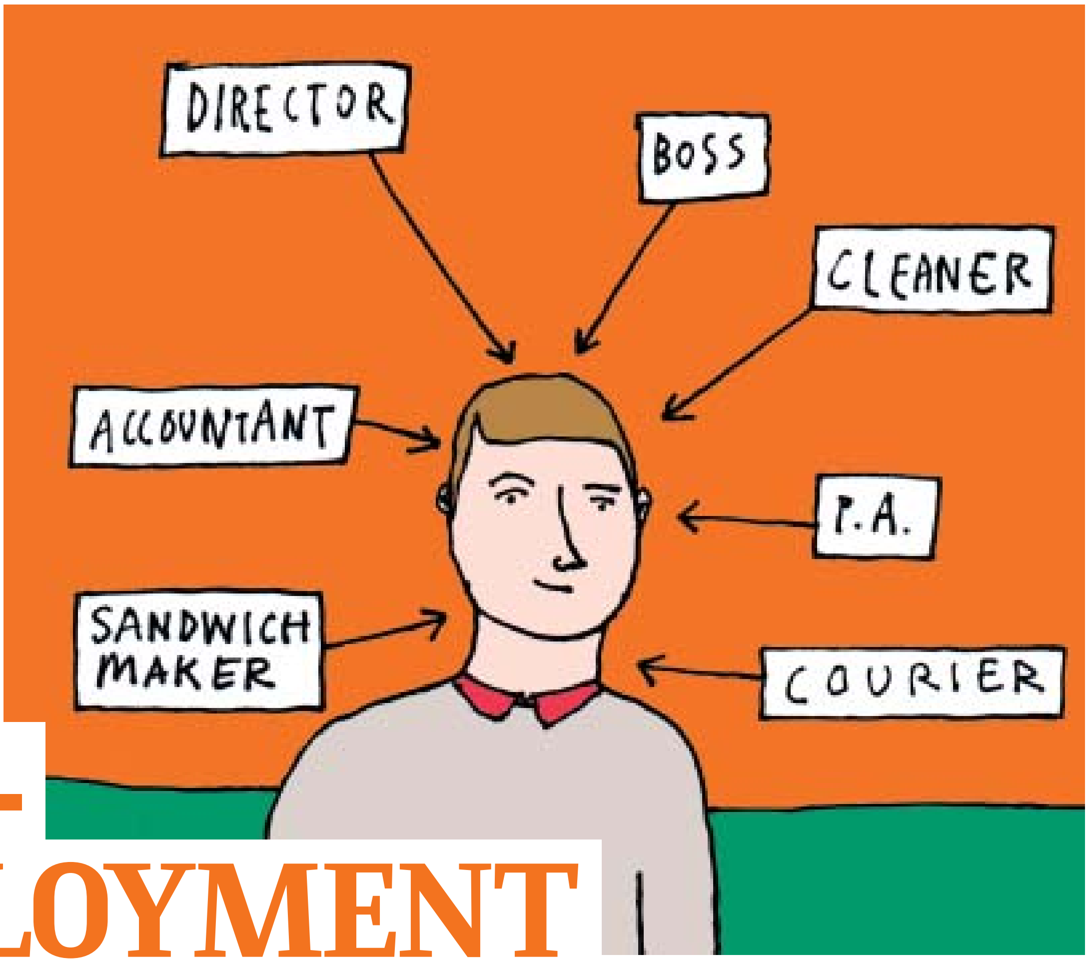

SELF-EMPLOYMENT

The pros and cons of operating as a company, plus how to work out your tax, business expenses and allowances if you're self-employed

Though changes in 2004-2005 have led to a reduction in the tax advantages of operating as a company, for many small businesses the advantages are still large enough to make it worthwhile. However, taking non-tax factors into account, many prefer self-employment.

TO INCORPORATE OR NOT

Until recently, small businesses were able to make annual tax savings of up to £4,000 by operating as a company rather than as a sole trader or partnership. This came about because of the differences in tax liability and legal status between companies and sole traders/ partnerships – see 'How they differ', opposite.

Background to 2004

Up to April 2004, you could pay substantially less tax as a company because:

- since April 2002, small companies have paid no corporation tax on the first £10,000 of profits. Profits from £50,000 to £300,000 were taxed at 19 per cent, and a system of marginal tax relief smoothed the transition between the zero and 19 per cent levels for companies with profits between £10,000 and £50,000
- as a director/shareholder of your own company, you were able to reduce your income tax bill, and avoid National Insurance altogether, by paying yourself a salary limited to the personal allowance. You then paid yourself the rest of the money in dividends.

What changed

From April 2004, in an attempt to level the playing field between directors of small companies and the self-employed, any money paid out as dividends to an individual is now taxed at a minimum average corporation tax rate of 19 per cent.

The change has affected only companies with profits of less than £50,000 – those with larger

DO YOU COUNT AS SELF-EMPLOYED?

To count as self-employed, you must convince the Revenue you genuinely work for yourself and not, in reality, for an employer. If you can answer 'yes' to these questions, it will usually mean you are self-employed.

- 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 risk your own money?
- 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?

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

profits have always paid tax at an average rate of 19 per cent anyway. If you have a smaller company and want to pay yourself a dividend, but pay an average corporation tax rate of less than 19 per cent, you now have to find money to pay extra corporation tax to the Revenue, thus cutting the amount of the dividend.

Businesses with the least profits have to pay the most in extra corporation tax but, even so, they still pay less tax overall than they would as sole traders or partners. However, the non-tax drawbacks of operating as a company (below), coupled with the April 2004 change, mean that people with comparatively small businesses may now be discouraged from incorporating.

Drawbacks

Against the tax-saving advantages of incorporating, people who are thinking of operating as a company need to consider the drawbacks. These include:

- more formal and costly accounting and reporting requirements
- more formal procedures for drawing money from the business
- tougher tax rules for expenses and fringe benefits
- the risk of being caught by the IR35 rules – see 'Watch out for IR35', p28
- the possibility of a big tax bill on closing down a self-employed business to switch to a company (see 'Closing down', p28).

STARTING UP

You can start trading as a self-employed person with few formalities. But, within three months of the end of the month in which you start, you must register with the Inland Revenue for Class 2 National Insurance or risk 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 Inland Revenue booklet P/SE/1. Registration also gets you into income tax self assessment and, if required, the VAT system.

Opening-year rules

Profits from self-employment are taxed according to special rules during the early years. In the first tax year, you're taxed on 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.

This is best illustrated with an example. Say you started on 1 November 2004 and your first accounting period ends on 31 December 2005 – that's 426 days in total. Your tax bill for 2004-2005 is based on profits for the 156 days from 1 November 2004 to the end of the tax year (5 April 2005). Your profits for the whole period to December 2005 are £10,000, so the taxable profit for 2004-2005 will be 156/426 x £10,000 = £3,662.

There may be a delay before you have the figures for the accounting period. 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. In our example, tax in the second year would be based on 365/426 x £10,000 = £8,568. (Special rules apply if your first accounting period is less than a year or there is no accounting date in your second year.)

Special rules apply if your first accounting period is under a year

In the third and subsequent years, you are taxed on the normal current-year basis: tax is based on your profits for the accounting year ending during the tax year.

Overlap profit

Under the opening-year rules, some profits (called 'overlap profits') are taxed twice. In the example, although the first accounting period from 1 November 2004 to 31 December 2005 was 426 days, tax was charged for 156 + 365 = 521 days (1 November 2004 to 5 April 2005 and 1 January 2005 to 31 December 2005). This means that (521 – 426)/426 x £10,000 = £2,230 is overlap profit. You can claim relief for this double taxation but not until you close down your business or move your accounting date to one falling later in the tax year. Many years may pass before you can claim relief, and inflation will erode its value.

CHOOSING YOUR ACCOUNTING DATE

You are normally taxed on the profits for the accounting year ending in that tax year. The bill is finally settled on 31 January following the end of the tax year concerned.

To keep things simple, opt for your accounting year to end on either 31 March or 5 April – this is known as fiscal accounting. Fiscal accounting avoids all the complications surrounding the opening- and closing-year rules as well as overlap relief. The drawback is that you 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, however, you carry forward higher overlap profits and you must take care to set aside enough to pay the eventual tax bill.

HOW THEY DIFFER

As a sole trader or a partner, your business has no separate identity from you for tax purposes: the profits you make each year are added to your other income; you deduct your personal allowance (£4,895 in 2005-2006) and pay income tax on the rest. You also pay National Insurance contributions (see p38).

But, if you operate as a company, your business has a separate legal and tax identity. Your company pays corporation tax on its profits and employer's National Insurance on the salary it pays you. As an individual, you take money out from the company, either as salary (in which case you are taxed as an employee – see p16 to p25) or as dividends (which are taxed as savings – see p48).

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 brought forward. If your accounting date is early in the tax year, the closing-year rules mean 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.

You must follow generally-accepted accounting practice

For example, if your accounting date is 30 April and you close down on 31 March 2006, your tax bill for 2005-2006 will be based on profits from 1 May 2004 to 31 March 2006, less any overlap relief.

CHANGING YOUR ACCOUNTING DATE

You can change the date which ends your accounting year. This results in a transitional accounting period that is either longer or shorter than the normal 12 months. The Inland Revenue must accept your change provided:

- 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 that falls 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 results in some profits being taxed twice and so creates new overlap relief that you carry forward as described under 'Starting up', p27.

If you move to a date that falls later in the tax year, you will be taxed on profits for a longer period than a year. But you can claim relief for some or all of any overlap profit you have been carrying forward. For further information, see Inland Revenue helpsheet IR222 *How to calculate your taxable profits*.

TAXABLE PROFITS

Broadly, you pay tax on your yearly takings less allowable business expenses, capital allowances and losses. The first step is to draw up the business accounts. You then need to make various adjustments to arrive at your taxable profit.

WATCH OUT FOR IR35

There are special rules (known as IR35 rules) that stop people paying less tax and National Insurance by operating through a personal service company rather than being employed directly.

The question you need to ask is: if your company or partnership did not exist, would you, in effect, be an employee of a client you work for? If so, under the IR35 rules, the fees the intermediary (your company or partnership) receives are taxed as if they were your salary. The intermediary is liable for income tax and National Insurance on this notional salary, wiping out any tax savings you made by paying yourself dividends.

The rules apply to companies and partnerships that supply the services of a worker to others. The sort of businesses affected include IT contractors, lecturers, artists, consultants and nannies. For more, see IR175 *Supplying services through a limited company or partnership*.

Rules for business accounts

As a self-employed person, you must follow generally accepted accounting practice so that your accounts give a true and fair view. If you're not using an accountant, there are numerous guides and software packages to help you – check out larger bookshops and computer stores to see what's available.

Money owed

Your business and tax accounts must be drawn up on an 'accruals' basis. This means they do not simply record what you received and what you paid out during the year ('cash basis'). You must also include any money you have earned during the period but not yet received, together with any expenses run up but not yet paid.

Valuing stock

If your business involves selling or making goods, you first work out your gross profit by subtracting from your sales revenue the cost of sales. Typically, this is what you actually paid for the goods or raw materials plus overheads directly associated with making the goods ready for sale.

You can't just deduct what you spent during the year buying in raw materials or goods for resale. You need to add in stock carried over from last year and deduct any goods or raw materials left at the end of this year. This will involve carrying out a stock take at the end of each accounting period.

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 should assume stock is used on a first-in, first-out basis, so stock in hand comprises your most recent purchases.

Depreciation and capital allowances

When you buy something that will be used in your business over a long period, it counts as a capital asset and, in your business accounts, the fall in its value over time should be spread across the asset's useful life rather than deducted in full in the year you buy it. The amount you deduct each year is called depreciation.

To arrive at your profits for tax, you must add back depreciation, but instead you can deduct capital allowances. In effect, capital allowances are depreciation worked out according to standardised rules.

Capital allowances are also used by the government to encourage certain types of spending. They can be claimed for capital spending on business equipment (such as vehicles, tools and computers), patents, research and development, specialist 'know how', and agricultural or industrial buildings.

To work out your capital allowances, you must keep a running record of what you spend on

WHICH EXPENSES YOU CAN CLAIM

NORMALLY ALLOWED	NORMALLY NOT ALLOWED
The 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; the cost of small tools.	Fuel for non-business use of your vehicles.
Recruitment agency fees; wages, salaries 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; employer's National Insurance (NI) contributions for employees; the cost of hiring locums or subcontractors; insurance premiums to cover providing locums in the event of your being ill; keyman insurance cover for 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); own NI contributions and income tax; your own pension costs (though you can get personal tax relief on these); your own life, keyman, accident, permanent health and private medical insurance.
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 domestic rates in Northern Ireland) or of mortgage interest if part of your home is used exclusively for business (although there may then be a capital gains tax bill when you sell your home); a proportion of council tax if you use part of your home for business.	The 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 your private use of the 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.
Telephone bills (but only a proportion of the bill if you also use the phone for private calls); postage; stationery; delivery costs; printing; software with a limited lifetime; books and magazines used only for business.	Most payments you make to clubs etc; money paid as result of extortion.
The running costs of your own car, such as insurance, servicing, repairs, road tax and petrol (only the proportion that relates solely to business use); the cost of hiring cars or vans; parking costs. But leasing charges are fully deductible only on cars costing up to £12,000.	Travel between your home and your workplace; the cost of buying a vehicle (although this may qualify for a capital allowance); parking and motoring fines.
Travel and accommodation on business trips and travel between different places of work; the cost of travel from the UK (and back again) to carry out business that is performed outside the UK, provided that the trips are exclusively for business reasons. If a business trip requires you to stay overnight, the reasonable costs for meals, including lunches. If you habitually travel on business (for example, as a commercial traveller), you can deduct the reasonable cost of meals taken away from home.	Meals in any other circumstances. This means that most self-employed people cannot claim the cost of meals or accommodation.
Newspaper and magazine ads, mailshots and other forms of promotion; free samples; gifts worth no more than £50 to any one person, provided they advertise your business and the gifts are not food, drink, tobacco or vouchers for goods.	Any business entertainment such as lunches with clients; most gifts.
Accountants' fees (but additional fees due to Inland Revenue 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 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.
Money owed to you which is unlikely to be paid.	General reserves for bad debts.
Interest on, and cost of arranging, business overdrafts and loans.	Your capital repayments; interest on overdue tax.
Bank charges, credit card charges, and the interest element of hire purchase charges (the amount you pay less the cash price); leasing costs (but these are restricted on cars costing more than £12,000 in the 2004-2005 tax year).	Capital repayments; the capital element of hire purchase charges.
Special clothing that is bought solely for work; fees paid to register trade marks and designs.	The cost of clothes which could be worn for non-work purposes; the cost of buying a patent (although this qualifies for a capital allowance).

capital items and the allowances you have already claimed in previous years.

You can claim part of the cost of business equipment (excluding cars) in the year you buy it, provided you count as a 'small enterprise'. A small enterprise has a turnover of £5.6 million or under, assets up to £2.8 million and no more than 50 employees. The amount you can claim is 50 per cent in 2004-2005 (40 per cent in other years). You can claim up to the full cost of some items.

You may be able to claim part of the cost of business equipment in the year that you buy it

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. Each year you can claim up to 25 per cent of the value of the pool as a 'writing-down allowance'. The value of the pool is reduced by the amount you claim.

If you sell a capital item, the sale proceeds are deducted from the pool before the writing-down allowance is worked out. If the proceeds of all the items you sell come to more than the value of the pool, the excess (called a 'balancing charge') is added to your profits for the year and taxed.

If you sell an item for less than its written-down value, the remainder normally continues to be written down gradually in future years. However, 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 disposal is within five years, you can claim the whole of the remaining value as a capital allowance. If you do not dispose of the asset within four years, 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.

ALLOWABLE EXPENSES

Some of the expenses you deduct in your business accounts might not be allowable deductions for tax purposes. The main expenses you can claim for (and those you can't) are explained in 'Which expenses you can claim', p29.

Strictly, any payment partly for business and partly for personal reasons is not allowable. But, in practice, you can claim a proportion where the business cost can be separated out – for example, on the basis of mileage if you run a car partly for business.

HIRING YOUR SPOUSE

If your spouse helps with the business and pays tax at a lower rate than you, a simple way to save tax is to pay them a wage. As long as this is reasonable for the work done, it counts as an allowable expense and can be deducted when you work out your profits. Provided their salary does not exceed £94 a week in 2005-2006, they will pay no National Insurance or income tax and you will pay no employer's National Insurance. But, as long as their earnings are £82 a week or more, they will be building up an entitlement to the state basic and second pensions and other state benefits.

Remember the national minimum wage is £4.85 an hour (from October 2004), and if you pay less, you may be open to legal action.

USING YOUR LOSSES

A loss sustained in an accounting year can be carried forward to set against future profits from the same business. Alternatively, you can use the losses immediately against either 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 of business, there is a special relief that lets you set your loss against income (but not gains) for the previous three years. In the last 12 months before closing down, your loss can be set against the previous three years' profits.

Losses can also reduce your Class 4 National Insurance contributions. See Inland Revenue helpsheets IR227 *Losses* and IR220 *More than one business* for more on National Insurance.

OTHER TAXES YOU MIGHT PAY

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

National Insurance

If you are self-employed, you usually pay Class 2 and 4 National Insurance contributions (see p38). However, some people do not have to pay contributions in 2004-2005. These include:

- anyone who is over state pension age on 6 April 2004
- anyone who is under age 16 on 6 April 2004
- anyone who is not resident in the UK for tax purposes.

If you have income from employment as well, there are limits on the total Class 1,2 and 4 contributions you pay. Either claim back any overpayment or, in the case of Class 2 and 4 contributions, ask to defer payment until your overall position is known. To request a deferment, get the National Insurance Contributions Office leaflet CA72 (available from your tax office or the Revenue's website).

Value added tax

You must register for value added tax (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 – £58,000 in 2004-2005 (the 2005-2006 level had not been published at the time of going to press). You must also register if at any time you believe your turnover will exceed the limit during the next 30 days. At or below the limit, you can voluntarily register for VAT. If you're not registered, you can't reclaim VAT on things you buy for business, but you use prices including VAT when recording expenses and allowances.

You can't reclaim VAT if you're not VAT-registered

Businesses with a taxable turnover of £150,000 or less excluding VAT 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 flat rate varies between 2 and 13.5 per cent depending on your type of business, with a discount for new businesses. For more information, or to join the scheme, visit www.hmce.gov.uk, or contact Customs and Excise on 0845 010 9000.

Business rates

If you have business premises, such as a shop or office, or you use part of your home exclusively for business, you must pay the uniform business rate. If a part of your home used for business is also used for domestic purposes, business rates shouldn't usually be levied, and you may be able to claim part of your council tax as an allowable business expense. If you use part of your home exclusively for business, you may be liable for capital gains tax when you come to sell it. But structural alterations to your home, hiring staff, using specialist equipment and customers visiting your home-business could justify business rates.

THE SELF-EMPLOYMENT TAX RETURN

You will need to complete the self-employment supplementary pages (SA103). If you've been in business for a while, you'll be sent them; if not, you should apply for them. Read the form and the Inland Revenue's notes on self-employment before starting, and order any helpsheets from the Revenue (0845 9000 404) or download them from its website (www.inlandrevenue.gov.uk/sa). You can file online (see p11).

Before filling in the form, collect together your business accounts for the accounting period or periods that form the basis of your 2004-2005 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

Self-employed people are required by law to keep all the records (business and personal) relating to their 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 2004-2005 tax return, you must keep your records until 31 January 2011. ■

MORE HELP

Inland Revenue helpsheets and leaflets

- CWL2 National Insurance for the self-employed
- IR56 Employed or self-employed?
- IR160 Enquiries under self assessment
- IR175 Supplying services through a limited company or partnership
- IR220 More than one business
- IR222 How to calculate your taxable profits
- IR227 Losses
- IR229 Information from your accounts
- IR2003 Supplying services: how to calculate the deemed payment
- P/SE/1 Thinking of working for yourself?
- SA/BK4 Self assessment – a general guide to keeping records