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An Introduction to the Tax System for the Self Employed

Registering with HM Revenue & Customs

If you start working for yourself, you must register with HM Revenue & Customs within the first three full months of self employment. Otherwise you may be liable to penalty of £100.

There are three ways that you can register:

- **Online** – visit www.hmrc.gov.uk and follow links to self-employed Register for Self Assessment and National Insurance
- **Phone** – call the Newly Self-Employed Helpline on 0845 915 4515
- **Post** – download and complete form CWF1 (accessed as in online above) or use the form incorporated in leaflet SE1 (Are you thinking of working for yourself?)

Once you become self-employed, the tax rules are quite different from those that may have applied when you were an employee. Instead of tax (and national insurance) being deducted from your earnings at source, you must be prepared to receive a bill at some time in the future. This can be a nasty shock if you haven't put enough money aside.

We aim to give you as much warning as possible of the likely timing and amount of tax payments, but it is not easy to do this during the first year of your new business, or if you do not keep your records up-to-date.

What profits do HM Revenue & Customs tax?

The starting point for the calculation of taxable profits is your profit and loss account. In calculating taxable profits you are entitled to claim deductions from your business income in respect of any expenses incurred for the purposes of trade (with a few minor exceptions).

When you buy equipment for your business, you will be entitled to deduct the full cost (up to a maximum of £100,000 per year). For most cars, you can deduct only a proportion of the cost for each year you own them and use them in the business.

If you take stock for your own use, the disposal should be shown in the accounts at market value, and not at original cost. It may be possible to avoid this by arguing that such items never actually formed part of your stock and showing the original purchase as private expenditure (drawings).

Tax is payable on the whole of the profits of a trade, and so payments for your own 'wages' (drawings) are not deductible. However, if your spouse works in the business, the wages are an allowable deduction, provided they are actually paid and are a reasonable reward for what is done.

How does HM Revenue & Customs allocate profit to tax years?

The aim of the system is that over the lifetime of your business the profits will be taxed in full, once, and once only. But to make the system fair, there are certain complications you will have to cope with.

The general rule is that the tax for a particular tax year is based on the profits of the twelve months to your accounting date in that tax year. For example, the tax for 2011-12 could be based on accounts for a year ending on various dates ranging from 6 April 2011 to 5 April 2012. This demonstrates that you get more time for the tax to be worked out if your accounts end early in the tax year, which is why 30 April is such a popular year-end for self-employed people.

How is the tax collected?

Tax returns

Tax returns covering income for the year ending 5 April 2012 have to be submitted to HM Revenue & Customs by the 'filing date' which is 31 October 2012 for paper returns and 31 January 2013 for online returns. The return will include a self assessment of your liability to income tax and capital gains tax.

There are automatic penalties for late filing of tax returns.

Payment of tax

Payments on account of income tax and Class 4 national insurance contributions (NICs) will be due on 31 January 2012 and 31 July 2012. These interim payments will be based on one half of the total liability (less any tax deducted at source) for 2010-11. You will have the right to reduce payments on account if you believe the income tax for 2011-12 will be lower.

The balance of income tax for 2011-12 is due on 31 January 2013 (along with the first payment on account for 2012-13 and any capital gains tax for 2011-12).

Interest and surcharges will be levied for late payment.

What about the complications?

Opening years

In the first tax year of your business, the tax payable is based on the profit arising between the starting date and the following 5 April. This is taken as the appropriate fraction of the profit shown in your first set of accounts. Say you start on 1 June 2011 and your first accounts run to 30 June 2012 with a profit of £13,000, then tax will be worked out (to the nearest month) on the profits of the following periods:

2011-12 1 June 2011 to 5 April 2012 - 10/13 x £13,000 i.e. £10,000

2012-13 1 July 2011 to 30 June 2012 - 12/13 x £13,000 i.e. £12,000

You can see that the profit from 1 July 2011 to 5 April 2012 (9 months) has been taxed twice. The 'overlap' profit of £9,000 will be available for deduction when the business comes to an end, or (at least in part) if you change your accounting date to one nearer 5 April.

Change of accounting date

If you decide to change your accounting date from 30 June 2013 to 31 December 2013, and the accounts for the 18 months ending 31 December 2012 show a profit of £27,000, the taxable profit for 2013-14 will be worked out as follows:

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Profit based on accounts	(18 months)	£27,000
Less overlap relief		£ 6,000
Profit for 2013-14		£21,000

Cessation

If you then cease trading on 31 August 2015, and your final accounts for the eight months ending on that date show a profit of £11,000, the taxable profit for 2015-16 will be:

Profit since accounting date in previous tax year	£11,000
Less balance of overlap relief not already used	£ 3,000
Profit for 2015-16	£ 8,000

What about national insurance?

The self-employed are subject to a two-tier system of national insurance contributions (NICs). Class 2 NICs are at a flat rate of £2.50 per week, if earnings exceed £5,315 per annum.

From April 2011, payments for Class 2 NICs will become due on 31 January and 31 July (the same as for a self assessment tax bill). Payment requests will be sent out in October and April, and payment can be made by various means, including Direct Debit (monthly or 6-monthly).

Profits between £7,225 and £42,475 are subject to Class 4 NICs at a rate of 9%. Any excess of profit above £42,475 is subject to Class 4 NICs at the rate of 2%, without any upper limit. Class 4 NICs are collected by HM Revenue & Customs and are payable at the same time as the instalments of income tax.

Save for your tax

It is essential that you make proper provision to ensure the availability of funds to pay income tax and Class 4 national insurance. Interest on unpaid tax is chargeable by HM Revenue & Customs, and is not deductible from business profits.

Please call us if you would like further help or advice on this matter.