

# Understanding tax

Death and taxes – the two things in life you can always count on! If you don't pay the right amount of tax or fail to meet the deadlines, you will face fines or legal action which could seriously damage your business.

Previously known as the Inland Revenue, HM Revenue & Customs (HMRC) is the main body for collecting taxes in the UK. The four main types of tax relevant to most businesses are:

<b>Income tax</b>	Paid by self-employed sole traders and partnerships. The amount is based on the business's earnings.
<b>Corporation tax</b>	Paid by limited companies. The amount is based on the company's profits.
<b>National Insurance (NI)</b>	Paid by all businesses. The amount is based on a contribution for each employee of the business, including the owner. NI is used to fund future state benefits such as your state pension.
<b>Value Added Tax (VAT)</b>	Paid by business with a turnover over the VAT threshold (£60,000 for 2004/5 tax year however you'll need to check with HMRC what the VAT threshold is each tax year as it can change from year to year). VAT is a tax on sales of goods and services.

The types of tax issues you'll have to think about will depend on:

- the legal form of business you have set up – sole trader, partnership or limited company
- if your business employs other people
- if your business's turnover exceeds the VAT limit

When you start up your business you should register with HMRC for tax purposes. HMRC is a great source of information, advice and guidance on everything to do with tax. Call them on 0845 915 4515 or visit their website [www.hmrc.gov.uk](http://www.hmrc.gov.uk) for information packs and to find out where free workshops for small businesses are running in your area.

You'll also need to keep good records of your income and expenditure. It's your responsibility to make sure all necessary tax returns are completed on time, NI contributions are paid and the tax arrangements for your employees are in place.

## Self-employed (sole traders and partnerships)

Sole traders and partners are classed as self-employed so they pay income tax on the profit that their businesses make. In partnerships, each partner is taxed on the profits they take from the business (split according to the terms agreed in their deed of partnership).

As a sole trader or partner you have to:

- register with HMRC as self-employed. Call 0845 915 4515 as soon as you start or within the first three months; failure to do so can lead to penalty fines.
- complete an individual self assessment tax return every year. The partnership (as well as the individual partners) must also complete a self assessment tax return.
  - HMRC will send you a tax return soon after the end of each tax year (5 April).
  - if you want HMRC to calculate tax for you, the form must be returned by 30 September. If you are happy to calculate the tax yourself, the form should be returned by 31 January.
  - payment deadlines are normally 31 January and 31 July.
  - contact the self assessment helpline on 0845 900 0444 for more information.

- pay your own Class 2 and Class 4 NI contributions.
  - class 2 NI is a fixed weekly amount collected normally by direct debit.
  - class 4 NI is a percentage of your taxable profits which is included on your tax return.

## Limited company

If your business is registered as a limited company then you will pay corporation tax on any profits you make. The rate of corporation tax depends on the level of profits the business makes. For example, in the 2004/5 tax year a small business with profits per year between £50,001 and £300,000 pays corporation tax at a rate of 19% (this is the correct rate for the 2004/5 tax year however you'll need to check with HMRC what the rates are in each tax year as they can change from year to year).

As a limited company you must:

- notify HMRC that your company exists and that it is liable for tax. Find your local HMRC office from their website [www.hmrc.gov.uk](http://www.hmrc.gov.uk). Failure to do this may lead to penalty fines.
- file a self assessment Company Tax Return for your company.
  - You will need to calculate how much corporation tax the company owes and pay it without prior assessment by HMRC.
  - there are penalties if the company does not deliver a return by the statutory filing date, normally 12 months after the end of the **accounting period**.

**Accounting period:** describes the period (normally 12 months) of a company's accounts

As a director of the company you will need to:

- pay income tax on your salary
- pay NI contributions

# Employees

**PAYE:** Pay As You Earn is the HMRC's system for collecting income tax from the pay of employees, including directors, as they earn it

When you employ someone in your business, you need to inform HMRC and take on certain responsibilities for deducting income tax (using the **PAYE** scheme) and NI contributions from your employees' wages.

With PAYE you deduct income tax from your employees' wages over the year to meet their tax liability. The amount you need to deduct is calculated using PAYE tax codes provided by HMRC for each employee. You also have to deduct NI contributions from your employees' wages.

You should calculate employees' PAYE and NI contributions on each pay day. These deductions must then be paid to HMRC, usually monthly or quarterly. At the end of the tax year you need to inform HMRC how much each employee earned and what PAYE and NI contributions you have deducted.

For more information call the HMRC telephone helpline for new employers on 0845 607 0143.

# VAT

If your business's turnover in a financial year is more than the **VAT** threshold (£60,000 for the 2004/5 tax year however you'll need to check with HMRC what the VAT threshold is each tax year as it can change from year to year), you must register with HMRC as a 'taxable person'.

**VAT:** Value Added Tax is a tax on sales of goods and services – it is not a tax on your business's profits

VAT is normally paid to HMRC quarterly. To work out the amount you need to pay, or get as a refund, you calculate:

- your input tax (A): the VAT paid on goods and services for your business.
- your output tax (B): the VAT you charge customers on the goods and services your business sells.

→ you must then deduct the input tax from the output tax ( $A-B=C$ ) and pay the difference (C) to HMRC.

There are four categories of goods and services:

- **standard rate** - VAT is charged at 17.5% (most goods and services)
- **reduced rate** - VAT is charged at 5% (for example domestic fuel)
- **zero rate** - VAT is charged at 0% (for example children's clothing and footwear)
- **exempt** - VAT is not payable (for example insurance)

For more information on VAT contact HMRC on 0845 010 9000.

## Record keeping

Good records will help you keep track of your budget and expenses but there are also legal requirements to store certain documents for a minimum period of time.






The types of records your company needs to keep will depend on its size but to begin with it's safer to keep everything for at least five years. If your business is set up as a limited company, employs other people or is VAT registered it will have to maintain different types of records and for longer periods.

Although it will vary from business to business, the common types of records that must be kept include:

- records of money paid into the business (for example daily cash sales, sales invoices paid by customers or the money received from a loan).
- records of money drawn from the business (for example purchases of stock or equipment, telephone and electricity bills, rent or loan repayments).
- bank statements and cheque book stubs.

HMRC has a series of leaflets which give more detailed advice. You can get hold of a copy by calling 0845 010 9000.

# Top tips

-  Tax is a crucial source of money for the Government, so HMRC's approach is strict. Make sure that any tax-related records are well organised and that you keep payments up to date and on time.
-  Keep all receipts and paper records of sales, purchases and wages in case they are required for a tax inspection.
-  Incorrect or fraudulent tax returns incur fines, even if submitted on time. To prevent these extra charges you must not only meet the deadlines but ensure the accuracy of the figures submitted too.
-  Check what changes are made to tax rates and allowances when the Chancellor of the Exchequer announces the annual Budget every April. These rates are subject to change every year and will determine how much tax you should plan to pay.
-  If you need help, talk to an accountant immediately – before your tax-related concerns grow into problems.

Many of our loans benefit from a guarantee provided by the European Investment Fund under the European Community's Multiannual Programme for small and medium sized enterprises.



Prince's Trust

The Prince's Trust  
Head Office,  
18 Park Square East  
London NW1 4LH  
Tel 020 7543 1234  
Fax 020 7543 1200  
Minicom 020 7543 1374  
Email [info@princes-trust.org.uk](mailto:info@princes-trust.org.uk)

Call our freephone number  
on 0800 842 842 and we'll  
put you straight through to  
your local office.