Time to be your own boss

Victoria Cavell discusses some of the important issues to cover when advising someone who is planning to start their own business.

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I have worked in tax for more than 20 years but have denied it when socialising for about 15 of those because it is the ultimate conversation stopper. However, as I have grown older, more friends are wanting to start their own business and, suddenly, they are keen to know someone with some tax knowledge. It is daunting for them to leave the safety of employment income and PAYE where the employer calculates the tax and National Insurance and pays the amounts to HMRC. They are venturing into a new realm of responsibility and self assessment tax returns.

Starting a business is a good tax topic. It is a cross-pollination of taxes and, for this reason, it is also a popular question for the Association of Taxation Technicians examiners.

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The ATT paper 2 considers the profits assessable to tax for different types of business. The paper 3 syllabus has been extended for the 2021 sittings onwards and now includes sole traders, partnerships and companies with an emphasis on their tax compliance obligations.

Asking about starting a business is a good way to find out what candidates know technically on sole traders and companies while ensuring this can be communicated in a clear and succinct way.

Key points

- Consider whether to be a sole trader or a company.
- Sole traders are responsible for paying the income tax and National Insurance on their trading profits.
- Understand the impact of choosing an accounting period.
- Remember important deadlines for submitting returns and paying tax.

This leads me to an important question to ask someone who is starting their own business: 'Are you intending to be a sole trader or to start a company?'

Sole trader or company?

Before someone can answer that question, they need to know what the difference is.

Sole traders are self-employed persons who own and run their own business. For tax purposes, the sole trader and their business are one and the same. The business does not pay tax itself. Tax is charged on the person running the business, the sole trader. Sole traders are liable to income tax and class 4 National Insurance contributions on the trading profits of the business, plus class 2 contributions which are calculated on a weekly basis. The trading profits are included on the sole trader's own self-assessment tax return for the year.

If a sole trader disposes of a chargeable capital asset in a tax year, such as a building, any profit is chargeable on them under the capital gains tax rules.

From a legal perspective a sole trader is personally liable for their business's debts and their personal assets may be at risk if creditors cannot be paid.

Companies are different. They are a separate legal entity from those who own the company – the shareholders – and from those who run it on a day-to-day basis – the directors. As a separate body, the company pays corporation tax on its trading profits and on any chargeable gains on the sale of capital assets. It does not pay National Insurance contributions on trading profits.

Limited companies also bring limited liability. The owners' personal assets are not exposed, unlike sole traders, because a company is separate from its owners. The owners only stand to lose what they put into the company.

There are different types of companies, but here we are considering the basic limited company and drawing attention to a key beneficial legal difference in liability. Setting up a company involves some formalities and more administration such as filing annual accounts. This can be off-putting and a step too far for someone first starting to trade, although it is a case of weighing up the options.

It is important to note that both sole traders and companies must consider whether they need to register for VAT.

We will assume that our interested party wants to pursue the simpler sole trader route. So how do they start?

Notifying HMRC

The best place to start is to tell HMRC. Sole traders must notify HMRC by 5 October following the tax year in which they start to trade. Let's look at the example of Amy, who left her employment on 31 December 2020 and started to operate as a sole trader on 1 January 2021. As this is in the 2020-21 tax year, she must notify HMRC by 5 October 2021.

Accounting period

Sole traders need to choose to which date they draw a set of accounts, referred to as the period of account, or accounting period. This is an important decision, because there is a risk profits will be taxed twice during those vulnerable early years of business.

Let's keep with Amy who started to trade on 1 January 2021. She decides to draw accounts to 31 December 2021 with trading profits of £24,000. A calendar year sounds sensible, but that is not necessarily the case. Individuals do not pay tax for a calendar year, nor do they pay tax for an accounting period. Income tax is calculated for a tax year and trading profits are allocated to each tax year using the basis period rules.

The basis period for the first tax year is always from the day the trade starts to the next 5 April. Amy started trading on 1 January 2021 – in tax year 2020-21. Her first basis period is 1 January 2021 to 5 April 2021 – three months.

Amy's assessable profits in 2020-21 are: 3/12 x £24,000 = £6,000, that is 3/12ths of the profits of the year ended 31 December 2021.

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The aim from the second year is to tax 12 months' worth of profits each tax year. How the rules apply will depend on whether there is an accounting period ending in the second tax year and the length of that period.

Amy's second tax year is 2021-22. First, we look to see if there is an accounting period ending in this tax year. In Amy's case there is because the year ended 31 December 2021 falls in

2021-22. As the accounting period is 12 months or more, we tax the profits of the 12 months running up to the end of the accounting period – that is the period from 1 January 2021 to 31 December 2021.

Amy's assessable profits in 2021-22 are therefore: 12/12 x £24,000 = £24,000.

But, because of the basis period rules, three months of those profits (£6,000) were already subject to tax in 2020-21. This is called overlap. Amy is taxed on those three months' worth of profits twice. When she stops trading she can obtain relief for those overlap profits. Relief may be given sooner if there is a change of accounting date.

It is possible to avoid overlap profits by opting for an accounting date of 31 March.

If Amy does this, assuming her profits accrue evenly each month, her trading profits would be:

Accounting period	*Trading profits*
Three months ended 31 March 2021	£6,000
Year ended 31 March 2022	£24,000

Then her assessable profits would be:

Tax year	*Basis period*	*Assessable profits*
2020-21	1 January 2021 – 31 March 2021	£6,000
2021-22	Year ended 31 March 2022	£24,000

The same rules are followed. In the first tax year – 2020-21 – the basis period is from when Amy started trading (1 January 2021) to the next 5 April – which happens to be her three-month accounting period to 31 March 2021.

For the second tax year – 2021-22 – Amy has an accounting period of the year ended 31 March 2022. The basis period is the 12 months to 31 March 2022. In this way, there are no overlaps.

Administration

Most people starting to trade want to get things right. They want to file their tax returns and pay what is due on time. There is a risk of penalties if such obligations are not met.

The filing deadline for self-assessment tax returns is 31 January after the tax year – for forms submitted online. So, for 2020-21, the return must be filed by 31 January 2022.

Sole traders usually pay income tax and class 4 National Insurance by two payments on account and a balancing payment.

The due dates, using 2020-21 as an example, are:

- First payment on account: 31 January during the tax year – 31 January 2021
- Second payment on account: 31 July after the tax year – 31 July 2021
- Balancing payment: 31 January after the tax year (the same due date as the return) – 31 January 2022

Each payment on account is 50% of the previous year's tax and class 4 National Insurance due. Class 2 contributions are due with the balancing payment.

There are exceptions for payments on account. They are not due if either:

- the tax due for the previous year was less than £1,000; or
- more than 80% of the tax liability for the previous year was collected at source.

In reality, many sole traders will not make payments on account in their first tax year especially if in the preceding year they were employees and all their income tax was collected at source through the PAYE system. Depending on when they start trading in the first tax year and their level of profits, they may not even make payments on account in their second tax year.

VAT

Sole traders will generally need to register for VAT if their taxable supplies exceed the VAT registration threshold (currently £85,000) or they may choose to register voluntarily. While many new traders will not be anticipating sales figures in that region at first, they generally want to know how VAT works.

Being VAT registered means the sole trader adds VAT to their sales and charges this to their customers. Using the standard rate of VAT at 20% will make the same product 20% more expensive to their customers. This is output tax that the sole trader collects and pays to HMRC.

After registering for VAT, the sole trader can recover the VAT they have paid on purchases coming into the business. This is input tax.

Output tax on sales less input tax on purchases gives the amount of VAT due to HMRC – or overall repayment due from HMRC. This is recorded on the VAT return which is usually submitted quarterly with the VAT payment.

There are many other points to consider but, even on a topic as engaging as starting a business, there is a limit on how much detail to go into initially. It is best to give a good overview and a 'contact me if you require further information' offering that professional check back before signing off.

Planning point

If a self-employed client's business income is approaching the VAT registration threshold, contact them to discuss their next steps.

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