

Tax and NI



Anyone starting up a small business needs at least a basic knowledge of tax. For the details, speak to a tax expert. A genuine expert should be able to save you much more in tax than the cost of the fees, as well as sparing you effort, time and stress.

This briefing explains:

- What taxes will affect your business.
- What can be claimed as business expenses.
- How to calculate National Insurance (NI) payments.
- How to pay less tax.

1 Different taxes

1.1 A self-employed person, or any employee of a business, pays **income tax** (see **3-4**).

1.2 A limited company pays **corporation tax** (see **5**).

1.3 **NI** is a form of taxation paid by both employers and individuals (see **13**).

1.4 **Value added tax (VAT)** is a tax on 'supplies' (usually sales) of goods and services.

1.5 **Capital gains tax** may be payable when you sell certain assets for more than you paid for them (see **14**).

1.6 **Inheritance tax** may be payable if you die leaving assets worth over £325,000. This personal tax is not covered in this briefing.

1.7 **Stamp duty land tax (SDLT)** is charged on transfers of land and property.

- For commercial property transactions, rates on transfers (excluding shares) are 1 per cent on values in excess of £150,000 (and values less than this where the annual rent exceeds £1,000), 3 per cent on values in excess of £250,000 and 4 per cent on values in excess of £500,000.

1.8 **Stamp duty** at 0.5 per cent is charged on share transfers above £1,000.

2 Are you self-employed?

A self-employed person can enjoy significant tax and NI advantages over a company employee (see **4** and **13**).

2.1 You are self-employed if you are your own boss and trade as a **sole trader** or as a **partnership**.

- If you trade as a limited company, you, as a shareholding director, are an employee of the company and not classed as self-employed.

2.2 Some people who work full-time for a single company call themselves **consultants**, or contractors, and claim to be self-employed. A tax inspector is unlikely to treat you as self-employed unless you can show that you:

- Control what you do, and how and when you do it.
- Have more than one customer.
- Bear an element of business risk.
- Have a right of substitution.

3 Income tax

3.1 There are currently **three income tax bands** (for the income tax year from 6 April 2011 to 5 April 2012):

taxable income (£)	tax rate
1-35,000	20%
35,001-£150,000	40%
Over £150,000	50%

Your taxable income is reduced by allowances (see **11**).

3.2 If you are a company **employee**, you pay income tax every time you are paid. This is called PAYE — Pay As You Earn.

- The tax year runs from 6 April to 5 April.

4 Tax for the self-employed

4.1 The self-employed pay tax on the **profits** they make — not on their drawings.

For example, if you make £30,000 profit, you pay income tax on the full £30,000 — even if you have drawn only £10,000 as salary and have retained the other £20,000 in the business.

- Profit is revenue less allowable expenses, excluding your salary. The expenses which are allowable are covered in **6** to **10**.
- The same tax bands apply as for staff.

4.2 You usually pay tax on the profit of a 12-month **accounting period**.

You pay tax on the profit for the accounting period which ends in that tax year.

- Tax is due in two equal instalments, on 31 January (during the tax year) and on 31 July after the end of that tax year.
- The interim amounts payable are based on the previous year's tax liability. If profits are down, it is possible to reduce payments.
- A balancing payment is then due on the following 31 January to adjust for the difference between the amounts paid and the tax due as a result of the actual profits.

4.3 A **new business** can initially be taxed twice on some of the first year's profits, depending on the accounting period.

- 'Overlap relief' may be available to correct the position, but the calculations are complex and there will always be a cashflow cost to the business. Consult your accountant or tax adviser.

4.4 Skilful tax planning can ensure that the self-employed pay their income tax much **later** than company employees.

- Take the example of a self-employed person with an accounting period which ends on 30 June 2011. This person will pay tax on those profits in part on 31 January 2012 and 31 July 2012 (based on prior year tax liability), and then make a final payment on 31 January 2013, based on actual profits.

5 Corporation tax

Corporation tax is payable on the profit — sales less allowable expenses, plus investment income and chargeable gains (see **14**) — of a limited company.

Expenses are covered in **6** to **8**.

5.1 There are **three corporation tax bands** for the financial year 2011 (ending 31 March 2012):

profit (£)	tax rate
1-300,000	20%
300,000-1,500,000	20-26%
Over 1,500,000	26%

If your profits fall between £300,000 and £1.5 million, you are eligible for marginal relief to ease the transition from one rate to the next. The limits are reduced for companies belonging to groups.

5.2 The top band will be cut by 2 per cent in 2011 and by 1 per cent each year over the next three years, reducing it to 3 per cent by 2014.

5.3 Companies have to **calculate** their own corporation tax liability.

- Companies with profits over £1.5 million pay corporation tax by quarterly instalments.
- Interest is charged on underpayments.
- The tax return can be filed later — normally up to 12 months after the accounting year end. It must be accompanied by accounts. Late returns incur automatic penalties.

5.4 Small to medium-sized companies (with profits of up to £1.5 million) continue to pay corporation tax **nine months** after the end of your accounting year.

6 Expenses

You need to be clear about what expenses are allowable when working out your profit figure.

Business costs are allowable, but personal ones are not. Allowable expenses include:

6.1 Goods and materials, including anything your business buys in and then resells.

- The allowable expense will be affected by the value of stocks at the year end. A common mistake is to value stock at its selling price, rather than cost. This inflates your profit figure and increases your tax bill.

6.2 Directors' and employees' wages, pensions, and employers' NI contributions (see **13**).

6.3 Premises costs, such as rent and rates.

- If you work from home, you can usually count a fair proportion of your gas, electricity, water, telephone and council tax charges as business expenses.

6.4 Selling costs, including marketing and advertising expenses.

6.5 Finance costs, such as bank charges and interest (including leasing and hire purchase interest).

6.6 General running expenses, including telephone bills, insurance, transport, travel and subsistence (eg hotel costs on a business trip), repairs, postage, accounting and most other services.

6.7 Spending on research and development.

- You can claim R&D tax credits on qualifying spending at 200 per cent. This means you can set £200 off against your profits for every £100 you spend.
- Only limited companies can claim R&D tax credits.
- R&D tax credits apply to staff costs and consumables used in your R&D efforts, plus expenditure on software, power, fuel and water.
- Companies not yet in profit (or not yet trading) can claim cash payments instead.
- To take advantage of these credits you must spend £10,000 or more on research and development in an accounting period.

6.8 Bad debts, where specific invoices are unlikely to be paid.

6.9 If you are not registered for **VAT**, you treat the VAT element as part of the expense.

- If you are registered for it, VAT is reclaimed separately.

In addition to allowable expenses, you can claim allowances to reflect the investments you have made in plant and machinery (see **8**).

7 Handle with care

Some expenses do not count. They cannot be deducted when calculating your profit figure, even though they may seem like perfectly necessary and legitimate business costs.

7.1 Personal expenses — including living expenses, ordinary clothes, and travel to and from your regular place of work.

7.2 Entertaining — including any food or drink bought for clients.

7.3 Certain professional fees — including the costs of forming a company and the costs of obtaining a lease.

7.4 Depreciation — instead, you claim capital allowances (see **8**).

7.5 Fines — including parking tickets.

All these exemptions can cause problems for start-up businesses that do not take professional advice.

8 Capital allowances

When working out your profits, you cannot count the cost of purchasing premises and equipment as an expense. This is often an important consideration for start-up businesses.

Instead you claim a capital allowance, which is then deducted from your profits, like an allowable expense. This applies to both limited companies and the self-employed.

8.1 Most capital allowances are spread over a number of years, and often **gradually reduce**.

- Plant and machinery is the main category and the allowance is a fixed percentage of the item's value (written down for tax purposes) at the end of each year, and the value is reduced each year by the previous year's tax allowance.

Note that however many years' allowances are claimed for, you will not recover 100 per cent of the cost of any item.

8.2 Capital allowances **range** from 0 per cent to 100 per cent, depending on who you are and what you are purchasing.

- There are 100 per cent allowances for energy saving and environmentally beneficial equipment. Loss making businesses can surrender losses attributable to expenditure on such equipment in exchange for tax credits.
- There are also 100 per cent capital allowances for businesses purchasing low-emission cars (emitting up to 110g/km of carbon dioxide).
- The Annual Investment Allowance allows businesses to claim 100 per cent capital allowances on the first £100,000 of investment on plant and machinery (excluding cars). Expenditure over the £100,000 limit will be dealt with under the main or special rate pools (see below). The Annual Investment Allowance is open to all businesses, not just small and medium-sized businesses. It will be reduced to £25,000 from April 2012.
- The 'special rate' pool gives 10 per cent capital allowances on integral features of buildings, thermal insulation and long-life assets. The rate will reduce to 8 per cent from April 2012.
- The allowance for qualifying industrial buildings and hotels is 3 per cent.

8.3 All equipment subject to the main rate is generally lumped together in a '**pool**', and capital allowances are calculated at 20 per cent of the total value. This will reduce to 18 per cent from April 2012.

8.4 Assets which have a useful life of four years or less are called '**short life assets**' and may qualify for accelerated capital allowances on disposal, depending on the circumstances.

8.5 New expenditure on company cars qualifies for **capital allowances**. The rate will depend on the car's CO₂ emissions.

- Cars emitting more than 160 g/km are allocated to the 'special rate' pool.
- Cars emitting less than 160 g/km are allocated to the main rate pool.
- Low emission cars (less than 110 g/km) qualify for 100 per cent capital allowances.

8.6 You can choose to **defer** capital allowances. For example, if you make a

trading loss and have no tax to pay, you can defer the tax benefit you would have had until a later year.

8.7 Repairs to machinery and equipment are fully tax-deductible. Only improvements to equipment count as capital expenditure.

8.8 If you are not registered for **VAT**, you can also claim capital allowances on the VAT that is charged on the equipment you buy.

8.9 Time your purchases so that you buy any equipment you need before your **year end**.

- If you make a purchase the day before your year end, you still receive the full capital allowance for the whole accounting period.

9 Cars and tax

9.1 If you are a **self-employed** person using your own car for work, you must keep a record of business miles travelled.

- Whenever your car is serviced, make sure the mileage reading is noted on the bill. This will enable you to work out the car's total mileage for the year — and provide evidence to satisfy the tax inspector.
- You must estimate what percentage of the mileage was for business purposes. For example, if the business mileage is 75 per cent of the total, you can claim 75 per cent of your car costs (petrol, insurance, repairs) as business expenses. You can also claim 75 per cent of the capital allowance if the car is only used for business (see **8.2**).
- Alternatively, you may be able to claim an allowance in line with HM Revenue & Customs Approved Mileage Allowance Payments (see **9.2**).

9.2 Employees who use their own cars usually receive a **mileage allowance**.

- If mileage allowances are paid in line with HM Revenue & Customs Approved Mileage Allowance Payments (AMAP), there is no extra liability. If they are greater than AMAP, the difference is taxable.
- AMAP for cars and vans are 45p a mile up to 10,000 miles, and 25p a mile thereafter.

9.3 An employee using a **company car** privately pays income tax on this 'benefit'. The employer also has to pay NI on it, as if the benefit were paid out as salary.

- Calculation of the benefit is based on the

- list price of the car and its CO₂ emissions.
- The list price percentage for electric cars and vans is 0 per cent, meaning that no income tax will need to be paid on the benefit.
- If fuel is provided for private use, this is subject to tax and employer's NI as a benefit, based on a fuel charge.

10 Pre-trading expenses

By the time you actually start trading, you may have spent thousands of pounds on research and setting up the business.

Provided you have formally notified HM Revenue & Customs (HMRC) that you have started up a business, most of these costs are usually allowable as business expenses in the first year.

10.1 From the moment you decide to go into business, start keeping a **record** (with matching receipts, invoices and bank statements) of all your business expenditure.

- Set up a separate bank account to make this easier.

10.2 Some costs are **not allowable**.

- For example, training courses are only an allowable expense once you have officially commenced trading.

10.3 If you form a **limited company**, the formation costs incurred are not allowable.

11 Non-taxable income

Below are the main types of allowances and non-taxable income.

11.1 Individuals receive a basic **personal allowance** of £7,475 (ie the first £7,475 of your income is not taxable) for 2011/12.

- If your husband, wife or civil partner has no other income, it makes sense from a tax point of view to employ her or him with a salary of at least £7,475. The employment must be a genuine job and the salary must be physically over to the employee.
- If you are in paid work (including self-employment) you may qualify for Working Tax Credit.
- The basic personal allowance is only available to those earning less than £100,000. Where income is more than £100,000, the

amount of the allowance is reduced by £1 for every £2 earned above the limit.

- There is a Child Tax Credit available if you are supporting a child below the age of 16. This replaces the Children's Tax Credit. It is paid at a higher rate for a child under the age of one, or a disabled child.

11.2 Redundancy payments below £30,000 are usually tax free. Check your situation in advance.

11.3 Certain **social security** benefits may be tax free, depending on circumstances.

- These include maternity and child benefits, family credit and the mobility component of disability living allowance.

11.4 Directors and partners (but not sole traders) can claim interest relief on money which they borrow personally and then **lend** to the business.

12 Losses

12.1 A **limited company** can offset its trading losses against all other income in the accounting period.

- Alternatively, the loss can be 'carried forward' against profits from the same trade, to reduce future tax bills, or 'carried back' and offset against profits from the previous year.

The company can be reimbursed for tax already paid.

12.2 A **self-employed** person can also offset trading losses against any other income received (earnings from a job, revenue from investments), plus any capital gains arising in that year.

- Alternatively, losses can be carried forward to offset against future profits from the same trade. Losses in the first four years, or in the last year, may also be carried back up to three years.

13 National Insurance

13.1 The self-employed pay **much less** NI than employees, in return for substantially fewer benefits.

13.2 Employees pay **Class 1** contributions. This is deducted from pay at source, with the employee's income tax.

- Employees earning less than £139 a week are exempted.
- Contracted-in employees pay 12 per cent on weekly earnings between £139 and £817, plus an additional 1 per cent on weekly earnings over £817. Contracted-out employees pay 10.4 per cent.

13.3 Employers pay an 'employer's contribution' on pay and the taxable value of any car and fuel benefit.

This is charged at 13.8 per cent for contracted-in employees on earnings over £136 a week.

- Employers pay nothing for employees earning less than £136 a week.
- The level at which employers start to pay Class 1 contributions increases by £21 per week above indexation from April 2011.
- The employer's contribution is an allowable expense (see 6.2).
- Start-up employers outside London and the south-east don't have to pay £5,000 in NICs for the first ten members of staff hired in the first year of business. All new businesses set up since 22 June 2010 benefit.

13.4 A self-employed person currently pays:

- Class 2 contributions of £2.50 a week (£130 a year). The National Insurance Contributions Office collects this. Direct debit is the simplest method of payment. Someone earning less than £5,315 a year (excluding any start-up grants) can apply to be exempted from Class 2 contributions. Ask for form CF10.
- Class 4 contributions of 9 per cent on profits between £7,225 and £42,475, plus an additional 2 per cent on annual profits above £42,475. HMRC collects this at the same time as income tax.

No tax-free lunch

Andrew Bacon's success in business was based on building relationships, and he spent a lot of his own time wining and dining customers. It was unquestionably essential for his work.

Andrew discovered too late that entertainment — however necessary — is not an allowable business expense. Being a self-employed top-rate taxpayer, he had to pay £4,000 tax on the £10,000 he had assumed could be written off as entertainment expenses.

If, as well as working as a self-employed person, you also have a job working for an employer, you will still be paying Class 1 contributions.

In this situation, you can apply to defer payment of the Class 2 and 4 contributions.

14 Capital gains

Capital gains tax (CGT) is a tax on successful investments, such as those in property and shares. If you sell something for more than you paid for it, CGT may be payable.

14.1 Higher-rate income tax payers are liable to pay CGT at **28 per cent**. For those paying the lower income tax rate, CGT is charged at a flat rate of **18 per cent**.

- Capital gains are added to any other income, to determine what the top rate should be.
- Gains falling within the middle rate band are charged at 20, rather than 22 per cent.
- The first £10,100 of capital gain each year is tax free. A husband, wife or civil partner can each claim this allowance.
- CGT is payable on 31 January following the end of the tax year in which the gain is made.

14.2 Limited companies pay corporation tax on any capital gain.

- Capital gains are treated as part of the company's taxable profit.

14.3 The **self-employed**, like other individuals, pay CGT at a flat rate of either 18 or 28 per cent, depending on income tax paid.

14.4 CGT **exemptions** include your gains in ISAs and increases in the value of your principal private residence and private cars.

- If you work from home — and have not claimed any part of your mortgage payments as a business expense — there is usually no CGT on any profits made from the sale of your house.
- Under certain conditions, some investment vehicles, life assurance policies and charitable gifts can also be exempt.

14.5 Capital **losses** can be set against capital gains from the same tax year and can then be carried forward against future capital gains.

14.6 Individuals can claim **entrepreneurs' relief** on the first £5 million of gains made on the sale of a business or its assets.

- The relief reduces the rate of CGT on gains up to £10 million.
- Claims can be made on more than one occasion up to the £10 million lifetime limit.
- Gains over £10 million are charged at the usual CGT rate.

14.7 Payment of some CGT can be deferred.

- You can get 'rollover relief' if you sell a building from which you trade (or certain other types of asset), and use the money to buy another such building (or asset).
- You can get 'reinvestment relief' if you reinvest the gain in qualifying shares in certain types of companies under the Enterprise Investment Scheme.

15 Paying less tax

There are three commonly-used ways of paying less tax.

15.1 New businesses expecting to make a first-year loss can delay incorporation.

- This may be advantageous, because a self-employed person can offset the tax loss against previous years' employment income and receive a tax rebate (see **12**). The business can still be incorporated later.
- Being self-employed has other implications, though, including unlimited liability.

15.2 If you are making profits, and your cashflow is sound, it may be worth trying to **reduce your profit** at the end of the year in

order to reduce your tax bill.

- Bring forward the purchase of items of equipment that you will have to buy later.
- Make full provision for specific bad debts.

15.3 Payments into a **pension scheme** are an efficient way of saving tax.

But putting money into a pension scheme to save tax is unwise if the cash is really needed to run the business.

16 Other tax opportunities

16.1 An ordinary employee given a **low interest loan** by the company receives a benefit, which is normally taxable as income.

- However, for loans up to £5,000, there is no tax payable.

16.2 No tax is payable on **long-service awards** up to a specified value.

- The value can be up to £50 for each year of service.
- To qualify, the employee must have served for 20 years.

16.3 Annual staff **parties** or similar celebrations paid for by the employer are tax free up to a specified limit.

- The cost must not be more than £150 per head a year.

16.4 Employees who receive shares under a **tax-favoured share scheme** are not taxed until they sell the shares.

- Where employers offer Share Incentive Plans (SIPs), employees can use up to £1,500 of salary each year, free of tax and NI, to buy shares.

17 The 2010/11 tax year

The information in the earlier part of this briefing applies to the current tax year. The main changes from the previous year are highlighted below.

17.1 The three **income tax** bands (see **3** and **4**) and rates for the tax year to 5 April 2011 were:

First time shock

When Philip Prince started his carpet cleaning business he made a lot of money very quickly. He spent it all, too — on a new van, on more equipment and on a holiday.

He was self-employed and chose the maximum 18-month accounting period to start with. It was nearly two years before the first tax bill came. When it did, it was enormous.

Philip was taxed on the money he had reinvested in capital equipment to build up the business — and buying that equipment had left him with no money to pay the tax.

taxable income (£)	tax rate
1-37,400	20%
37,401-£150,000	40%
Over £150,000	50%

17.2 Corporation tax (see 5) bands for the tax year ending 31 March 2011 were:

profit (£)	tax rate
1-300,000	21%
Over 1,500,000	28%

17.3 The **personal allowance** was £6,475.

17.4 National Insurance (see 13).

- Employees earning less than £110 a week were exempted. Other employees paid 11 per cent (9.4 per cent if contracted out) on any extra, up to £844 a week.
- The employer's contribution rate was 12.8 per cent on earnings above £110 a week (less if contracted out).
- The self-employed paid Class 2 contributions of £2.40 a week.
- Class 4 contributions were charged at 8 per cent on profits between £5,715 and £43,875.
- The earnings limit for exemption from Class 2 contributions was £5,075.

17.5 Capital gains tax (see 14).

- The annual exemption for individuals was £10,100.

18 Next steps

Having read this far, you will have a basic grasp of how tax works. You should now:

18.1 Discuss your specific situation and business with a **tax specialist**.

- Check that the specialist is properly qualified — either a member of the Chartered Institute of Taxation or the Association of Taxation Technicians (020 7235 2544; www.att.org.uk).

18.2 Make sure your present **accounting system** shows how much tax is payable each month.

18.3 Make realistic **provisions** for your future tax bills.

- Plan cashflow so that when a tax demand arrives, you have the cash to pay it.

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