Introduction

Some of the decisions and actions that a person has to take when starting a business can have significant and lasting effects. The foundations put in place at the beginning of the business are very important, and can affect its survival. This chapter deals mostly with the taxation of sole traders, but begins by briefly describing some of the main tax and financial considerations in starting an unincorporated business. An individual intending to start a business must also:

- Thoroughly survey the market in which they intend to operate.
- Formulate forecasts into a business plan.
- Raise the necessary finance.

These matters are not covered here.

Trading vehicle

An individual intending to start a business must decide whether to trade as an unincorporated business or to incorporate. A limited company might not be initially attractive for several reasons, including the following:

- Limited liability provides relatively little protection for shareholders who are also directors if banks, other providers of finance or trade creditors require personal guarantees.
- The costs for limited companies of complying with company law requirements are greater than accounting and compliance costs for sole traders or partnerships.
- The tax, national insurance and financial position of a sole trader is generally more flexible than for a limited company.

On the other hand, the rate of corporation tax for small companies is considerably lower than the 50% highest rate of income tax. A company with profits up to £300,000 currently pays corporation tax at 20%. A company might therefore be attractive where the owner does not need to withdraw all or most of the profits as remuneration, which would be liable to income tax and national insurance contributions (NICs). Profits can often be paid as dividends, which are not liable to national insurance.

There are many other matters that have to be considered in deciding whether and when to incorporate. (See also Topic 27 the separate topic 'Starting a business'.) The remainder of this chapter deals only with unincorporated businesses.

Registration

It is essential to register as self-employed with HM Revenue & Customs (HMRC) as soon as possible after the business starts.

- An individual will be liable to a penalty if he or she does not notify liability for Class 2 NICs by 31 January after the end of the tax year in which that individual becomes liable. That penalty may be up to 100% of the NICs unpaid as a result of the failure to register.
- Similar penalties may be charged in relation to income tax paid late as a result of failing to register by 5 October following the tax year in which the business starts.

The registration procedure covers income tax and NICs (see the separate topic 'The taxation of sole traders').

- Individuals can register online through the HMRC website: www.hmrc.gov.uk/selfemployed/register-selfemp.htm
- It is possible to register by telephoning the special HMRC helpline for the newly self-employed: 0845 915 4515 between 8am and 8pm, Monday to Friday and 8am to 4pm, Saturday and Sunday.
- Alternatively one can download the form CWF1 from the HMRC website, or use the version at the back of the HMRC leaflet SE1, *Thinking of working for yourself?* That leaflet also includes a form for registering to pay Class 2 NIC — the basic flat rate contributions — by direct debit (form CA5601).

The registration form should be sent to:

National Insurance Contributions and Employer Office
Central Agent Authorisation Team
Benton Park View
Newcastle upon Tyne
NE98 1ZZ

HMRC will issue a self-assessment tax return in the April following the start of the business and every April thereafter.

Income from self-employment, that is to say, running an unincorporated business, or carrying on a profession or vocation on one's own account (or in partnership, but that aspect is not covered here) is taxed as trading income under the Income Tax Acts. See Topic 24, the separate topic 'Partnership tax' for discussion of partnerships.

Income from trades, professions & vocations

Income tax is charged on the profits earned in a period of account (the period for which accounts are drawn up). Trades, professions and vocations are taxable under practically identical rules. In the rest of this chapter, 'trade' and 'trading' should be taken to include a profession or a vocation.

Profits are calculated by using ordinary accounting principles. Accounts must be drawn up on an accruals basis. This means:

- Income and expenses must be included in the accounts for the period in which the date of the invoice falls, rather than when the income is received or the expense is paid.
- Stock held at the year end and work-in-progress must be accounted for. Where service contracts are performed over a period, work-in-progress must now generally be included in the accounts at full billable value of the work done at the accounting date rather than at cost, as previously.

Accounts can be drawn up to any date in the year. Periods of account are normally 12 months, but a shorter or longer period of account can occur at the start or end of trading and when a trader makes a permanent change to the date to which accounts are regularly to be drawn up.

Basis of assessment

In the tax year in which the trade starts, the individual is taxed on the profits earned in that tax year. For example, an individual who starts a business on 1 January 2011 will be taxed in 2010/11 on the profits from 1 January to 5 April 2011. If the accounts are drawn up to a later date, then the profits must be apportioned on a time basis.

The second year's assessment is normally on:

- The profits of the 12 months ending on the chosen accounting date in that tax year.
- The profits of the first 12 months of trading where the accounting date is less than 12 months after the start of the business.
- The profits of the tax year itself, where there is no accounting date ending in that year. This can occur if the business starts near the end of a tax year and has a long first period of account, such as 1 March 2010 to 30 April 2011.

The taxable profits in the final tax year of a trade are those of the whole period since the end of the period of account that was taxed in the previous tax year. This period could be nearly two years. For example, if an individual draws up accounts to 30 April each year and ceases trading on 31 March 2011, the assessment for 2009/10 will be on the profits for the year ending on 30 April 2009 and the assessment for 2010/11 will be on the profits for the period from 1 May 2009 to 31 March 2011.

Overlap profits

The rules for the first two years can have the result that some profits are taxed in both years. These are known as 'overlap profits'. Relief for this double taxation is normally given against the assessment for the tax year in which the business ends. However, a change of accounting date could result in earlier relief for overlap profits.

Example 23.1 – Overlap profits

Paula started trading on 1 October 2009, making up accounts to 30 September. The trading profits are:

Year ended 30 September 2010	£16,000
Year ended 30 September 2011	£18,000
2009/10 assessment:	
1.10.09 to 5.4.10: 6/12 × £16,000	£ 8,000
2010/11 assessment:	
12 months to 30.9.10	£16,000
2011/12 assessment:	
12 months to 30.9.11	£18,000

So £24,000 has been taxed in respect of the £16,000 earned in the first year. This means that there are 'overlap profits' of £8,000, which are carried forward and can only be relieved in full:

- When trading ends sometime in the future, or
- On a change of accounting date that results in more than 12 months of profits being taxed for a tax year.

Choosing an accounting date

The existence of overlap profits and the special rules for when a business stops trading mean that the choice of accounting date is not straightforward.

- Many businesses will want to prepare their accounts to 31 March or 5 April. This is the most straightforward and avoids both overlap profits and an abnormally large assessment for the final year of trading.

- For example, a business makes up its accounts to 30 June each year and stops trading on 31 January 2011.

  - The assessment for the tax year 2009/10 will be on the profits of the year ended 30 June 2009.

  - In the final tax year, 2010/11, the tax assessment will be on the profits of the period 1 July 2009 to 31 January 2011, the full 19 months that have passed since the end of the accounting period taxed in the previous tax year.

  - The taxpayer can deduct overlap profits brought forward from when the business started. However, where the profits earned early in the business were comparatively small, the overlap relief will also be small, leaving a large assessment for the final year.

  - The taxpayer might also have other income, such as a pension or employment earnings, after the end of the business up to the following 5 April. Such income must be included in the tax return for the final year of the business and could increase the tax payable on the business profits.

- If the accounting date of the business is 31 March, then a business that ends on 31 January 2011, for example, would be taxed as follows:

  - The assessment for 2009/10 will be on the profits of the year ended 31 March 2010.

  - The assessment for the final tax year, 2010/11, will be on the profits earned in the ten months from 1 April 2010 to 31 January 2011.

  - So the taxpayer can never be taxed on more than 12 months' income.

- There are some disadvantages of an accounting date ending late in a tax year, for example, 31 March:

  - There may be only seven months from the end of the accounting period up to the date the tax return has to be sent to HMRC (ten months for internet filing).

  - In contrast, a business with a 30 April year end will have at least 19 months to complete tax returns.

  - Similarly, tax is payable sooner after the profits have been earned, giving a cashflow disadvantage if profits are rising.

  - It is more difficult to decide whether to request a reduction in payments on account before the payments are due, because the amount of profits will not be known in time.

  - The annual limit on contributions to registered pension schemes is 100% of earnings of the year capped by £50,000 from 6 April 2011 (subject to unused relief brought forward). If there are no earnings, contributions of up to £3,600 gross can be made. Anyone who wants to maximise pension contributions needs to know the amount of earnings before the end of the tax year.

- ➢ The opportunity to claim child tax credit and working tax credit may be missed. Entitlement to these credits is based on income of the entire tax year, but claims cannot be backdated by more than three months. A taxpayer with a late accounting date may not realise that a claim is worthwhile until late in the tax year. It is possible to make annual claims regardless of income, just to protect the right to a tax credit award if income turns out to be low enough, but this obviously involves extra work.
- ➢ A late accounting date also makes it more difficult for a tax credit claimant to provide confirmation of income after the end of the tax year by the due date of 31 July, but estimates can be used and the final figures provided later.

Deductions for expenditure

Most revenue expenses are deductible if they are incurred wholly and exclusively for the purposes of the trade. Loan and overdraft interest are generally deductible.

The costs of entertaining and gifts are not deductible.

Private expenditure is not deductible. Examples are ordinary clothing such as business suits and the trader's meals, except in conjunction with travel requiring overnight absence.

Capital allowances

Depreciation is not deductible. Instead, capital allowances are given for purchases of equipment for the business and for some other types of capital expenditure. The most important allowances are for plant and machinery, which includes fixtures and fittings and motor vehicles.

These allowances are given as a deduction in calculating taxable profits.

- All businesses may claim a 100% allowance (the annual investment allowance – AIA) for up to £100,000 spent on qualifying plant and machinery in a period of account. The maximum annual amount will be reduced to £25,000 for expenditure incurred after 5 April 2012.
- Expenditure on certain limited categories of asset (such as designated energy-saving equipment) qualifies for a 100% first-year allowance (FYA). This includes new cars bought and first registered after 5 April 2009 that have CO_2 emissions of up to 110 grams per kilometre (g/km).
- Remaining expenditure on qualifying assets is placed in an expenditure pool at cost price, from which writing down allowances (WDAs) at 20% are deducted each year. This percentage of WDA will reduce to 18% from 6 April 2012.
- When a pooled asset is sold, the proceeds are normally deducted from the pool balance. If the proceeds are greater than the pool balance (which may be zero if the AIA has been claimed), the excess is treated as a balancing charge and is added to the profits for the relevant year.
- A reduced rate of WDA of 10% applies to certain expenditure including long-life assets, and integral features and thermal insulation of buildings. This rate of WDA will reduced to 8% from 6 April 2012.
- When the balance in the 10% or 20% pool falls to £1,000 or less, the full amount may be written off in period of accounts commencing from April 2008.
- There is no AIA or FYA available for cars other than low emissions cars. Cars purchased from 6 April 2009 are assigned to the 20% or 10% pool. Cars with CO_2 emissions not exceeding 160g/km attract 20% WDAs. Other cars qualify for 10% WDAs only.

- Where an asset, such as a car, is used privately as well as for business, only the business proportion of the capital allowances can be claimed. Privately used assets are allocated to individual pools. When such an asset is sold, the proceeds are deducted from the asset's own pool and the residue of the value in the pool is treated as a balancing allowance, or a balancing charge if the proceeds exceed the pool balance.
- Where capital expenditure is incurred before the business starts, the allowance is given as if the expenditure had been incurred on the first day of trading. The rate of allowance is determined by the date on which the expenditure was actually incurred.

Pre-trading expenditure

Costs will often be incurred before the business has started trading.

- Income tax relief is given, provided the expenditure is of a revenue nature and incurred for the business within seven years before starting to trade. It is therefore important to keep a record of such expenditure.
- Pre-trading expenditure is deducted as an expense on the first day of trading.

Trading losses

If a trader makes a loss in a period of account, the assessment for the tax year in which that period of account ends will be nil.

The loss can be carried forward and must then be deducted from subsequent trading profits as soon as such profits arise.

Alternatively, a trading loss can generally be deducted from other income of the tax year in which the period of account of loss ends or from income of the previous tax year.

A temporary extension to this relief allowed losses from one or both of the tax years 2008/09 and 2009/10 to be carried back up to three years. The amount of losses that can be carried back to the immediately preceding year is unlimited. After carry-back to that year, a maximum of £50,000 of any unused losses for each of 2008/09 and 2009/10 was available for carry-back to the earlier two years.

There are special rules for calculating the losses that can be deducted from other income where the loss occurs in the opening years of the trade. They ensure that the rules that may give rise to double taxation of profits, as explained above, do not also produce double tax relief for losses.

There is also provision for:

- Losses in the first four tax years of the trade to be carried back and deducted from income of the three previous tax years.
- Losses in the final 12 months of trading to be carried back and deducted from income of up to three tax years before the year of cessation.

Losses in early years

Special tax relief is available where a business incurs a loss in any of its first four tax years.

- The loss relief is given against the income of the previous three tax years. Thus losses incurred in the trade can be carried back and set against earned or unearned income of earlier years.
- The losses are carried back against the income of the earliest year first.
- This relief is an alternative to the general relief that allows a loss to be offset against other income of the tax year in which the loss occurred or carried forward, and to the temporary extended loss relief that was available for losses of the tax years 2008/09 and 2009/10.

The best way of relieving any loss will depend on the individual's personal circumstances. The claim must be made within 12 months after 31 January following the year of the loss. There are restrictions on the use of losses that have been generated in the following circumstances:

- The trade is not conducted on a commercial basis with a view to making a profit.
- The trader spends on average fewer than ten hours a week involved in the trade.
- The trade is farming or market gardening and a loss has been made in each of the previous five tax years.
- Tax avoidance arrangements have been used to generate the loss on or after 21 October 2009.

Introduction of private assets

Where an individual introduces private assets into a business, the appropriate tax relief is available.

- Where the assets become trading stock, they should be introduced at their market value. This could exceptionally give rise to a capital gains tax (CGT) charge and advice should be taken.
- Capital allowances are available on a car previously used privately. Normally the car is introduced into the business at its market value at that time and the allowances calculated accordingly.

Goods for own use

If a trader takes business goods for his or her own use, the correct accounting treatment is to include as income their cost price or the amount the trader pays to take the goods out of the business.

- For tax purposes, the trading profit must be adjusted to replace the figure included in the accounts by the market value of the goods.
- If significant amounts are involved, for example, if a builder constructs or renovates a property for their own use, it is advisable for all costs to be met privately, rather than through the business. Any labour diverted from the business should be paid for at market value.

In all cases, the VAT implications must also be considered.

Tax returns and tax payments

The tax return must normally be completed and sent back to HMRC by 31 October following the end of the tax year if filed on paper and by the following 31 January if filed online.

- The return must include all the taxpayer's income from all sources and any capital gains.
- Taxpayers filing on paper can choose whether to calculate their own tax liability or ask HMRC to do it. Returns filed online automatically include a calculation.
- HMRC will calculate the liability to tax and Class 4 (profit-based) NICs before the due date for payment if a paper return is filed by 31 October.
- If HMRC issues a tax return after 31 October following the end of the tax year, then the return must be submitted within three months of the date of issue. The same rule applies to returns issued after 31 July and filed on paper.

- There is an automatic penalty of £100 where a return is made late, unless the taxpayer has a reasonable excuse for lateness. This penalty was reduced to the amount of tax owing on 31 January for the tax years 2009/10 and earlier, but this reduction is removed for later tax years.
- From October 2011, where the tax return is more than three months late, a daily penalty may be charged. If the return is over six months late, another penalty of £300 or 5% of the tax due is charged. This penalty is doubled if the return is more than 12 months late.

Tax payments

All income tax (and Class 4 NICs) for the year ended 5 April must normally be paid by the following 31 January.

- Interest is charged on amounts outstanding after that date.
- In addition, a 5% surcharge is payable on any tax and Class 4 NICs paid more than 28 days late (that is, normally, after 28 February following the tax year). A further 5% surcharge is payable on any tax and Class 4 NICs not paid six months after the due date (that is, normally, 31 July).
- Payments on account (or interim payments) may be required on 31 January in the tax year and the following 31 July.
  - ➢ Each interim payment is normally half the amount of the income tax and Class 4 NICs payable for the preceding year.
  - ➢ The taxpayer can request that the interim payment be reduced to half the current year's liability if that is likely to be less.
  - ➢ Interest is charged on late payments on account.
  - ➢ Individuals starting in business do not, in practice, have to make payments on account in the tax year in which the business starts, unless they had tax to pay under self-assessment in the previous year (for example, because they had a previous business or a large amount of investment income taxable at the higher rates). People sometimes think this means the first year's profits are exempt from tax but this is not the case.
- It is important to make provision for tax liabilities as soon as possible from the start of the business. Normally, new businesses have to pay the equivalent of 150% of the first year's tax liability in one lump sum on 31 January following the first tax year because they have not made interim payments.

Minimising tax

There are a number of ways of reducing tax, especially at the start of the business, when cashflow might be tight.

- If the accounting date is not at the end of the tax year, some of the profits of the first accounting period are taxed twice. In these circumstances, it can be advantageous to maximise expenditure deductible against income during the first period of trading so as to minimise the profits.
  - ➢ An individual could employ a spouse for the first year, and also perhaps pay a pension premium for the spouse's benefit.
  - ➢ The remuneration paid to the spouse must be justifiable in relation to the duties performed, and the spouse's own tax position must be considered.

- ➢ Up to £100,000 a year of expenditure on most types of business equipment is deductible in full against profits – the annual investment allowance (AIA) (see above). Making such purchases in the first year can increase the amount of income relieved.
- ➢ Where capital allowances are only given at 20% or 10%, for example, on most cars, or where financial considerations do not permit purchase of expensive equipment in the first year, the business could lease assets rather than buy them outright.
- ➢ For cars leased from 1 April 2009, the whole leasing cost may be deductible from taxable income, subject to a disallowance of 15% of the lease rental payments on cars with carbon dioxide (CO_2) emissions above 160g/km.

- Making payments into registered pension schemes will reduce the tax liability of any individual subject to higher rate tax – see chapters 14, the separate topic 'Pensions tax rules' and 15, the separate topic 'Pensions tax planning'.

National insurance contributions (NICs)

As a self-employed individual, a trader is liable to both Class 2 and Class 4 contributions.

Class 2 contributions

Class 2 NICs are charged at a flat rate and are not earnings-related. It is nevertheless necessary to establish the actual net earnings for the year, because if they are low (see table below), the taxpayer can apply for a small earnings exception certificate. Once that certificate is approved, no NICs are due. The actual net earnings for the year are the net profits shown by the business accounts for a tax year, which runs from 6 April to the following 5 April. If the accounting year straddles 5 April, the profits or losses must be apportioned for this purpose. The taxpayer may wish to continue to pay Class 2 NICs to retain entitlement to the state pension or other benefits (see below).

Class 4 contributions

Earnings for Class 4 purposes are the profits that are chargeable to income tax, after adjusting for items such as capital allowances and trading losses.

Some further items that can be deducted for income tax, such as personal allowances, are not deducted for Class 4 purposes.

- Class 4 earnings correspond with the tax year in which the profits are assessed for income tax.
- Therefore if taxable profits of £20,000 are earned in the accounting period ended 30 April 2011, they are assessed for 2011/12 (period of account ending within the tax year, except generally at the start and end of self-employment, for which there are special rules, as we have seen).

Losses

The treatment of losses for NICs can be different from the income tax position. If trading losses are set off against income from other sources, such as dividend income, instead of being carried forward for tax purposes against future trading profits, the losses can still be carried forward for Class 4 purposes.

Example 23.2 – Class 4 NICs

		£
Profits	30 April 2009	8,000
Losses	30 April 2010	4,000
Profits	30 April 2011	15,000

Assessable	£	£
2009/10		8,000
2010/11 (Losses set against other income for tax purposes)		Nil
2011/12	15,000	
Less losses b/f	(4,000)	
Profits for Class 4 purposes only		11,000

Although profits of £15,000 are taxed for 2011/12, only £11,000 is taken into account when calculating the Class 4 NICs payable.

Two or more income sources

Earnings from more than one source of self-employment must be added together when calculating both Class 2 and Class 4 NICs.

Working tax credit and New Deal incentives

Payments of working tax credit (WTC) and grants under the New Deal scheme do not count as earnings liable to Class 2 or Class 4 contributions. The New Deal scheme and certain WTC payments to people over 50 are aimed at helping people take up employment or self-employment.

NIC rates

Changes in the rate of NICs normally take place at the start of the tax year (6 April). The rates are given below.

Class 2 contributions

	2010/11	2011/12
	£	£
Weekly flat rate	2.40	2.50
Small earnings exception limit	5,075	5,315
Maximum payable (53 weeks)	127.20	132.50

The flat-rate contribution is normally payable by self-employed people for any week in which they are over the age of 16 and under pensionable age.

- Pensionable age is currently 65 (for men and for women born after 5 April 1955) and 60 (for women born before 6 April 1950).
- For women born between 6 April 1950 and 5 April 1955, a sliding scale fixes the pensionable age at which contributions will cease.
- Pensionable age will eventually rise further for both sexes, with the first set of changes due to be phased in from 2016.
- Self-employed individuals may claim exception from liability if they have low income.
    - ➢ They should apply on form CF10 for exception where earnings from self-employment are expected to be less than the small earnings exception limit – see table above.
    - ➢ If exception is approved, a certificate is issued for a period that can be as long as three years, and will end on 5 April.
    - ➢ The certificate can be backdated for 13 weeks only, and so some NICs might be paid unnecessarily if application is not made in good time.
    - ➢ In the case of an ongoing business, some evidence, such as accounts or details of receipts and payments, must be provided with the application.
    - ➢ For a new business, it is only necessary to state that earnings are expected to be below the limits.
    - ➢ If the conditions for the certificate are no longer fulfilled, it becomes ineffective.
    - ➢ One should always inform the National Insurance Contributions Office (NICO) of any change in circumstances.
- In practice, the NICO applies some concessions that ignore the strict rules. A self-employment involving a couple of hours a week is ignored.
- No Class 2 NICs are payable by people who are also employees and earn a substantial amount from their employment if their spare-time self-employed earnings are less than £1,300. There is no need to apply for an exception certificate, although the NICO should be informed in writing.
- Class 2 NIC liability does not end during weeks of inactivity or holiday, but there is normally no liability during complete weeks in which the person is entitled to sickness, invalidity or incapacity benefit, maternity allowance, or similar benefits.
- Women who on 6 April 1977 were married, as well as some widows, were entitled to make an election to pay reduced NICs. These elections cease to be effective in circumstances such as divorce or a gap in employment or self-employment, but a few elections remain in force. No Class 2 NICs are payable by self-employed married women who have a valid election in force. Reduced NICs do not count towards the state pension.

Class 4 contributions

	2010/11	2011/12
Main rate	8%	9%
	£	£
Lower annual limit	5,715.00	7,225.00
Upper annual limit	43,875.00	42,475.00
Maximum payable at the main rate	3,052.80	3,172.50
Additional rate on earnings above upper limit	1%	2%

- Class 4 NICs are payable at the main rate on self-employed earnings that fall between a lower and upper limit.
- These limits are given in the table above.
- An additional 2% Class 4 NIC is payable on all earnings above £42,475 (2011/12) without upper limit.
- Class 4 NICs are not payable by anyone who is under 16 or has reached pensionable age at the beginning of the year of assessment. The pensionable age rules are the same as for Class 2 NICs.
- A married woman's reduced liability election has no effect on Class 4 NICs.

Annual maximum contributions

An individual who is employed and self-employed in a year may have to pay NICs at the main rate (9% for Class 4 and 12% for Class 1) on both types of earnings, potentially up to the upper earnings limit for each.

Where this occurs, maximum limits on main rate NICs are set to prevent excessive liability.

For 2011/12, the individual then has to pay additional rate NICs at 2% on earnings from each employment that exceeds £139 a week (other than any on which main rate NICs are being paid) and on earnings from self-employment that exceed £7,225 a year if maximum main rate NICs are being paid on employment income.

Maximum yearly NICs at main rate

	2010/11	2011/12
	£	£
Class 1 + 2	4,279.22	4,312.08
Class 2 + 4	3,180.00	3,305.00
Class 1 + 2 + 4	4,279.22	4,312.08

Class 1 plus Class 2 NICs

Where someone is both employed and self-employed in one tax year, or has more than one employment, total primary (employee's) Class 1 NICs at the main rate plus Class 2 NICs must not be more than an amount equal to 53 times the maximum weekly primary Class 1 NICs at the main rate. In practice, if a person's earnings from employment are at least £42,475 in 2011/12, Class 2 NICs are nil because maximum Class 1 NICs are being paid in the employment.

Class 2 plus Class 4 NICs

Where someone is only self-employed, the maximum total Class 2 plus Class 4 NICs at the main rate is calculated as follows:

	2011/12
Class 2	**£**
£2.50 × 53	132.50
Class 4	
9% of £42,475 − £7,225	3,172.50
Maximum	**3,305.00**

Class 1, Class 2 plus Class 4 NICs

Where someone is both employed and self-employed, there is a separate annual limit on Class 4 NICs payable at the main rate. Since the introduction of the 1% rate on earnings and profits above the upper limits, this calculation has become complex. The principle is that maximum Class 4 NICs payable are limited to:

- The maximum Class 2 payable (£132.50 in 2011/12); plus
- The maximum Class 4 NICs payable at the upper annual earnings limit (£3,172.50 in 2011/12); minus
- Class 2 NICs actually paid; minus
- Primary Class 1 NICs actually paid.

This means that no Class 4 NICs (at the main rate) have to be paid if Class 1 plus Class 2 contributions are equal to or more than £3,305 in 2011/12.

Deferment

It might not be known during the course of the tax year whether these maximum limits for Class 2 and main rate Class 4 will be exceeded. Where an individual reasonably expects that the limits will be exceeded, an application should be made on form CA72B for deferment of Class 4 contributions, Class 2 contributions or both. The application should be made before the tax year starts, but the NICO usually accepts later applications.

The NICO will reassess the situation after the year end, when all contributions can be accounted for.

Any additional liability will be payable direct to the NICO, usually between 12 and 18 months after the tax year end.

Benefits

- Class 2 NICs entitle the contributor to most of the contributory state benefits, with the important exception of jobseeker's allowance. Jobseeker's allowance is only available where Class 1 NICs have been paid.
- The payment of Class 2 NICs provides entitlement to basic allowances and state pension only, because the additional or earnings-related amounts (i.e. the State Second Pension, S2P) are available only where non-contracted-out Class 1 NICs are paid.

- Many benefits require a minimum number of Class 2 contributions, and it is important to check the contribution conditions. Where both Class 1 and Class 2 NICs have been paid at various times, the situation can become complicated, and specialist advice should be taken.
- Class 4 NICs do not provide any entitlement to state benefits whatsoever, and therefore it is particularly important to ensure that Class 4 NICs are not paid unnecessarily.

Collection of contributions

Class 2

- Anyone liable to pay Class 2 NICs must notify HMRC immediately.
- A person will be liable to a penalty for failure to notify their liability for Class 2 NICs by 31 January after the end of the tax year in which they become liable.
- There will be no penalty if there is a reasonable excuse for the failure.
- Where there is no reasonable excuse, the penalty will be a percentage (up to 100%) of the NICs unpaid as a result of the failure to notify.
- The £100 fixed penalty for late notification of liability to pay Class 2 NICs ended on 5 April 2009.
- Notification is usually made at the same time as notification to HMRC of self-employment for income tax purposes, by completion of a single form.
- From April 2011 Class 2 NICs will be due in two payments on 31 July and 31 January. Taxpayers can spread their payments by arranging to pay monthly by direct debit from a bank account. Alternatively, payment can be made six-monthly by direct debit or by a number of other means.

Class 4

- The close link with income tax liabilities extends to the collection of Class 4 contributions except where deferment has been granted.
- Class 4 contributions are paid with tax under self-assessment.
- Payments on account are due on 31 January in the tax year and 31 July following the end of the tax year, with any balance payable on the following 31 January.
- Interest is charged on both tax and Class 4 contributions if they are paid late.

Overseas matters

Class 2 NICs are normally due when someone is self-employed in the UK, and is also ordinarily resident here.

- People who become self-employed outside the UK might wish to pay Class 2 NICs to maintain their contribution record, and they may do so in some circumstances.
- Similarly, someone coming to the UK from abroad and starting self-employment who has not yet established ordinary residence here might wish to start paying Class 2 NICs immediately, and this will normally be possible.
- Class 4 NICs are not due unless a person is self-employed and resident in the UK.

Special categories of self-employed earners

There are special rules for certain self-employed workers. The more important ones are as follows:

Share fishermen

Self-employed fishermen who share the profits of a fishing boat registered in Great Britain pay Class 2 and Class 4 NICs, even though they might often work outside the UK's territorial waters.

They pay a special higher rate of Class 2 NICs, and in return qualify for jobseeker's allowance. Their Class 2 rate is £3.15 for 2011/12.

Sub-postmasters

Sub-postmasters are employees of the Post Office, but might also be self-employed because they run an attached shop. Although Class 1 NICs are deducted from their salary, the salary is often not taxed under PAYE; instead it is included with shop profits and taxed as income from self-employment. This is normally beneficial for tax purposes, but special rules are needed to determine the Class 2 and Class 4 NICs.

- The salary is excluded for the purpose of deciding whether earnings are below the small earnings exception limit.
- Where some Class 2 contributions are payable, the annual maximum contributions rules described in the separate topic 'The taxation of sole traders', apply in the normal way.
- The gross amount of salary on which Class 1 NICs have been paid is excluded from profits when calculating Class 4 contributions. Class 4 liability might also be limited as a result of the annual maximum rule.

Others

Actors, examiners, outworkers, volunteer development workers, mariners, oil-rig workers and divers are other examples of workers to whom special rules may apply.

Other NIC points to consider

Other points to consider are:

Arrears

- Where Class 2 NICs have not been paid for past periods, the NICO might agree to payment by instalments, but the department has powers to take proceedings in a magistrates' or higher court.
- Late payments might be charged at a higher rate, and might not qualify for benefits. Interest is not charged on late payments.
- Class 4 arrears are normally associated with income tax liabilities and are dealt with under HMRC's powers, including penalty and interest provisions. The powers also include the possibility of court action, but arrangements can sometimes be made to pay off the arrears gradually.

Credits and voluntary NICs

Credits are available in a wide range of circumstances that prevent the individual from working, such as sickness, unemployment, maternity, child rearing, caring duties, jury service and certain approved training. The credits improve an individual's contribution record for benefit purposes. No credits are given to self-employed people simply because their earnings are too low to pay Class 2 NICs. In this situation, an individual might want to consider paying voluntary Class 2 or Class 3 NICs. In theory, there is the option to pay Class 3 voluntary contributions, but in practice there is no point, as Class 3 contributions are set at £12.60 a week in 2011/12, compared to £2.50 for Class 2.

People who reach state pension age after 5 April 2010 need to have paid 30 years' worth of contributions to qualify for a full basic state pension. Previously men needed 44 years' contributions and women 39–44 years, depending upon their date of birth. This reduction in required qualifying years limits the need for voluntary contributions.

Repayments

There is no automatic right to repayment if NICs are incorrectly paid, although the NICO will normally reallocate NICs if the wrong category has been paid. If reallocation is not appropriate, a claim for repayment can be made, but this can be a lengthy process. Also, if Class 2 repayments are claimed because earnings are low and exception could have been applied for, the repayment claim must be made by 31 January following the end of the tax year.

The NICO annually checks the contribution levels of Class 1 and Class 2. If there is any overpayment, the individual is informed and invited to apply for repayment. This is not the case with Class 4, as no records are kept. Any overpaid Class 4, other than liabilities that are reduced as a result of an amendment to a tax return, must be reclaimed on the appropriate form (CF28E). It is therefore much better to apply for exception or deferment where possible.

Disputes and appeals

The appeals procedure for NICs is the same as that for dealing with income tax disputes.

- Where agreement cannot be reached, a senior officer of the Board of HMRC will make a formal decision.
- This decision is appealable to the First Tier Tax Tribunal in writing within 30 days, although the Tribunal has discretion to admit late appeals.
- The taxpayer can ask HMRC to carry out an internal review (also known as statutory review) of a decision before the appeal is notified to the Tribunal.
- Either party may express dissatisfaction with a First Tier Tribunal decision.
- An appeal may then go through the Upper Tribunal, Court of Appeal and eventually to the Supreme Court.

Couples

Class 2 and Class 4 NICs are calculated separately for husbands and wives, and for civil partners. Their NICs are not affected by each other's profits or losses.

Furnished holiday lettings

Under special tax rules, income from certain holiday lettings is taxed as if it were trading income. Class 2 NICs might be due, depending on the amount of time spent on the business. The normal rules concerning limits and annual maximum contributions apply. No Class 4 NICs are charged on this particular type of income. Property letting is generally not treated as self-employed trading.

Value added tax

It is important to understand the VAT rules in the very early stages of the development of the business.

HMRC leaflets, in particular, *Should I be Registered for VAT?* (Notice VAT 700/1) are recommended as introductory reading.

See also the separate topic 'General principles of value added tax'.

Registration

VAT is a tax on business turnover. Every business must register for VAT if its taxable supplies (i.e. business income on which VAT would have to be charged, including zero rated supplies) are more than the registration thresholds. These thresholds are normally increased in line with inflation each year. Since 1 April 2011, the registration limit has been £73,000.

Normally a business has to consider its taxable turnover over the previous 12 months, unless at any time taxable supplies are expected to be more than £73,000 within the following 30 days. From 1 January 2010 the business must also include in its taxable turnover the value of services purchased from overseas suppliers which are subject to the reverse charge rules.

Registration is compulsory if:

- At the end of any month, the total value of taxable supplies made in the past 12 months or shorter period is more than £73,000. In that case, a form VAT1 must be completed and sent to HMRC within 30 days. Most businesses can register online through the HMRC website. The date of registration is the first day of the second month following the month in which the turnover limit was exceeded.

Example 23.3 – Registration limits and dates

Limit exceeded in month ending	Notify on VAT1 by	Registration date
31 January	2 March	1 March
31 August	30 September	1 October

- At any time there are reasonable grounds for believing that taxable supplies of more than £73,000 will be made within the next 30 days. The date of registration is the date when it is known that the limit will be exceeded.

Some VAT incurred on purchases before registration can be reclaimed, and it is important to identify this. In particular, tax on services that have been bought can only be reclaimed if they were supplied no more than six months before the date of registration.

Penalties

Every non-registered business must watch their taxable turnover very closely. If a business should have been VAT registered at an earlier date, HMRC will levy VAT on the taxable turnover from the date it should have been registered, less any allowable VAT incurred on purchases.

A penalty might be charged as well, unless the business has a reasonable excuse for its failure to register. Ignorance of the VAT rules is not an excuse.

Voluntary registration

If a business with a turnover of less than the registration limit wishes to register, then it can usually do so. An obvious advantage of 'voluntary registration' is that VAT on purchases can be recovered, whereas an unregistered business can only obtain relief if the cost of VAT can be deducted when calculating taxable profits. A business may register voluntarily in order to take advantage of the flat rate VAT scheme (see below).

- In general, when supplying goods and services to the public, non-registration will give a competitive edge and might increase profits, although this depends on the amount of VAT on purchases that cannot be reclaimed.
- Goods and services from non-registered suppliers might not be attractive to VAT-registered customers, because this will normally increase the cost to them. The reason is that the

non-registered trader's prices will have to take account of the VAT on purchases that cannot be reclaimed.

- Non-registration also indicates that the business is small and might reduce credibility.

Accounting for VAT

Every VAT-registered business must account for 'output' VAT on the value of its taxable business supplies.

- Most outputs are standard rated. VAT is charged at 20% from 4 January 2011. A few outputs are rated at 5%, for example, certain residential property renovations.
- Some outputs are zero rated. They are still taxable but at the zero rate of VAT.
- Other outputs are exempt from VAT. This means that no VAT is charged.

The important distinction between an exempt output and a zero rated output is that VAT on purchases can be recovered if they relate to zero rated supplies, because they are taxable, but not if they relate to exempt outputs.

It is important that every business determines the correct rate or rates of VAT on its outputs at an early stage, so that it charges all the VAT it must pay to HMRC, and restricts its claims for input VAT to the portion reclaimable.

There are penalties for large under-declarations of VAT, unless there is a reasonable excuse. There are also interest charges where VAT is paid late.

The VAT return

A return of the value of outputs less inputs must normally be completed on a quarterly basis and sent in within a month of the end of the quarter. Businesses can submit VAT returns online. If they do so, the filing deadline is seven days later, but they must also pay any VAT due by electronic means. Online filing is now compulsory for all businesses with turnover over £100,000 and all newly registered businesses. All other VAT registered businesses will be required to file online from April 2012.

Where output VAT exceeds input VAT, the balance must be paid to HMRC within a month of the end of the quarter, or up to ten days later if paying by direct debit. Penalties are imposed automatically if returns or payments are late. HMRC will accept monthly, rather than quarterly, returns provided this is agreed with them in advance.

The extra paperwork can be worthwhile if the business consistently reclaims VAT. This would occur where a business mainly makes zero rated supplies, so that the value of inputs is more than the value of output VAT on any standard rated sales.

Small businesses – annual accounting

Small businesses with a turnover of up to £1.35 million can use the annual VAT accounting scheme. Nine equal monthly payments are made by direct debit (based on an estimate of the total VAT due) and the tenth payment, to balance the account, is sent in with the annual return.

Cash accounting

Small businesses can account for VAT on a cash paid and received basis, rather than on an accruals basis, if their turnover is likely to be not more than £1.35 million. Where a small business has to wait a considerable period to be paid by its customers, this method of accounting might be beneficial.

Flat rate scheme

An optional flat rate VAT scheme is available for businesses with taxable turnover of up to £150,000. The scheme allows businesses to pay VAT to HMRC at a flat rate on the whole of their gross turnover (including VAT charged to customers). The rate is determined by trade sector.

- The advantage to businesses is that it simplifies accounting for VAT.
- Some businesses may pay more VAT under the scheme, and some will pay less than they would using normal VAT accounting.
- All turnover of the business, including exempt and zero rated supplies must be included in the turnover subject to the flat rate. This will include the income from let property owned by a VAT registered sole trader.
- Whether it is beneficial for a business to adopt the scheme should be considered in the light of the taxable and exempt turnover of that business, the VAT on expenditure that could otherwise be offset, and the relative importance of the administrative convenience.

Special schemes

There are several special schemes which retailers can use to apportion sales that are both standard rated and zero rated. Discussion of the schemes themselves is outside the scope of this section – refer to VAT Notice 727.

Partial exemption

A business that makes both exempt and taxable supplies has to make a special calculation of the VAT it can reclaim.

- The bookkeeping system should allow for purchases to be segregated into those relating entirely to exempt supplies, those relating entirely to standard rated or zero rated supplies, and those which relate partly to both types of supplies.
- Only input VAT directly attributable to taxable outputs can be reclaimed.
- Where the input VAT cannot be directly attributed to exempt or taxable supplies, only a proportion of the VAT can be reclaimed.
- The full VAT can be recovered where the business meets one of three de minimis tests.
    - ➢ Test one: total input tax incurred is no more than £625 a month on average and the value of exempt supplies is no more than 50% of the value of all supplies.
    - ➢ Test two: total input tax incurred less input tax directly attributable to taxable supplies is no more than £625 a month on average and the value of exempt supplies is no more than 50% of the value of all supplies.
    - ➢ Test three: the VAT relating to exempt supplies is not more than £7,500 a year, and at least 50% of the total input tax incurred relates to taxable supplies.

This is explained in more detail in VAT information sheet 04/10 and VAT Notice 706, *Partial Exemption*.

Buying an existing business

There are special VAT rules where an individual starts up in business by taking over an existing concern.

- If various conditions are satisfied, VAT will not be charged on any of the assets purchased.
- HMRC will allow the new owner to take over the previous owner's VAT registration number.

- This should normally be resisted because the new owner takes over not only the VAT number, but also the previous owner's liabilities to HMRC.
- The new owner should ask for a new VAT registration number. Further information can be found in VAT Notice 700/9: *Transfer of business as a going concern*.

Taking on employees

If a new business takes on employees, it is important that the employer appreciates the burden of complying with the PAYE regulations.

Complying with PAYE

Employers must deduct income tax and employee's NIC from salaries, and account for this to HMRC, together with employer's NIC and any student loan deductions.

- Amounts must be paid 14 days after the end of each tax month, i.e. by the 19th of each month, with an extension to the 22nd if paying electronically.
- Penalties can be imposed for late paid PAYE for periods starting after 5 April 2010.
- If the employer fails to deduct the full amount of PAYE tax and NIC that is due, the employer will still have to pay the full amount to HMRC and might not be able to recover it from the employee.
- If the monthly payments of tax and NIC average less than £1,500 a month, the employer can pay quarterly.
- Annual PAYE returns must be made by 19 May following the tax year, with automatic penalties for non-compliance.
- Returns of benefits in kind provided for employees and expenses paid to them (P11Ds and P9Ds) are due by 6 July following the tax year and penalties can be levied for lateness and errors, up to £3,000 for each incorrect form.
- Most employers (with very few exceptions) must file annual PAYE returns electronically and are subject to a penalty of up to £3,000 for failing to do so (on top of the existing late filing penalties).
- Employer's NIC on benefits in kind is due by 19 July after the end of the tax year, with the return of benefits (form P11D(b)) due by 6 July.
- HMRC conducts compliance checks on employers, and will impose penalties for any mistakes made where the employer has failed to take reasonable care, or has made deliberate errors.

It is advisable to register as an employer with HMRC before taking on any employees. HMRC will then send all the necessary information to enable the employer to comply with the obligations.

Self-employed labour

One way to avoid PAYE and NIC regulations is to use self-employed labour, but this can involve complications and risks.

- HMRC will want to be satisfied that the self-employed workers are indeed genuinely self-employed, and not employees in another guise.
- Employers could find it very difficult to convince HMRC that their workers are self-employed.
- If HMRC thinks that workers are not self-employed, the employer could have to pay the income tax and NIC that should have been deducted under the PAYE system, plus penalties

and interest. The employer is unlikely to be able to recover the income tax and NI from the employee. However, HMRC can collect the tax due under PAYE directly from the worker who may get credit for the tax he or she has paid on a self-employed basis on the same income.

If there is any doubt whether a potential recruit should properly be treated as employed or self-employed, the employer should contact HMRC for an employment status ruling, or consult an experienced tax adviser.

Spouse or partner as employee

It is normally worth ensuring that both husband and wife (or civil partner) have income so as to make use of their personal tax allowances. For example, many self-employed business people pay their spouses/partners a salary for help in running the business, if they are not separately employed or self-employed.

- It is normally possible to justify a modest salary for answering the telephone, making appointments, helping with administration, etc.
- It is not compulsory to pay the national minimum wage (NMW) rate to family members who live at home and work for the business. But the NMW rate can be used as a guide as to what to pay for the hours worked.
- The salary should be actually paid to the spouse, not allocated as drawings for the business owner.
- Unless the spouse/partner has other income, a small salary would be covered by the personal allowance and will therefore save tax.
- A salary between the NICs lower earnings limit and the earnings threshold will not require any NICs payments, but will give entitlement to benefits including the basic state pension and S2P. Furthermore, the S2P benefit will accrue as if earnings were £14,400 a year. For 2011/12, the salary should be between £102 and £136 a week.
- Where spouses are heavily involved in the business, it might be better to bring them in as business partners so that they can share in the profits without the need to pay tax and NICs under PAYE, although they will of course have to pay tax and Class 4 NIC on their profit share and will not accrue S2P benefits.

Pensions and private insurance

Self-employed NICs give entitlement only to the basic state pension in retirement. It is therefore important to make additional provision.

Pension

Contributions to registered pension schemes receive favourable tax treatment.

- Individuals can contribute up to 100% of their earnings to their pension schemes each year up to a maximum of £50,000 in 2011/12, although individuals who have contributed less than this in earlier tax years can carry forward their unused relief up to three years.
- People with little or no earnings can contribute up to £3,600 a year.
- There is a maximum permitted tax-exempt fund, or its equivalent in retirement benefits. This is called the lifetime allowance and is £1.8 million in 2010/11 and 2011/12.
- Basic rate tax relief at 20% is normally given by deducting it from the pension payment. So a person who wishes to add £3,600 to a pension plan would pay £2,880. The pension administrator would recover the £720 deducted from HMRC.

- Higher-rate and additional rate tax relief is given when the individual makes a claim on their self-assessment tax return.
- Contributions are often paid without deducting tax to pension plans that started before July 1988. Basic and higher rate tax relief are given in the self-assessment.

Private insurance

Self-employed people, not being employees, are not covered under any employer's sick pay, medical insurance or group life schemes; and few state benefits are available to them. For these reasons, self-employed people should consider the following personal insurances when starting in business or at least as soon as profits and cashflow allow:

- **Term life insurance** This is the cheapest type of life cover and can be for any number of years, for example, 10 or 15 years. There is normally no tax relief on the premiums paid, even if the policy is part of an individual pension arrangement.
- **Income protection insurance** There is normally no tax relief on the premiums paid (but benefits are normally tax-free).
- **Private medical insurance** There is normally no tax relief on the premiums paid.

In addition, taxpayers should consider whether their spouses or civil partners should be insured, particularly if they have young families.

Tax planning key points

Being your own boss can be an exciting venture and one that many people often think about. To do so successfully requires careful planning and a knowledge of how several important tax areas will affect sole trading individuals.

- Individuals should choose their trading vehicle carefully and make sure they understand the pros and cons of any set up.
- The tax, NICs and VAT requirements can be complex. Once important dates and milestones have been identified, they should be closely adhered to, with an understanding of the consequences of failure to comply with any regulations.
- Maintaining cash flow is crucial and thoughtful tax planning can often minimise tax, freeing up funds to work for the business.
- There are several organisations as well as Business Link that can provide guidance and advice.

This guide is for general information only and is not intended to be advice to any specific person. You are recommended to seek competent professional advice before taking or refraining from taking action on the basis of the contents of this publication. The guide represents our understanding of the law and HM Revenue & Customs practice as at September 2011, which are subject to change.