iContract

DECISIONS, DECISIONS

Contracting - Financial Matters

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Contracting – Financial Matters

So you've decided you're ready to turn your skills and experience into a successful contracting career. At first it sounded too easy – more money, more flexibility, more control. But then you realised the pay-off was having to figure out things like tax, pensions and insurance all on your own.

Many first-time contractors hit the ground running, only to find the administration of working for themselves all too much. By taking the time to plan out how you will operate, how you will structure your income for tax purposes, as well as which insurance and pension plan is right for you, you can focus on your contracting projects, rather than being tied up in the nitty gritty of your accounts.

The team at iContract remember being where you are now, all set to embark on a contracting career, only to be baffled and quite frankly a little frightened, by all the financial jargon that goes into running your own shop. In this easy-to-digest guidebook, we draw on our experience and share the most up-to-date information on tax, mortgages, pensions and insurance, so there are no nasty surprises when you head out on your own.

Limited company or Umbrella company?

You may never have imagined yourself as an all-powerful company director. But if you set yourself up as a contractor under your own company, that's exactly what you will be.

There are lots of reasons why it's a good idea for contractors to present themselves as a company and many people choose to set one up when they set out on their own.

The protective layer of a limited company brings security to freelancers and contractors. The company becomes liable for its own debts, PAYE payments can be set up for more straightforward tax payments, and your overall tax bill can even work out much less than it would otherwise be, thanks to the legal advantages of setting up a limited company.

Limited companies offer a great framework for contractors, but they also come with responsibilities and for that reason some people choose a more service-heavy solution.

Umbrella companies are companies that are set up and run by a limited company separate from the contractors who trade under its name. Contractors pay to belong to an umbrella company, and in return invoice and get paid under that company name, administered by somebody else who makes sure you have all the legal bases covered.

It costs more for the umbrella company's service, but for some contractors, relieving themselves of the administrative burden is worth every cent. So which should you choose? This might give you a clearer picture of the pros and cons to help you decide:

Umbrella Company

Advantages
- All legal, tax and financial stuff handled for you
- Same legal protection
- Ideal for those testing the water with contracting
- No company admin or invoicing hassle
- Some of the umbrella companies especially when set up PAYE through your recruitment agencies provide paid annual holidays (i.e. 5 days per year). It's worth checking with your recruitment agent.

Disadvantages
- Umbrella companies take a small % cut from your income, although it is treated as expenses which is tax deductive
- Some tax saving, but less than that with a limited company
- Slightly less flexibility
- No overall control of the company

It's up to you how you choose to structure your arrangements as a contractor. Those who are new to contracting and don't have experience running a business, or who are unsure about whether they'll still be contracting in a year's time are good candidates for an umbrella company option. There's also no reason why you can't start with an umbrella company and move over to your own limited company later, when you are more established Umbrella companies will typically charge a monthly fee, often on a sliding scale depending on the level of service you choose. Finding a good umbrella company setup can be a great time, stress and hassle-saver, but it is important to make sure you're getting value for money, especially in the early days of your contracting career.

Accountancy, tax and legal compliance are amongst some of the trickiest aspects of working as a contractor. Umbrella companies can handle some of this for you, as can your accountant. But a savvy contractor will not just hand the umbrella company their business blindly. Make sure you read the other chapters in this guidebook to ensure you're always one step ahead, regardless of who is managing your taxes.

Limited Company

Advantages

- Invoicing, earnings and payment flexibility
- Legal protection from limited liability structure
- Freedom to take on different types of work
- No income deduction taken from umbrella companies

Disadvantages

The contractor (i.e. you) is responsible for:

- Company admin: record income, expenses and VAT
- Manage and filing accounts: calculate and ensure you are paying the correct corporate and personal taxes
- No holiday payment

A limited company structure puts you in control of the finances including how your income is distributed and how much of your business expenditure you can claim each financial year. Due to the flexibility of this option, contractors can see tax savings when they manage their company well. But that management takes time and requires more accounting skills and legal knowledge than you may have realised. A limited company is required to file its annual report, audited by a professional accountant, on an annual basis. It is therefore vitally important to choose a good accountant or accountancy firm who can provide you the right advice and help you manage the process.

Of course, accountants tend to charge by the minute, so we understand you don't want to run to your accountant for every little question. As a director of a limited company, it is important that you understand the tax requirements and financial planning yourself. To guide you through this new and confusing world, iContract has pulled together an essential guide to accountancy and tax for contractors.

Accountancy and tax advice for contractors

Ask any contractor what they find easiest about their job and few, if any, will say it's tax. Accounting, record keeping, filing for and paying taxes can be both the most mind-boggling and boring aspect of the job.

Getting the right advice is really important, because you want to be sure you are always staying on the right side of the law. Get it wrong, and you could end up paying a hefty price in fines, fees and interest. In some cases, you might even end up with a criminal conviction.

Yes, accountancy and tax is serious and necessary, but it can also bring you great benefits. Organising your affairs in the most tax-efficient way can bring you significantly greater savings and more money straight to your pocket. The first step to handling your financial obligations as a contractor is to understand which taxes you need to pay.

Which taxes should you pay?

Income Tax/NI

Contractors need to pay income tax on any money they earn. For those without a limited company, or an umbrella company in place, this will usually be through a self assessment. That means completing a tax return every year, documenting your earnings and allowable expenses. Your tax is calculated as a percentage of what's left. This information must be submitted to HMRC (Her Majesty's Revenue and Customs) in a timely, accurate way – unless you are paid via the PAYE (pay-as-you-earn) system, in which case your employer must submit the relevant information for you.

Umbrella companies pay via PAYE, which means you are essentially treated like an employee. Unless you also take dividends from your company, you may not need to complete a self assessment return.

VAT

Contractors who bill work in excess of a certain threshold are legally required to collect VAT (value-added tax) on behalf of the exchequer, adding a percentage on to the total cost of any work commissioned and remitting forward to HMRC on a monthly or quarterly basis. You are liable for adding VAT costs to your total invoice amount and for making payments to HMRC accordingly.

VAT registered contractors and companies benefit from being able to reclaim VAT on purchases, which means spending on VAT applicable goods and services is cheaper for VAT registered contractors than non-registered contractors.

Contractors can obtain further savings by registering for the VAT flat scheme, which allows small businesses to charge VAT based on a 20% rate, but to pay HMRC a reduced rate if they opt out of claiming VAT on purchases. To be eligible for the VAT flat scheme, you must be VAT-registered and expect an annual turnover of £150,000 or less. The flat rate contractors pay depends on the type of business they run. The flat rate for management consultants is 14%. You can view a full list of VAT rates for different industries here: https://www.gov.uk/vat-flat-rate-scheme/how-much-you-pay

The pitfall of the VAT flat scheme is that you are no longer able to reclaim VAT on purchases. However, for contractors who do not purchase equipment and services on a frequent basis, the flat scheme can still be the best option because of the substantial tax savings. One further benefit of registering for the VAT flat scheme is you are entitled to a further 1% discount in the first year of operation, reducing effective VAT rate you pay to 13%.

Corporation Tax

Corporation tax is the tax a company must pay on its profits. As a contractor who sets up a limited company, you will have to pay corporation tax.

Tax planning tips tor any contractor

Being a contractor means you can plan your tax affairs. An employee is paid and taxed through PAYE, so the tax is automatically calculated and deducted from your pay cheque. A contractor, on the other hand, is responsible for calculating and managing his own corporate tax. Your company's business expenses need to be deducted against your revenue to calculate your net profit. The corporate tax you pay is then calculated based on your net profit, rather than your revenue. The corporate tax rate in the UK is currently 20%. The trick is to offset your business expenses against your income to reduce your total tax bill and to give you the flexibility to manage your own takings through dividends and salary.

Dividends vs. Salary

There are two main ways you can choose to be paid by your company. As a director/employee, you can take a salary, paid through PAYE and taxed accordingly. But as a shareholder, you can also take dividends – a share of profits, to which you are entitled as the 100% owner. In the end, both salary and dividends are cash in your bank account, but the tax implication between the two is different.

Salary tax rate

Salary is taxed at the prevailing income tax rate based on your tax band. The table below shows the personal tax rate for tax year 6 April 2016 to 5 April 2017.

Band	Taxable income	Tax rate
Personal Allowance	Up to £11,000	0%
Basic Rate	£11,000 to £43,000	20%
Higher Rate	£43,001 to £150,00	40%
Additional Rate	Over £150,000	45%

The personal allowance for tax year 6 April 2016 to 5 April 2017 is £11,000. The personal allowances and tax rates are adjusted on an annual basis. Make sure you regularly check the new rates at: https://www.gov.uk/income-tax-rates

Dividend tax rate

Prior to 6 April 2016, dividend tax rates were based on total dividend amount and not associated with your total income. However, from 6 April 2016 onwards, dividends are taxed based on your income band, where your total income includes your salary and dividends. The first £5000 in dividends are tax-free and are not included in the below calculation.

Band	Total income (salary + dividends)	Tax rate
Basic Rate (and non-tax payers)	Up to £43,000	7.5%
Higher Rate	£43,001 to £150,000	32.5%
Additional Rate	Over £150,000	38.1%

To keep updated on the latest dividend tax rules, please check: https://www.gov.uk/tax-on-dividends/how-dividends-are-taxed

How much should I take out as salary vs. dividends?

Historically, this has been an easy answer. Take the minimum salary level under the income tax personal allowance and take the rest in dividends. This is because dividends were taxed at a lower rate than income tax, so you could effectively reduce your tax bill by allocating as much of the income to dividends as possible.

However, the recent change in dividend tax rules changes things and has closed the gap between salary and dividend rates.

Here are some examples to illustrate this:

John is on a contract with a contract rate of £500 per day. He worked 200 days in total from April 2016.

- Total Revenue = £500 x 200 = £100,000
- Business Expenditure = £20,000
- Net profit = £80,000
- Corporate tax rate @ 20% of £80,000 = £16,000 (although salary is tax deductive, but here we assume you save £16,000 in the account to pay future corporate tax on a conservative basis)
- Remaining cash in the bank after corporate tax = £80,000 - £16,000
- Total = £64,000

Scenario 1

John wants to take out £50,000 in total from a combination of salary and dividends and leaves the remaining £14,000 in the business as the retained earnings. Salary is paid on a monthly basis while dividends can be taken out any time of the year.

To take out his personal allowance of £11,000 as salary only and the rest as dividends.

- Salary = £11,000 (monthly salary £917)
- No income tax payable
- Dividends = £39,000
- The first £32k is subject to a basic dividend rate of 7.5%. John can use his £5k dividend allowance to offset the lower threshold dividend tax. The remaining £7k is taxed at a higher dividend rate of 32.5%. Therefore the dividend tax John pays = (£32,000-£5,000) x 7.5% + £7,000 x 32.5% = £4,300

Can John reduce his tax bill by using a different combination of salary and dividends?

Scenario 2

Now let's assume John takes out £43,000 salary and £7,000 dividends.

- Salary = £43,000 (monthly salary £3,583)
- Income Tax = (£43,000 - £11,000) x 20% = £6,400
- Dividends = £7,000
- Dividend tax = (£7,000 - £5000) x 32.5% = £650
- His tax bill in this case will be made up of income tax of £6,400 and dividend tax of £650, with a total tax bill of £7,050.

However, salary is subject to national insurance contributions, while dividends are not (we will cover national insurance contributions in the next chapter). This adds on additional costs for taking out salary.

The new rule indeed closes the gap between total tax paid using different salary and dividend combinations, and the best option for calculating a contractor's tax is not always immediately obvious.

In order to plan your tax efficiently, you will need to consider your earnings as a combination of salary and dividends, which tax band that will put you under, and to run through several scenarios to calculate which combination best benefits you.

Is there any way you can plan ahead to reduce your effective tax rate, you ask?

Well, yes. Adjusting the total cash you would like to take out from the business instead, can put you into a different tax bracket and reduce your effective tax rate significantly. The magic number is the basic rate bracket of £43,000!

Scenario 3

For example, in view of the high tax rates, John might decide he needs to instead take out £43,000 to keep himself within the basic rate category. He can keep more cash in the company, which can be used for investments and business purchases in the following years.

The most efficient way to take £43,000 is to fully utilise both the £11,000 personal allowances on the income tax and the £5000 tax-free dividend.

- Salary = £11,000 (monthly salary £917).
- Tax = No income tax payable.
- Dividends = £32,000
- Tax = Since John's total income is £43,000, he falls under the basic dividend rate of 7.5%.
- Dividend tax = (£32,000 - £5000) x 7.5% = £2,025
- Therefore, in taking £43,000, the total tax John will owe will be £2,025 only, an effective tax rate of just 4.7%. By reducing the total cash he takes out of the business by £7k, John can reduce his effective tax rate significantly.

Although every contractor has to consider his own personal circumstances when deciding how much he would like to earn from the business, in order to reduce the tax bill, it is more beneficial for a contractor to keep the total income under £43,000 per year and to take a combination of salary and dividends to fully utilise both personal allowances and free dividend amount to minimise the total effective tax rate.

One thing to note though is salary is tax deductive while dividends are not. Therefore, by taking a smaller salary, your corporate tax will increase. The best structure is probably to take a salary more than £11,000, and the rest in dividends, keeping the total income at £43,000. The optimal level will depend on your business expenditures. If you know your ongoing business expenditures, then your accountant should be able to work out the magic combination!

National Insurance Contribution

One further item to add into your total calculation is national insurance contribution. If you are an employee of the company on PAYE, both the employer and you need to pay a national insurance contribution. Dividends, on the other hand, are not subject to national insurance contributions.

So as an employee of your company, you also need to pay national insurance, and you should deduct this from your pay cheque before salaries are paid.

Any salary-earner above the primary threshold of £672 per month or £8,064 per year, is obliged to pay a national insurance contribution. A slightly higher secondary threshold of £676 per month or £8,112 per year is used as a starting point for employers to pay their national insurance contribution. National insurance contributions are physically paid by employers but the majority comes from the employee's earnings and is paid through direct salary deductions. The employers pay 13.8% of the total income above the secondary threshold level, while 12% of the total income above the primary threshold is paid by employees through direct salary deductions. However, as a contractor who owns 100% of your company and only has yourself as the PAYE salary-earner, it does not make much difference who pays the bill (employer or employee). National Insurance Contributions are capped at an upper earning limit of £43,008. Any salary above £43,008 is not subject to national insurance contributions.

Now let's look at John's income again in the above example.

In scenario 1, John takes out a salary of £11,000.

- National Insurance contribution paid by John = (£11,000 - £ 8,064) x 12% = £352
- National Insurance contribution paid by John's company = (£11,000 - £ 8,112) x 13.8% = £399
- Therefore, John's company collects £352 from John and pays a total of £399. For John as a single contractor with a limited company structure, his total costs are £399.
- His total tax bill including national insurance contribution is £4,300 + £399 = £4,699

In scenario 2, John takes out a salary of £43,000.

- National Insurance contribution paid by John = (£43,000 - £ 8,064) x 12% = £4,192
- National Insurance contribution paid by John's company = (£43,000 - £ 8,112) x 13.8% = £4,815
- His total tax bill including national insurance contribution is £7,050 + £4,815 = £11,865
- Therefore, when we add national insurance contributions into the tax equation, taking out dividends is much more cost effective than salary.

In Scenario 3, the salary is £11,000 again,

so the national insurance contribution is £398.54. The total tax bill including the national insurance contribution is £2,025 + 399 = £2,424.

Most self-employed people pay National Insurance through Self Assessment.

Some self-employed people don't pay National Insurance through Self Assessment, but may want to pay voluntary contributions. These are:

- Examiners, moderators, invigilators and people who set exam questions
- People who run businesses involving land or property
- Ministers of religion who don't receive a salary or stipend
- People who make investments for themselves or others - but not as a business and without getting a fee or commission

However, for majority of contractors, we are liable to pay national insurance on our salary through self-assessment. Therefore. It's not difficult to see taking out a low salary and high dividends while keeping your total income at £43,000 is still the ultimate combination. Again the exact combination depends on your business expenditures and your corporate tax. Always checks with your accountant if you are not sure!

Legitimate expenses

Businesses incur expenses in the course of trading. As a contractor, you are no different. Equipment, resources and materials and other types of work-specific expense are deductible from your income. This can reduce the overall amount of money you need to pay corporate tax on, as corporate tax is based on net profit, not revenue.

Those paid through PAYE aren't able to do this and need to take the hit on anything they personally spend concerning their job or working life. But as a contractor, you can claim expenditures directly in the course of your trade through your limited company. This includes business travel, training, insurance, phone costs, IT, advertising and even a share of household bills if you spend a proportion of your time working from home. Make sure that the expenses you claim are directly related to your business, for example travel to a client site or client meetings are legitimate, but personal holiday is not. You can set a daily allowance for lunch when you are on a client's site but dinner with colleagues for leisure is not a legitimate expense. When you are in doubt, ask yourself, "does the activity this expenditure is associated with help my business function?" Sometimes you can claim part of the expenditure if it is partly business partly personal, but the proportion needs to be determined in a measurable way. If you are not sure, check with your accountant to make sure the amount and proportion you claim is legitimate before you put these claims through.

Tax payment schedule

Different taxes have different payment schedules and timeframes and, as a contractor, you need to know when these are so you can be prepared. These payment dates depend on your incorporation date, accounting period and VAT registration date. The following example outlines when you need to pay taxes due, based on an incorporation date of 1st Jan 2015, an accounting year end 31 Dec and a VAT registration date of 1st Jan 2015.

	Filing date	Payment date
Corp. Tax	31st Dec 2015	31st Dec 2015
VAT	Monthly: 7th Apr 2015–7th Jan 2016 Quarterly: 7th May, 7th Aug, 7th Nov 2015	
Personal Tax	31st Jan 2016 (for April 2014 to April 2015) 31st Jan 2017 (for April 2015 to April 2016	

Mortgage Guide

One of the biggest concerns for contractors is securing credit and in particular, applying for a mortgage. Mortgage applications are less straightforward for contractors than for employees, who can evidence a steady, stable income. As a contractor, you may need to provide more information to verify your income and to convince the mortgage lender of your credit stability.

Here are our top tips for ensuring you can still apply for a mortgage, regardless of your employment status:

Decide how much you can borrow

The amount you can borrow is related to your income and can be calculated using an online mortgage calculator. Provide a realistic measure of your annual earnings – don't overestimate the amount you can borrow, or try to be too ambitious about the size of mortgage you are looking for. Banks aren't willing to lend money to those they don't think can afford it, so make sure you have reasonable expectations about the amount of money you could borrow.

Halifax allows you to use your day rate to calculate an annual income as long as you have been contracting in the same industry for several years and plan to continue doing so.

Most banks will need at least 2 or 3 years' worth of accounts to assess your income level. If you are just starting out contracting, the truth is, it will be very difficult to get a mortgage. Whilst minimising your salary will help reduce your tax liabilities, your mortgage eligibility will be tested based on your income level. So think ahead and balance the two out!

Stress test your application

This step is often overlooked, but is essential for contractors looking to take out a mortgage. Interest rates can jump about over the course of your mortgage, causing you to have to pay more or less in mortgage interest, depending on the type of mortgage agreement you have in place.

With interest rates of up to 5%, can you still afford your mortgage payments? While interest rates remain at historically low levels now, there are no guarantees this will always be the case. By applying different scenarios to your calculations, you can work out whether you could continue to afford your mortgage throughout the duration of your repayment term.

Tidy up your credit profile

Your credit profile and overall credit score are used as important gauges of your creditworthiness. As a contractor, you simply can't afford to be applying for a mortgage with black marks on your record and you need to fix any issues with your credit profile before applying.

Remember that searches on your credit profile will themselves be visible to other lenders and too many applications in a short period of time can damage your perceived creditworthiness. Make sure you are paying debt off and that you are making repayments on time across the board. A low credit score coupled with your self-employed or contractor employment status is likely to make it difficult to secure the mortgage you need.

Gather appropriate documentation

Banks and other lenders need to see documentation to support your application. For most, this would be in the form of identification cards and passports, payslips and perhaps bank statements. For contractors, you may also have to show accounts, CV, contracts or other financial records proving your income over a period of time that will convince the lender of your ability to meet long term repayments.

A copy of any contracts you currently have will be helpful, demonstrating the amount and frequency of your pay. Make sure all your documentation is in order and you have all the paperwork you need ahead of your application – this will make it easier and less time-consuming to complete the process of applying for your mortgage.

Save for your deposit

Having a sizeable deposit reduces the amount you need to borrow, convinces the lender you will be more likely to repay and provides additional security behind your application from the get-go.

Thanks to government schemes, it is possible to take your first steps on the housing ladder with as little as a 5% deposit on the value of your mortgage. But the more you can contribute up front, the easier you will find it to secure the mortgage you need. Make a concerted effort to save for a house before jumping into an application – it's always in your interests to have a bigger deposit to play with.

Check your expenses

Due to the new mortgage regulations imposed last year, all lenders are required to carry out affordability tests on mortgage applicants. This means your income is not the only criteria, as lenders assess your regular outgoings and use the remaining income (income minus regular expenses) to determine your affordability.

Lenders ask for 3 to 6 months' worth of bank statements as evidence of your regular outgoings and to prove what you have stated in your application. So make sure you plan ahead and rack up a sensible spending record before you make an application.

Remember the tax factor

Remember that there is tax to pay when you buy a home, in the form of stamp duty. The stamp duty land tax threshold is £125,000 for primary residential properties for tax year April 2016. This means that you have to pay a stamp duty ranging from 1% to 7% of the purchase price for any properties valued at more than £125,000. From 6th April 2016, all buy-to-let properties are liable to pay a stamp duty.

Whether you are looking to buy your first home or to use your contractor income to invest in buy-to-let, make sure you add the stamp duty to your cost base. Think about how much you might have to pay in stamp duty and make sure you know the threshold at which this tax kicks in. It could end up saving you thousands of pounds, or in the worst-case scenario, leaving you with an unexpected tax bill you might struggle to afford.

Other top tips for securing your mortgage

- Look for specialist mortgage brokers, and contractor-focused deals. These do exist and can be based on annualised contract rates, or even multiples of your day rate in some cases. For example, Halifax offers contractor mortgages based on a multiple of your daily rate, with no need to file accounts or tax returns and without the lengthy and complicated mortgage application for contractors. It's worth checking it out.

- Freelancers, and those with multiple clients, should aim to secure a retainer from at least one client. Some banks and other lenders have the flexibility to look more creatively at your financial position, which can lead to a better chance of securing the mortgage you want.

- Consider interest-only options. These provide lower monthly costs, with the ability to repay capital when it is convenient to do so – the perfect setup for contractors. However, with tightening FSA/FCA regulation around these types of loans, they may become less common.

- Don't rush in feet-first. Don't rush in to buying a property because you feel you have to – you may well end up prejudicing your monthly financial position and feeling undue amounts of stress as a result.

Prepare for the future – your pension

When you make the decision to become a contractor, you are foregoing many of the benefits associated with a full-time job. One of these is a company pension and it's becoming an increasingly important feature of modern life to help provide for retirement.

With an aging population, setting aside money as a pension pot is crucial for you to live comfortably in your senior years. While it might seem like a long way off, the last thing you want is to be struggling to afford a roof above your head when you are elderly, all because you didn't plan ahead.

You need pension provision

Anyone who works a full-time job will more than likely be enrolled in a pension plan, often organised and provided by their employer. These plans take payments over a working lifetime, invest the capital and return the applicable amount in chunks once the qualifying terms have been met.

As a contractor, you can't rely on working to put food on the table until the day you die. That means you need to set money aside as quickly and as diligently as possible for your future, so you have as much money as possible to live on when your income streams finally stop.

Everyone needs to think about their pension provision, but it's even more important for those under their own employment, like contractors and taking the right steps now can set you up with a more comfortable pension for later life, with the added benefit of saving tax in the process.

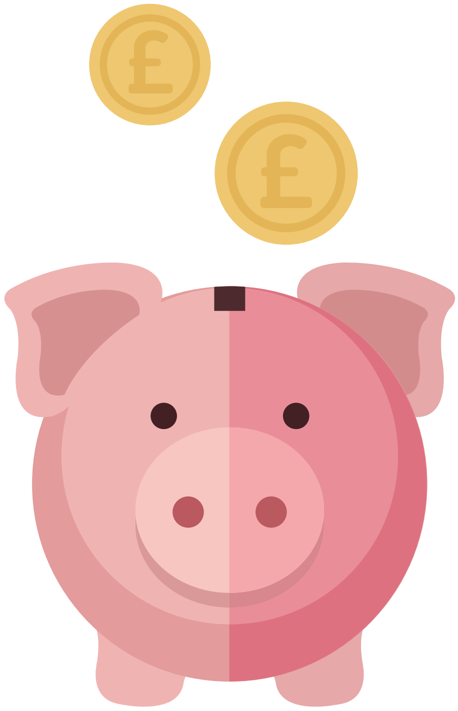
Save tax whilst providing for your future

Paying into a pension fund is tax deductible, so contractors who choose to do so now can save money today on their income for tomorrow.

The government wants people to provide for their own pensions and encourages this through deferring applicable taxes. This means that there is a financial incentive for contractors and freelancers to save money for their pensions as soon as possible, to reduce their tax liability, whilst feathering their nest for the future

State pension for contractors

Contractors are in a tricky position when it comes to the state pension, with many unable to claim the full amount due to them as a result of interrupted National Insurance payments.



Contractors often choose to pay themselves a smaller salary so they can avoid National Insurance payments. This is good in the sense of saving on your tax bill in the short term, but means that the state pension entitlement you receive will be proportionately less. As a result, many contractors choose to pay into a private plan, as the main source of their income beyond retirement.

Choosing your pension plan – personal/stakeholder or executive

Since changes to tax law (IR35 in particular), pensions remain one of the major tax breaks still available to those working as contractors and you'll want to make sure you take advantage of them.

There are two main types of pension plans you will likely choose from:

Personal/stakeholder pensions

This is the most common type of pension plan you will encounter and one that pretty much anyone can take out. Provider charges and fees are capped at 1% and payments of up to £300 per month can be made before there are any further tax complications.

A major advantage for contractors choosing stakeholder pensions is that they can nominate a base year of earnings from any of the past 5 years. You can then nominate your highest grossing year as your base year and pay more into your pension than would otherwise be the case.

Executive pensions

The other major type of pension you are likely to encounter is the executive pension plan, which is offered to those running businesses who have previously neglected pension planning and instead focused on building their business. The calculations used for working out how much you can pay in to an executive pension plan are different from those used in personal plans, so you may be able to pay in more each month than would otherwise be permitted.

Other issues to consider when thinking about your pension

- How many years stand between now and when you wish to retire? The longer there is between when you start building up resources for retirement and when you need to start drawing an income, the more time the investment will have to grow.

- Which investment vehicle will you use? Examples include stocks, bonds, ISAs, property and cash and each has its advantages and disadvantages, including; accessibility, risk, tax treatment and cost, so it's worth doing your homework.

- How much of your income is available to invest towards retirement planning? In most cases, in order to build up sufficient capital, a significant percentage of income has to be set aside to meet this objective. However, there is little point in concentrating on retirement planning at the expense of other priorities. As with most things in life, it is a matter of balance and compromise.

- What income do you require in retirement? This is one of the most important aspects of retirement planning and also one of the hardest to establish. It is usually a considerable number of years away and involves a lifestyle that it is difficult to envision at a younger age. There are also a number of variables outside your control that can impact the situation, such as inflation, levels of state support, investment returns and so on.

- Nevertheless, it is vital to set an income objective at the outset and revise this as time passes. A useful starting point may be to look at your current outgoings and decide which will continue into retirement, which will cease (e.g. mortgage repayments) and which ones you may need to add in as you get older, e.g. higher health care expenditure.

The State Pension

Alongside occupational pensions, contractors can expect to benefit from state support, in the form of the Basic State Pension and the State Second Pension (S2P). The amount payable varies depending on contributions to National Insurance.

The majority of contractors will be entitled to the maximum Basic State Pension, which is maxed at £119.30 per week for tax year 2016/2017. The S2P was scrapped in 2012/13, apart from for Final Salary Schemes, where S2P remains for the time being. This was based on the individual's record of NI contributions and their income level. S2P benefits accrued up until 6 April 2012 are still protected and will still be paid on retirement.

Annual Allowance

Paying into a pension scheme can be hugely tax efficient for contractors. Contributions of up to £40,000 per annum can be made without further taxation, with any amounts over and above this subject to measures to recoup marginal tax relief.

In some circumstances, it is possible to 'carry forward' unused Annual Allowance amounts from previous years. This means in better years, you can set aside a greater proportion of your income up to the maximum of £160,000 over 4 years, in order to maximise relief and the overall savings to tax.

The Lifetime Allowance is £1 million from the 2016/17 tax year and tax relief is available on contributions at the marginal rate of tax applicable for the individual.

Pensions can quickly become a challenging subject, especially for contractors with no formal legal or financial background. As a result, many contractors choose to seek professional advice on these issues. iContract makes this possible by putting you in touch with the experts in just a few clicks.

Professional and Health Insurance

Insurance is another area contractors need to think about. As a sole contractor, you are your business – without you, you can't earn money.

That means any period of illness or absence comes at your own expense, unless provision is in place. It means that you are liable for damages if anything goes wrong and this financial responsibility is enough to land even a successful contractor in hot water.

Insurance is one of those business expenses many contractors feel they can do without. But on both a professional and personal level, having the right type and extent of cover in place is key to maintaining peace of mind, whatever happens in the future.

As a contractor, you will be legally required to have some form of insurance in place. The most common are set out below.

Professional Insurance

Professional indemnity insurance

covers the integrity of your work as a professional contractor and provides for negligence resulting in damages to your employer or client. PIL covers your back in the event you are sued for negligence, error or omission in the course of your work.

Public liability insurance

is available to cover your liability in many circumstances – such as liability to employees, to members of the public and to your clients. Make sure the value of insurance cover you are taking out is enough to protect you.

Professional indemnity and public liability insurance are usually compulsory for contractors if you carry out any work for an established company before the contract starts. Depending on the employer, the amount you are required to insure may differ, although commonly, the minimum coverage level for both is £1m.

Business property insurance

protects you against damages to any premises you operate from and ensures the assets of your business are covered against any possible losses.

Income protection

policies provide coverage against losses to your income as a result of illness, accident, or some other insured basis. This type of insurance pays out when you are otherwise unable to earn money, provided the reason for your absence is covered by the policy. This is a lifeline for many contractors, who are just as susceptible as anyone else to injury or periods of absence.

Health Insurance

For some contractors, health and medical insurance is important – both for safeguarding their own wellbeing and for covering the medical costs of others that you may become liable for through the course of the work you do.

With all types of insurance, you will be charged a premium and usually this can be paid at monthly intervals to keep your cover active.

Failure to make payments on your insurance will leave you without the cover you anticipate. This is playing with fire and you may even find it difficult to obtain further coverage in future when the time comes for renewal.

Whether its health insurance for yourself or others, or simply general liability insurance for your contracting work, make sure you are up-to-date with your premiums to stay safely covered at all times.

What to look for when buying insurance

Insurance is often seen as a commodity cost – the cheapest provider wins.

But not all insurance policies and providers are the same. In fact, different policies will have radically different terms of cover, exclusions and conditions. You need to be fully aware of the exact scope of your cover before committing to one provider – the cheapest isn't always the best. The last thing you want, in the event of a crisis, is to think you are insured, only to find your cover doesn't extend as far as you thought.

When buying insurance of any kind, you need to be sure:

- you have the coverage you need
- you know the exclusions and exemptions from cover
- you can afford to pay the premiums
- you are aware of any excess, or other clauses that may affect your rights
- you have read the policy document and you understand what you have bought

Buying insurance can be tricky, especially for those new to contracting. Yet it can be the difference between trading safely with the protection you need to weather any storm and playing with fire in the hope that you will never fall victim to any potential business disaster.

As a contractor, your sole source of income depends on your ability to find and perform work. Without insurance, you are gambling against your livelihood – a far from ideal situation for those with families and other commitments.

Don't rush in to buying insurance and feel free to speak to an independent financial advisor if you feel you would benefit from a further discussion about your options. It's well worth getting the right cover in place as soon as possible, so you can rest easy in the knowledge that you're protected.

Contracting might sound like living the dream – dictating your own hours, rates and projects – but working for yourself also means navigating the worlds of tax, insurance, pensions and mortgages on your own. For those who have always worked as a full-time member of an organisation's staff, where the accounts and HR teams took care of everything for you, it can be extremely daunting to tackle on your own.

Your team at iContract is always on hand to guide you through the process of financial management for your contracting business. We have access to experts across all aspects of financial planning for contracting and are always just one click away.

Contracting may be your chance to go out on your own, but with iContract, it doesn't mean you are alone.

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CONTRACTING MADE SIMPLE

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