



An Introduction to the Tax System for the Self Employed

Registering with HM Revenue & Customs (HMRC)

If you start working for yourself, you must register with HMRC by 5 October following the end of the tax year in which your self employment starts. Otherwise you may be liable to a penalty based on the tax due to HMRC.

There are three ways that you can register:

- Online – visit <https://www.gov.uk/log-in-file-self-assessment-tax-return/register-if-youre-self-employed>
- Phone – call the Newly Self-Employed Helpline on 0300 200 3500
- Post – download and complete form CWF1

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 HMRC 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).

For most of the equipment you buy for your business, you will be entitled to deduct the full cost (up to £200,000 from January 2022). 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 out of the business for your own use, this should be shown as a sale at market value in the accounts, and not at original cost. It may be better to show 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, their

wages are an allowable deduction, provided they are actually paid and represent a reasonable reward for what is done.

How does HMRC 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 current rule that has applied for many years, has been 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 2022/23 could be based on accounts for a year ending on various dates ranging from 6 April 2022 to 5 April 2023. However, HMRC have announced that from 2024/25, tax will be charged on the profits actually arising in the tax year. This will mean that if your business has an accounting date other than a date falling between 31 March and 5 April, the profits from two sets of accounts will need to be apportioned to calculate the profits relating to the tax year. There will be a transition period in 2023/24 where adjustments will be made to ensure that the principle of taxing profits in full once, and once only is maintained.

How is the tax collected?

Tax returns

Tax returns covering income for the year ending 5 April 2022 have to be submitted to HMRC by the 'filing date' which is 31 October 2022 for paper returns and 31 January 2023 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) for 2022/23 will be due on 31 January 2023 and 31 July 2023. These interim payments will be based on one half of the total liability (less any tax deducted at source) for 2022. You will have the right to reduce payments on account if you believe the income tax for 2022/23 will be lower.

The balance of income tax for 2021/22 is due on 31 January 2023 (along with the first payment on account for 2020/21 and any capital gains tax for 2021/22).

Interest and penalties 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 started on 1 June 2019 and your first accounts run to 30 June 2020 with a profit of £13,000, then tax will be worked out (to the nearest month) on the profits of the following periods:

2021/22 1 June 2021 to 5 April 2022 - $10/13 \times £13,000$ i.e. £10,000

2022/23 1 July 2021 to 30 June 2022 - $12/13 \times £13,000$ i.e. £12,000

You can see that the profit from 1 July 2019 to 5 April 2020 (9 months) has been taxed twice. Previously this 'overlap' profit of £9,000 would have been available for deduction when the business came to an end. However, as 2023/24 is to be a transition year to the proposed tax year basis, this overlap relief will instead be used to relieve the additional tax due in that year.

Transitional year

Continuing the example above, if your accounts to June 2023 show profits of £15,000, and the accounts to June 2024 show profits of £18,000 the tax for 2023/23 will be worked out (to the nearest month) on the profits of the following periods:

2023/24 1 July 2022 to 30 June 2023 PLUS 1 July 2023 to 5 April 2024

$12/12 \times £15,000$ PLUS $9/12 \times £18,000$ i.e. £28,500

However the overlap profit of £9,000 would be offset against this, reducing the taxable profit to £19,500.

Tax year basis

In 2024/25 your business will be taxable on the tax year basis, regardless of its accounting date. You will calculate your taxable profits from the accounts to 30 June 2024 which showed £18,000 profit and the accounts to 30 June 2025 which show £20,000 profit as follows:

2024/5 6/4/2024 to 30/6/2024 PLUS 1/7/2024 to 5/4/2025

$3/12 \times £18,000$ PLUS $9/12 \times £20,000$ i.e. £19,500

£21,000

Cessation

If you are already within the tax year basis when you cease then cease trading, you will simply pay tax on the period from 6/4 to your date of cessation. If on the other hand you still have unused overlap relief when you cease, this will be offset against your profits to cessation.

£ 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 £3.15 per week, if earnings exceed £6,725 per annum. However, for 2022/23 no Class 2 NICs will be payable on profits between £6,725 and £11,908.

Payments for self-employed Class 2 NICs are due on 31 January following the end of the tax year.

Profits between £11,908 and £50,270 are subject to Class 4 NICs at a rate of 9%. Any excess of profit above £50,270 is subject to Class 4 NICs at the rate of 3.25%, without any upper limit. Class 4 NICs are collected by HMRC 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 HMRC and is not deductible from business profits.

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

Cash basis for small businesses

In order to try to simplify the calculation of taxable income for small businesses, HMRC introduced an optional alternative system for eligible unincorporated businesses. Such businesses may calculate taxable income figures on a simpler cash basis if this suits the business. They will not have to compile figures of debtors, creditors and stock, or distinguish between 'capital' and 'revenue' expenditure and will not have to compute capital allowances to arrive at taxable income.

A second measure allows all unincorporated businesses to choose to use flat rate expenses for particular items of business expenditure.