Chapter 1

Working for Yourself

In This Chapter

- Looking at what self-employment means
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- Ensuring accounts are to your best advantage
- Uncovering the classes of national insurance
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According to the Federation of Small Businesses, around four million people in the UK work for themselves. But whatever the exact head-count, the Inland Revenue taxes all these businesspeople. This chapter looks at dealing with the tax authorities as the owner of your own business instead of as an employee in someone else's.

Doing your taxes correctly can put your new firm on the road to success; messing them up is a sure-fire road to commercial oblivion or even bankruptcy. In this chapter we show you the tax advantages of self-employment and steer you away from some of the dangerous pitfalls.

Defining the Terms

Most people who strike out on their own, even if they go on to become multi-billionaires, often start as sole traders – the technical term for working for yourself, being a one-person band, or working as a freelancer.

For some, being self-employed means running a full-time business complete with commercial plans, business bank loans, staff, and public-liability insurance. If that's you, then, one day, you may hope to be a really big company and even float the company on the stock market. Lots of quoted companies started off as ventures run from an entrepreneur's dining room table.

Some sole traders offer the skills they have, such as plumbing, management consultancy, car mechanics, or writing books about business, directly to the client or end-user. Most of these businesspeople will never be big firms but they enjoy the freedom (as well as the responsibilities) of self-employment.

And for a growing number, it's all about part-time boosts to their earnings from a paying job that can be anything from regular wheeling and dealing on online auction sites to being a buy-to-let landlord.

Whatever category you are in, you are in business. And that puts you firmly into the tax-paying net even if you already pay income tax because you work full-time for an employer.

Some small businesses decide to become companies rather than sole traders. The advantages, and tax implications, of limited company status are dealt with in the next chapter.

Meeting HMRC's standards for self-employment

HMRC applies basic tests to determine whether you are really self-employed rather than working for someone else. Pass them and you can be on the way to tax savings! The standards are that:

- You work for more than one customer – and preferably several.
- You work from your own premises, or, if you don't, you work from several locations. If you're a writer, for example, you probably work from your home; however, if you're a plumber, you travel to your customers' premises.
- You're in control of what you do and the hours you work. You must be able to turn down work you do not fancy, and you should set your own prices.
- You have a business address – often your home – from which you carry out some business functions, if only message taking.
- You supply and maintain your own vehicles, tools, computers, and/or other items of equipment needed for your trade or profession.
- You correct bad work in your own time and at your own expense.
- You are legally liable for your mistakes.

Some businesses have acquired a reputation for turning people whose main function is selling their labour into self-employed workers when they should be employed under PAYE. Some examples are computer consultants who work for one company, sub-contract builders who work for others on sites, and hairdressers who rent the chair and basin space in the salon. HMRC makes big (and usually successful) efforts to deny such people self-employed status and the tax savings that can go with it.

Delving into the grey area

Most know when they start as a sole trader. They do work for customers in return for a commercial rate of reward. But there is a grey area where you may not know if you are trading or simply selling something.

One activity HMRC is targeting is selling via online auction. Proceeds from these sales are not, as some believe, always outside the tax net. Nor are car boot sales. Tax inspectors look for evidence of trading.

If you buy goods, either from wholesalers, or from other auctions, or from junk or charity shops with the intention of selling these things on at a profit, you are trading and so face a potential tax bill.

If you're clearing out the loft or spare room and have a one-off sale as an alternative to carting the lot to the charity shop or dump, then you are not trading, so there are no tax hassles. Although, should you find a Picasso in your loft and sell it for wads of money, you can face a Capital Gains Tax bill on the proceeds!

It is your responsibility to register, so find out about your status if you are in doubt. You cannot argue against a fine or penalty by saying you did not know or that you were waiting for HMRC to contact you.

Testing your wings while staying employed

These days, HMRC insists that the newly self-employed register within three months of starting up their activity. But, in practice, someone on PAYE who earns a one-off payment, perhaps for contributing to a publication or a one-off consultancy payment, does not need to register as self-employed although the remuneration she receives for this must be declared for tax. No absolute rules govern this – if you're unsure of your status, make sure you register with HMRC, just to be safe.

Formalising Your Status

Just as no job is complete until the paperwork is done, neither can you start a business without filing forms with HMRC and deciding when your tax year runs. The following sections tell you what you need to do.

Registering your new business

The self-employed have to register as such with HMRC. This procedure includes making arrangements to pay national insurance contributions, which you will probably have to make. The upcoming 'Scanning National Insurance' section covers this issue.

You can register by:

- Calling a special helpline on 0845 915 4515. It's open between 8.00 a.m. and 8.00 p.m. seven days a week (except Christmas Day and one or two bank holidays).
- Filing form CWF1. Find it in HMRC leaflet PSE1 Thinking of working for yourself? Or download it online at `www.hmrc.gov.uk/forms/cwf1.pdf` or register online at `www.hmrc.gov.uk/startingup/register.htm`.

Failing to register within three months of starting self-employment can bring a £100 penalty. In some cases, the business's exact start date may be debatable, so it is best to register as soon as you can.

Larger penalties can be imposed if tax is paid late because an unincorporated business failed to register by 5 October of the following tax year in which it was set up.

Choosing your tax year carefully

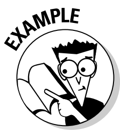
Most businesses have an accounting year that runs alongside the tax year from 6 April to 5 April, though you may find it more convenient to use 31 March as the end date for your tax year. If you use 5 April or 31 March as the last day of your year, you're opting for fiscal accounting, so-called because your business year is the same as the tax, or fiscal, year. Fiscal year users account for tax by the 31 January following the end of their year.

You can use any other date for your year-end. Choosing a different date can give you longer to file and more time to keep the tax earning interest in the bank, which sounds like a great tax-saving idea. However, while many accountants still recommend choosing a different date, there are drawbacks.

Filing your first two returns

If you don't opt for a fiscal year-end, you have to meet extra requirements when filing tax returns for your first two years of operation. Your first year's tax bill is based on profits, if any, from the start of trading until the next 5 April – even though that's not the year-end date you chose. So, depending on when you start your business, your first tax bill may cover a matter of a few days or virtually a whole year.

Taxes for the second year are based on either the 12 months trading that ends on the date you chose in that year or your first 12 months of trading. You have to use the second option if the selected year-end date is less than 12 months after the start of the business.



Jessica starts her business on 1 August 2007 and decides on a 31 July year end. She makes a regular £2,000 a month profit. Under the start-up rules for the first two years, she has to account for her business from her 1 August 2007 start-date to 5 April 2008 on her 2007–8 tax return due in by 31 January 2009. She has to declare profits of £16,000 for these eight months because her selected year-end date is less than 12 months from the start of her business.

So far, so good. But her second year-end date is after her first 12 months of trading, so she has to account for the full 12 months from 1 August 2007 to 31 July 2008. Her profits here will be £24,000. Now for the really bad bit, which sounds like something out of Alice in Wonderland.

Even though Jessica has had to pay tax on her first eight months, she also has to pay tax on the first year. Now these overlap to a big extent. So, although she has only 12 months of trading to earn her money, she is assessed for 20 months of tax payments. On her £2,000 a month profits, she has earned £24,000 but she has to pay as though she has earned £40,000 (that's 20 months or 12 months plus eight months).

Of course, no one who is self-employed has exact months like that all the time. But we selected the same amount each month to make a complicated overlap a little simpler.

Lessening the effects of overlap

Having to pay tax on profits you haven't yet made is known in the tax trade as overlap. And you ignore it at your peril. For most small businesses, overlap is something to avoid. The answer is to align your business year with the tax year.

You can change your accounting year-end during the life of your business to lessen the effect of overlap if you need to. You can elect for a year-end change by notifying HMRC on a self assessment form or sending your tax inspector a letter.

If you don't cure your overlap while you are in self-employment, you only get your excess tax payment back when you cease trading. Such an event can be many years in the future, and the overpayments you made on starting will not be adjusted for inflation or changing tax rates.

If you have to borrow extra cash because paying overlap tax takes cash out of your business, you can claim the interest against a future tax bill.

Those setting up a business where the costs of the first year or so of trading are likely to be greater than their earnings obviously need have less fear of overlap as there will be no profits to tax.

Signing on for VAT

Whether you are a self-employed sole trader, a partnership, or a limited company, you have to register for VAT once your annual sales top a threshold amount (£64,000 in 2007–08) determined by the Chancellor of the Exchequer. This threshold tends to rise each year roughly in line with inflation. (For the current VAT threshold, go to HMRC Web site at `www.hmrc.gov.uk`.)You also need to register if your earnings in any one quarter are such that, multiplied by four, they would exceed the threshold. (See Book VI Chapter 4 for more on this.)

Keeping Accounts to Keep Everyone Happy

Here's a scary thought: The biggest single cheque you'll ever write out may well be to HMRC. In this section, we show you how to minimise your tax bite legally. And, in keeping with this book's theme of making sure that you don't give up all the tax you've saved by sending it all back, and, even worse, paying penalties, we focus on how to stick to the rules.

You have to keep records of your business for five years following the final filing date for your trading year. Someone with a trading year ending on 31 March 2008 will file by 31 January 2009 and needs to keep the paperwork (or computer records) until 31 January 2014.

Filling out Schedule D can pay dividends

Self-employed people have to fill in the basic self assessment tax form and also the self-employment pages (downloadable from the Inland Revenue Web site at `www.hmrc.gov.uk/sa/index.htm` or available via the HMRC helpline on 0845 9000444).

If you are self-employed, you will end up being taxed under what the taxman and accountants used to call Schedule D (which we'll still use as shorthand). Being on Schedule D can make your personal bank balance happier, most importantly because you can claim many expenses against what you earn. (See the following section.)

Those who work for someone else on PAYE can claim business expenses against tax only if those expenses are 'wholly, exclusively, and necessarily' incurred in carrying out their contract of employment. That definition is really tough to meet. But when you are on Schedule D, the 'necessarily' part of the PAYE definition goes. The reason? No outsider can define 'necessity'. Do you actually need to advertise your services in one particular way? Do you necessarily need a new vehicle when you can do the work using a clapped-out pushbike? Is your computer over-specified and do you need one at all?

All these choices are open to big companies and small firms alike and all the expenses can be set against the company's tax or your personal self-assessment form.

Counting your credits

You have a lot of freedom as a self-employed person. You can choose how you'll carry out your business and money spent wholly and exclusively for your business can be set against your earnings.

WARNING!

The tax authorities are not idiots. Don't try putting the costs of a Rolls-Royce down against tax, claiming it is a vehicle you use 'wholly and exclusively' for your business – unless, of course, you run a wedding limousine hire firm.

HMRC is always on the lookout for exaggerated expenses, but you don't have to exaggerate to minimise your tax bill. Just make sure you deduct everything you're legally allowed to, including:

- The administrative cost of running the business against your earnings from it. This sounds elementary, but many people with start-ups or those who have a small business on the side still have the mindset of working for an employer who picks up all the costs of running the business. All those little items such as postage stamps, fuel, mobile and fixed telephone charges, and even heating and lighting for your workplace add up over a year and are legally deductible.
- The cost of equipment including computers, machinery, and other big items. We explain how to deal with big items in the next section. Cars have rules of their own and are covered in the next section.
- Bank charges on business accounts and interest on loans for your business.
- A proportion of the costs of running your home if you use part of your property as a base. There are no specific rules for this. It's a question of common sense. If you have a house with six rooms and use one fairly regularly for your business, then look at your domestic bills and take a sixth part.

  Obviously, if you use other premises solely for business, then you can deduct all the costs.

  Always make sure you say the rooms you use are 'non-exclusive' and don't claim mortgage interest or council tax for that portion of your property otherwise you could run into Capital Gains Tax problems when you sell the home and incur a business rate from the local council.
- Accountancy and legal fees and the costs of debt collection.
- Pension contributions can count against self-employment earnings.
- Publications, stationery, postage, wages and other costs of employing people, insurance, travel, subsistence, gas, electricity, water – all the way down to the batteries in your calculator.

Accounting for big business items

Big expenditure items such as plant and machinery, cars, and computers are not counted against your profits in the same way as the goods and services you buy in to make your business work. With these big items, you can claim capital allowances against your profits. A capital allowance is a proportion of the purchase cost that you can set against profits each year as long as you own the item. The result is that tax relief against the expenditure made on these items can be spread out over several years.

The following list explains capital allowances for major items:

- From April 2008, the old first-year capital allowances applicable to small and medium businesses are replaced by a new Annual Investment Allowance of £50,000 for all businesses, whether they are self-employed or incorporated, and regardless of their size. That means that in the year in which the purchase was made, 100 per cent of expenditure, up to £50,000, on general plant and machinery other than cars can be offset against taxable profits.
- The annual *writing down* allowance, applied to the written-down value of equipment brought forward from earlier years (in other words, over the first year allowance) is reduced from 25 per cent to 20 per cent from April 2008. So if you buy an item costing £60,000, then £50,000 of that can be offset against tax in the first year; 20 per cent of the balance of £10,000 (£2,000) can be offset in the second year, 20 per cent of the remaining £8,000 (£1,600) in the third, and so on. You never get to zero!
- Cars qualify for a 25 per cent capital allowance each year with a limit of £12,000 on the value of the car. Using this ceiling, the maximum allowance in the first year is £3,000, then 25 per cent of the remaining £9,000 (£2,250), and so on.

  Low-emission vehicles benefit from a 100 per cent allowance for the first year. The vehicle manufacturer will tell you if your vehicle qualifies as less noxious – printing the rules in full would take up a large part of this book.

Capital allowances are available against the actual cost of the asset. You set the costs of any bank loan or other financing against business expenses.

You cannot claim capital allowances greater than your profits. But there is nothing to stop you claiming less than your maximum and then carrying the remaining amounts into a subsequent year.

Claiming extra help as you start up

Money you spend before you start can be counted against your profits once you set up. This expenditure may include the money you paid for a computer and other machinery you already possess and the cost of feasibility studies into your hoped-for business. These sums will normally be counted against your first year's profits. But if you make a loss, you can count them against the next year (and so on, for a total of four years if you fail to make a profit).

Accounting for loss-making

With the best will in the world, your self-employment could result in a loss. In such a case, you have two tax options, which we explore in the next two sections.

Deducting the loss from other taxable sums

Provided you have earnings from a PAYE job, a pension, from dividends or interest, or from taxable capital gains, you could set your loss off against these amounts. This is a good route for a self-employed person whose business is part-time. Someone earning £20,000 from a PAYE post, and losing £2,000 on her business would end up with a tax bill based on £18,000.

TIP

If you make a loss in any of the first four years of a new business, you can offset this loss against tax on your salary in the three years preceding the establishment of your business. You may have to prove you intended to make profits during this period: Tax inspectors look out for loss-making 'hobbies' whose main function is to dodge tax.

You have to inform the tax inspector within 12 months following the 31 January after the end of your loss-making business year.

Subtracting the loss from future earnings

If your losses exceed your taxable sums, you can carry forward the loss against future profits. You can do this for as many years as you need – there is no limit. But you have to tell the Inland Revenue within five years of the 31 January following the end of the tax year in which your personal accounted year finished.

In most cases, it makes sense to offset your losses against earnings, dividends, interest, and capital gains from elsewhere. But if you expect your self-run business to be very remunerative in the future and take you into the top tax band, then consider subtracting early losses from future earnings.

Scanning National Insurance

As a self-employed person, profits you make from your business are added to other earnings, pensions, dividends, and interest for income tax. National insurance is different. There are special rules for the self-employed and two sets of payments you may have to make.

Complicating the classes

National insurance comes in four classes, numbered one to four. Class 1 is for employed persons. The self-employed have to look at Classes 2 and 4, which we do in the next sections. And in case you're wondering, Class 3 is voluntary – it's paid by people who do not work but who wish to keep up their record to qualify for the state retirement pension and other benefits.

Class 4 is collected through the annual self assessment return. It is the only national insurance to be collected in this way. Most people pay Class 1 via their salary packet, while Class 2 and Class 3 are paid usually with a direct debit.

Paying Class 2

As a self-employed person you have to pay a fixed £2.30 a week (in 2008–9) in national insurance. This maintains your payment record for the state pension and health-related benefits – but not jobseeker's allowance.

TIP

If your earnings from all self-employment are below the Class 2 threshold (£4,825 in 2008–9), you are exempt from Class 2.

Paying Class 4

Class 4 national insurance is effectively an additional tax on the self-employed. It does not provide any benefits, but that doesn't mean you don't have to pay it if your profits (what you take in less your costs) are at least £5,435 in a year. If your profits are below that figure, you don't have to worry about Class 4.

But if you do have to pay, it is currently (2008–9) charged at 8 per cent of your taxable profits from £5,435 a year to £40,040. The 8 per cent stops there. But there's a 1 per cent surcharge on all sums above that. So if your profits were £50,040, you would pay 1 per cent on the £10,000 above the upper profits level.

Putting a cap on National Insurance

Someone with a mix of self-employment and employment could end up paying Class 1, Class 2, and Class 4. The bad news is that many pay more in national insurance for the same amount of income if it comes from a variety of sources, such as self-employment and employment, than they would if it all came from one source. The good news is that there are ceilings on payments.

If all your income comes from being self-employed, then you cannot pay more than £2,888 (in tax year 2008@'nd9) in Class 2 and Class 4 together. The HMRC Web site (`www.hmrc.gov.uk`) or your local tax office can give details of future rates. And if you have earnings from employment as well, there is a chance you have paid a lot more than you should when you add up all the sums from your job and your self-employment. Check with HMRC if you think you may have overpaid.

REMEMBER

This limit does not include the 1 per cent national insurance surcharge on earnings over £40,040.

TIP

If you know, or reasonably suspect, that you will hit the overall national insurance limit, you can apply for Class 2 and/or Class 4 payments to be deferred until you know the outcome of the year's earnings pattern. You should do this before the start of the tax year, but HMRC, which runs the national insurance collection, often allows later applications.

Hiring Helpers

Being a sole trader doesn't mean you have to work on your own. It's a tax definition, after all. You may need to pay for help on a part- or full-time basis or to hire someone to help out every now and again. If you have family, you may want to make the most of the tax advantages you can reap by employing them. The next sections tell you how to look at employees as ways to lower your tax.

Employing your family

You can employ your family in the business and thereby take advantage of the lower tax rates your spouse or children fall under to reduce your household's overall tax bill.

You do have to keep a few rules in mind, though:

- You have to hire your relative to do real work at commercial wage rates. You cannot get away with paying a small child £100 an hour for taking telephone messages!
- Local authorities have rules on children working. This will not apply to a few hours working in the home. But if you want to employ a child under 16 in other circumstances, always check with the council first.

- Family members who earn more than £105 (in 2008–9) in any week are liable for national insurance payments. As the employer, you also have to pay national insurance on their behalf. This is called the national insurance earnings threshold.
- Your teenage children might have no income to offset against their personal allowance. Or you might be a top-rate tax-payer and have a partner whose maximum is at the basic or lower rate.

You set up a computer repair service working from a small shop. Your 16-year-old helps you at your premises for four hours a week at £5 an hour. That's £20 a week – say £1,000 a year, allowing for holidays and some overtime. You can offset the £1,000 against your profits. And, if your teenager has no other income, he or she does not have to pay tax at all as the £1,000 is well within the personal allowance limit. Had you done the work yourself and not used your child, the £1,000 would have been taxable as profits at up to 40 per cent, so the household would only have £600 instead of the full £1,000.

You have to pay the money for real, of course. The taxman can ask for the audit trail to see how the payment goes from your business to the family member concerned.

Establishing a partnership with your partner

If you and your spouse or partner are both involved in running a business, it could be worth exploring a partnership structure. There are legal concerns such as each partner being liable for debts incurred by other partners. For tax reasons, it is best to have a partnership contract which sets out how profits will be shared.

Starting a Business For Dummies by Colin Barrow (Wiley) sets out who should and who should not set up as partners. You need to work out whether you are better off with a partnership but, more importantly, whether your relationship could stand it.

HMRC is on the lookout for phoney partnerships, established solely with the aim of reducing a couple's overall tax bill. If you have a business partnership with your spouse, you may have to show that both work in the firm and both contribute work according to the proportion of the profits you each earn. This is a measure to prevent couples sharing profits on a 50-50 basis to use up tax allowances of the non-worker when only one works.

Paying employees

If you hire employees, you are in the same situation as any other employer. You have to sort out any PAYE tax and national insurance contributions they owe. (See Book V Chapter 2 for information on employees' tax and national insurance contributions.)

Giving Up Work

Stopping work is easier than starting. You should inform the Inland Revenue if you intend to stop working in your business. And if you were caught by overlap, now is the time to claim it back. Your final accounts can also take care of what happens when you sell plant, machinery, vehicles, or stock.

The reality of self-employment is that most businesses cease entirely when the self-employed person retires or goes back to working for someone else. A few businesses have a future value. (See the section Selling Up and Tax Rules in Book VI Chapter 2.)