 515 (open from 08.00 to 20.00 Monday to Friday, and 08.00 to 16.00 Saturday and Sunday), or by completing form CWF1 'Becoming self-employed and registering for Class 2 National Insurance contributions and/or tax'. Alternatively you can write to the HMRC National Insurance Contributions Office, Self Employment Services, Customer Accounts Section, Benton Park Road, Newcastle NE98 1ZZ.

Members of the LLP take remuneration in the form of drawings, which have no effect on the profits of the LLP declared for income tax purposes; in other words, drawings cannot be deducted from the profit figure to arrive at taxable profits. These drawings are not subject to PAYE and do not need to be processed through a payroll system.

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4.8 Who can form an LLP?

Any person, meaning any natural or legal person, can form an LLP. However, the LLP Act was brought into force mainly with a view to allowing partnerships, such as accountants and solicitors, to incorporate as LLPs. Professional partnerships today tend to be very large, and the partners do not have the close relationships on which traditional partnership law is based. The LLP legislation aims to address those issues by allowing for limited liability whilst keeping a structure similar to that of a partnership.

4.9 Can I incorporate an LLP if I already run a traditional partnership?

Yes. However, the LLP will have limited liability only from the date of incorporation. This means that any earlier liabilities of the partnership will be unlimited. In addition, you will need to consider your tax position. There should be no problem if the whole of the partnership business is transferred to the LLP. However, if only part of the business is transferred the tax legislation on de-mergers and cessation of business will apply.

4.10 What can an LLP not be used for?

HMRC has indicated that it will take a dim view of any attempts to use the LLP as a tax avoidance vehicle. The Finance Act 2001 contains provisions to prevent tax loss through investment and property investment LLPs. The exemptions for income and capital gains will not apply to pension funds, pension business and life assurance companies, or to friendly societies whose income and gains are received in the friendly society's capacity as a member of a property investment LLP.

4.11 Do I need any formal documents?

No formal written agreement is necessary between the members, but it is a good idea to have an agreement setting out the rights and obligations of each member. If there is no formal written agreement the LLP will be governed by default provisions set out in the Limited Liability Partnership Regulations 2001.

4.12 What liability might members of an LLP have if something goes wrong?

Given that LLPs are relatively new, there are no decisions yet by the courts where something has gone wrong. This is therefore a hard question to answer but it looks as if the following describes the position as most people understand it at present:

- 4.12.1 If, for example, a member of an LLP were to give bad advice to a client and the client suffered a loss as a result, the client may be able to take the LLP to court and be awarded appropriate compensation
- 4.12.2 It is possible that the member who actually gave the advice may also be required by a court to pay compensation to the client
- 4.12.3 It is however probable that any other members who were not directly involved in the advice will not have any personal liability. In a normal partnership it is quite possible that they would have had a personal liability.

It will still be essential for LLPs (and individual members) who might find themselves in this position to have suitable insurance cover.

The other area that needs to be considered is to do with what the law calls unlawful or insolvent trading. In just the same way as company directors can be prosecuted for these offences, members of an LLP can also be prosecuted (and can be disqualified from being a member of an LLP in the future).

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4.13 Advantages

The most obvious advantage of an LLP over a partnership is clearly the limitation of the members' liability. For example, an LLP would not be bound by the actions of a member where that member had no authority to act on behalf of the LLP and the person who was dealing with the member either knew this or neither knew nor believed that the member was a member of the LLP.

A traditional partnership would be bound by the partner's actions and the other partners would have to rely on indemnities in their partnership agreement to recover any loss incurred through the actions of the defaulting member.

Like a partnership, an LLP is tax transparent. This means that the members of the LLP are charged to tax in exactly the same way as the partners in a partnership, therefore avoiding expensive National Insurance charges on the profit shares.

An LLP has complete flexibility as to the internal structure which it wishes to adopt: there are no requirements for board or general meetings or decision-making by resolution. An LLP does not have a memorandum or articles of association.

Inheritance Tax business property relief is available to the members.

The transfer of assets from the old partnership to the LLP is free of stamp duty as long as it is completed within 12 months of incorporation.

4.14 Disadvantages

The additional filing requirements may be viewed as a disadvantage. LLPs are required to file certain documents at Companies House, including details of members, their salaries and the LLP's annual accounts. Documents that are filed at Companies House may be viewed by the general public.

Because LLPs are relatively new, there does not yet exist a body of law applicable to them, which means that there is less legal certainty than for limited companies, where a body of law has been developed through the courts over time.

4.15 Useful links and resources

Companies House website: www.companieshouse.gov.uk

Telephone: 0870 333 3636

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5. Differences between incorporated and unincorporated businesses

5.1 Disadvantages of incorporation

5.1.1 High burden of compliance: cost, time, complexity and penalties

A number of returns need to be made, all of which attract penalties that, in general, are significantly heavier than those of an unincorporated business, if they are not filed within a strict time limit. They include:

- Corporation Tax Return
- Accounts
- A separate computation of taxable profits
- Details of loan account transactions
- Form P35 in relation to proprietor's remuneration
- A form P11D (return of taxable benefits and expenses) for each director
- No reporting is needed by the company in respect of dividends but the shareholder needs to include it on their tax return.

The reporting requirements - and penalties for getting it wrong - are far less for an unincorporated business. This can be a very important factor for a small business, particularly a one-man business, where the proprietor is devoting perhaps 40 or 50 hours a week to servicing customers and has neither the time, nor in many cases the ability, to grapple with tax forms and the business does not have the funds to engage someone to do it. All of the reporting requirements for the unincorporated business can be dealt with together after the year end (other than VAT returns) with a significant cost saving. Pay As You Earn (PAYE) for the small unincorporated business can be an additional problem.

5.1.2 Payment of tax on money withdrawn from business (salary or loan) even with trading losses (if the loan is not repaid within nine months of the Company financial year end)

Small businesses are not normally financially sophisticated and often do not have reserves. The proprietor tends simply to draw from the business bank account the money that he needs to live on, rather than starve, irrespective of the legal structure of the business. When a small business makes losses, incorporation therefore creates a double whammy. At the time when the company is desperate for funds to survive, money that the proprietor needs for living expenses must either be taken as earnings and taxed at his marginal rate - with the company getting a tax deduction only if and when it reaches profitability - or left as a loan on a director's loan account, which is charged at 25 per cent under the Income and Corporation Tax Act 1988 S419 if the loan account is overdrawn and not repaid within nine months of the accounting period end. This tax charge will be repaid, however, as and when the overdrawn balance reduces, so that HMRC is only ever holding 25 per cent of the overdrawn balance. With an unincorporated business there is no tax charge at all on such necessary drawings.

Excess drawings do not cause significant problems with an unincorporated business as tax is due on the partners share of the business profits, not the drawings taken from the business. In an incorporated business, Section 419 imposes a higher effective tax rate than on earnings.

5.1.3 Loss on trade cannot be offset against other income

5.1.4 Hard to withdraw capital which has been introduced into a business without tax and/or regulatory issues

5.1.5 Capital Gains Tax (CGT) penalties when selling assets

The company has to pay tax by reference to the increase in value of its goodwill already in existence at or on 1 April 2002, property and other assets, and the shareholder then has to

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pay tax again on the increase in value of its shares (which are now more “valuable” because of the notional gain on sale of the assets).

5.1.6 Early payment of tax and NICs on salary compared to profits

PAYE and employee/er NICs are usually paid monthly, whereas NICs and income tax on profits for sole traders have longer payment periods

5.1.7 Corporate debt and Foreign Exchange rules apply

5.2 Advantages of incorporation

Although the list of advantages for having a company is longer, many of these items apply to only a small number of companies. The disadvantages apply to most.

5.2.1 Limited liability

5.2.2 Corporate vehicle may mean outside loan finance is easier to obtain

5.2.3 Retained profits taxed at a low rate within company

A small company pays corporation tax on retained profits and pays further tax/NICs only when paid out. Thus the company can reinvest in the business more tax-efficiently than the sole trader.

5.2.4 Outside investors can take a share of the company easily

5.2.5 Owner managers can obtain Statutory Sick Pay (SSP) and Statutory Maternity Pay (SMP) and similar benefits

Note: 10 per cent of SMP is paid to small employers, so the owner managed company can claim the cost back from the Government with a 5 per cent margin. As the cost is borne by the company and then recovered, the margin remains within the company. Sole traders cannot claim SMP.

5.2.6 Entitled to R&D tax credits

5.2.7 Spread personal tax on profits by timing of withdrawals

A corporate business which had a two good years followed by a fallow year could pay out the profits as salary/dividends over three years and utilise the business owner’s lower rates of personal tax. In contrast, the sole trader would be taxed in full in the two years. Reliefs become available only if the business is loss-making, when the sole trader regains the advantage of greater flexibility.

5.2.8 Can claim tax relief on amortisation of intangibles e.g. goodwill but only if acquired or created after 1 April 2002

5.2.9 Raise funds through Venture Capital (VC) schemes and Enterprise Investment Schemes (EIS)

5.2.10 Can have occupational pension scheme and NIC relief for pension payments

See PCG’s Guide to Pensions for further information about the increased flexibility available after “A-Day” on 6 April 2006.

5.2.11 Cash available for filing by internet

The number and variety of differences between the self-employed small trader and the corporate business means that changing from one structure to another is not a trivial matter.

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6. Working through a limited company

6.1 Background

Many freelancers have, for some time, tended to run their own limited companies. There are two main reasons for this. Firstly, sections 44-47 ITEPA 2003 (often colloquially referred to as "s134" after an earlier piece of legislation detailing the same provision) oblige agencies to pay workers on a PAYE basis under most circumstances - in practice, most agencies will therefore only pay a fee to a limited company, and not to an unincorporated sole trader.

Secondly, end-users are generally keen not to be deemed the employer of any freelancers working for them. Traditionally, having a limited company in the contractual chain between the end-user and the freelancer was seen as a safeguard against employment claims; there has been at least one court case where an employment relationship was found despite the presence of a limited company, but many end-users still prefer to deal with incorporated freelancers.

In the 2007 Budget the Government introduced measures to remove the tax advantage offered by Managed Service Companies. These measures form part of the 2007 Finance Bill and are effective from 6th April 2007.

In order to appreciate fully the implications of this legislation, we have outlined the position before the legislation came into force. The first three solutions come under the general heading of 'managed services' and two of these are no longer viable options since the introduction of the legislation.

6.2 Managed Service Company (MSC)

Where a contractor was successful in securing an engagement through an agency, but did not have his/her own company, then the chances were that he/she would be directed by the agency to a Managed Service Company Provider (MSCP) or PAYE Umbrella (although these do not count as an MSC) who would undertake a range of services which included the formation, administration and, where appropriate, closure of those companies in order to meet statutory obligations.

The MSCP's services did not end there. The worker would complete a weekly time sheet and submit this to the MSCP who would invoice the agency, collect the worker's fees and deposit these into the MSCP's client account. The MSCP would pay the worker on the basis of a level of salary and dividends agreed with the worker and retain the various amounts needed to meet the PAYE, Corporation Tax and VAT obligations of the worker's company.

Furthermore, it would act as company secretary for the company which would usually include ensuring that the MSC had the appropriate insurances such as Employer's & Public Liability as well as Professional Indemnity. Often the arrangement with insurers - as in the case of MSCP's own fees - would usually be charged only to the managed service company in the weeks where the contractor was undertaking an engagement.

It was possible to operate a fully commercial relationship via this type of structure, outside of IR35, and freelancers would often do so.

6.3 Composite Company

These companies have been used in the Construction Industry as much as they have been in the freelancer market. Each company would have had a small number of individuals within it - the number would depend on their earnings in order to remain within the small companies rate for corporation tax - and each individual's shareholding would have been based on those earnings. It is unlikely that any of the shareholders would have had any contact with the others.

Usually only individuals deemed to be on engagements outside of IR35 would have been put into these companies and so they will have benefited from low salaries and high dividend payments.

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A feature of these composites was that the contractor had virtually no input into the running of the company (see Managed Service Company above) and his/her contribution was usually limited to the completion of a weekly timesheet and expenses form.

6.4 Umbrella Company

The contractor is an employee of the Umbrella which could have hundreds, even thousands of individuals all on PAYE on its payroll. In general terms the individual is caught by IR35 and so there are no issues about status, other than the End User (and Agency) does not want to be the employer.

The Umbrella therefore supplies the worker to the agency for a contract at the End User. The benefit to the worker is that by being an employee of the Umbrella, he can claim travel and subsistence expenses that would not be available to an employee deemed to be based 'on-site'.

The Umbrella charges the worker a fee for the provision of its service, but the worker is still better off than someone on PAYE as an employee of the End User.

This is something of an oversimplification; in reality, umbrella companies come in all shapes and sizes and can be quite complicated.

Their purpose is to make life simpler for contractors while maximising their earnings, by taking responsibility for administrative affairs and compliance on behalf of the contractor, and reducing the amount of tax that they pay. Some offer a lot of benefits, whilst others offer nothing different from standard temporary employment. If you have any doubts, you should seek independent advice from a qualified accountant before signing up.

6.5 Service Company

These companies are often referred to as "Personal Service Companies" or "PSCs", which is not a term recognised by the PCG as having any basis in law.

Nevertheless, typically the contractor is a director/shareholder of his/her own company, the company has its own bank account, invoices for its work, but looks to the services of an accountant acting in a professional capacity to assist with accounts preparation and the submission of tax returns. This may extend to the provision of payroll and other services, but the contractor is clearly in charge of his/her own affairs.

How the contractor is paid depends on the IR35 status of the engagement(s). Where the engagement is deemed to be 'outside of IR35' the contractor typically receives a low salary with the balance in dividends; where the contract is caught by the IR35 Intermediaries Legislation, then the contractor pays him/herself via the deemed payment method.

6.6 Will the MSC Legislation affect me?

There has been a lot of confusion about what the new rules will mean for freelancers and contractors and the starting point is to define an MSC.

- A company is a MSC if it meets ALL of the following criteria:
- it supplies the services of individual workers to a client
- the payments made by the company to workers are in proportion to the services they have provided
- these payments are more than they would be if they were employment income
- an MSC scheme provider is involved with the company

A "company" in this sense can include schemes utilising partnerships and Limited Liability Partnerships also.

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Exemptions are provided for recruitment agencies and the professional provision of legal and accounting services.

Where you are operating through an Umbrella Company or through your own limited (service) company as defined by 6.5 above, then these rules will not apply to you.

Under the new rules, "Managed Service Company Providers" will have to deduct full PAYE and NICs on all income paid to their contractors AND this must be done irrespective of whether or not the contract in question is caught by IR35.

If your MSC Provider claims it will be able to get round the new rules, please be aware of the following:

PCG know that HMRC are keeping a close eye on MSC Providers who claim to have found ways around the new rules and typically these involve changing their offering to "accountancy services".

PCG advises that sticking with a scheme provider claiming to be able to get round the new rules is the most risky option available: you could well end up as part of a test case.

Moving forward, Service Companies will be the most tax efficient vehicle for independent contractors who seek to be in business on their own account - particularly if their engagements are outside of IR35. For those whose engagements are caught by the Intermediaries Legislation and who wish to reduce their administration, then working through an Umbrella Company may prove to be the best solution.

6.7 What's involved in working through my own company or through an Umbrella?

When running your own company, you will be liable for ensuring that all of your company administration and legislative paperwork is up to date and you will also incur an accountant's administration fee for preparing and signing off your accounts each month - this will be circa £100 per month but will depend on the size and complexity of your accounts. You will also be charged a one-off upfront company registration and set-up fee, typically in the region of £250.

Using an umbrella company will naturally incur costs in the provision of employment services. Generally, their costs are around £100 per month; the majority of umbrella companies do not have an up front joining or registration fee.

In addition to the reduced administration costs of using an umbrella company, the benefits for the freelancer include having someone else handling all the company administration, removing the requirement for the freelancer to do so. This could constitute a substantial time saving for the individual as well as removing the need to be aware of the legal requirements and risks involved with running a limited company. Some schemes also come with built-in insurance cover, for example, for IR35 investigation.

6.8 When is an umbrella right for me?

An umbrella company scheme may be suitable for:

- contractors starting up who expect to work through an agency for the foreseeable future
- contractors who are "caught" by IR35
- contractors who do not want the additional administration and finance hassle involved in running their own business and who are happy to hand these functions over to an umbrella company
- contractors wishing to maximise their take home pay by leveraging Revenue dispensations for genuine, receipted expenses
- new contractors who think that they may struggle with the responsibilities of running a company

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- short-term contractors who want to avoid the costly process of forming a company and then arranging for it to be dissolved

6.9 What are the potential benefits of using an umbrella scheme?

These are some of the benefits of using an umbrella scheme rather than running your own limited company:

- not having to expend time and effort running your own limited company and worrying about administration, accounting, banking, official documentation, tax returns and all the other responsibilities associated with being a director
- once you have been set up with the umbrella, you simply complete and submit your timesheets and expense claims, and the umbrella bills the agency and handles the debt collection and payroll processing
- employee status for the purpose of dealing with banks and other financial institutions regarding proof of earnings
- pre-approval by HMRC of the most common allowable expense claim items
- The range of services on offer varies widely between umbrella companies, and these are some of the additional benefits you might like to enquire about:
 - bundled insurances, including Professional Indemnity cover and Employers and Public Liability Insurance.
 - verification of agency credit status, to help ensure that you do not work for a company that might not be able to honour its contractual obligations.
 - discounted training packages, discounted hotels and discounted gym membership.

6.10 Will working through an umbrella company protect me from IR35?

IR35 does not apply to umbrella companies, because the contractor is an employee and is paid by PAYE and expenses - not dividends. The new MSC tax rules of April 2007 have removed MSCs from the scope of IR35: instead, all payments made by an MSC to a freelancer must be made on a PAYE basis, irrespective of the IR35 status of the contract.

6.11 Will an offshore company protect me from IR35?

Some freelancers have been told that they can use an offshore company to avoid IR35. This is not the case. It does not matter where your company is incorporated, as this does not affect how HMRC determines IR35 status. There are freelancers working in the UK with companies incorporated in countries such as Ireland, the Netherlands and so on. There are reciprocal legal and tax agreements between the UK and these countries. However, some agents and clients are nervous about dealing with foreign companies.

While PCG cannot comment on specific cases, you should be aware that some of these arrangements are subject to scrutiny by HMRC and indeed some of these schemes have been successfully challenged by HMRC. Careful investigation should be applied before entering into any of these arrangements.

6.12 Clarification of rules about dispensations and allowable expenses

There appears to be confusion in some quarters, particularly in the context of umbrella companies, between the notion of a "dispensation" and an "allowable expense".

Put simply, an "allowable expense" is an expense which may be offset against taxable income or taxable turnover. It must have been incurred wholly, necessarily and exclusively for business purposes.

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If such an expense is incurred on behalf of an individual on the payroll, the standard procedure is to account for it as a benefit in kind on the P11D form, and then claim the notional personal tax back under S336 ITEPA2003 (what was S198 of the Taxes Management Act 1970 – indeed everyone still refers to these as ‘S198 claims’) on the individual’s Self Assessment return. This typically happens when the individual pays for something out of their own pocket, and is reimbursed (effectively tax-free) by the company.

This involves a degree of paperwork resulting in no actual tax being paid, so the Revenue sometimes issues “dispensations”. A dispensation essentially says “if you spend up to this amount on this activity, you do not need to account for it on your P11D or make a S198 claim on your income tax self-assessment form”. However, a full record of the expenditure, that is, a receipt, must still be kept, and the amount of the expense is then offset against the turnover in the usual way when calculating profit for Corporation Tax purposes.

To give an example, suppose that HMRC issues your company, or an umbrella company through which you supply services, with a dispensation for £87 a night accommodation and subsistence while working away from home. Suppose on a given night you only actually spend £59. Then it is the £59 which is an allowable expense against corporation tax and not the £87. You need not account for the £59 on your P11D or self-assessment return, because you have a dispensation. You must, however, have records for it in the normal way for any expense when deducting it from your turnover for corporation tax purposes. Any attempt to claim tax relief on the £87 figure when only £59 has been spent is evasion and could rightly be treated harshly by HMRC.

Similarly, you cannot then pay £87 tax free to yourself from your company to “reimburse” a cash expense that was never incurred. You can pay only £59 to match the actual expenditure.

A dispensation is simply a way of reducing administration and should not be viewed as a way to claim carte blanche on all types of unreceipted expenses.

Put differently, there is nothing “magic” about an umbrella company’s PAYE as opposed to any other company’s PAYE - it operates in precisely the same way. You can claim allowable expenses against tax, but you cannot artificially inflate those expenses according to dispensation limits. PCG would strongly urge those freelancers operating through umbrella companies to ensure that their records are correct and in particular that they are deducting the correct amount of expenditure in tax calculations. Indeed, you may wish to consider asking your umbrella provider for a copy of the dispensation that they have been given by HMRC.

6.13 Useful links and resources

PCG website: www.pcg.org.uk

PCG Quality Umbrella: www.pcg.org.uk/qualityumbrella

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SECTION THREE: ACCOUNTING, BANKING AND INSURANCE

7. Choosing an accountant

7.1 Why do I need an accountant?

An accountant can take care of most of the administrative work associated with running a limited company. Your accountant may also be able to advise you on tax and legal matters and help you manage your personal and company tax liabilities.

7.2 How do I find an accountant?

You can look in the Yellow Pages but you should really choose an accountant that understands freelancing - please refer to PCG's Quality Accountant scheme on page 22 for details. You will probably spend a lot of time talking to your accountant, so treat this as a long-term relationship and choose carefully. You need someone you can talk to, get along with and, most importantly, trust.

There are some large accountancy firms aimed solely at freelancers. These specialise in freelancer issues, such as IR35. Some users of these firms have reported that the overall standard of service is variable and they can have issues dealing with non-routine matters, although it is worth noting that some of the specialist accountancy practices offer money-back guarantees on their services. Equally, problems have also been reported with smaller or non-specialised accountancies.

When choosing an accountant, you should look for:

- Personal recommendations - ask other freelancers or post a question on the PCG forums.
- Membership of a professional body such as one of the Chartered Institutes. This offers you more protection against malpractice. Remember that anybody can call themselves an accountant, qualified or not. Accountants who specialise in handling freelancers are usually limited companies and, therefore, in the event of there being a complaint, the freelancer has full rights under UK law.
- Evidence that the accountant understands freelancing. Does the firm handle the accounts for any other freelancers?
- What does this accountant know about IR35 and S660?
- Location - it really does not matter where your accountant is but, if you have any problems, it is nice to know you do not have to travel far to sort them out.
- A PCG Quality Accountant (see page 22)

7.3 Can't I do it myself?

You can keep your company accounts yourself if you wish, using a spreadsheet or a simple accounting package such as Sage or QuickBooks. This should not take you more than a few hours a month.

However, you may still wish to get a qualified accountant to draw up the end-of-year accounts. Your accountant will also calculate your corporation tax liability and complete the corporation tax return for you. It is your legal responsibility to make sure your accounts are correct so it really is worth the cost. But, if the thought of wading through all those receipts fills you with horror, you can get your accountant to do the whole lot for you.

7.4 How much do accountants cost?

A good business accountant will charge between £80 and £100 plus VAT per month. For this, the accountant will draw up your end-of-year accounts and may prepare your VAT returns. This is the minimum level of service most freelancers use. If you want your accountant to do any more for you, like preparing your expenses or issuing invoices, you will be charged accordingly.

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PCG Quality Accountant - accredited accountant scheme

PCG's accredited accountant scheme, PCG (QA), is designed to help freelancers choose their accountant by identifying and promoting those who have been given additional and specialist training in freelance-specific issues and have undertaken and passed our exacting training and assessment programme.

Developed and delivered in association with Accountax Consulting Limited, the PCG (QA) scheme involves:

- Strict entry criteria and rigorous application process
- Two-day training programme on :
 - IR35 (intermediaries legislation)
 - S660A (settlements legislation)
- Customer service training
- Annual assessment, including feedback from PCG members

PCG (QA) complements the other offerings in PCG's quality services portfolio and provides the following benefits:

- Access to trusted and credible accountancy advice from a published list of all accredited accountants
- Reassurance that PCG accredited accountants will have received relevant and up-to-date training in freelancer-specific issues and submitted a marked assignment
- The ability to provide feedback to PCG which will be taken into account when performing annual reviews
- An incentive for accountants to provide top-notch customer service geared towards freelance consultants' and contractors' needs

About PCG (QA): www.pcg.org.uk/qa

7.5 Useful links and resources

Institute of Chartered Accountants for England and Wales: www.icaew.co.uk

Institute of Chartered Accountants for Scotland: www.icas.org.uk

Association of Chartered Certified Accountants: www.acca.org.uk

List of PCG affiliates: www.pcg.org.uk/affiliates

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8. Choosing a bank

8.1 Why do I need a separate business bank account?

“You” are not the same in legal terms as “the company”, so “the company” needs its own account. Always keep your personal affairs separate from those of the company. Some freelancers prefer to have the separate accounts in separate banks so the bank cannot use knowledge about your business to make decisions regarding your personal finances. However, others prefer to develop a relationship with a particular bank.

8.2 Should I just use my local bank’s business account?

You do not need to choose a bank with a “local” branch. There are specialist freelancer accounts and high-rate business savings accounts available over the internet and from non-high street banks. These accounts are generally better value. Many freelancers choose to run two accounts - one with higher interest where they set aside money for tax and VAT.

8.3 What sort of account do I need?

As a freelancer, you will probably be looking for an account that offers the following:

- Free banking.
- A good rate of interest on cash savings (you will be keeping thousands of pounds of tax money in here). Rates vary but should be within a couple of percentage points or so of the current Bank of England rate. Use a separate business savings account to earn as much interest as you can. Remember that the interest earned on company money is outside of IR35.
- You’ll need a company chequebook. A company credit card may be useful but many freelancers use their personal credit cards for expenses and then claim these back from their company. In this case, be careful to clearly separate business and personal use!
- If appropriate, loan finance, overdraft and other credit arrangement facilities.

8.4 Useful links and resources

List of PCG Affiliate members - banking products and services: www.pcg.org.uk/banking

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9. Insurances

9.1 Do I need any kind of insurance?

Yes. Insurance can provide financial compensation and peace of mind when things go wrong, but even some seasoned freelance contractors are unsure as to which types of insurance they need. Very few types of insurance are compulsory for small businesses, but it can be a false economy to neglect those which really should be viewed as essential.

Included within the annual PCG membership fee:

9.2 Professional Expenses Insurance (tax investigation insurance)

If HMRC does decide to investigate your company, you will need the services of your accountant or a professional adviser to help you, and possibly additional legal advice. PCG has its own tax investigations insurance policy which provides the representation services bundled within the PCG membership package.

PCG's professional expenses insurance (PEI) policy covers all members and pays up to £75,000 per member per membership year, to cover professional fees relating to tax investigations covering:

- Income Tax Self Assessment Full and Aspect* Enquiries
- Corporation Tax Self Assessment Full and Aspect* Enquiries
- Employer Compliance Disputes in respect of PAYE, P11D and NIC
- VAT and IR35 Disputes, S660A enquiries

*Please note that Aspect Enquiries have an excess of £150 - payable at the time that the claim is accepted - and a maximum limit of indemnity of £1,500. If an Aspect Enquiry develops into a Full Enquiry or IR35 Dispute, then the £75,000 maximum limit will apply.

PCG's policy covers the fees of the appointed specialist tax consultants, but may, at the discretion of the Insurer, also include any necessary costs of your accountant. Such costs will include the gathering of necessary information to answer HMRC's queries and representing you at a hearing with the Commissioners. It does not cover any taxes or fines levied if your appeal is unsuccessful, but you can buy such insurance cover separately (see Tax loss insurance).

Included within the annual PCGPlus membership fee:

Professional Expenses Insurance (tax investigation insurance), plus:

9.3 PAYE Audit Cover

A PAYE audit is a routine check from HMRC to ensure that your company is keeping appropriate PAYE records and operating PAYE correctly. These are not investigations, although a PAYE visit may become an investigation if non-compliance is established. HMRC runs these checks regularly, but does not publish details of how it chooses whom to audit.

Cover for a PAYE audit is not a common feature of most tax investigations insurances, however, PCG has taken out an insurance policy to guarantee expert advice and support throughout the whole process of an IR35 investigation. **PAYE Audit Cover** provides a representation service for the benefit of PCGPlus members only. Designed for any business that runs a payroll, including partnerships and sole traders that have employees, PAYE Audit Cover also includes expert professional support during the PAYE compliance visit itself. You have the option to hold the compliance visit at an office other than your company's own, with an IR35 expert present throughout, thus guaranteeing you the very best support and advice at this crucial stage.

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9.4 Jury service expenses insurance

Being called for jury service can have a major financial impact on a micro business, especially if the person called is the main fee earner for the business, since compensation currently amounts to little more than expenses for the individual.

Under the jury service expenses policy taken by PCG, as the only policy holder, eligible members can claim a jury service allowance of up to £300 per day, less any amount recovered from the relevant court, for up to ten days. The daily rate payable takes into account the current engagement.

9.5 Business interruption insurance in respect of contracting through an Agency

This is a unique insurance policy that the PCG has arranged as part of PCG*Plus* membership and which will pay up to £5,000 in the event that an Agency suffers bankruptcy leaving the *Plus* member with unpaid fees and up to £1,000 where an Agency defaults on its contractual obligations.

Compulsory for most businesses:

9.6 Employers Liability insurance

The Employers' Liability (Compulsory Insurance) Act 1969 requires all employers, unless they are exempt, to have at least £5 million of employers' liability insurance with an approved insurer to protect them against claims from employees for accidents or sickness caused through work. In practice, most insurers offer at least £10 million cover.

The law was amended with effect from 28 February 2005 to exempt very small businesses that employ only their owner - see the Employers' Liability (Compulsory Insurance) (Amendment) Regulations 2004, SI 2004/2882. In a letter to PCG, the Department for Work and Pensions (DWP) confirmed that if a limited company employs only the owner, and that owner owns more than 50 per cent of the issued share capital, then the company is exempt.

As a freelance consultant or contractor operating outside IR35, however, you are likely to have a substitution clause in your contracts. Without employers' liability insurance, you cannot fulfil this clause without breaking the law, so in practice you ought to have cover. There are no hard and fast rules about who counts as your employee for the purposes of employers' liability insurance. People who you may think of as self-employed may be considered as your employees for the purposes of employers' liability insurance; what matters is the real relationship with the people who work for you and the degree of control you have over the work they do for you. Even part-time and casual staff may count as your employees.

The law is enforced by the Health and Safety Executive (HSE); its inspectors can ask to see your certificate of insurance at any time. These must be retained for at least 40 years after the insurance has expired. You can be fined up to £2,500 for any day which you are without suitable insurance. If you do not display the certificate of insurance or refuse to show it to HSE inspectors when they ask, you can be fined £1,000. The Financial Services Authority keeps a register of authorised insurers, which is available on its website.

9.7 Motor insurance

Third-party liability insurance is compulsory for all vehicles used on the road.

Comprehensive insurance includes this but also provides cover for fire, theft and accidental damage. Personal accident cover, for certain bodily injuries sustained by the driver, is usually offered as an extra option. You should ensure that business use is specifically covered.

Essential or advisable for most businesses:

9.8 Public Liability insurance

Public liability insurance covers you against accidents to members of the public or damage to property that occurs as a result of your business activities. It also covers any related legal costs.

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Even if you work from home, you may need public liability cover. If clients visit you there, the policy will cover you if they injure themselves while they are on your premises - it could be something as silly as tripping over a computer cable.

If you regularly work off-site, your policy should cover this too.

9.9 Property and contents insurance

You will need to insure your business property, including premises, fixtures and fittings, stock, computers and equipment. If you work from home, you need to check that equipment used for business purposes is still covered by your home contents insurance, or purchase specific business insurance.

In response to a growing trend in homeworking, an increasing number of insurers now offer buildings and contents policies that specifically include cover for business stock and equipment.

Recommended for most freelance service businesses:

9.10 Professional Indemnity insurance

Professional indemnity insurance protects you against your legal liability for losses suffered by your customers as a result of your negligent advice. It is legally required in certain professions, such as law, accountancy and financial services. It is common in other areas, such as management and computer consultancy, publishing, engineering and design. If you give any advice which could make you liable, or if you are working in a collaborative arrangement, you should have a suitable policy.

Your policy should include retroactive cover, so that you insured for any claims arising in the next 12 months, but also for your work or decisions back to the date you commenced trading. When you complete your proposal form, you will need to disclose any likelihood of a future claim, as the underwriters will want to protect themselves from taking on any current or known claim exposure.

Professional indemnity insurance works on a "claim made" basis, and so when you cease trading, retire, or take a permanent job, it is wise to purchase run-off cover for at least 12 months after that in case a claim is made against you, after your policy has expired, for work done previously.

Recommended for product businesses:

9.11 Product liability insurance

Product liability insurance covers you against injury or damage caused by faulty goods. This can be important if you manufacture, repair, install or even retail goods; a small defect could open you up to massive claims. Your policy should guard you against safety claims, manufacturing quality, spoilage and indemnity costs (medical bills and so on).

Other insurances worth considering:

9.12 Tax loss insurance

Some insurers offer policies that indemnify against any outstanding tax, NIC, interest and penalties suffered in the event that an IR35 enquiry finds against the taxpayer.

PCG members can take out a tax loss insurance policy with Abbey Tax Protection, to complement the tax investigations services provided through PCG's policies for the professional expenses insurance (PEI) bundled with membership for all contractor members and the PAYE Audit Cover available to PCG*Plus* members.

Please note that before tax losses insurance can be purchased, any contracts that you wish to insure must have been reviewed by one of the reviewing organisations listed on the PCG's website.

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9.13 Life Insurance

You will now be without death in service benefits from an employer and your dependents could be exposed to potential financial hardship.

You can arrange life cover personally or via your company so that the family is protected and any mortgage or other debts can be repaid in the event of your death. A lump sum payment or ongoing annual benefits can be paid to beneficiaries and you should always consider the merits of writing policies in trust to ensure a smooth payout

In the case of pension related life insurance, paid for by your company, you can also receive tax relief on the premiums

9.14 Income Protection

As a freelancer, you do not have the safety net of a permanent employer to pay for sick leave. It is worth investigating permanent health insurance to cover your personal outgoings should you ever be unable to work for long periods. Some policies will pay a tax free income on the very first day of any illness or incapacity, all the way through to retirement if necessary.

It is important to ensure that both salary and dividends are covered by the plan and it is best to be wary of so called mortgage payment protection plans which offer only short term benefits and often do not recognise freelance income

It is advisable to apply for all forms of health related insurance before you experience symptoms of a serious nature.

9.15 Critical Illness Insurance

Unlike Income protection which pays an ongoing benefit until you recover and are fit to work, critical illness insurance will pay a lump sum on diagnosis of a specific range of illness. If you go on to make a full recovery the benefit cannot be reclaimed by the insurer. Any pay-out can help fund any necessary changes to home, car or simply provide a financial cushion to help your recovery free of financial concerns.

9.16 Private medical insurance

Private hospital care can make a lot of sense. Quicker treatment times through private care can help you avoid lengthy layoffs and help you get back to work sooner. In this way the income that would otherwise have been lost means that these policies can sometimes be self financing and also helps you to avoid a more serious long term break in your income.

9.17 Business interruption insurance

Business interruption (or "consequential loss") insurance compensates you for extra costs incurred and trading profits lost if your business suffers serious disruption after, say, a fire.

9.18 Legal expenses insurance

Legal expenses insurance covers legal costs such as solicitors' fees and court costs. Many policies offer legal guidance via a telephone helpline.

9.19 Key man insurance

Key man insurance can make your business less vulnerable to the illness or death of key employees. Premiums can often be offset against corporation tax

9.20 Useful links and resources

PCG - Insurances: www.pcg.org.uk/insurances

HSE guide: www.hse.gov.uk/pubns/hse40.pdf

Financial Services Authority: www.fsa.gov.uk

PCG Affiliates - insurance: www.pcg.org.uk/affiliates

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10. Statute of Limitations

10.1 Introduction to the Statute of Limitations

The main purpose of a limitation period is to place a time limit on the period within which a party can commence legal proceedings, or in some circumstances, to require notice of a claim to be given to the other party to potential legal proceedings.

Limitation periods are imposed by statute, primarily the Limitation Act 1980. There are different limitation periods for different types of cause of action. For example, the limitation period is six years for a normal contract claim, but 12 years if the contract was created by deed.

If a limitation period has expired for a particular claim, the claim will be "statute-barred". This means that it will no longer be possible for the claimant to effect recovery for that claim against the alleged wrongdoer.

The time runs from different dates, depending upon the cause of action, and in respect of negligence and contract claims, it is possible to bring a claim outside the six year limitation if the "latent damage" was not discovered until after expiry.

The Statute of Limitations is a complex area of law, and you should consult a qualified legal practitioner for advice about your specific circumstances.

10.2 Implications for Professional Indemnity insurance

Professional Indemnity insurance policies are almost always written on a "claims-made" basis, for which there are two triggers:

- The date of the event
- The date that the claim was made

In an extreme case, a claim could be made up to six years after the event occurred, according to the Limitation Act 1980, and so it is extremely important to maintain a current Professional Indemnity insurance policy to cover that period of time, even if you have closed your company.

Whether the date of the event is covered by your policy depends on the specific terms relating to the inclusion of a retroactive date clause or the provision to cover you from the date that your company was formed.

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SECTION FOUR: TAX MATTERS

11. What is VAT?

VAT stands for "Value Added Tax". It is a tax which VAT registered businesses charge when they supply their goods and services in the UK or the Isle of Man, but there are some exceptions. It is also a tax on goods, and some services, that are imported or acquired from outside the UK.

VAT does not apply to certain services because the law says that these are "exempt" from VAT. They include:

- Loans of money
- Some property transactions
- Insurance
- Certain types of education and training

Supplies which are exempt from VAT do not form part of your taxable turnover.

There are three rates of VAT in the UK:

- 17.5% (standard rate)
- 5% (reduced rate)
- 0% (zero rate)

11.1 VAT registration

11.2 Will I have to register for VAT?

You will probably have to register for and charge VAT if:

- Your taxable turnover reaches or is likely to reach a set limit, known as the VAT registration threshold. This was changed to £64,000 from 1 April 2007.
- You have taken over a business as a going concern.
- You acquire goods from other European countries.

You can opt to register for VAT if your taxable turnover is less than this, if what you do counts as a business for VAT purposes. Turnover is classified as the amount of money going through the business, not just the profit.

Note: The threshold is calculated on a continual 12-month rolling basis and NOT just in the 12-month trading period that forms the basis of the business accounts. One should register within 30 days of the end of the month in which the threshold was crossed.

11.3 Why would I want to register for VAT if I don't have to?

You may wish to reclaim the VAT which you pay to your suppliers. Other benefits include increased credibility for your business.

Once you are registered, you have to account for output tax on all your taxable supplies, as well as sending in regular VAT returns. Therefore, you need to consider whether registering will really benefit you.

If you make only exempt supplies, you cannot normally be registered for VAT. If you are registered and make some exempt supplies, you may not be able to reclaim all the VAT you incur on your purchases or other business expenditure.

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11.4 The VAT flat rate scheme

HMRC has introduced a new scheme with the aim of simplifying VAT for small businesses.

This allows you to pay VAT as a percentage of your turnover instead of having to work out the VAT on all your sales and purchases. This can help you in a number of ways:

- Simplify your record keeping - no need to separate out the gross, VAT and net values in your accounts.
- Few rules to follow - no more problems about what "input tax" you can and cannot reclaim.
- Certainty and peace of mind - you always know how much of your takings you will need to pay to HMRC and with few opportunities for mistakes, you will have less worries.

You can apply to join the scheme if you expect that in the next 12 months:

- Your taxable turnover (excluding VAT) will not be more than £150,000; and
- Your total turnover (excluding VAT) will not be more than £187,500.

To see what flat rate to use, you need to look at the categories published by HMRC, and decide which one best describes what your business will be doing in the coming year. The following list is by no means exhaustive, and is intended only to give an indication of the categories that might be relevant for freelancer businesses, together with the flat rate VAT percentage applicable:

Entertainment or journalism	11.0 %
Photography, publishing	9.5 %
Computer repair services	11.0 %
Accountancy or book-keeping	13.0 %
Advertising	9.5 %
Architect, civil or structural engineer or surveyor	12.5 %
Computer and IT consultancy or data processing	13.0 %
Lawyers or legal services	13.0 %
Management consultancy	12.5 %
Financial services	11.5 %
Printing	7.5 %

From 1 January 2004, you can deduct 1 per cent off the flat rate that you use for your first year of VAT registration. On the first anniversary of your VAT registration, the rate will revert to the standard percentage.

11.5 Useful links and resources

HM Customs & Excise website: www.hmrc.gov.uk

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12. Taxation of limited companies

12.1 What kind of tax will I have to pay as a limited company?

There is one very important point to remember - you and the limited company are two separate legal entities. You have your own tax responsibilities (income tax, employee's National Insurance Contributions (NICs)) and the company has tax to pay too. A company pays three main types of tax, one of which, VAT, was covered in the previous section. The other two are corporation tax and Employer's National Insurance Contributions.

12.2 Corporation tax

This is like income tax for companies. It is currently charged at a much lower rate than income tax. There are three tax bands, according to the company's annual profit. The tax rates start at 20 per cent, the small companies rate on the first £300,000 of taxable profits, with a marginal rate of 32.5 per cent on the next £1,200,000 taxable profit, and a full rate of 30 per cent for taxable profits exceeding £1,500,000 in the financial year. Most freelance businesses fall within the small companies band and are charged 20 per cent (for 2007/08). In the Budget of 2007, it was announced that this rate will rise to 21% (2008-9) and then 22% (2009-10).

12.3 Employer's National Insurance Contributions (NICs)

These are payable when the company pays salary to an individual of more than the current Earnings Threshold (ET) of £5,225 per year and are currently at a rate of 12.8 per cent.

12.4 Can I pay less tax as a freelancer?

As a freelancer your tax bill may well be less than that of an employee, but this is for a good reason: unlike an employee, you will have to cover your own holiday pay, sick pay, training, insurance costs and other responsibilities. Whether your disposable income ends up being higher than it would have been if you were an employee is down to your own financial management.

You may now end up paying more tax as a freelancer than as an employee, thanks to IR35. For now, let us look at the situation without IR35.

First of all, your company must pay all its company tax liabilities described above. You can become more "tax efficient" in the way the company pays its employees, including you.

The company can be used to make sure that you have money available for times when you are sick, or out of contract. There is no law that says you must pay out all of the money your company earns. In fact, you should avoid paying out any more than you need.

12.5 As a freelancer, will I still have to complete a Self Assessment Return?

If you are working through your own company, or self-employed, then you will need to complete a Self Assessment Return, including any dividend payments and "benefit in kind" you have received from the company. A freelancer who works through an umbrella company and therefore receives all his income after tax has been deducted has no automatic requirement to complete a Self Assessment Return. However, any person who is sent a Self Assessment Return must complete it even if they do not meet any other criteria for requiring a form, indeed even those people that are not sent a form but have something to declare (such as a chargeable Capital Gain) have a duty to notify chargeability.

See www.hmrc.gov.uk/sa for more details.

12.6 What happens if I forget to send in a tax form?

Many statutory forms (Self Assessment, P35 Employers Annual Return, etc.) carry a deadline. If you miss the deadline, you will receive an automatic fine. You may also void any possible claim that could be made under any Professional Expenses Insurance that you hold.

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12.7 What is the difference between Schedule D and Schedule E?

Schedule D* relates to the self-employed status of a sole trader or partner. You pay tax on demand based on your tax return at the end of a year's trading. You also pay Class 2 NI contributions (much less than Class 1) and Class 4 contributions on any profit over a certain level. Your NI contributions do not entitle you to benefit in case of unemployment.

Whether you are self-employed or not - and whether you are taxed as self-employed or not - depends on the specific details of each individual contract you have. The key employment status indicators are whether the client can direct you in how you do the work, whether you can send a substitute, and whether there is "mutuality of obligation" such that you have to keep on doing the work and the client has to keep on providing it. These are the key issues that the tax man will look at if you are being investigated: length of contract and whether you have more than one contract at a time are, at most, minor status indicators.

Schedule E covers employed people. If you are employed, you pay tax by Pay As You Earn (PAYE) and NI at the Class 1 rate, whether you are employed by your own company, someone else's company, an agency or the client.

** NOTE: The schedule system does not exist any more. Instead, what used to be Schedule E is now within ITEPA 2003 and Schedule D is now within ITTOIA 2005. However, references to Schedule D and Schedule E do make things nice and simple and the terms are still used in historical contexts.*

12.8 What else should I beware of?

The tax authorities may perform various forms of investigation into both companies' and individuals' affairs. These include PAYE and VAT reviews; the former has increasingly been seen to be used as a 'cover' for IR35 audits. It is important to keep paper records and an audit trail of every single transaction, such as purchasing equipment or declaring dividends. Whenever you take on a contract, get it reviewed and come to a rational decision on its IR35 status. Make sure you have good professional representation in dealings with the authorities. PCG's website library includes a document explaining how to take reasonable steps to determine your IR35 status, which represent good practice in business and tax management. You could also consider having the contract reviewed by an independent specialist to determine the IR35 status.

12.9 How do dividends work?

Dividends are a proportion of post tax profits paid to the owners of a company. A limited company is owned by its shareholders. So, if you hold shares in a company, you may be entitled to receive a dividend. The total amount of dividend you receive depends on the number of shares you hold. So, if you have 50 shares and are paying a £500 dividend per share, you will receive £25,000 but the total paid out in dividends cannot exceed the retained profits of the Company. When a company intends to pay out a dividend, it holds a directors' meeting to declare the dividend. The implementation of the Companies Act 2006 may lead to this process being simplified; if so, this will take effect from October 2008.

12.10 How do I declare a dividend?

When operating through your own company, you may declare a dividend. Your accountant can assist you with calculating funds available for distribution and preparation of the appropriate paperwork. In general, you should not declare a dividend more than four times a year, although dividends can be declared as frequently as the directors choose. However, HMRC may consider any regular 'same value' payments to be salary, e.g. a standing payment of £1,000 every month. Dividend paperwork must conform to the law otherwise HMRC can consider it as salary and as such the amounts will be subjected to PAYE. This will negate any benefit from using dividends. Declaring a dividend is not the same as actually paying out the dividend. When the company declares a dividend, it signals an intention to earmark a given amount of money for shareholders in its accounts. The cash can stay in the company's business or savings account and the shareholders can then draw it out as they wish.

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12.11 Why can't I pay myself monthly?

Most limited company freelancers distribute funds by a mixture of salary and dividend. Salary should be set, as a minimum, to allow for the requirements of staying within the National Insurance scheme, as outlined elsewhere within this guide and paid monthly, often by direct debit. Remaining funds can be distributed as dividends, as outlined in the previous section.

12.12 Retaining money in the company

Limited company freelancers will need to ensure they retain some funds within their company when paying dividends. These funds cover future costs such as salary, expenses and running costs. Some freelancers retain larger funds within their companies when they are planning for future expenses such as equipment, training or periods without fee-earning work. Such funds, if retained over the year-end, will be subject to corporation tax at the prevailing band rate.

Dividends do not constitute an allowable deduction in calculating taxable profits. Consequently, the corporation tax liability will be the same, whether the dividend is paid or the funds are retained.

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13. Personal taxation of limited company directors and employees

13.1 Employee's National Insurance Contributions

Employed people, including officers of the company, pay Class 1 contributions, which are based on how much they earn and are deducted from their pay by their employer.

Current (2007/2008) weekly earnings limits and percentages are:

Lower earnings limit	£87
Up to £100	Nil
Over £100:	
First £100	Nil
- Excess up to £670	11%
- Over £670	1%

Lower Earnings Limit (LEL)

This is the minimum level of earnings that an employee needs to qualify for benefits, such as Retirement Pension and Jobseekers Allowance. If an employee's earnings reach or exceed this level, but do not exceed the Primary Threshold (£100), they will not pay NICs but will be treated as having paid them when claiming benefit. For this reason, you must keep details of an employee's earnings at or above the LEL on a form P11 or equivalent record and report them at the end of the year on a form P14.

Primary Threshold (PT)

When the earnings exceed this level NICs become payable by the employee and employer. This is set at the same level as the PAYE threshold.

Upper Earnings Limit (UEL)

Where earnings exceed the UEL, the employee pays NICs at 1 per cent on those earnings above the UEL. The UEL does not apply to employer's NICs, which are payable on all earnings above the PT, including those above the UEL, at the appropriate rate.

NICs for company directors

NICs for company directors should be calculated based on an annual, or pro-rata annual, earnings period. This is to prevent the exploitation of the NIC rules which do not work on a cumulative basis.

13.2 Income tax and PAYE

Directors and employees of limited companies pay income tax on their taxable income. This will be deducted monthly through PAYE (Pay As You Earn), which is HMRC's system for collecting income tax from the pay of employees, including directors, as they earn it. An employer is required to deduct income tax and National Insurance contributions (NICs) from its employees' pay and to submit the deductions to HMRC.

This usually needs to be done by the 19th of each month, unless your average monthly payments are likely to be less than £1,500, in which case you may be able to pay them quarterly.

Employees and directors are also taxed on benefits in kind, such as a company car or medical insurance. As an employer, you will also have to pay class 1A NICs on benefits. These are declared annually via a form P11D.

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14. Taxation of sole traders, partnerships and LLPs

14.1 Tax transparent

Sole traders, partners and members of limited liability partnerships are classified as self-employed and pay income tax and National Insurance contributions on their respective shares of the profits and gains of the business.

Income is calculated as:

- Your trading profits, including any adjustments for capital allowances and balancing charges, plus
- Any New Deal Allowance that you receive

From this you can take away:

- Interest and annual payments, if they are only to do with your business and have not already been deducted in working out the trading profits for tax purposes
- Business or "trading" losses, which can be set against profits.

The following must not be deducted:

- Personal tax allowances
- Retirement annuity relief, personal pensions relief and pension contributions
- Drawings

14.2 National Insurance contributions

Self-employed people pay two classes of National Insurance contributions:

- Class 2, paid at a weekly flat rate
- Class 4, paid on profits and gains at or above a set level

This applies to all people who are normally self-employed, and aged 16 or over, and under state retirement age. Class 4 liability does not cease until 5 April following retirement age.

Class 2 contributions, currently £2.20 a week, count towards Incapacity Benefit, state retirement pension and Bereavement Benefit.

Class 4 contributions are based upon your taxable profits for that year, which you will show on your annual Self Assessment tax return. They are worked out on a percentage of your annual profits between a lower and upper limit. The following limits and percentages currently apply (2007/08):

Lower limit	£5,225
Upper limit	£34,840
Rate on difference between upper and lower limit	8%
Rate above upper limit	1%

14.3 Employees

If you employ someone, you will be responsible for deducting tax and Class 1 National Insurance contributions from their pay and remitting it to HMRC. You will also be responsible for payment of Class 1 employer's National Insurance contributions.

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15. Self Assessment

15.1 What is Self Assessment?

It is up to you to provide accurate information on your income and expenditure each year, via a Self Assessment tax return.

15.2 How does it work?

Each year, HMRC will send you a tax return that is tailored to your circumstances. You should receive this in April, and if you do not, contact your tax office.

You need to fill in your tax return with details of all sources of:

- Taxable income
- Taxable gains
- Reliefs and allowances

If you want the HMRC to work out how much tax you need to pay, you must submit your return by 30 September following the issue in April. The deadline for the submission of the Return is 31 January following its issue to avoid paying a penalty but if you submit the form after 30 September you will also need to calculate the tax due and pay the amount by 31 January.

15.3 Record keeping

The law says that everyone who pays tax must keep the records that they need to fill in a tax return. You must keep all your records for at least five years from the latest date for sending back your tax return. You can be fined up to £3,000 for each year that you fail to keep proper records. The legislation does not prescribe what records to create but it does say that if you create any records in your business, these should be retained.

If you claim business expenses, you should keep the necessary records to back them up. Sometimes you may not get evidence, such as a receipt, for small cash expenses. If this happens, make a brief note of the amount you spent, when you spent it and what it was for.

Keeping good records will also benefit you in that it gives you the information you need to manage your business, and may also help reduce your accountant's fees, if you use one.

15.4 Making payments

Most self-employed people make two payments on account for the tax year before the return for that year is due, on:

- 31 January in the tax year, and
- 31 July following the end of the tax year

Each payment includes half of your income tax and Class 4 contributions bill for the previous year. Any additional or balancing amount due is paid on 31 January, the filing date for the Return

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16. Tax treatment of business expenses

For small business owners, the classification of business expenses as allowable or non-allowable can be a minefield. Here we set out to shed some light on the rules.

Allowable expenses are those costs that you incur wholly and exclusively for the purpose of earning business profits, and may be deducted from your turnover for the purposes of reducing the tax liability of the business; if not totally then at least in part. They include, for example:

- Goods purchased for resale although an adjustment is required for closing stock
- Wages, rent, rates, repairs, lighting and heating
- Running costs of vehicles or machinery used in the business
- Professional fees, interest paid on monies borrowed to finance business expenditure or items, and leasing charges on items used for the business.

Non-allowable expenses include costs that you incur for a non-business purpose, such as, for example:

- Your own personal expenses or drawings
- Capital costs
- Costs which are recoverable under insurance

16.1 Wholly and exclusively

For expenses paid by the company to be allowable, the basic rule is that they must be incurred *wholly and exclusively* for purposes of trade. Normally, if an expense results in a “benefit in kind” for an employee, then it is deductible for the company.

If the business is a sole trader or partnership, any private use by the owners restricts the amount of the expense that is allowable for tax purposes.

Expenses paid by the employee are allowable only if they are incurred *wholly, exclusively and necessarily* in the performance of the duties of the office or employment.

16.2 Benefits in kind

Where a company incurs costs or provides assets for the private use of directors or employees, these normally result in a benefit in kind charge, that is, additional income tax payable by the employee and Class 1A National Insurance contributions, currently 12.8 per cent, for the employer.

If a company pays an employee’s personal liability, such as a private holiday for them and their family, this should be treated as salary, incurring tax and National Insurance charges accordingly.

16.3 Duality of purpose

HM Customs & Revenue (HMRC) does not regard any expenditure that has a dual purpose element to be allowable for taxation. For example, a suit or dress purchased to wear at work has a dual purpose in that you need to wear clothing anyway, so tax relief is not available on the expense.

In the famous case of a barrister who claimed the costs of buying and keeping clean the black clothing worn in court, the Revenue successively argued that although she bought the clothes solely for work, she had to wear them to remain decent. She lost her case.

16.4 Capital items and depreciation

A distinction should be made between ‘revenue’ and ‘capital’ expenditure; this section addresses expenses that fall under the ‘revenue’ banner.

Generally, capital items are those items that will have enduring benefit to the company, such as computers, motor vehicles and office furniture. If they are connected to the trade, it may be

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possible to claim capital allowances over a period of time, based on percentages specified by HMRC, but you may not claim their cost as an allowable expense.

Depreciation is not usually tax deductible either, except for pure finance leases, not commonly used by small businesses.

16.5 Legal and professional fees

Fees for preparing your company accounts are deductible as they relate to your trade. Legal fees incurred on taking on a new lease are not deductible as they relate to capital. If a company pays the cost of an employee's personal tax return, this is classified as a benefit in kind.

The costs of recovering debts, defending business rights, preparing service agreements and appealing against rates on business premises are allowable. Expenses (including stamp duty) for acquiring land, buildings or leases are not allowable against income.

16.6 Subscriptions

Subscriptions to professional and trade associations on HMRC's approved list are allowable, as are trade magazines.

16.7 Debts, taxes, penalties and fines

Specific bad debts written off are allowable, whereas a general reserve for bad or doubtful debts is not. If the company is not entitled to recover VAT, the VAT inclusive expense is allowable.

Interest and penalties relating to income tax, PAYE, NIC and VAT are not deductible, nor are fines and other penalties for breaking the law unless a benefit in kind is assessable on an employee. Corporation tax interest under self assessment is deductible and taxable in the company's hands.

16.8 Interest

Interest charges incurred to finance the business, but not owners' drawings, will normally be allowable. In certain circumstances, interest on funds borrowed in your personal capacity and introduced into the business will be allowable, provided that it does not involve overdraft or credit card interest, and that you can prove that the money was borrowed for the business.

16.9 Entertainment and gifts

Business entertainment is not an allowable expense, nor is the cost of gifts to customers, unless they are £50 or less in value and carry a conspicuous advertisement for the business. Gifts of food, drink, tobacco, vouchers and tokens exchangeable for goods are specifically excluded.

Staff entertainment, such as a Christmas dinner or summer party, is an allowable expense for the company and will not be classified as a benefit in kind for employee provided that the cost per head is less than £150 per annum and the event is open to all staff. **Note:** This concession is not available to Schedule D (self-employed) businesses.

16.10 Travelling and subsistence

An employer may reimburse an employee for travel, accommodation and subsistence costs incurred wholly, exclusively and necessarily for the purpose of the duties of the employment. Travel to a temporary workplace is allowable until the expectation arises that the assignment will last for longer than 24 months, after which it is classified as ordinary commuting and therefore not allowable.

Home to office travel is defined as ordinary commuting, and it is therefore important to establish where the business is being operated from. If you genuinely operate from home, you can normally claim travelling expenses when visiting clients.

Employees who use their own cars for business purposes may claim 40p per mile for the first 10,000 business miles and 25p thereafter in each tax year. Sole traders and partners can alternatively claim a percentage of the actual costs incurred, such as petrol, capital allowances, interest on a

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loan to purchase a car, insurance, oil, maintenance and road fund licence. The percentage must be justifiable, and therefore it is best to keep a detailed mileage log of actual business and total mileage.

The London congestion charge is allowable provided that it is incurred exclusively for business purposes.

Subsistence up to reasonable levels while away on business is allowed: this will usually cover the cost of a meal with reasonable alcoholic and non-alcoholic drinks; and tea, coffee, and soft drinks between meals.

The cost of overnight accommodation is allowed if solely for business purposes, and the employee may also be reimbursed for incidental costs such as laundry, newspaper and telephone calls home, up to £5 a night in the UK or £10 a night outside the UK.

Subsistence not related to an overnight stay can present problems in terms of the 'duality of purpose' rules: you are expected to "eat to live, not eat to work". There are arguments for claiming such meals, but this is definitely a grey area.

16.11 Use of home for work

If you work from home, you may theoretically claim a proportion attributable to business use of lighting, heating, cleaning and insurance, as well as a proportion of rent, business rates, council tax and (in Northern Ireland) domestic rates.

You should be extremely wary of this though, as it could create capital gains problems for you when you sell your home. It may be better to consider claiming a nominal amount, such as £104 a year, instead. HMRC automatically accepts £2 per week as being reasonable without the need to produce receipts to justify the claim.

16.12 Wages and salaries

You should issue a P60 at the end of the year to support the amounts paid, and ensure that the level of remuneration is justified for the work done, as HMRC may disallow remuneration paid to employees that it considers excessive.

Payments to a spouse should be made to an account in his or her sole name, not to a joint account.

Drawings by Schedule D taxpayers (sole traders and partners) are not allowable for tax purposes.

16.13 Training

Where the purpose of training is to provide a business owner with new skills, the cost is treated as capital and is not deductible for income tax. If the purpose is to update existing skills, then the expense is allowable.

Where the IR35 rules apply, training expenses may be included within the five per cent allowance for general expenses but not claimed separately in their own right.

16.14 Telephone and internet

The cost of a mobile phone is allowable, and if invoiced to the company, there is no benefit in kind, even if there is an element of private use. If invoiced to the employee, then the benefit in kind is assessed on the portion attributable to private use. It is helpful if you have itemised bills to prove the split between business and private use.

Note that the deduction is allowed only if you can identify a specific cost relating to the business calls. For example, if the employee takes out a monthly contract with the telephone company and pays £50 per month to cover rental and 100 "free" calls. If the bill for the month is only ever this £50, i.e. not all of the "free calls" are used; it will not be possible to claim anything even if half of the calls are business. HMRC take the view that he has not incurred an additional expense in making the business calls.

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The cost of broadband and other internet services is allowable, and if invoiced to the company then incidental use by the employee does not rate as a benefit in kind. If the service is invoiced to the employee and reclaimed, the element of private use by the employee may be treated as earnings.

16.15 Private consumption

The sales price of goods funded by the business but taken for private consumption by a sole trader or partner must be taxed as income in your accounts.

16.16 Working overseas

Medical expenses incurred whilst working abroad as part of your employment duties can be paid by the company without being rated as a benefit in kind. The same applies to business travel costs involved in sending the employee abroad to do their job.

16.17 Insurance

Business insurances are allowable, as are life insurance, personal accident insurance, permanent health insurance and private medical insurance for employees. A sole trader's or partner's own life, accident, permanent health and private medical insurance expenses are rarely allowable.

16.18 Important notes

You should ensure that all claims are supported by receipts to justify that the cost was actually incurred.

The rules for what counts as allowable are more generous for self-employed people (Schedule D taxpayers) than for employees.

The VAT treatment of the expenses mentioned here may differ from the tax treatment, and different rules apply to any contracts covered by IR35.

Expenditure is normally allowable within the company's accounting period in which it was incurred. Special rules, however, can mean that revenue expenditure incurred up to seven years before commencing trade may be treated as incurred on the first day of trading.

16.19 Useful links and resources

New employers' helpline: 0845 607 0143

Self assessment helpline: 0845 9000 444

HMRC website: www.hmrc.gov.uk

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SECTION FIVE: GETTING PAID

17. Salaries

17.1 Do I need to pay myself the minimum wage?

If you are a director of your own company then the minimum wage legislation is unlikely to be applied, unless you have a contract of employment with your company. If, however, you work through an umbrella arrangement you will have to pay yourself at least the minimum wage.

17.2 How should I pay myself?

As a freelancer you have far more control over how and when you are paid. You can pay yourself just enough to stay under the higher rate tax bracket and use your partner's tax allowance too if they are shareholders or employees of the company. See Appendix C.

You can reduce your total tax burden by paying a higher proportion of your income in the form of dividends, which do not bear National Insurance, and the rest as salary. However, some accountants advise that you should pay yourself a "reasonable" salary of, say, at least £20,000 per annum (or some similarly random amount) so as to reduce the likelihood of being caught by IR35 or the threat of an HMRC investigation. However, if you pay yourself a salary of over £5,225 (based on tax year 2007/2008 rates) per year, you will still be part of the National Insurance scheme and be eligible for the State Pension and social security benefits. This salary is the top of the nil band, which means that no National Insurance is paid.

17.3 How should I pay myself if I am caught by IR35?

You should continue to use the mechanisms above. There is no requirement under IR35 to pay yourself more salary, nor will paying yourself a salary protect you from IR35. You should make allowances for the extra tax in the company's accounts but you need only pay the tax annually in April. Whilst failure to draw the net salary component of this in the same tax year will result in this being subject to corporation tax as company profits (dividends can only be declared from post corporation tax profits), retaining the tax component until the year end will increase the interest you can earn on it.

17.4 What are the payroll requirements of running a limited company?

Even if you pay yourself mostly through dividends you will probably receive some kind of salary from your limited company. An employee's salary is subject to certain taxes that must be accounted for by the employer - in this case, your limited company. These are:

- PAYE (Pay As You Earn) Income Tax
- Employee's National Insurance Contributions (NICs)
- Employer's National Insurance Contributions (NICs).

The first two are payable by the employee and deducted "at source". That is, they never even reach your bank account and are shown as items on your payslips. An employee is legally entitled to a payslip showing tax deductions and any tax due is paid directly to the HMRC by your limited company.

Your limited company will need to run a payroll system so it can properly account for PAYE and NICs. It is fairly easy to work it out manually yourself. The HMRC provides guidebooks that show you how to do it. However, if you maintain your own company accounts using simple accountancy software, you can buy an extra payroll module that will calculate the tax and produce payslips for you. Alternatively, you can ask your accountant to manage your payroll.

It is advisable to draw a salary in excess of the NIC nil bands from a limited company to ensure continuity of contributions and therefore the right to social security benefits.

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18. Drawings

18.1 How do I pay myself if I am self-employed?

If you are:

- the owner of a sole proprietorship
- a partner in a partnership; or
- a member of a limited liability partnership

then you will not be paid a salary via a payroll. Instead, you have equity in the business, from which you take money out of the business in the form of drawings. These are not classified as business expenses unless you are being reimbursed for a business expense paid for with personal funds. You are not taxed on the drawings taken out of the business, instead you are taxed on the profits made or in the cases of a partnership, your share of the profits. Consequently, a sole trader who makes a loss will have no tax liability even though drawings were taken in the year.

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19. Client invoices

19.1 Cash is king

For any business, cash flow is extremely important. Every year, businesses become insolvent, even profitable ones, because one needs cash, not profit, to pay bills or loans. It is a matter of having the cash at the right time.

It is very important to get into the habit of producing cash forecasts based on best and worst case scenarios, so that you can take action quickly if problems arise.

19.2 Improving cash flow

One of the most basic ways to improve cash flow is to get clients to pay their bills more quickly. These are some tactics to consider:

- Ask for a deposit payment in advance, of 20 per cent or 50 per cent, for example.
- Don't assume that you have to offer 30 day payment terms - try offering 14 days instead, and where third party expenses recharged at cost are involved, insist on repayment within seven days.
- Offer early discount settlements.
- Send out your invoices promptly, and ensure that they are sufficiently clear and detailed, and that they reflect the terms of your contract, so that the client does not have any reason to query the invoice or delay or withhold payment.
- Make sure that your terms and conditions are clearly outlined in your contract with the client, and that there is no scope for ambiguity.
- Chase outstanding invoices vigorously, and keep dated notes of all conversations.

19.3 Useful links and resources

The Better Payment Practice Campaign: www.payontime.co.uk

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SECTION SIX: RUNNING YOUR BUSINESS

20. Working from home

Working from home is on the increase, thanks to the falling cost of new technology - computers, mobile phones and faxes. Estimates show that nearly three million people work from home some or all of the time.

20.1 Benefits of working from home

Tangible benefits cited for choosing to work from home include:

- Low-cost way of launching a business.
- No nightmare journeys on commuter trains or gridlock on motorways.
- Flexibility of working methods and hours.
- Increased productivity levels without typical office interruptions and "chat gaps."
- Low operating costs.
- The ability to accommodate family demands.
- The chance to stroll out in one's own garden for a 10-minute break.

20.2 Potential drawbacks

Properly implemented, giving up the office can work like a dream, but you need to be disciplined, organised and have access to the right technical equipment. Also, home working does not suit everyone. For some people, the drawbacks outweigh the benefits:

- Feeling isolated and bored.
- The chance of increased pressure and longer hours.
- Diminished sense of personal satisfaction.
- Clashes between business and family demands.
- Not being able to switch off.
- Poorer rewards if the working from home holds back development of the business.
- Interruptions from family, neighbours and friends who do not respect work regime.

Not all businesses can operate effectively from home either. Some, for instance, have to follow strict regulations, whilst others must comply with planning regulations and local by-laws. If your business requires any structural changes to your home, you will need planning permission and there may be other planning and legal issues to consider, if the business generates noticeable smell, noise or traffic.

20.3 Some advice from experienced home workers

Opportunities for procrastination at home are greater than they would be in a conventional workplace.

- Treat your working time as seriously as you would time on a client or employer's premises.
- Make sure those you share your home with see it that way too.
- Aim for a definable, permanent workspace - not the kitchen table.
- The right furniture and equipment are essential investments. Get a good chair, especially if you work long hours at a computer. A top-of-the-range chair like the ergonomically advanced Aeron may be out of your league, but an adjustable chair offering the right lumbar support and synchronised mechanism can cost as little as £125.

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- Installing a separate telephone line lets you make a clear distinction between your work and home life. When you finish working, you can let a machine answer business calls for you.
- If you have sufficient bandwidth to support the use of a peer-to-peer internet telephony network, like Skype, you can effect considerable savings. Calls between Skype users are free, and calling traditional landlines or mobiles from Skype is relatively cost-effective.
- Remember to get specific insurance cover for your business equipment.
- Discipline yourself to ignore household jobs until you have finished your work.
- Develop support networks that keep you in the loop.
- Make time to socialise and meet new people, particularly if you live alone.
- If you are freelancing, arrange the occasional meeting with those you work for - personal contact is so much more memorable than email or phone conversations.
- Timetable breaks - include sessions away from your work to eat, exercise and socialise.
- Work in your pyjamas if you must, but for most people it is much better to get dressed properly in the morning.
- Likewise, the temptation of daytime television could leave you wondering where all the hours and revenue went.

20.4 Will I have to pay business rates for my home office?

Following a key ruling by the Lands Tribunal on 4 August 2003, thousands of home-based workers can rest assured that their home offices are unlikely to attract a business rating.

Previously, if the majority use of a room in your house was a home office, you could be liable for rates on that part of the building. The impact of the new judgement is that if you work from home, use such office equipment as might be found in any domestic study, have not made structural alterations, and do not employ people from the premises, then business rating will not normally be required.

The Valuation Office, which is responsible for assessing the rating system, has said that it accepts this decision and its instructions to staff had been amended accordingly. Each case will be considered on its merits, and the Valuation Office Agency will consider the extent and frequency of business use in each individual case.

The Lands Tribunal president also advised the Valuation Office to be careful how it identified those who might still be subject to business rates. He advised an approach which looked at whether the business on the premises was advertised, or whether planning permission had been sought for building alterations or business use.

A Valuation Office spokesperson confirmed that the advertising of a business in itself is not an issue, simply that it is a way of identifying business use, and that other factors such as employees on site, frequent visitors or structural alterations would be the determinants. The Tribunal president also emphasised that there was no significance in itself whether the worker was employed or self-employed.

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21. Accounting records

The sort of records that you keep will depend on your type of business, but the minimum requirement for most types of business will be:

- A cash book - summary and analysis of all bank account entries, cash receipts, payments and drawings
- A petty cash book - a record of all your petty cash transactions

Other account books you should consider keeping include:

- Accounts receivable ledger
- Accounts payable ledger
- Fixed asset register
- Project/job costing ledger
- Time recording system

21.1 Using a computer system

You may use a computer system to keep your records, but you will still normally have to keep the original paper records unless you microfilm them or use an optical imaging system.

Apart from the statutory requirements to maintain records, you may find it extremely helpful to use a standard small business accounting software package to manage your business. There is a number of very competent packages available that allow you to do everything from project estimating and billing, through to calculating VAT and producing profit and loss and balance sheet statements.

21.2 Mixing personal and business finances

One of the most common mistakes that small business owners make is to mix business and personal finances, for example, using petty cash or a business credit card to buy personal items, and then not accounting correctly for the transactions.

Once you start mixing your business and personal money, HMRC is entitled to consider that your personal accounts may constitute part of the business records, and can ask to see your personal bank records.

In terms of best practice you are therefore advised to:

- Pay for business expenses using your business bank account, business credit card or petty cash.
- Pay for personal expenses using your personal bank account, credit card or cash.

This is not always possible when you are just setting up your business, but the sooner you establish business accounts and use them for all business expenses, the better.

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21.3 Retention of accounting records

The length of time for which you need to keep accounting records depends on a number of factors:

- Legal and related requirements
- Space considerations
- Costs
- The need for your business to access the records
- Historical value

The following list of suggested retention periods is not exhaustive, but attempts to give you some indication about how long to keep individual records and the justification or reason:

Payments cash book	6 years (Companies Act)
Purchase invoices (revenue items)	6 years (Companies Act)
Purchase invoices (capital items)	10 years (Companies Act)
Purchase ledger	6 years (Companies Act)
Petty cash records	7 years (Companies Act, VAT)
Bank paying in counterfoils	6 years (Statute of Limitations)
Bank statements	6 years (Statute of Limitations)
Receipts cash book	10 years (Companies Act)
Sales ledger	10 years (Statute of Limitations)
Remittance advices	6 years (Statute of Limitations)
Deeds of covenant	12 years (Statute of Limitations)
Income tax and NI records	6 years (Taxes Management Act)
Payroll and payroll control account	7 years (Statute of Limitations)
Staff personnel records	7 years after cessation of employment (Statute of Limitations)
Expense accounts and records	7 years (Statute of Limitations)
Title deeds, leases, searches etc	12 years after interest in property ceases (Statute of Limitations)
Fixed assets register	Indefinite (Companies Act)
Agreements (under seal)	12 years after expiry (Statute of Limitations)
Agreements (other)	6 years after expiry (Statute of Limitations)

Note: CA 1985 S222 (5) states that the time limits for retaining accounting records, for private companies, is for a period of three years from the date on which they were made. However, records such as those used for operating PAYE requires them to be held for six years and as a general rule it would be sensible for directors to keep all accounting records for a period of six years.

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SECTION SEVEN: SECURING WORK

22. Using agents

22.1 Do I need an agent?

You do not have to work through agents if you are able to find client work directly. Agents are basically outsourced buying operations for clients - the better ones also act as an outsourced marketing service for you. At present around 75 per cent of contract work is secured via agencies.

22.2 How do I choose an agent?

Primarily, you will need an agent who can use their client base to find you work, offers good contract terms, is prepared to take time to get to know you and your skills and expertise (so they can sell you effectively), who will pay promptly and who has projects to offer you. Some of the big agents offer extra "perks" such as discounted training schemes but these extras really do not add up to much over the course of a contract. Start by looking at agents offering a work opportunity you may be interested in.

Nowadays, a "good" contract is outside IR35 and on true business-to-business terms. A "bad" contract contains clauses that restrict your ability to work for clients or place personal liability on you or your family. Typically, this sort of contract will look more like a contract of employment than a business contract. There have been several relevant court cases regarding the status of freelancers (outside the IR35 issue) e.g. O'Murphy v Hewlett Packard (2001), Dacas v Brook Street (2004) and Cable & Wireless v Muscat (2006). Because of the uncertainty regarding status and employment rights many clients insist on outsourcing contracts through agencies, while some clients use Preferred Suppliers, which leads to a restriction of choice. However, if you can find direct work it may help your IR35 status and you may be able to negotiate a favourable rate.

Try to find out as much as you can about the contract from the agent before you give permission to send your details to the client. Do not let agents put you forward for a role for which you are not suitable. Agents are required to ask your permission before submitting your details to a client.

Some agents are Affiliate members of PCG. They have access to non-IR35 contracts from PCG and receive PCG newsletters. They are therefore more likely to understand the issues facing freelancers than agencies that are not Affiliate members.

You could consider having your own company contract and terms and conditions of supply of service drawn up by a legal expert. Some agents are already willing to accept such contracts. PCG has a list of recommended legal experts who can help draw up such contracts. Once your company has such a contract it can easily be adapted for direct to client use as well.

22.3 How do I find a contract?

Most contracts are still obtained via agents, although increasingly freelancers are relying on the internet or personal contacts to find work. You should have an updated business profile and CV (or consultant profile) to send out. Most agents use email. Agents may want to register your details on their database but, in reality, most contracts are found on one of the freelancing job websites before the agent ever searches the database.

Something approaching 80 per cent of the agency freelancing market now passes through the Jobserve, Jobsite and Engineers on the Web websites. Freelancers search the online contracts database and, if they find a contract they like the look of, submit details via email to the agent or client who is advertising. If you submit your details to an agent and hear nothing in the next few days, you have not been selected for interview.

22.4 What information should I send to an agent?

Once you have selected an agency to represent you then send them your business profile, CV or consultant profile with detailed descriptions of the projects that you have worked on, detailing all of your relevant skills, qualifications and companies that you have worked with. Do whatever you

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can to make the CV easy to read and be clear on your speciality. It will save you a great deal of time in sifting through phone calls later. Bear in mind that you will have to make regular calls to these agents to update them with your latest projects and whether or not you are currently looking for a new contract. Agencies will also need basic details of your business, such as company and VAT registration numbers. Some clients may require references.

22.5 How do I make sure I get the right contract at the right rate?

Much of this comes down to your interview and negotiating technique. Remember, this is a two-way process and is your only opportunity to find out whether you are committing yourself to six months doing work which is not right for you. Make sure you ask all necessary questions to understand the task you are looking to undertake. This is also your chance to improve your position with the client and the agent. If the client really wants your company's skills and experience, you can generally get a better deal.

The agent will usually be paid commission as a percentage of your hourly rate, anywhere from 5 per cent to 25 per cent, depending upon industry and sector. So the agent gets paid only if you get work. Some clients have agreements with agencies to supply freelancers on a fixed level of commission. In this case, the agent's margin is usually non-negotiable, so if you want more money it will need to come from the client. You therefore need to push home your advantage during the initial discussion with the clients. Like all sales meetings, it helps if you have researched the potential client - it will impress if you clearly understand what they do and their market.

Your negotiations with the agent are just as important as those with the client. If the client really wants to hire you, this gives you a stronger hand to take a larger share of the money being paid to the agent.

Contract negotiation is not just about getting more money. You may want to secure a non-IR35 contract, which can reduce your tax and NI liability. You could also consider negotiating the right to work from home, more project control and so on. A rate will often be slightly higher if you accept payment terms of 30 days rather than seven.

If you are nervous about the thought of going for lots of interviews or negotiating, remember that it is just a normal part of freelancing and gets easier with practice. Do not take it personally - you are no longer an employee, so this is a straightforward business-to-business negotiation. There are many books you can buy to improve your negotiating skills and some local Chambers of Commerce run negotiating courses. Does the level of agency commission matter if I'm happy with my rate?

Sometimes it does. Let us say you are getting paid £25 per hour and the client is paying £50 per hour for your services. All clients expect to pay an agency margin but, because some agents have two-sided non-disclosure clauses, the client may, in this case, think you are a £40-an-hour freelancer. This will have an impact on the level of expertise the client will expect you to have. This, in turn, could have a significant effect on the relationship you have with your client during the contract. So, make sure you use the interview as an opportunity for you and the client to gain an understanding of the relationship between yourselves and the agent.

22.6 Can I rely on agents to represent my business?

Some agencies have gained a poor reputation among freelancers. This is mostly due to bad service or giving misleading information about a contract. However, they are certainly not all bad, and perform a useful function for many freelancers. When dealing with an agent, remember that fundamentally they are salespeople. They want to "sell" you a contract and to "sell" you to the client. This is how they get their commission. They are businesses, first and foremost, in a competitive world.

PCG members regularly share experiences about agencies and can point you in the direction of good ones. Have a look on the PCG forums.

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22.7 Timesheets

Most agencies pay on the basis of timesheets signed by a representative of the client. The exception will be fixed-price work, although even here the timesheet may be the recognised indicator of progress. Many clients also have project time sheet systems. Typically a freelancer will raise an invoice on a frequency agreed at contract negotiation time, usually weekly or monthly, which is reconciled with the signed-off timesheets. It is in the interests of all parties that timesheets be filed regularly and accurately as they are the basis for clients' and agents' cashflows and ultimately the freelancer's income.

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23. Marketing yourself

23.1 An alternative to using agencies

Many freelancers are not comfortable with being reliant upon agencies to find them work, and are keen to explore alternative ways of securing projects and assignments.

Failing to market yourself proactively can be the most expensive mistake you make as a freelancer. Many freelancers believe that they do not have the time, but often, this is arguably an excuse for the fact that they really do not understand what they need to do, what it entails and where to start, so they convince themselves that it is acceptable or better to do nothing.

23.2 Devising a basic plan

Unless you are borrowing money for your business venture, you probably do not need to produce a written marketing plan, but you will almost certainly find it invaluable to consider the following points, and commit some of your thoughts, at least, to paper:

- Clearly define your product and service offerings
- Identify your target audience and market segments
- Review the scope, size and trends within your market segments
- Define your pricing model
- Identify your main competition
- Identify your strengths and weaknesses (SWOT analysis)
- Differentiate your products and services by defining a series of Emotional Selling Points (ESPs)
- ask existing customers why they bought from you

23.3 Creating the right image

You do not need to spend a fortune on creating a suitable image for your business, but as a minimum you will need a few basic items:

- Basic logo, which is scaleable and can be used for print, web and fax
- Business cards, which are high quality, durable, and clearly state what you do
- Letterheads, which do not need to be pre-printed, but should use quality paper, and must have the company registration number printed on them
- Website, with a proper co.uk, .com or similar domain name
- Email address, with a proper domain name (not a hotmail account)

Other material to consider might include:

- Response mechanisms, such as a contact form on your website
- Marketing collateral, such as printed brochures and downloadable white papers

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23.4 Targeting

One of the keys to successful marketing is to focus your attention tightly by targeting the most appropriate potential clients with the most suitable offerings.

- What market sectors are my customers in?
- Why did my current customers buy from me?
- What do I have experience of doing?
- Try and target your activity through niche marketing
- Create a "most wanted list" of companies you want to do business with

23.5 Get organised

Being well-organised is crucial to ensuring that your efforts pay dividends. It is all too easy to lose touch with key contacts and forget to follow up leads and opportunities. The secret is to take a systematic approach.

- Create an electronic database of names, using a proper contact management system
- Your first category of contacts should include every person and organisation you know who is personally capable of offering work. Include everyone you have ever worked for in the past. This list represents your hottest prospects.
- Your second list should comprise everybody you know who might know someone else who might be able to offer you work. Dismiss no one - include people you haven't spoken to in months or even years.
- Your third list should comprise the most detailed list of people or organisations whom you do not know personally but you would want to work with or work for - they might include the leading companies in your industry. This is your wish list of possible clients. Use directories, libraries, guides or whatever resources are available.

Once you have identified all these people you need to contact them, but do not ask for any business. Instead, ask them for some advice and feedback. Firstly, it takes the pressure off them if they are not in a position to offer any work and secondly, you will be seen as someone who cares about what they think and have to say - everybody likes to be asked for advice.

By talking with a number of existing and potential customers you will get a clear idea of what motivates people to employ freelancers in your industry. Go through your notes and extract the most insightful comments from this research.

Think deeply about the information you have been given and start to write down how you can address those concerns, how you can and will solve their problems. This approach is opposite to the way most freelancers operate - the only time they ever make contact with someone is to ask for work. If you think about what you can do to help a client solve their problems and allay their fears or anxieties, a letter or brochure which addresses and answers those concerns and is conveyed in a sincere but professional manner will gain you more business.

23.6 A good website sells

Having a good, professional website is essential. It should be content-rich, easy to navigate, quick to load, and consistent with the image that you portray via your business stationery, in your contacts with potential clients, and any other marketing material. Also, make sure that:

- It is optimised to achieve a good search engine ranking
- You submit your site regularly to the search engines
- You list your site in one or more of the major directories such as Yahoo!, Looksmart, and the Open Directory Project

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- You list your site on PCG's Directory, if you are a member, and on other freelancer websites.
- You offer downloadable content, such as white papers.
- Your site includes a useful response mechanism, such as a contact form, and that you specifically ask visitors to opt in for email newsletters and the like.

23.7 Cost-effective marketing via email

Marketing via email can be very effective, and cost very little, but you must email only those people or businesses that have agreed to receive email from you.

The EU Directive on Privacy and Electronic Communications was introduced on 11 December 2003 in an attempt to crack down on spam by regulating the dissemination of direct marketing via email and SMS.

The first new rule applies to all marketing messages sent by electronic mail, regardless of who the recipient is.

- The sender must not conceal their identity and
- The sender must provide a valid address for opt-out requests

The second new rule applies only to unsolicited marketing messages sent by electronic mail to individual subscribers.

- Senders cannot send such messages unless they have the recipient's prior consent to do so.

This strict "opt-in" rule is relaxed if three exemption criteria, as follows, are satisfied:

- The recipient's email address was collected "in the course of a sale or negotiations for a sale"
- The sender sends promotional messages only relating to their "similar products and services" AND
- When the address was collected, the recipient was given the opportunity to opt out (free of charge except for the cost of transmission) which they did not take. The opportunity to opt out must be given with every subsequent message.

23.8 Directories

It is worth listing your company in all the online and printed directories, most of which offer a basic listing for free. These include Yellow Pages, Kellysearch, AskAlix.com and various trade directories.

23.9 Networking

For freelancers, networking can be one of the most effective ways of finding new business. After all, people buy from people, and so face-to-face contact is likely to work much better than cold calling, advertising or other forms of promotion. A recommendation by someone who knows you can be extremely influential indeed, and the power of "word-of-mouth marketing" has led to the growth of some very effective networking organisations.

In order to win more business from networking:

- Develop and practice delivering a focused 60-second pitch about what you do
- Spend some time developing your networking skills
- Look to join a local business networking group such as BNI (Business Network International) or BRE (British Referral Exchange) or consider LinkedIn.
- If you are a PCG member, go to regional Real Life Meetings, and visit the Commercial forum to post your requirements for goods and services, or respond to those posted by fellow members

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- Build up a list of associates (e.g. a web developer may need a graphic designer) with whom you can work and exchange business opportunities

23.10 Public relations (PR)

Often viewed as being the preserve of larger companies, effective PR can be very useful for small businesses and can help them to punch above their weight. Here are some of the things that you might consider doing:

- Look for press opportunities in relevant trade journals
- Write white papers and technical articles
- Write sales stories
- Issue short press releases on recent successes
- Make yourself available for interviews

23.11 Develop a positive attitude

Having a positive attitude and believing in yourself are very important if you are to succeed in marketing yourself. Not only that, but planning, organisation and persistence will pay dividends. Never forget that people buy from people, and so always try to treat your business contacts as you would like to be treated. Listen carefully to what they want, ask them for feedback, keep your promises, and be thoroughly professional in all your dealings with them.

And finally, remember that having a proper marketing strategy and marketing expenditure is a pointer for being in business on your own account.

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SECTION EIGHT: YOUR PERSONAL FINANCES

24. Planning your work

If you are accustomed to working as a permanent employee, in planning your work as a freelancer, you will need to take into account the fact that you will no longer have paid holiday and sick leave, and that you have to be able to weather periods without work and income.

24.1 What about holidays?

As a freelancer there is no such thing as “holiday” pay. In fact, you do not get sick pay either. When a company takes on an employee, it will usually include a cost margin to cover these eventualities, so the employee’s annual salary will generally include a given number of “paid” holidays. Some companies even take out insurance against employees becoming sick.

As a freelancer, you need to factor these additional costs into your revenue calculations. You will not work 365 days a year. Apart from your holidays, there are many reasons why you may not be earning. You may be “between contracts” for a period of time. You or a family member may fall sick and you may have to take time off work.

You may be able to insure against illness but as insurance rarely pays out everything you hoped, you can also “insure” yourself by having savings set aside. This brings us to your buffer.

24.2 What is a “buffer”?

Every freelancer needs a buffer. Use your freelancing income to build up a cash reserve fund in your company sufficient to pay you enough to cover your living expenses for at least six months. You need to remember that any money you take out of your company for personal use will be subject to tax (in the case of dividends) or tax and NIC's (in the case of salary). You need to allow for these amounts in your calculations as the taxman will expect to be paid on time. Remember also you may have VAT to pay in the future as well as other standing business expenses such as insurance, accountancy fees, software support agreements, telephone bills, and so forth, even though your company may not be generating any income.

By building up a cash buffer you will protect yourself against the inevitable breaks in freelancing. You will never be forced to take an unsuitable contract and you will never have to worry too much about short-term breaks due to illness or circumstances. You can take out Permanent Health Insurance to protect yourself against being unable to work for longer periods of time due to ill health.

24.3 I can't afford to save

Then you cannot afford to be a freelancer. As a freelancer, you have opened up the potential to earn more than as an employee. This comes with extra responsibilities. Freelancing can be unstable. Rates are determined by market forces and can go down as well as up.

Many freelancers suffer from the “ratchet-effect”. It is easier to expand your lifestyle to fit your expanding income than to contract your lifestyle to fit your shrinking income. You'll sleep much easier as a freelancer if you know you've either got substantial savings and investments, or you are living below your means by a comfortable margin.

If you are self-employed, you should have a high interest savings account into which you save between 25 per cent and 30 per cent of your gross income each month to meet your tax liabilities in January and July each year.

25. Pensions

25.1 How should I plan for my retirement?

As a freelancer, you are responsible for your own retirement - there is no corporate pension scheme you can join, unless you set one up yourself. However, if you are director of your own company, you have more options open to you than a standard employee.

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25.2 Private pensions

A private pension scheme relies on direct payments to an organisation which invests on your behalf. They can be set up by an employer or private financial company, and broadly speaking, there are two types:

- occupational pensions
- personal pensions (including stakeholder pensions and group personal pensions)

25.3 Personal pensions

A personal pension is a type of private pension that is approved by HM Revenue & Customs and receives certain tax advantages. You take out a personal pension under a contract with a pension provider and contribute to it yourself.

Personal pensions are money-purchase arrangements in which your money and any additional contributions from a third party, such as an employer, is invested to build up your pension fund. Most personal pension providers require you to make payments on a regular basis, or lump sums, for example at the end of your tax year. The value of the final pension you receive in these schemes depends on the amount invested, the time invested and the quality of the funds you invest in. You, as an individual, bear any risk on the investment returns in these schemes.

25.4 Stakeholder pensions

A stakeholder pension scheme is a flexible and portable personal pension arrangement that must meet strict government standards. The main differences between stakeholder pensions and other personal pensions are:

- annual management charges capping as set down by law
- the amount you can contribute to a stakeholder pension each year is not determined by your earnings, so they are suitable for non-earners, including children, too.

The charge capping means that some providers choose to invest in simple tracker funds that do not provide the wide range of investments many unit-linked personal pension funds offer.

25.5 Taking pension benefits

There are now many ways that you can draw an income from a pension. Traditionally, individuals took 25% Tax Free Cash (TFC) and the balance as an annuity. However, annuity rates are very poor, and they lack flexibility and often offered poor death benefits. New rules allow more flexible options, including taking part of your pension whilst you slow down to a part time role, but leaving the balance to grow, or Unsecured Pension (USP) or Alternatively Secured Pension (ASP). See the PCG's Guide to Pensions for more information on this (this is a member only resource).

25.6 Pension alternatives

There are disadvantages with pensions, such as the lack of flexibility, management charges and the fact that you can take only 25 per cent of all your pension arrangements as a tax-free lump sum. However, for contractors who operate through a limited company, company pension contributions to a pension represent one of the most tax efficient ways of getting money out of the business as it can save National Insurance (NI) contributions, income tax and corporation tax. Although your pension contributions attract tax relief, the payments you receive when you retire will be taxable, though there will be no NI to pay.

There are many alternatives to a standard pension for a company director - see the paragraphs about SIPPs further on. Or, if you would prefer your retirement income, rather than the contributions you make today, to be tax-free, you could take out an ISA. Of course there are other options as well, such as building up a large property portfolio, where you can benefit from the power of gearing, but being a landlord is a decision not to be taken lightly.

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As a freelancer, your lifestyle will be quite variable. You may end up working abroad and could even retire overseas. You can use your company's surplus funds to save for your retirement. To do this, simply leave the money in the company by using a corporate savings account. However, growth rates are only likely to keep pace with inflation, and this is far less tax efficient than company pension contributions (see PCG Guide to Pensions for an explanation on how your company can make pension contributions on your behalf and claim them as an allowable business expense).

25.7 Executive Pension Plans (EPPs)

Many contractors were paying into an EPP prior to A Day (the date when pension rules changed in April 2006). EPPs were occupational schemes, set up for people running their own limited company. Their key advantage was that their funding limits were more generous than conventional schemes and there could be an opportunity to take more than 25 per cent tax-free cash (TFC) out of the scheme. These advantages disappeared after A-Day as other schemes can now offer similar flexibility, however if you would be entitled to more than 25% TFC this option can be protected. If you have such a scheme and are unsure what to do, you should take professional advice.

25.8 Self-Invested Personal Pension Plans (SIPPs)

A SIPP is a personal pension with a wide choice of investments. It lets you choose from a wide range of funds and other investments. You can hold individual stocks and shares in a SIPP should you wish. The SIPP wrapper provides the tax advantages and legal framework for your collection of investments for retirement. What you hold within the SIPP wrapper is up to you. You are able to choose and switch between a wide selection of funds and permitted investment types. With a personal pension you can choose only from a limited selection of investment funds.

There are two investment "wrappers" from which to choose:

- Self-Invested Personal Pension (SIPP) - contributions are based on age-related allowances
- Small Self Administered Scheme (SSAS) - the corporate alternative, used by company directors and managers. Works under the same age, salary and length of service rules as the more widely known Executive Pension Plan (EPP)

25.9 State pension provisions

In addition to any occupational schemes and personal pension arrangements, you may be able to benefit from basic pension provisions made by the State, which currently comprise:

- Basic State pension. The Pension Service (part of the Department for Work and Pensions) will pay your basic State Pension based on your National Insurance record. You may also qualify for the additional State Second Pension based on your earnings and National Insurance contributions.
- State Second Pension (S2P). An additional State Pension on top of your basic State Pension, paid by The Pension Service. This was called SERPS, but since 2002 it is called the State Second Pension. Self-employed people cannot build up a State Second Pension.

25.10 Seeking Financial Advice

If you wish to obtain advice about a pension or retirement planning, you should use an Independent Financial Adviser. You can find an IFA close to where you live through the www.unbiased.co.uk website. Check that the adviser has the G60 or J04/J05 pension qualification if you want someone that has specialist advice. Ensure that the adviser understands the rules on company contributions to pensions. PCG are affiliated with Wealth Matters (www.wealth-matters.co.uk) who have been providing pension advice to PCG contractors for over 6 years.

25.11 Useful links and resources

PCG's Guide to Pensions: available for members at www.pcg.org.uk/pensions

For a state pension forecast: www.thepensionsservice.gov.uk

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FSA publications: www.fsa.gov.uk/consumer/pensions/5_tools/publications.html

HMRC overview of Pensions Tax Simplification: www.hmrc.gov.uk/pensionschemes/pts.htm

Find an Independent Financial Adviser (IFA)- www.unbiased.co.uk

PCG Affiliate Member: www.wealth-matters.co.uk

26. Company cars

26.1 Should I have a company car?

Your company can own a range of assets, such as tools, equipment, and even premises. For example, if you use a laptop for your work, this can be purchased and owned by the company. However, company cars are slightly more complicated.

If the company owns the car, then the company will pay for everything but:

- If you are a director or employee of a limited company, you will be taxed on the “benefit in kind” from having a company car.
- If you are self-employed, you have to calculate the value of the private usage of your car and exclude that from your allowable business expenses calculation.

From April 2002, new regulations reward environmentally friendly cars with discounts on company car tax rates.

Alternatively, if you use your own car for business miles, you can claim back compensation from your company. The amount you can receive tax-free is determined by the HMRC approved mileage allowance payment (AMAP). You can claim back from the company an amount per mile, depending on how many business miles you have covered in that tax year. You should retain a mileage log detailing the business journeys undertaken. For the 2007/2008 tax year, the AMAP rates are:

	First 10,000 business miles in the tax year	Each mile over 10,000 miles in the tax year
Cars and vans	40p	25p
Motor cycles	24p	24p
Bicycles	20p	20p

If the company pays you more than the AMAP rate, you will be liable to pay tax and NICs on the excess. If the company does not pay you a mileage allowance, or pays less than the AMAP rate, then you can claim tax relief against your earnings for the difference. This is called “mileage allowance relief” (MAR), and requires you to keep detailed records of your business miles and the mileage allowance payment made by your company.

Note also that you can claim a tax free business passenger allowance of 5p per mile; to qualify, the passenger must also be an employee on business travel.

26.2 Useful links and resources

For the latest rates and more information about all these schemes, see the HMRC website: www.hmrc.gov.uk/rates/travel.htm

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SECTION NINE: CLOSING A COMPANY

27. Options

There are two main options available:

27.1 Dividends

All remaining funds in the company after payment of all liabilities are treated as a final dividend distribution and allotted to the shareholders as usual. As with any other dividend, for basic rate taxpayers there is no further liability to tax. Higher rate taxpayers will pay an additional 25 per cent of the net dividend received that falls into the higher rate bracket. Careful planning is required here as you may well not know what other income you will receive in the rest of the tax year.

27.2 Capital distribution

Known as Extra Statutory Concession ESC C16, this route is actually a published HMRC concession and, as such, must be claimed. Also, if HMRC denies the concession, there is no appeal process, although that would be very unusual.

Essentially this concession treats the final distribution of the company as capital, rather than revenue and is therefore subject to Capital Gains Tax rules. There are two useful reliefs for CGT. Firstly, the first £9,200 of annual capital gains are exempt from tax, and this applies to each taxpayer. A typical husband and wife 50:50 split would therefore give £18,400 tax free during the 2007/08 year (assuming no other capital gain in the year). Secondly, there is taper relief.

This reduces the gain still further on a percentage basis so, for shares held for more than two years, the taxable gain would be reduced to 25 per cent of the total.

For example, take a situation where there is £75,000 left in the company after all liabilities have been paid, and the share capital is split equally. Also assume that both individuals are higher rate tax payers. The difference between the two treatments is as follows:

	Dividend	Capital
	£75,000	£75,000
Annual reliefs (£9,200 x 2)		(£18,400)
Taper relief at 75%		(£56,250)
Chargeable to tax	£75,000	£350
Higher rate tax payable	£18,750	£140
Saving		£18,610

As you can see the savings can be significant. Care must be taken to ensure that the application for the concession is made in the correct way and that you get written approval from your tax inspector first. Your accountant will be able to tell you what is required.

Timing is important. The assets qualify for full business asset taper relief on the day the company ceases trading. After that, they are classified as non-business assets. The taper relief you will get is a time-apportioned average of the very generous business rate and the measly non-business rate. So, every day that passes the taper relief wastes away.

The obvious question that most of you will be asking now is "why don't I just do this every three years?" The answer to that is that HMRC will deny the concession if they suspect systematic tax avoidance. However, if the reason for closing the company were genuine (for example a contract ending with no others in prospect), then there would be nothing to stop one doing just that. Make sure that you obtain professional advice from a qualified accounting practice, and do not forget about the Statute of Limitations, mentioned in this guide.

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28. Maintaining PCG membership after business closure

Abbey Tax has advice for PCG members regarding the recommended period of time for which they should maintain their PCG membership after closing their business.

Essentially, HMRC can enquire into the final accounts of a company for up to two years after the company ceases trading. Using the example of a company, ABC Ltd, with a 31 December 2004 year end:

The company ceases trading on 31 December 2005. The final accounts and final Corporation Tax Self Assessment Return must be submitted to HMRC by 31 December 2006. HMRC has until 31 December 2007 to enquire into that return (i.e. the "enquiry window" closes).

Thereafter, HMRC cannot make any further enquiries unless a "discovery" is made at a later date. A discovery is a matter that HMRC subsequently becomes aware of, that would materially affect the previously declared tax position of ABC Ltd. An example of this might be an HMRC enquiry into a business which had engaged ABC Ltd showing that ABC Ltd had been paid £100,000 for services provided and not the £50,000 shown in ABC Ltd's accounts. Such a scenario is extremely rare and is unlikely to be covered by any form of insurance, because it is likely to be deemed fraudulent. Therefore there is no need to go beyond the two-year period that ends with HMRC's enquiry window closing.

The advice from Abbey Tax is therefore that you should keep your membership in place to cover the two-year enquiry window, thus ensuring cover under the Professional Expenses Insurance (PEI) policy. Similarly, PCG*Plus* members should maintain their membership for the same period, to ensure PAYE Audit Cover as well as cover under the Professional Expenses Insurance (PEI) policy.

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SECTION TEN: NOTES



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SECTION ELEVEN: APPENDICES

29. Appendix A: PCG background

The Professional Contractors Group (PCG) was formed in May 1999 in response to the Government's IR35 proposals. It has since evolved from operating as a single issue group to being a fully-fledged trade association. As the not-for-profit representative body for freelance consultants and contractors, PCG is dedicated to representing and promoting their interests in terms of regulations, taxation, economics, employment and other issues that affect their businesses. PCG members operate in a diverse range of sectors, including IT, management, financial, marketing, engineering, oil and gas, telecommunications and accountancy.

PCG's aim is to work for proper recognition of independent freelancers as a genuine and valuable sector of the economy, generating wealth and employment, providing industry with a flexible workforce.

PCG has worked with HMRC to improve its employment status manuals (ESM), and with the DTI to ensure the inclusion of an opt-out clause for freelance contractors in its agency regulations. It also sits on the IT and Engineering Skills Panels for Work Permits UK, and has advised about measures to counter Intra-Company Transfer (ICT) abuses, as well as clearing the IT Skills Shortage list.

PCG is the most comprehensive source of IR35 advice, guidance and tools. Its legal cover has saved members an estimated £4 million in professional charges and taxes since its inception. So far, over 1,400 tax status cases have been concluded, all but three of them successfully.

Benefits of membership include bundled professional expenses insurance, access to free tax and legal help lines, IR35 and Section 660A analysis and manuals, pensions guide, standard contract templates and discounted professional indemnity, public liability and employers liability insurance. Members also have access to a wealth of technical and commercial advice via the discussion forums, not to mention a comprehensive range of member services and preferential rates from suppliers, including home office insurance, hotels and travel, business software, training, office space, preferential car buying arrangements, discounts on a range of goods and services.

For more information on what PCG is doing for you, visit our website at www.pcg.org.uk

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30. Appendix B: IR35 background

IR35 is the “intermediaries’ legislation” which was announced in the 1999 Budget and came into force in April 2000. IR35 was introduced because the Government believed that some people were providing their services through a limited company or a partnership as a means of avoiding tax. IR35 allows the HMRC to treat fees paid to a company or a partnership as an individual’s personal salary.

Many contractors have been caught up in the legislation and subsequently taken to court. A number of recent IR35 court cases against individual contractors have ruled against the Government, so that the anticipated increases in National Insurance and Tax receipts have never materialised.

IR35 applies to individuals who provide services through a limited company in which they own more than 5 per cent of the shares, or a partnership in which they take more than 60 per cent of the fees (the “intermediary”), to another business (“client”). The legislation allows HMRC to “look through” the intermediary and determine whether, if there had been a direct contract between the worker and the client, it would have been a contract of employment, in effect of applying the case-law distinction between employment and self-employment to the relationship.

If the relationship is found to be one of “disguised employment”, the fees paid to the intermediary by the client are deemed to have been paid by the intermediary to the worker, and should be subjected to PAYE and NICs. A fixed 5 per cent allowance may be deducted from the fee to cover business expenses, irrespective of how much is in fact incurred in expenses, or how much is in fact paid to the worker as salary or in any other form.

IR35 applies only where the consultant is a significant share-holder or partner, which in practice means small companies and partnerships. Large service companies are unaffected. IR35 does not create an actual employment relationship between the worker and the client. The worker gets no employment rights with respect to the client. The intermediary company remains liable for all PAYE and NICs, including employers NICs, on the fees received, and remains liable for holiday pay, sick pay, maternity pay and so forth for the worker.

PCG’s Guide to IR35 is available for members to download from the website.

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31. Appendix C: S660A background

From 2003 to 2007 HM Revenue and Customs and its predecessor, the Inland Revenue, attempted to reinterpret the settlements legislation, often referred to as "S660A" for short, to penalise jointly-owned limited companies. PCG fought off this attack by supporting the Arctic Systems case all the way to the House of Lords, which found in favour of Arctic's owners, Geoff and Diana Jones, in July 2007.

Currently, therefore, freelancers whose spouses are joint owners of their limited companies will not face an extra tax charge on dividends paid to the spouse. Past tax years are therefore safe from attack, and HMRC will not be able to back-date the tax as it had wished.

HMRC had sought to apply the settlements legislation to freelance contractors and consultants when:

- There is a limited company (or partnership)
- Ownership is shared with someone else (e.g. a spouse)
- The freelancer is the sole or main fee-earner
- The other owner receives dividend or profit share

Many freelance businesses, under advice from their accountants, operate precisely this structure. Typically, when assessing liability, HMRC sought to go back six years, which could result in a tax assessment of over £40,000.

However, the Government announced its intention to legislate immediately after the House of Lords' ruling. The form of this legislation has not yet been announced, but it may mean that, in future, joint ownership of a company with a spouse will not offer any tax advantages (though there may be other reasons for opting for this set-up).

PCG's Guide to S660A, available to members only, includes full background information and details of the legal position of S660A. At the time of publication this Guide was being updated following the House of Lords judgment; be sure to check www.pcg.org.uk for the updated version.

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32. Appendix D: Other PCG resources

Guide to IR35

Guide to S660A

Guide to Pensions

Guide to Agency Regulations

Draft sample contracts

Freelancers - your flexible workforce

Guide to insurance

Complete library of articles and papers on the website, some of which are available for non-members to download

PCG forums:

Members only

Accounting FAQ

Client/Agency Matters

Contracts

Legal FAQ

Oil, Gas and Engineering

Working Overseas FAQ

Members and Affiliates

Affiliates

Commercial

Technical

Members, Advisers and Suppliers

Case Law

Legal and Accounting

Lobbying and External Affairs

Press



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About PCG

The Professional Contractors Group (PCG) is the not-for-profit trade association for freelance consultants and contractors in the UK.

The value of freelancing

One in seven workers in the UK choose to work for themselves and freelancing has become the preferred way of working for the very best talent in every sector.

Our aim is to win proper recognition of independent freelancers, who provide industry with a flexible workforce, generate wealth and make a valuable contribution to the economy.

Our members

Our members work in a wide variety of sectors, including information technology, oil and gas, transport, engineering, finance and banking, management consultancy, marketing, media, telecommunications, construction and pharmaceuticals.

We work to promote our members commercially and support their development, actively developing tools, services and relationships that will assist them. Our objective is to help members improve and enhance their business prospects and continually improve the professionalism of the freelance community and the way in which it is perceived.

Member benefits

We offer our members a broad range of services, including cover under our insurance policies, legal and tax helplines, comprehensive guides, draft contracts and regular events.

Representation

We represent freelance consultants and contractors in the UK on matters relating to regulations, taxation, economics, employment and other issues that affect them.

In seeking to exert influence, our policy team engages in direct discussion with senior Ministers and civil servants, participates in consultation exercises, forges relationships with unions and other organisations and produces a comprehensive range of research and policy papers. In line with our case law strategy, we also support a selection of cases for our members each year.

The photographs on the front cover feature PCG members, representing a wide range of disciplines, skills and market sectors.

For further information

www.pcg.org.uk

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