




A guide to **freelancing**

Chapter 06 – Get out

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corner



When an entrepreneur goes to a venture capitalist for funding, one of the key questions they get asked is ‘what is your exit strategy’. Investors want to know the founders’ plans for selling or floating the business.

But as an independent professional it’s rare to end up with a business you can sell. That said, there may come a time where you want to get out and do something else, or simply retire.

If you are a sole trader, or partner, no problem, you just tell HMRC you’re no longer trading, pay your tax for the year, and you’re done.

But if you have a limited company, and you have accumulated some money in the business, you need to decide how to take it out.



Aside from the usual route of salary/dividends as described in the previous section on 'how to pay yourself', there are two other options:

1. take it out as capital
2. make a company pension contribution.

OPTION 1: TAKE ALL THE MONEY OUT OF YOUR LIMITED COMPANY AS CAPITAL

By taking the money out as a capital distribution, rather than salary or dividends, the money gets taxed as capital gains, rather than as income. This method is also known as 'Members' Voluntary Liquidation.' The advantage is that the first £12,000 of capital gains is tax exempt (and if your spouse or partner is also a shareholder then each of you can take out that amount).

You can also claim Entrepreneurs' Relief as long as:

1. The company is a trading company
2. You are an employee/director of the company.
3. You own a minimum of 5% of the company's voting shares, and have owned them throughout the 12 months before you stopped trading
4. You don't start up doing the same or similar trade, in a company or sole trade, within a 2 year period of time.

Entrepreneurs Relief means that anything over the tax exempt amount of £12,000 is only taxed at 10%. Without this relief you would end up paying 20% (from April 2016) if you are a higher rate taxpayer.

Bear in mind that you can claim Entrepreneurs' Relief as long as you're not intending to set up an identical, or very similar, company within the next two years. This is because HMRC recently introduced changes to the scheme in order to crack down on 'phoenixism', a tactic used by some people to limit their IR35 exposure by closing down their limited company every few years and then creating a new one straight away, doing the same thing.

But as long as you're following IPSE's best practice guidelines, and you're protected by your IPSE membership, you should have no need to resort to phoenix-like tactics!

OPTION 2: MAKE A COMPANY PENSION CONTRIBUTION

If you have a pension shortfall, you can make a lump sum contribution of up to £40,000 into a pension. This should reduce your corporation tax bill for your last year of trading, because you can claim it as an expense against tax.

If you still have money left over in the company then take the remainder out as described in Option 1 above – that will reduce your overall bill. Again, if your spouse or partner is a shareholder, each of you can take this pension amount.

Here’s a list of items that you can claim. It’s not an exhaustive list so, if in doubt, ask your accountant or tax adviser.

Capital items: computers, cars, furniture, equipment, property	Legal and professional fees	Subscriptions to professional and trade associations on HMRC's approved list	Trade magazine subscriptions or purchases	Bad debts (as long as they've been individually identified, formally written-off and you're not waiting to be paid)
Interest on debts incurred to finance the business (as long as it isn't used to pay the directors)	Entertaining employees and/ or directors of your own limited company (but not clients or anyone outside the company)	Travel (but not to a client site where you have been for more than 24 months – and this ceases to be allowable from the moment that you know you will be there for more than 24 months, nor to your regular office/workplace if you have one, as that is seen as normal commuting, nor if you are 'deemed employed' under IR35)		
Mileage for your own car at 45p per mile for the first 10,000 miles and 25p per mile thereafter		Use of home for work (HMRC automatically accepts £4 per week for employees, sole traders and partnerships, but if you have a limited company it becomes more complicated and you should discuss the best approach with your accountant)		
Accommodation and subsistence	Mobile phone bill (as long as the contract is in your limited company's name – if it isn't, or if you're a sole trader, you can only claim for itemised calls made for business, not the whole bill)	Training (but only if used to update existing skills or in connection with new services you are genuinely seeking to launch)	Salaries (for limited companies)	
Phone and Internet (put the contracts in your business name)	Rental of office premises	Insurance (but only business ones such as Professional Indemnity, and not personal ones such as life insurance)	Pension contributions paid by your limited company, up to £40,000 p.a. (you can get your pension scheme via IPSE to avoid paying the full market-rate on commission charges)	

Bear in mind that if a limited company buys things for the private use of directors or employees, these are classed as 'benefits in kind', which are taxable. So if your limited company pays for a private holiday for you and your family, this should be treated as salary, incurring tax and National Insurance charges accordingly. Benefits in kind need to be declared annually on the P11D form.

When it comes to claiming expenses there can be a few grey areas, so if in doubt contact the IPSE tax helpline (see www.ipse.co.uk/what-ipse-does-for-you/your-safety-net/tax-support.html).

Oh and one more thing – instead of spending your valuable time manually inputting the figures from your receipts into a spreadsheet you can use a service such as www.receipt-bank.com to process them for you. HMRC says it's ok to have your receipts stored electronically as long as all the original information on the paper receipt is clearly readable.

HOW TO PAY YOURSELF EFFICIENTLY

If you're a sole trader or in partnership you don't have the option to 'pay yourself' because any money you receive from your business activities is yours already.

As a sole trader, you are taxed on your profit, which is the difference between the amount you invoiced and the expenses you claimed. Partners are also similarly taxed on their share of the profit.

Limited company directors, on the other hand, have more options – and some are more tax efficient than others. Unlike with sole traders or partners, money received by your company isn't yours. It belongs to your company. To make it yours you can take money out of the business as salary, dividends or both.

PAYING YOURSELF DIVIDENDS FROM YOUR LIMITED COMPANY

Dividends can be paid to the owners (shareholders) of a company from the retained (post-tax) profit, as long as the correct procedures are followed. This involves the Board of Directors having a meeting,

formally voting the dividend and providing a written record of that decision.

By law you have to issue the dividend to the shareholder(s) using a proper dividend voucher (ask your accountant for one).

The advantage of paying yourself dividends is that neither employee nor employer NICs are payable. However, the total paid out in dividends cannot exceed the retained profits of the company. You also can't claim dividends against the company's corporation tax.

Dividends can be declared as often as you like, although if you are paying yourself regular dividends of the same amount (e.g. £1,000 once a month) there's a risk that the taxman could seek to reclassify the payments as salary, which would defeat the purpose of paying dividends because you would have to pay NICs.

Also, make sure that the dividend payment is completely separate from other payments. If HMRC sees composite payments which are a mix of salary and dividend, they may try to argue that it is all salary.

SHOULD I PAY MYSELF SALARY OR DIVIDENDS FROM MY LIMITED COMPANY?

If you are a UK taxpayer, generally speaking it's more tax efficient to pay yourself a mix of salary and dividends from your limited company.

A popular route is to pay no more than £12,500 in salary, and the rest in dividends. The reason for the £12,500 figure is that this is the tax free personal allowance for 2019-2020, so no income tax needs to be paid on it (assuming you have no other income from other sources). You'll need to pay some National Insurance on that level of salary, but it's a very small amount and will earn credits towards state benefits, such as the state pension.

However, different circumstances can alter the figures and relative benefits, so the best option is to ask your accountant to work out the most tax efficient route for you. For example, if your partner or

spouse is also a shareholder, then you can take advice on ways of distributing the income between you – but make sure you fully understand the legal and legitimate ways of doing this.

If in doubt, phone the IPSE tax and legal helplines at www.ipse.co.uk (members only).

Being tax efficient by registering for VAT

You don't have to register for VAT until the total amount you invoice in any 12-month period exceeds £85,000.

However, you have the option to register before you reach this threshold, and if you spend a lot on goods or services that charge VAT on top, you may be better off doing so.

Being VAT registered allows you to claim back VAT on any goods or services you buy. It does also mean you have to charge VAT to your clients, but as long as they are VAT registered it won't make a difference to them because they can normally claim back the VAT you charge them.

Every quarter you'll need to file a VAT return. To fill out the return you need to know your total sales, costs and VAT amounts for the quarter. You then pay HMRC the difference between the amounts of VAT your business charged and the amounts it spent on VAT.

As long as your turnover is less than £1.35 million, you can join the Cash Accounting Scheme, which means you don't have to pay HMRC until you have actually received the money. If you're not on this scheme you have to pay HMRC based on the invoiced amounts rather than on money received.

It's important to bear in mind that being VAT registered does add extra admin, so be sure to look at your figures with your accountant to check that it's actually worth it. If your business hardly spends on anything containing VAT, then there's no point registering if you don't have to.

The Flat Rate Scheme: spending more than 2% of your turnover on goods?

There are various different VAT schemes. The simplest of these is the Flat Rate Scheme, which you can join if your business turnover is less than £150,000.

Up until April 2017 it was a particularly tax efficient scheme for independent professionals. Unfortunately the rules changed and it probably only makes sense to join this scheme if your business spends more than 2% on goods (or £1000 per year if costs are more than 2%). Independent professionals tend to spend more on services than on goods, therefore many freelancers and contractors have found it no longer makes sense to stay in the scheme. Again, ask your accountant to assess this for you.

Finally, be aware that special rules apply if you sell e-books, PDFs or digital images to consumers in EU countries. By consumers they mean private individuals – the rules don't apply if you're selling to businesses. Find out more at: www.gov.uk/government/collections/vat-moss-vat-on-sales-of-digital-services-in-the-eu

MAKING THE CASH FLOW

Bankers are very fond of the phrase “a pound today is worth more than a pound in the future” (because you could invest it or earn interest on it).

Since they know a thing or two about getting richer, it's worth taking a leaf out of their book. Once your cash has been earned you need to get it flowing into your bank account as soon as possible.

Here are some ways to achieve that:

- Don't take ages to invoice your client – they won't thank you for it. Invoice them promptly and get a proper system in place to track payments.

- Consider arranging 7 or 14 day payment terms with clients—there is no reason why it should have to be 30 days. Perhaps your client would also be willing to pay 50% up-front and 50% on completion. Be sure to make the agreed credit terms clear in the initial contract.
- If you are working with a new client with no visible track record, it's worth vetting them by asking for supplier references or doing a professional credit check.
- If the payment is overdue, a polite call to the accounts department is usually all it takes. Don't be shy about this – as long as you're friendly you will usually find people to be very helpful.
- If a client or agency does completely default on payment you're entitled to charge interest on the debt. If they still won't pay, as long as you're an IPSE member you can claim up to £10,000 compensation.

You also want to avoid big gaps in your cashflow. Every year lots of businesses go bankrupt because they don't have cash at the right time, even though they have loads of work. Try to build a financial buffer to get you through any periods without income, and if you haven't already done so, join IPSE so you can claim compensation for business interruption through illness/injury or tax investigations.

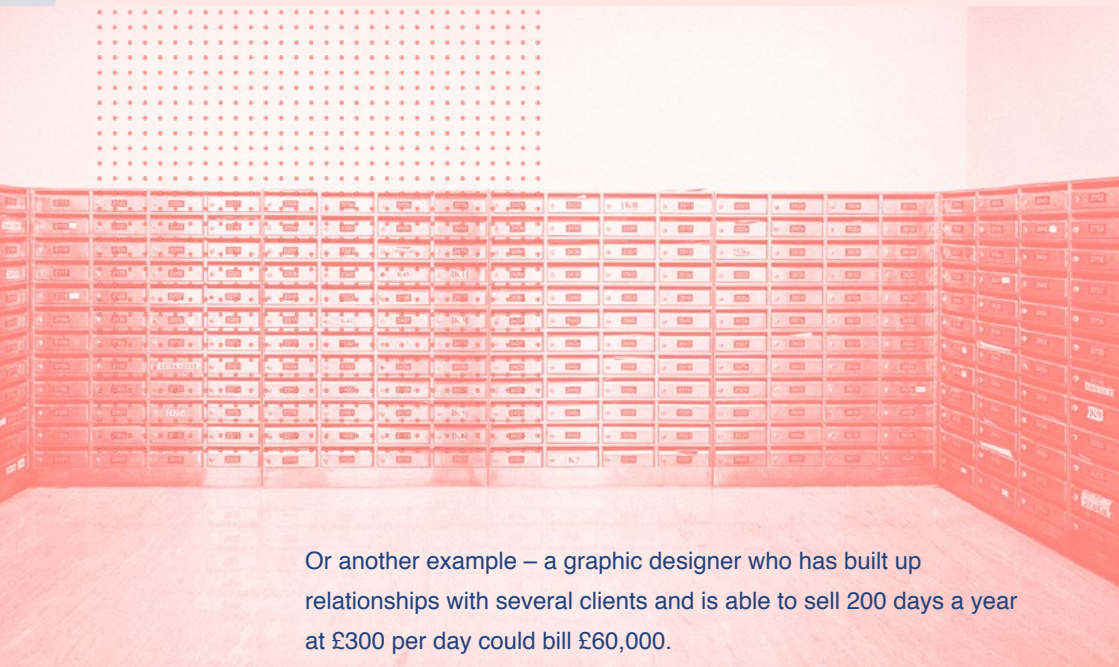
BECOMING MORE BANKABLE

Once you have developed the skill of landing enough work to live off, the next challenge becomes how to grow the business.

Independent professionals who crack the first hurdle - how to get work - usually find they're able to bring in a relatively sustainable income year on year.

For example, a specialist IT contractor who lands a one-year contract at £500 per day could bill £120,000 that year, and then have a few months' gap before landing another similar contract.





Or another example – a graphic designer who has built up relationships with several clients and is able to sell 200 days a year at £300 per day could bill £60,000.

But once you reach a certain income level (which varies according to sector and specialism) at some point you usually hit a ceiling, where it becomes very difficult to invoice any more than that.

There are, after all, only so many hours in the day and only so much that clients are willing to pay.

Some freelancers have no desire to break through the ceiling and are happy to carry on at that level indefinitely. Others, however, are keen to keep on growing the business in order to put away enough for retirement, to be able to retire early, or in case they couldn't work in the future.

But how do you do that, when there's a limit to the amount of hours you can work?

One answer is to build a team, by sub-contracting, or hiring employees. However, this usually means taking on the burden of management, and many people who strike out on their own do so because they want to get away from all of that.

It also means you have to ramp up the sales effort substantially before you actually see any benefit – having more people on board doesn't instantly translate into more money for you.

In fact, in the early days, until you gain momentum, you might see a drop in your income because you're using your margins to pay others.

The alternative is to stay independent. It is still possible to grow the business – it just means you have to increase the value of your time.

These are some of the ways to do that:

1. Keep increasing your daily or hourly rate
2. Charge a project fee instead of charging for your time (this can work well if you're able to speed up your work as you become more practiced – if you charge the same fee, but it takes you half the time to produce, you're effectively doubling your rate)
3. Negotiate a share in the success of the project, either through a percentage of profit or a performance bonus

Negotiating any kind of rate, fee or bonus becomes much easier if you're well-known in your industry. Daniel Priestley, author of the bestseller 'Key Person of Influence', says that the top 20% of people in any industry earn over 80% of the money.

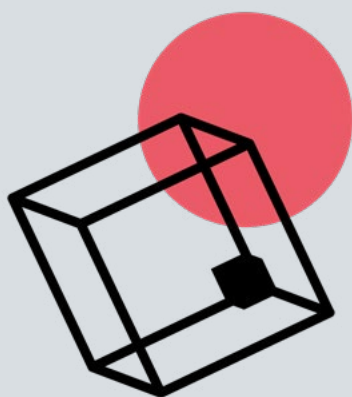
These are the people who have invested time and effort in building their profile to become known as thought leaders in their field and can charge correspondingly high rates. To give you an idea of just how much, take Clayton Christensen, a Harvard professor and one of the world's leading management thinkers. He's reputed to charge \$90,000 per day – that's if you're willing to travel to his office. If you want him to come to you, expect to pay double, plus expenses.

You don't have to be a professor to command high rates. What you do have to do is put in the hard graft to build your industry insight. If you don't currently have that insight, spend time on research until you understand more about your clients' challenges than any of your competitors.

Understanding the unique context of your prospective clients is what sets you apart from the average Joe who charges average rates. The narrower your particular niche, the easier it is to do that.

Thanks to the internet, anyone with the dedication and inclination to do so, can become a world authority on most subjects – if you're in any doubt of that, read the book *Makers* by Chris Anderson, which describes how a young Mexican with no qualifications taught himself so much about drones that he was hired to head up a successful technology start-up.

Gaining those crucial insights, and finding the people who derive value from it, is very hard work. It takes a lot of discipline, particularly when you're busy with client work.



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