



Umbrella or Limited Company?

Here we take a look at the pros and cons of both umbrella companies and limited companies, and why other structures are less compatible with the contracting model.

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Contractors work under two main payroll structures – umbrella companies and limited companies. Both have their benefits and drawbacks, but a contractor's individual circumstances will usually mean that one offers more advantages over the other. Changing legislation, as well as the length and value of a contractor's typical assignments, are just some of the things that need to be taken into consideration when choosing between payroll structures. Our position as an independent broker means that we have an unbiased overview and many years of experience working with providers of both structures. Here we take a look at the pros and cons of both umbrella companies and limited companies, and why other structures are less compatible with the contracting model.

Limited Company

Perhaps the main benefit of contracting via a limited company is that it offers a tax efficient means of operation. Unlike a permanent or umbrella employee, you pay yourself a combination of a basic salary (typically low), and draw the rest in the form of dividends (shareholder profits). As dividends are not subject to National Insurance Contributions, this can result in a tax saving, providing you're not caught by the IR35 rules (see below). You are also able to reclaim VAT on certain company purchases and business expenses when working via a limited company, while many umbrella companies will not allow expense claims.



Setting up your own limited company means that you will become the majority shareholder and director of your company, which carries certain obligations and liabilities. You will need to form a new company, and register it with Companies House (the registrar of companies in the UK), where you will also have to submit your annual accounts. Thereafter, you will be obliged to ensure that the company is run responsibly, and to meet your HMRC tax deadlines. Limited companies pay Corporation Tax on their annual profits (at a rate of 19%), and VAT is added to all your invoices and repaid to HMRC each quarter.

Although running a limited company can be quite time consuming, the good news is that much of the initial start-up process and the daily administration of the company can be handled by a specialist accountant. They can ensure your company is set up quickly and correctly administered, with varying costs depending on the level of services you require.

[Read more about running your limited company here.](#)

Sole Trader Vs Limited Company

Although working as a sole trader might seem the most straightforward option, it is incompatible with contracting for a number of reasons. Clients hire contractors on direct contracts made between the client company and the contractor's own limited company, umbrella company or their recruitment agency - if one is involved. However, recruitment agencies will not hire sole traders, as The Income Tax (Earnings and Pensions) Act 2003 does not allow self-employment when an agency is involved in the relationship between supplier and client.



This means that your agency would be obliged to treat its sole trader contractors as 'employees' for tax purposes, and deduct income tax and National Insurance Contributions from your income. This is also the reason that many recruitment agencies don't operate a payroll service. If you are hired as a sole trader, then in theory you could claim employment rights from the agency, and HMRC could pursue the agency for any unpaid income tax and National Insurance Contributions (NICs) if you were deemed to be an employee under the IR35 rules (see below).

Although contractors may be hired directly by the client on some assignments, rather than via an agency, a business structure that only allows this route of sourcing work is limiting. Additionally, a limited company offers greater tax benefits and professional appeal for contractors who source most of their contracts directly from the client. Another important consideration is that sole traders are liable for all the debts and liabilities of their business and do not have the protection of a limited liability structure in case things go wrong.

Umbrella Company

Many people who are new to contracting won't necessarily know what an umbrella company is. Simply put, an umbrella company is a standard UK limited company, operated by a third-party supplier acting as an 'employer'. Contractors who sign to an umbrella company become employees of that company under an 'overarching contract of employment.' A contract is then signed between the umbrella company and recruitment agency (or end client) on behalf of the contractor who will be carrying out the assignment.



The umbrella provides a payroll service to its employees, processes all timesheets and invoices, and pays its employees a salary after allowing for deductions. An umbrella will also chase late payments and act as an intermediary for all payment-related issues with the client. Therefore, an umbrella company entirely eliminates the need for contractors to spend time on paperwork or administrative functions, while also providing a level of payroll expertise that can be a useful buffer, particularly for those new to contracting.

How does an umbrella company work?

- 1.** Once you have secured a contract role, the umbrella company (as your 'employer') signs a contract with your recruitment agency.
- 2.** You will also sign a contract of employment with the umbrella.
- 3.** Once you have completed a pre-agreed time period, you complete a timesheet and pass it onto your manager to sign, before submitting to both your recruitment agency and the umbrella company.
- 4.** The umbrella company will invoice the recruitment agency, which subsequently bills the end-client.
- 5.** Once the umbrella company receives payment from the agency, your umbrella will process your payroll and pay you a salary, following deductions for employment taxes, the pre-agreed umbrella fee/margin, personal taxes, and pension contributions (if applicable).

Further advantages of using an umbrella include same-day set up and the provision of some statutory benefits such as sick pay and holiday pay and employment protection. This gives contractors a fast and efficient means of getting paid, with some employment security. However, possibly the most considerable benefit of contracting through an umbrella, and one that accounts for their rising popularity, is that using one entirely cancels out the risk posed by IR35.

IR35 Considerations

From 6th April 2017, IR35 rules changed for public sector contractors, making the client, rather than the contractor, responsible for determining the IR35 status of an assignment. If a contract is considered inside (caught) by IR35, the party paying the worker's personal service company (PSC) must deduct PAYE and NI at source before making payment to the PSC. The changes were also due to come into force in the private sector on 6 April 2020, **but were postponed until April 2021 as part of the government's Covid-19 support package for businesses.**



In anticipation of reform, many businesses introduced forms of 'blanket' IR35 determinations in an attempt to reduce liability for making incorrect assessments. This included a 'no PSC' policy that forced thousands of contractors out of their limited companies and onto the payroll. Although some companies subsequently deferred this decision until April 2021 when the new rules take effect, there's a likelihood that this may happen again as the new deadline approaches.

Other forms of blanketing included 'role based' assessments that group contractors together depending on their role description. **Although blanketing has been widely criticised as non-compliant, contractors currently have limited options if they disagree with their status determination.** If your contract work is caught by IR35, then the benefits of contracting via your own limited company, should the client still allow you to use it, are vastly reduced. With your IR35 status set to 'inside', you will no longer be able to pay yourself through a combination of low salary and high dividends.

When IR35 applies to a contract, this also means that expenses are subject to the 'Supervision, Direction and Control' (SDC) rule. Contractors working on assignments inside IR35 are considered to be employees, therefore travel to and from your normal place of work is not an allowable expense. Although travel away from the normal place of work is still permitted to be reimbursed, a compliant umbrella company will not allow you to claim these directly through them. Expenses must be approved by the client and paid directly by them or the recruitment agency. Contractors operating through a limited company are also restricted from claiming these expenses when operating inside IR35.

[Find out everything you need to know about IR35 in our comprehensive guide.](#)

Umbrella Company Vs Agency PAYE

Agency PAYE is sometimes available as a payroll option that also removes the IR35 risk. However, with agency PAYE, contractors are limited to contracts sourced via that particular recruitment agency. With an umbrella company, the contractor's employment can continue from contract to contract, regardless of the agency. This means that although they may have multiple contracts with different end clients, they will only have one employer – the umbrella company.



This continuity of employment can make life easier when applying for a mortgage or borrowing money, or when contractors frequently work on short-term contracts. The crux is that umbrella companies receive their income from the contractor, and so are more easily able to act in their best interests. Agencies, however, are paid by the end client and can therefore be conflicted in the advice and support they give.

Although there are many individual aspects to consider when weighing up between an umbrella company and a limited company, the comparison table below may help you to decide. It's also worth remembering that you can change between umbrella and limited company payment structures according to whether a contract is inside or outside IR35. This will allow you to both eliminate risk when necessary, while maximising earnings where your contract is clear of the IR35 rules.

Umbrella Company vs. Limited Company: Pros and Cons Summary

	Limited	Umbrella
Tax Efficiency	The most tax-efficient way to contract. Most directors take a low salary. No National Insurance is payable on dividends and other tax planning options are available.	Your entire salary is taxed via PAYE. Less tax-efficient than working via a limited company.
IR35	Risk of being blanketed. If caught, most tax benefits of being limited are lost.	IR35 is irrelevant, as you are already taxed as an 'employee'.
Ease of set up and use	Company formation can be completed in a few hours, Registration for taxes (VAT, Corporation Tax) can take a few weeks. Monthly admin required to compile accounts, some annual obligations as company director.	Instant set up, very little admin and no legal duties.
Duration	Not ideal for short-term contracts, due to admin required to set up and then subsequently close the company.	Good for short-term contracts.

Summary Contd.

	Limited	Umbrella
Low earning contracts	Not generally recommended for contracts paying under £15-20/hour.	Good for lower-paid contracts.
VAT	Joining the Flat Rate VAT scheme can be profitable – including a discounted rate in the first year.	VAT is collected by the umbrella, no extra benefit to contractor.
Insurance	Your company needs to pay for business insurances (e.g. Professional Indemnity).	Insurance cover is typically included in umbrella fee.
Image	Conveys a professional image – that may be helpful.	Increasingly attractive to clients because of IR35.
Experience	May be better off using an umbrella if going limited appears daunting at first.	Ideal if you want to try out contracting before making a decision on the best business structure.
Multiple clients	Good if you intend to provide services to multiple clients.	Not ideal if you plan to work for several clients at the same time.

Every accountancy practice that ContractingWISE works with is run by expert contractor accountants who have extensive experience of all aspects of company administration and support. We can also match you with an umbrella company that will meet your specific needs. Whatever option you choose, we can ensure a fast, efficient and hassle free set up to help keep your contracting career on track.

**To talk to a member of our team call:
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