The tax system for the self-employed

Registering with HMRC

If you start working for yourself, you must register with HMRC. You can do this at any time up to 5 October of your business' second tax year. If you do not register you may be liable to a penalty.

It is now preferable to register online. You can also register by telephone or by using the form (CWF1 - register if you are a self-employed trader) incorporated in leaflet SE1 (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 an unwelcome surprise 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).

When you buy equipment or motor vehicles, you will be entitled to deduct a proportion of the cost each year you own them and use them in your business. Claims for such capital expenditure are known as capital allowances.

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 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 general rule is that the tax for a particular tax year is based on the profits of the 12 months to your accounting date in that tax year. For example, the tax for 2018/19 could be based on accounts for a year ending on various dates ranging from 6 April 2017 to 5 April 2018.

This means that you have more time for the tax to be worked out if your accounts year-end is earlier in the tax year, which is why 30 April remains such a popular year-end for self-employed people.

Although this can be a disadvantage if there is a business downturn and tax is then payable on the higher profits when maybe income has reduced.

How is tax collected?

Tax returns

Tax returns covering income for the year ending 5 April 2018 should have been submitted to HMRC by 31 October 2018 for paper returns or 31 January 2019 for online filing. The return will include a self-assessment calculation of your liability to income tax and capital gains tax.

If you don't want to work out your own liability, you should send the tax return back by 31 October 2018 or file online by midnight on 30 December 2018 if you wish HMRC to collect any tax you owe through your code, if you also receive income subject to PAYE. You can ask for this provided you owe less than £3,000. The final date for filing your 2018 tax return is midnight on 31 January 2019.

There are automatic penalties for late filing of tax returns.

Over the period 2018 to 2020, the tax return is to be replaced by the personal tax account (PTA), which taxpayers can update with their income and capital gains on an ongoing basis.

Sources of income reported to HMRC (PAYE income from April 2017 is a point in case and interest paid by banks and building societies from 2018) will be shown on the PTA for the taxpayer to check and approve, rather than requiring him to submit a return.

Payment of tax

Payments on account of income tax and class 4 NICs are due each year on 31 January and 31 July. These interim payments will be based on one half of the total liability (less any tax deducted at source).

You will have the right to reduce payments on account if you believe the income tax for the current year is less than the previous year.

Interest and surcharges will be levied for late payment.

What about any 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 2018 and your first accounts run to 30 June 2019 with a profit of £13,000, then tax will be worked out (to the nearest month) on the profits of the following periods:

- 2018/19 1 June 2018 to 5 April 2019 - 10/13 x £13,000 i.e. £10,000
- 2019/20 1 July 2018 to 30 June 2019 - 12/13 x £13,000 i.e. £12,000

You can see that the profit from 1 July 2018 to 5 April 2019 (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 2019 to 31 December 2019 and the accounts for the 18 months ending 31 December 2019 show a profit of £27,000, the taxable profit for 2019/20 will be worked out as follows:

Profit based on accounts (18 months)	£27,000
Less overlap relief	£6,000
Profit for 2018/19	**£21,000**

Cessation

If you then cease trading on 31 August 2020, and your final accounts for the 8 months ending on that date show a profit of £11,000, the taxable profit for 2020/21 will be:

Profit since accounting date in previous tax year	£11,000
Less balance of overlap relief not already used	£3,000
Profit for 2020/21	**£8,000**

National insurance

The self-employed are subject to national insurance contributions (NICs), known as class 4 and class 2 NICs, both paid with the self-assessment tax liability.

Class 2 NICs at a weekly rate of £2.95 are only mandatory if earnings exceed £6,205 a year, but they do carry an entitlement to state pension, so those with income below the threshold frequently opt to pay them.

Class 2 NICs will be abolished in April 2019. Pension entitlement will then be determined by the Class 4 contributions paid.

Profits between £8,424 and £46,350 are subject to Class 4 NICs at a rate of 9%. Profits in excess of £46,350 are liable to Class 4 NICs at the rate of 2% 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 NICs. Interest on unpaid tax is chargeable by HMRC, and is not deductible from business profits.