

complete guide

to tax and expenses

did you know?

- You will be fined if you don't inform the tax man as soon as you start trading
- If turnover exceeds £70,000 a year you must register for VAT
- Becoming a limited company could save you money
- You can claim expenses if you use your home for business
- You can pay a salary to your spouse and any children over 13, for working in your home business

starting a business?
working from home?
running a home business?

**all you need to know
about small and
start-up business
tax and expenses**

There are a number of things you need to consider when starting a business, including if you operate from home, such as when to notify the tax man.

Many of us will have started out on a part time basis while still holding down a full time job, until you are ready to 'take the plunge'.

Often this will either be in the same line of work as your main employment, or it could be the development of a personal hobby or interest.

A significant proportion of people will have just 'drifted' into self employment, via online mediums such as eBay. So, if it's just a little income on the side, when do you have to register as a 'proper' business with HM Revenue and Customs (HMRC)?

Unfortunately, the ever benevolent tax man now requires us to register immediately, as soon as you have undertaken your first piece of self employed work.

A few years ago, you were able to notify HMRC at the end of the first year's trading, on submission of the first year's accounts and tax returns. This is no longer an option, and you are now all obliged to advise HMRC, within three months of undertaking your first piece of self employed work. Failure to do so will now result in an automatic fine of £100.

Options for doing so are the completion of a **CFW1 Form**, which you can download from www.hmrc.gov.uk/leaflets/se1.pdf or by calling the Newly Self Employed Helpline, on 0845 915 4515.

Once registered, you will now be classified as self employed, and you will be sent a Self Assessment Tax Return to be completed annually, showing your income and expenses from your self employment as well as details of your employment. You will be subject to tax and national insurance on any profits you make, but the good news is that any losses incurred (which is quite common in the first year or two) can be offset against your employed income, which will usually then result in a tax rebate.

So, there is no such thing as 'casual part time income' from self employment. You must register immediately, or face financial penalties.

There are, also, many misconceptions, among new business owners, as to when they should register for VAT. There is, however, no legal requirement to do so, until the business turnover exceeds the registration threshold (currently £70,000).

It is possible to register for VAT voluntarily, even if you are below the registration threshold.

Reasons you might want to would include:

- In order to reclaim the VAT incurred on large initial capital outlays at business start up (equipment, vans etc).
- To reclaim VAT on ongoing purchases and expenses, thereby making them 17.5%* cheaper. (although you should be wary if you are mainly selling to the public).

- To improve your company image. If a company is not registered for VAT, then any potential large customers will realise that its turnover is below £70,000, and may refuse to deal with such a small company, on the grounds that its continuity cannot be assured. This will be a potential issue for any very small or start-up business.
- To take advantage of the potential cash flow benefits of operating the flat rate scheme. (Yes, that's right. The flat rate scheme can actually benefit your cash flow, as you can see in the example later).

When considering voluntary registration, you need to be aware of who your customers are. If you are dealing mostly with business customers, then they will, in the main, be able to reclaim any VAT that you charge on your products and services.

If, on the other hand, you mainly deal with the public, they are unable to make such a reclaim and your goods and services immediately become 17.5% more expensive. Alternatively, you can make your current prices VAT inclusive, and lose out on the extra profit. Either way, this will be a major factor in choosing whether or not to register for VAT before you actually need to.

* 20% from 4 January 2011.

Example of Flat Rate Scheme

Anna is a locum vet, dealing exclusively with veterinary practices, all of whom are VAT registered.

Her expected turnover, at £50,000 in year 1, is somewhat below the current VAT registration threshold, so registration is not compulsory. What are the implications of registering under the flat rate scheme?

First, as all of her customers are VAT registered, there is no problem with them claiming back the VAT, so this will not be a barrier to registration.

Secondly, because she is one person, working from home, and basically just selling time, there will be little or no input VAT for her to claim on payments out and expenses.

Under current rates, at 17.5%, she will charge a total estimated VAT amount of £8,750.

The current VAT flat rate for vets is 10% (though this is calculated on the GROSS amount invoiced, in this case; £58,750 (£50,000 plus VAT)).

In the first year of the scheme, there is a 1% discount available for new users. In this case, the VAT payable to HMRC, in year 1, will be £5,287.50 (£58,750 @ 9%).

As you can see, Anna has charged £8,750 to her clients, but only had to pay £5,287.50 to HMRC, resulting in a £3,462.50 positive impact on her cash flow. On this occasion, it was considered to be worthwhile registering for the flat

rate scheme, but rates will vary from one business to the next, and each case should be considered individually. It's definitely worth a look though, and the calculation is straightforward, as you only need to identify total sales.

structure

A key decision, from the outset, is; what business structure am I going to use?

One of the fundamental questions when starting a new business is; "Should I run my business as a sole trader, partnership or limited company?"

The government has, in recent years, been herding us all in the direction of the limited company, as it allows it to monitor statistical business data, and enforce deadline compliance, via Companies House. In the majority of cases, therefore, under current legislation, it will be preferable to run your business as a limited company. Some of the benefits of doing so include:

Limited liability

A limited company is a separate legal entity, distinct from yourself as director / shareholder. If your business fails, your house and other assets are not at risk (unless you have guaranteed any debts personally, or you have been guilty of fraud in your conduct as a director).

An alternative to the limited company is the limited liability partnership (LLP) which is favoured by some accountants. While, as the name suggests, this will have the bonus of limited personal liability for partners, it will lack some of the other benefits of the limited company, such as the associated tax savings.

Image

The perception held by most people is that limited companies are larger entities, and this automatically gives increased credibility.

Taxation savings

Over the last few years, legislation has changed almost yearly. For some of that period, the first £10,000 of a limited company's profits were tax free. Although this provision is not currently in force, the Small Companies Corporation Tax rate was cut by one percentage point to 20% in the June 2010 budget.

Currently, a self employed person will pay a basic rate of income tax of 20% (rising to 40% from £37,400 of income or 50% if it's more than £150,000) plus 8% class 4 national insurance. This, obviously, represents a minimum saving of 8% on every penny earned for a limited company.

So, even with the slightly increased accounting costs involved with a limited company, it can be well worth considering the change for those who are still operating as sole traders. It's also worth noting that, under self assessment, you pay your tax six months in advance. Corporation tax, however, is currently paid nine months after the year end, giving you some quite favourable cash flow assistance.

Okay, so that's all very well, but how do you go about setting up a limited company? What does it involve? Is it more work or more expensive? Will you have to have an audit, register for VAT or find a company secretary?

The latest Companies Act 2006 has now completed the task of simplifying the limited company process, by, among other things, removing the requirement to have a company secretary, from 1 April 2008.

Other recent simplifications include:

- The audit requirement for small companies has been removed for companies whose turnover is below £5.6m. Also, smaller companies are only required to submit the most basic abbreviated accounts to Companies House, so your turnover, gross profit etc will not be a matter of public record.
- The requirement to have two directors has now also been removed.
- Limited companies were previously required to have at least two shareholders. This was, in reality, a bit of a pointless exercise, anyway, as business owners would simply issue 100 shares, 99 to themselves and 1 to their partner. This requirement has, once again, been removed.

The net effect of all of this is that, from April 2008, it is now possible to form and run a limited company with just one person, without the need to involve anyone else. The structure of the business, therefore, becomes as simple as that of a sole trader.

The other benefit of this is in the costs involved. The fact that most of us will never require an audit, will significantly reduce accountancy costs, and the simplified company structure means that you can now form a brand new limited company online from as little as £25.

expenses

If you are working from home, what expenses can you actually claim?

One thing that any small home based business owner will need to know is; "What expenses can I claim for running my business from home?" Surprisingly, there are no 'standard' or recognised methods of calculating these allowable expenses.

In the 'good old days', accountants would simply claim a global 'round sum' amount (often about £20 - £30 per month) to cover these costs, which was never challenged by HMRC, as it was not significant or worth amending.

However, in 2004, the limit of these round sum amounts was capped at £2 per week (or £104 per year). Anything above this rate was increasingly likely to trigger an investigation. In 2009 though, this was increased to (wait for it) a massive £3 per week.

If you feel that the £3 is insufficient (and who wouldn't) you can claim specific costs, based on actual expenditure, provided you can support your claim.

Main criteria

- You must actually work from home, and have a dedicated area for this work (doing the books on the kitchen table once a week simply won't cut it)
- Expenses must be 'wholly and exclusively' for the business. If mixed usage (part business, part personal) the business part must be separately identifiable.
- Where an area of the house is used partly for business, and partly for personal, the expenses will be apportioned by time used, as well as floor area utilised.

Calculating the 'business' element

As a general rule, you tend to apportion all of the property expenses on the basis of floor area utilised. In reality, this may be difficult to calculate, so it is perfectly acceptable to work on the basis of numbers of rooms in the house.

If, for example, you use one room for business purposes, and there are four further rooms, the business element will be 1/5, or 20% of the total running costs of the home. If you further estimate that this room is used 50% for business, and 50% personal, the percentage claimed will be halved to 10%.

what can you claim?

The following property expenses can be claimed:

- Light and heat
- Rent / mortgage interest
- Council tax
- Water rates
- Property insurance
- Cleaning
- Re-decoration and repairs (internal and external)

other claimable costs

In addition to your home, you can claim any expenses utilised ‘wholly and exclusively’ for the purposes of the business, including:

- Telephone (including line rental) apportioned by call time (incoming and outgoing). A dedicated business line can be claimed in full.
- Broadband (as telephone costs).
- Business insurance.
- Repairs to business equipment.
- Capital allowances (wear and tear) on business equipment (including computers and peripherals, office furniture and fixtures such as shelving etc). Annual Investment Allowance currently means that you can claim 100% of the cost in the first year, up to a capital cost of £100,000.
- Printing, stationery, postage and advertising.
- Computer software used for business.
- Travelling and subsistence costs (a whole topic in its own right). Subsistence relates only to yourself. Any entertaining of suppliers, business associates and, even, customers is totally disallowable.
- Motor expenses of running business vehicles (less any personal element).

Pitfalls

When claiming expenses relating to your home business, you need to be aware of some potential issues:

- Most mortgage companies ask you to stipulate whether or not there is a business element to your use of the property. You may need to be able to prove to them that you have separate business insurance to cover us for this.
- Running a business from home may attract the attention of the Valuation Office Agency who will determine whether or not a property will attract business rates. Guidelines for this can be found at: www.voa.gov.uk/council_tax/working_from_home.htm.

One major concern in the past has been that, if you claimed an area of your home as 100% business use, then, on sale, this element of the property would not be eligible for Principle Private Residence Relief, which could, potentially give rise to a Capital Gains Tax liability. In June 2008, however, HMRC announced that this would no longer apply, so, for now, you are no longer subject to any CGT on the sale of your house, One thing to be aware of here, though, is that, if you are running a substantial business from home, and the VOA determine that all, or part, of your house should be subject to business rates, then you may still be subject to CGT on that proportion of the home.

Legislation is constantly being updated, and the only piece of advice that never changes is; always check with your accountant, when looking to claim or calculate these expenses.

salaries

Some 60% of UK businesses are family owned, and most are based from home, so how can you use that to your advantage?

It used to be common practice to pay a spouse or partner a small wage, in order to utilise their tax free allowances, or lower rate tax banding (where applicable).

This loophole has now been partially closed, as any such salary must now be 'earned' by the partner. This can be difficult to prove when they have a full time job elsewhere.

One way around this, for limited companies, is to issue a number of shares to your partner, so that they are able to receive part of the dividend paid for the year. Dividends are not earned, so you don't have to prove that they work for you, nor are they liable to national insurance.

Alternatively, if they do actually play a part in the business (such as bookkeeping or administration) then a salary is permitted, as long as it is at a commercial rate. One of the best ways to prove this is to ensure that they sign the odd document, from time to time, such as letters, cheques, etc.

That's all very well, but what about the kids? Can you pay them a salary too? Everyone, including your children, has a tax free personal allowance of around £6,500, so can you use this to your advantage?

The simple answer is; "Yes", so here are a few of the basics:

The Children And Young Person's Act states that no person under 13 years of age may be employed, other than in very specific areas, such as acting, modelling and sporting activities, so employing your eight year old as head of marketing could just raise a few eyebrows.

Also, the national minimum wage doesn't need to be paid to workers in the family business, provided they are members of the employer's family, and share the family home. That said, the more you can pay them, within reason, the greater the expense, for tax purposes.

As with most things, common sense is the watch word here. You need to be able to argue that your kids are performing tasks that are well within their capabilities. Many, these days, are highly computer literate, and may have done work for you on your websites, spreadsheets, etc. Others may have helped you with despatching goods, filling mail shot envelopes, etc.

So, as long as your kids are over 13 and they perform appropriate tasks within your business, for a sensible salary there is nothing to stop you paying them for work done. This will reduce your business tax liability and boost or replace their pocket money which is, of course, paid by you out of taxed income.

So, you know what you can claim, but how do you record it all?

The fact is, there is no prescribed format for keeping records. The main criteria is that they must be sufficient to allow you to prepare your tax return, or to make a claim.

Records can be manual or prepared on your computer, but they must be supported by any relevant documentation, such as invoices, receipts and bank statements.

HMRC have identified three steps to remember when looking at bookkeeping:

- Set up a system. It doesn't matter what system you use as long as it keeps the information together is suitable to your business and is simple to use.
- Keep records throughout the year. Don't allow paperwork to pile up, and make sure records are complete and accurate.
- Keep your records for as long as required. The current minimum requirement is six years, so you must retain your records for at least that long.

Although the format of the records is not critical, there are many reasons why you need to maintain adequate records on an ongoing basis.

- It helps you to pay the right tax at the right time, thereby ensuring you don't pay too much tax, and that you avoid any penalties and interest.
- To provide you with the financial information you need to run your businesses.
- Better records will mean reduced accountancy costs.
- Better and up to date records will allow early and accurate calculation of your tax liability, thereby allowing you to budget more effectively for it.

Keeping records: a quick guide is available on the HMRC website, at www.hmrc.gov.uk/startingup/keeprecs.htm.

further details

HMRC has a 'Register as self-employed' page on its website, including details on 'Starting in business', 'The first steps' and 'Self employment and Self Assessment'. This can be found at:

www.hmrc.gov.uk/selfemployed/iwtregister-as-selfemployed.htm

There is a further page aimed at people thinking of starting up in business. This includes such things as; 'Starting Up In Business', 'Working For Yourself – The Guide', 'VAT Requirements' and 'Are Your Workers Employed or Self Employed'. This is available at:

www.hmrc.gov.uk/businesses/tmastarting-up-inbusiness.shtml

HMRC also has guidelines in place to determine whether, or not, what you are doing actually constitutes a trade (rather than, say, a hobby from which you might happen to earn a little money). These are known as the 'Badges of Trade', and can be found at:

www.hmrc.gov.uk/manuals/bimmanual/BIM20200.htm

Examples of what expenses you can claim for working from home, and how to calculate them are included in the HMRC guidance notes which can be found at:

www.hmrc.gov.uk/manuals/bimmanual/BIM47825.htm

As well as the 'quick guide' to keeping records, there is a page on the HMRC website that covers all aspects of record keeping, including individuals, directors, partners, self employed, corporation tax and VAT. Check it out at:

www.hmrc.gov.uk/record-keeping/index.htm



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