Working for yourself

ACTION POINTS

Register your business
You must register with Revenue & Customs within three months of becoming self-employed. You must also register for VAT if you meet the turnover limits.

Keep good records
You must keep records of income and expenses relating to your tax return for at least five years.

Employ your spouse or partner
You can save tax if they work for you.

Remember self assessment
You'll have to fill out a tax return and the supplementary pages for the self-employed.

A layman's guide to tax essentials for the self-employed – from starting up to closing down

You can easily start trading as a self-employed person. But you must register with Revenue & Customs within three months of the end of the month when you start. If you don't register, you normally face a fine of £100. You can register by calling the helpline for the newly self-employed (08459 154515) or by filling in form CWF1 in HMRC booklet SE1 *Are you thinking of working for yourself?*, from www.hmrc.gov.uk. Registration also gets you into income tax self assessment and, if required, the VAT system.

TAXES YOU MAY PAY

If you work for yourself, you may have to pay some or all of the following types of tax.

Income tax

You start to pay income tax when your profits plus your other income exceed your tax-allowable outgoings and tax allowances.

National Insurance

You pay less in National Insurance than someone who is employed. As we explain in our chapter on National Insurance, p63, this means your rights to some state benefits are reduced.

You pay class 2 contributions if profits are above a certain limit – £4,465 a year in 2006-2007 (£4,345 in 2005-2006). If they are below this, you can choose not to pay any National Insurance, though it is probably worthwhile paying to preserve your entitlement to the basic state pension. Once profits reach a certain limit – £5,035 a year in 2006-2007 (£4,895 in 2005-2006) – you also have to pay class 4 contributions.

Value added tax

You must register for VAT if, at the end of any month, the taxable turnover of all your business activities in the year ending on the last day of that month exceeds a set limit – £61,000 from 1 April 2006. You must also register if you believe your turnover for the next 30 days will exceed the limit. At or below the limit, you can choose to register for VAT. If you are not registered, you cannot reclaim VAT on things you buy for business, but you use prices including VAT when recording expenses and allowances and thus get tax relief on the VAT.

Businesses with a VAT-exclusive turnover of £150,000 or less, and a total turnover under £187,500, can apply to use the flat-rate scheme. Under this, you do not have to keep full VAT accounts. Instead, VAT is calculated as a percentage of your total turnover including VAT. The rate varies from 2 to 13.5 per cent, depending on the type of business, with a discount for businesses newly registering for VAT. For more, or to join the scheme, phone Revenue &

TIP
Keep a running record of what you spend on capital items, such as cars, and allowances you have already claimed in previous years. You will need them to work out your capital allowances.

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Customs on 0845 010 9000 or visit www.hmrc.gov.uk.

Business rates

If you have business premises, or you use part of your home solely for business, you must pay business rates. If you use your home only partly for business, business rates shouldn't usually be charged and you may be able to claim part of your council tax as a business expense. Structural changes, hiring staff, customers visiting and using specialist equipment could justify business rates. You may be liable for capital gains tax when you sell if you use part of your home exclusively for business.

WHEN YOU PAY THE TAX

You are normally taxed on profits for the accounting year ending in the tax year, and you normally pay tax in the January of the relevant tax year and the July following the end of it. Any final payment to clear any remaining tax must be made by the following 31 January (see 'Payments on account', p65).

TO INCORPORATE OR NOT

This chapter explains the tax treatment of people who work as a sole trader or in a partnership. But you can run your business as a limited company.

Until April 2004, small businesses were able to make annual tax savings of up to £4,000 by operating as a company. These tax breaks have now been largely eroded, though for small businesses (profits under £50,000) there is still an incentive to incorporate.

Tax benefits aside, however, operating as a small business means more hassle; more formal and costly accounting

TAXABLE PROFITS

What you need to take into account when working out your taxable profits

Broadly, you pay income tax on your yearly takings less allowable business expenses (see p25), capital allowances and losses. (Expenses normally have to be incurred wholly and exclusively for the purpose of the business.)

To find your taxable profit, you first need to draw up the business accounts, then make adjustments, as explained here.

STOCK VALUES

You can deduct from your profits the cost of goods or raw materials bought for resale but only if they are actually sold during the accounting year.

First, work out your gross profit by subtracting the cost of sales from your sales revenue. Typically, this is what you paid for the goods or raw materials plus overheads directly associated with making them ready for sale. The value of the stock will usually be the cost to you but if it's lower, it should be the sale price you can get. You can't just deduct what you spent during the year buying in raw materials or goods for resale.

Second, add in stock carried over from last year and deduct any goods or raw materials left at the end of this year. See the working sheet in IR222 *How to calculate your taxable profits* for help.

MONEY OWED

Your business and tax accounts must be drawn up on an 'accruals' basis. This means they don't just record what you received and what you paid out during the year. You must also include money that you earned during the period but have not yet received, together with expenses run up but not yet paid. The value of your own time has traditionally not been included in this calculation. It is included for accounting periods ending after 21 June 2005. See HMRC helpsheet IR238 *Revenue recognition in service contracts – UITF 40* for how this affects your tax and how to work out any adjustment.

DEPRECIATION

When you buy something that will be used in your business over a long period, it counts as a capital asset. In your business accounts, you deduct the cost by spreading its fall in value across the asset's useful life, known as depreciation.

You can't deduct depreciation in your tax accounts, so instead of deducting the cost of the item in full in the year you buy it, you claim tax allowances, called capital allowances. In effect, capital allowances are depreciation worked out according to standardised rules. In this way, the depreciating value of the capital assets you buy reduces the amount of tax you pay.

TIP

If you run a small or medium-sized enterprise, you can claim 40 per cent of the cost of business equipment in the year you buy it.

CAPITAL ALLOWANCES

The government uses capital allowances to encourage certain types of spending. For example, you can claim capital allowances for capital spending including business equipment (vehicles, tools and computers), patents, research and development, specialist 'know-how', and agricultural or industrial buildings.

If you run a small or medium-sized enterprise, you can claim 40 per cent of the cost of business equipment in the year you buy it. From April 2006, small enterprises can claim 50 per cent for one year. Certain assets, including cars and plant or machinery for leasing, do not qualify. A small enterprise has a turnover of £2.8 million or under, assets up to £1.4 million and no more than 50 employees. Medium-sized enterprises have a turnover of £11.2 million or under, assets up to £5.6 million and up to 250 employees. Businesses qualify if they meet two of the three criteria.

The remainder of the expenditure is carried forward in a 'capital pool' along with the remaining value of other items bought in the same or earlier years. You can claim up to 25 per cent of the value of the pool each year as a 'writing-down allowance'. The pool's value reduces by the amount claimed.

Proceeds from sales of capital items are deducted from the pool before the writing-down allowance is worked out. If the proceeds of all the items you sell exceed the pool's value, the excess (the 'balancing charge') is added to your profits for the year and taxed.

and reporting; more formal procedures for drawing money from the business, and tougher tax rules for fringe benefits and expenses. It also brings with it the possibility of a big tax bill on closing down a self-employed business to switch to a company (see 'Closing down', p24).

If you sell an item for less than its written-down value, the remainder normally continues to be written down gradually in future years. But you can claim immediate relief if you have elected to have an item treated as a 'short-life asset'. Each short-life asset has its own pool and provided that disposal is within five years, you can claim all the remaining value as a capital allowance. If you do not dispose of the asset in this time, the balance reverts to your main pool.

You have a separate pool for assets used both privately and in your business – the allowances are in proportion to the business use. A car costing more than £12,000 usually also goes into a separate pool and the writing-down allowances are capped at £3,000 a year.

LOSSES

You can use losses to reduce your overall tax liability now or in the future and, in some cases, to reduce tax due on income or profits received previously. You can carry forward indefinitely a loss made in an accounting year to set against future profits from the same business; or you can use the loss immediately against your current or previous year's income and capital gains tax bills. In both cases, you must set the loss first against income, with any unused part then set against capital gains for the same year. In the first four years, you can set your loss against income (not gains) for the past three years. In the last 12 months, you can set a loss against profits for the past three years.

STARTING UP AND CLOSING DOWN

We run through the rules that apply in the first few years of starting up in business and when you close a business down

Profits from self-employment are taxed according to special rules during the early years and during the last year.

ACCOUNTING YEARS

When you start in business, you have to choose an accounting period – the period (normally 12 months) over which your tax will be worked out. You can choose any date as the end of your accounting period. But it's most straightforward if you run your accounting year to end on either 31 March or 5 April. This avoids all the complications surrounding opening- and closing-year rules, as well as overlap relief. On the downside, however, you'll have only nine months after the end of your accounting year to draw up your accounts and pay the tax.

If your profits are increasing year by year, it's worth considering having an accounting date early in the tax year – 30 April, for example. This is good for cashflow because it maximises the delay between the end of your accounting year and settling the final tax bill. On the downside, you carry forward higher overlap profits (see p24) and you must take care to set aside enough to pay the eventual tax bill.

STARTING UP

In the first tax year, you're taxed on your profits from the date you started up to the end of the tax year. This is worked out as a proportion of the profits for your first accounting period. See 'Example', overleaf, to see how this is worked out and also refer to HMRC helpsheet IR222 *How to calculate your taxable profits*.

There may be a delay before you have the figures for the accounting period in question. In the meantime, you still have to send in a tax return giving an estimate of the relevant profits.

In the second tax year, you are normally taxed on the profits for the 12 months up to the accounting date that falls in that tax year – see 'Example', overleaf. (Different rules apply if your first accounting period is less than a year or there is no accounting date in your second year.)

In the third and subsequent years, tax is based on your profits for the accounting year ending during the tax year.

Warning

To count as self-employed, you must convince Revenue & Customs that you genuinely work for yourself and not, in reality, for an employer. See our 'Self-employment criteria at a glance' box, below, for the sorts of question to ask yourself.

SELF-EMPLOYMENT CRITERIA AT A GLANCE

To count as self-employed, you must convince Revenue & Customs that you genuinely work for yourself and not, in reality, for an employer. The more of these questions you can answer 'yes' to, the more likely it is that Revenue & Customs will accept you are self-employed.

For more guidance, see HMRC booklet IR56 *Employed or self-employed?* If you are still unsure, seek professional advice or arrange an appointment with your local tax office and ask for a written decision about your employment status.

- Can you send somebody else to do the work? Would you pay them out of your own pocket?
- Do you control how the work is carried out – for example, where and when you work?
- Do you put your own money at risk?
- Do you provide the main items of equipment that are required in your work, not just small tools which employees provide for themselves?
- Do you agree to do a job for a fixed price regardless of how long it takes?
- Do you regularly work for a number of different people?
- Do you have to correct mistakes in your own time and at your own expense?

Overlap profits

Because of the way profits are taxed when you first set up in business, under the opening-year rules some profits may be taxed more than once. They are called overlap profits and you get overlap relief against this double taxation – but not until you close your business or change your accounting date to one falling later in the tax year, by which time inflation will have eaten into the amount you get. See 'Example', below.

You have no overlap profit and avoid the complications of the opening-year rules if you have an accounting year that coincides with the tax year.

CLOSING DOWN

Special rules also apply in the last year of your business. For the tax year you close down, you are taxed on your profits from the accounting date for the previous tax year up to the date of closure, less any overlap profits (see above) brought forward. If your accounting date is early in the tax year, this means you may have to pay tax on nearly two years' worth of profits in one tax year. The overlap period will also be long but if the overlap profits have been carried forward for many years, they may be small compared with the profits to be taxed.

CHANGING ACCOUNTING YEAR DATES

You can change the date which ends your accounting year – but you must tell Revenue & Customs by 31 January following the tax year in which you make the change.

Changing the end of your accounting year results in a transitional accounting period that is either longer or shorter than the normal 12 months. Revenue & Customs must accept your change provided that:

- the first accounting period on the new basis does not exceed 18 months
- you give notice of the change in the tax return covering the first period on the new basis and you send in this return on time
- you have not already changed your accounting date in the last five years or if so, you have genuine commercial reasons for making a further change at this time.

Moving to an accounting date earlier in the tax year means that you will be taxed on your profits for the 12 months up to the new accounting date. You do this by adding in a proportion of the profits for the last accounting year on the old basis. This means some profits are taxed twice and so creates new overlap relief that you carry forward – see 'Starting up', p23, and 'Closing down', left.

If you move to a date later in the tax year, you will be taxed on profits for a period longer than a year. But you can claim relief for some or all of any overlap profit you have been carrying forward. For more information, see HMRC helpsheet IR222.

£ SAVE BY EMPLOYING YOUR FAMILY

Employing your spouse or partner can be an easy way to save tax

If your spouse or partner helps with the business and pays tax at a lower rate than you, paying them a wage is a simple way to save tax. As long as the wage is reasonable for the work done, it counts as an allowable expense and can be deducted when you work out your profits. Provided that their salary does not exceed £97 a week in 2006-2007, they pay no National Insurance or income tax and you pay no employer's National Insurance. But as long as their earnings are £84 a week or more, they will be building up an entitlement to the state basic and second pensions and other state benefits.

TIP

You can get overlap relief against any overlap profits you may have in your first year but only when you close your business or move your accounting date to one later in the year.

EXAMPLE

Bob starts up as a self-employed builder on 1 November 2005. He sets his first accounting period to end on 31 December 2006, giving 426 days in total. Bob's tax bill for 2005-2006 is based on profits from 1 November 2005 to the end of the tax year (5 April 2006) – which works out to 156 days.

Bob's profits for the whole period to December 2006 come to £10,000, so his tax bill for 2005-2006 is based on profits of:

156/426 x £10,000 = **£3,661**

In the second tax year, Bob is taxed on the profits for the 12 months up to the accounting date that falls in that tax year (31 December 2006). Bob's tax bill in his second year is based on profits of:

365/426 x £10,000 = **£8,568**

Although Bob's first accounting period is 426 days, his tax is worked out on 521 days (156 + 365). This means that some of Bob's profits are taxed twice. He pays tax on:

(£3,661 + £8,568) = **£12,229**

This means Bob carries forward £2,229 of overlap profit. Bob won't be able to claim overlap relief against this until he closes his business or moves his accounting date to one later in the tax year.

! Warning

You are required by law to keep all the records (business and personal) relating to your tax return for five years from the 31 January following the relevant tax year. So for your 2005-2006 tax return, you must keep your records until 31 January 2012.

SAVE BY CLAIMING ALLOWABLE EXPENSES

Make sure you claim all the expenses you can

Not all business expenses are tax-deductible. Here are the main expenses that you can ✓ and can't ✗ claim.

MATERIALS AND GOODS

✓ Cost of goods for resale and the cost of raw materials; discounts on sales; payments to subcontractors and the cost of materials supplied in the construction industry; fuel costs if your primary business is road transport; cost of small tools.

✗ Fuel for non-business use of your vehicles.

SALARIES AND WAGES

✓ Recruitment agency fees; wages, salary and redundancy payments to employees; insurance costs and pension benefits for employees and their dependants; costs of training employees; the cost of temporary secondment of your employees to certain charitable and educational organisations; some types of childcare provision for the children of your employees; National Insurance (NI) contributions for employees; the cost of subcontractors; insurance cover to provide locums if you are ill; key person insurance cover for your employees (although the benefits from the policy may be taxed); staff entertainment such as the Christmas party (up to certain limits).

✗ Your own wages, salary or drawings from the business; wages paid to family if excessive for work done; cost of premises and equipment for a workplace crèche (though this may qualify for capital allowances); your own NI contributions and income tax; your own pension costs (though you can get personal tax relief on these); accident, permanent health and private medical insurance.

FEES, INTEREST AND LOANS

✓ Accountants' fees (but additional fees due to a Revenue & Customs investigation only if there is no extra tax, interest or penalties as a result); some solicitors' fees; some costs of architects and surveyors; the cost of some professional indemnity insurance.

✗ Legal fees/fines if you break the law; cost to settle tax disputes; cost of insurance that includes cover for accountancy fees for negotiating tax where you were fraudulent or negligent.

✓ Interest on, and cost of arranging, business loans and overdrafts; bank charges, credit card charges, and the interest on hire purchase charges (the amount you pay less the cash); leasing costs (but restricted on cars costing more than £12,000 in the 2005-2006 tax year).

✗ Your capital repayments; interest on overdue tax; the capital element of hire purchase charges.

PREMISES

✓ Dedicated business premises: heating; lighting; cleaning; water rates; rent; business rates. If you work from home, a proportion of the lighting, heating, cleaning and insurance costs; a proportion of rent (and capital gains bill when you sell your home); a proportion of council tax if part of home used for business.

✗ Initial cost of buildings (but part may qualify for a capital allowance); council tax relating to the private use of your main home; a proportion of other bills relating to the private use of your main home.

✓ General maintenance of business premises (a proportion if you work from home); repairs to business equipment.

✗ Alterations and improvements to business premises (may qualify for capital allowances); any proportion relating to private use.

MISCELLANEOUS

✓ Phone bills (but only a proportion of the bill if you also use the phone for private calls); stationery; software with a limited lifetime; books and magazines used only for business; fees to register trade marks and designs.

✗ Most payments to clubs etc; money paid as a result of extortion; cost of buying a patent (though this qualifies for a capital allowance).

✓ Money owed to you that is unlikely to be repaid.

✗ General reserves for bad debts if not based on accurate calculation.

! Warning

If you can divide an expense between business and personal cost (car running costs between business and personal travel, say), the business proportion is deductible. If the nature of the expense means it cannot be divided (such as the cost of a transatlantic flight), then no deduction is allowed.

TRAVEL, ACCOMMODATION, ADVERTISING, ENTERTAINMENT

✓ Running costs of your own car, such as insurance, servicing, repairs, road tax and petrol (only the proportion that relates solely to business use); cost of hiring vans or cars and parking. Leasing charges are fully deductible only on cars costing up to £12,000.

✗ Travel between home and workplace; cost of buying a vehicle (though this may qualify for a capital allowance); parking and motoring fines.

✓ Travel and accommodation on business trips and travel between different places of work; cost of travel from UK (and back again) to carry out business performed outside the UK, provided trips are exclusively for business. If a business trip requires you to stay overnight, reasonable costs for meals, including lunches. If you habitually travel on business (as a commercial traveller, for example), you can deduct the reasonable cost of meals taken away from home.

✗ Meals in any other situation. This means that most self-employed people can't claim the cost of meals or accommodation.

✓ Newspaper and magazine ads, mailshots and other promotion; free samples; gifts worth up to £50 to any one person, provided they advertise your business and are not food, drink, tobacco or vouchers for goods.

✗ Any business entertainment such as lunches with clients; most gifts.

CLOTHING

✓ Cost of special clothing bought solely for work.

✗ Cost of clothes that could be worn for non-work purposes.

TAX RETURN

People who are self-employed have to complete the self-employment supplementary pages (SA103) as well as the main tax return. If you've been in business for a while, you'll be sent them; if not, as with all supplementary pages, you should apply for them – contact the Revenue & Customs orderline (0845 9000 404).

- Read the form and Revenue & Customs' notes on self-employment before starting.
- Order any helpsheets that you need from Revenue & Customs (0845 9000 404) or download them from its website (www.hmrc.gov.uk/sa). You can also file online (see p62).
- Before filling in the form, collect up your business accounts for the accounting period or for the periods that form the basis of your 2005-2006 tax bill.
- If you don't have business accounts, get records of all your receipts, expenses, and monies drawn from, and new money paid into, the business.
- You'll also need records of your capital pool(s) brought forward from last year. Your last year's tax return should show any overlap profit and losses you're carrying forward.

Keep your records

Remember that as a self-employed person, you are required by law to keep all the records (business and personal) relating to your tax return for five years from the 31 January following the relevant tax year, though you don't need to send them in with your form. So for your 2005-2006 tax return, you must keep your records until 31 January 2012.

PUT IN A CLAIM FOR EXPENSES

Rob Patterson is a freelance designer. Like many people starting out in business, he employed an accountant. The accountant was good but Rob found the cost was too high.

Rob did his own accounts last year but didn't claim many expenses. But this year he read his *Tax Saving Guide* and realised that more of his expenses could be set against tax. He's now claiming for expenses that people in his profession run up, such as magazines, training DVDs and software. In addition, as he has to travel to Northern Ireland on business regularly, he's also now claiming for hotel bills and meals.

In total Rob has managed to add around £2,000 to the expenses that he can set against tax. As he's a basic-rate taxpayer that means £440 off his income tax bill. Rob said: 'I had no idea I could claim half of this. If I hadn't read the *Tax Saving Guide*, I'd have carried on paying too much tax.'

CHECKLIST

Here are some things that you should do when you start up as a self-employed person

✔ Get a copy of HMRC's free pack SE1 *Are you thinking of working for yourself?* This will give you all the information you need about being self-employed and details of some useful contacts.

✔ Register with Revenue & Customs within three months from the last day of the month in which you became self-employed. That way, you will avoid paying a £100 fine if you are eligible for class 2 National Insurance contributions.

✔ Keep a list of fixed assets, such as cars and office equipment. You will need it when it comes to working out your capital allowances.

✔ Get a copy of the tax return. You can see what Revenue & Customs is asking for, so that you can set up your accounts.

✔ Keep records – of stocks or raw materials and any other goods bought, used or sold, and of all costs, including petrol, if your car is used solely or partly for business.

✔ Make (and keep) a list of items you own but can use in your business, such as a computer, to claim capital allowances and, if you are registered, VAT.

✔ Put money by to cover your tax bills in January and July. If you miss the deadlines, you will have to pay interest to Revenue & Customs.

✔ Get adequate pension and insurance. If you're self-employed, you don't have an employer to sort these things out for you.

✔ Choose your accounting year end. See p23 for more about how this affects your tax.

✔ If you have spent money on your business before you started trading, you can claim it as a pre-trading expense when you fill in the self-employment pages of your tax return.

MORE HELP

HMRC helpsheets and leaflets

- IR56 Employed or self-employed?
- IR160 Enquiries under self assessment
- IR220 More than one business
- IR222 How to calculate your taxable profits
- IR227 Losses
- IR229 Information from your accounts
- IR238 Revenue recognition in service contracts – UITF 40
- SE1 Are you thinking of working for yourself?
- SA/BK4 Self assessment – a general guide to keeping records
- SA100 Individual tax return
- SA103 Self-employment supplementary pages