

Introduction

Some of the decisions and actions that a person has to take when starting a business can have significant effects for some time. The foundations put in place at the beginning of the business are very important, and can affect its survival. This section briefly describes some of the main tax and financial considerations in starting an unincorporated business. An individual intending to start a business must also:

- Conduct a thorough review of the market.
- Formulate forecasts into a business plan.
- Obtain any necessary finance.

These matters are not covered in this section.

Trading vehicle

The businessperson must decide whether to trade as an unincorporated business or to incorporate. A limited company might not be initially attractive for several reasons, including the following:

- Limited liability provides relatively little protection for shareholders who are also directors if banks, other providers of finance or trade creditors require personal guarantees.
- The costs for limited companies of complying with company law requirements are greater than accounting and compliance costs for sole traders or partnerships.
- The tax, national insurance and financial position of a sole trader is generally more flexible than for a limited company.
- The special tax and national insurance rules for personal service companies, usually referred to as IR35 companies, add an additional layer of complexity.

On the other hand, the rate of corporation tax for small companies is considerably less than the 40% higher rate of income tax. A company with profits up to £300,000 currently pays corporation tax at 21%. A company might therefore be attractive where the owner does not need to withdraw all or most of the profits as remuneration, which would be liable to income tax and national insurance contributions (NICs).

Profits can often be paid as dividends, which are not liable to national insurance. There are many other matters that have to be considered in deciding whether and when to incorporate. These are the subject of "Incorporation: the advantages, disadvantages and pitfalls" on page 1. The remainder of this section deals only with unincorporated businesses.

Income tax and national insurance

Registration

It is essential to register as self-employed with HM Revenue and Customs (HMRC) as soon as possible after the business starts.

- A person will be liable to a penalty if they do not notify their liability for Class 2 NIC by 31 January after the end of the tax year in which they become liable. That penalty may be up to 100% of the NIC unpaid as a result of the failure to register.
- Similar penalties may be charged in relation to income tax paid late as a result of failing to register by 5 October following the tax year in which self-employment started.

The registration procedure covers income tax and NIC (see page 6, “National insurance contributions”).

- It is possible to register by telephoning the special HMRC helpline for the newly self-employed: 0845 915 4515 between 8am and 8pm, Monday to Friday and 8am to 4pm, Saturday and Sunday.
- Alternatively one can complete the form CWF1 at the back of the HMRC leaflet SE1, *Thinking of working for yourself?* The leaflet also includes a form for registering to pay Class 2 NIC – the basic flat rate contributions – by direct debit.
- The registration form can be taken to any HMRC office or sent to:

National Insurance Contributions Office Self-Employment Services Application Processing Centre
Longbenton Newcastle upon Tyne NE98 1ZZ

HMRC will issue a self-assessment tax return in the April following the start of the business and every April thereafter.

Tax returns and tax payments

The tax return must normally be completed and sent back to HMRC by 31 October following the end of the tax year if filed on paper and by the following 31 January if filed online.

- The return must include all the taxpayer’s income from all sources and any capital gains.
- Taxpayers filing on paper can choose whether to calculate their own tax liability or ask HMRC to do it. Returns filed online automatically include a calculation.
- HMRC will calculate the liability to tax and Class 4 NIC before the due date for payment if a paper return is filed by the due date of 31 October.
- If HMRC issues a tax return after 31 October following the end of the tax year, then it must be submitted within three months of the date of issue. The same rule applies to returns issued after 31 July and filed on paper.
- There is an automatic penalty of £100 where a return is made late, unless the taxpayer has a reasonable excuse for the return being late. If the return is six months late, another penalty of £100 is charged. These penalties are reduced to the amount of the tax liability if that is less. There are also provisions for daily penalties and a tax-gear penalty in some circumstances.

Tax payments

All income tax and Class 4 NIC for the year ended 5 April must normally be paid by the following 31 January.

- Interest is charged on amounts outstanding after that date.
- In addition, a 5% surcharge is payable on any tax and Class 4 NIC paid more than 28 days late (that is, normally, after 28 February following the tax year). A further 5% surcharge is payable on any tax and Class 4 NIC not paid six months after the due date (that is, normally, 31 July).
- Payments on account (or interim payments) may be required on 31 January in the tax year and the following 31 July.
 - Each interim payment is normally half the amount of the income tax and Class 4 NIC payable for the preceding year.
 - The taxpayer can request that the interim payment be reduced to half the current year’s liability if that is likely to be less.

- Interest is charged on late payments on account.
- Individuals starting in business do not, in practice, have to make payments on account in the tax year in which the business starts, unless they had tax to pay under self-assessment in the previous year (for example, because they had a previous business or a large amount of investment income taxable at the higher rates). People sometimes think this means the first year's profits are exempt from tax but this is not the case.
- It is important to make provision for tax liabilities as soon as possible from the start of the business. Normally, new businesses have to pay the equivalent of 150% of the first year's tax liability in one lump sum on 31 January following the first tax year because they have not made interim payments.

Basis of assessment

A self-employed person is normally taxed on the profits of the accounting period ending in the tax year. For example, the profits of the year ended 31 December 2009 are taxed in 2009/10 (tax year ended 5 April 2010) and have to be shown on the 2009/10 tax return, due on 31 January 2011 if filed online and on 31 October 2010 if filed on paper. There are special rules for the first two tax years in which the business is carried on.

- The first year's tax assessment is on the profits earned from the start of trading to the following 5 April.
- The second year's assessment is normally on:
 - The profits of the 12 months ending on the chosen accounting date in that tax year.
 - The profits of the first 12 months of trading where the accounting date is less than 12 months after the start of the business.

Overlap profits

The rules for the first two years can result in some profits being taxed twice. These are known as overlap profits. Relief for this double taxation will not normally be given until the business ends. However, a change of accounting date could result in earlier relief for overlap profits.

Example

Paula started trading on 1 October 2009, making up accounts to 30 September. The trading profits are:

Year ended 30 September 2010	£16,000
Year ended 30 September 2011	£18,000
2009/10 assessment	
1.10.09 to 5.4.10: $6/12 \times £16,000$	£ 8,000
2010/11 assessment	
12 months to 30.9.10	£16,000

So £24,000 has been taxed in respect of the £16,000 earned in the first year. This means that there are 'overlap profits' of £8,000, which are carried forward and can only be relieved in full:

When trading ends sometime in the future, or

On a change of accounting date that results in more than 12 months of profits being taxed for a tax year.

2011/12 assessment

12 months to 30.9.11

£18,000

Choosing an accounting date

The existence of overlap profits and the special rules for when a business stops trading mean that the choice of accounting date is not straightforward.

- Many businesses will want to prepare their accounts to 31 March or 5 April. This is the most straightforward and avoids both overlap profits and an abnormally large assessment for the final year of trading.
- For example, a business makes up its accounts to 30 June each year and stops trading on 31 January 2011.
 - The assessment for the tax year 2009/10 will be on the profits of the year ended 30 June 2009.
 - In the final tax year, 2010/11, the tax assessment will be on the profits of the period 1 July 2009 to 31 January 2011, the full 19 months since the accounting period taxed in the previous year.
 - The taxpayer can deduct overlap profits brought forward from when the business started. However, where the profits earned early in the business were comparatively small, the overlap relief will also be small, leaving a large assessment for the final year.
 - The taxpayer might also have other income, such as a pension or employment earnings, after the end of the business up to the following 5 April. Such income must be included in the tax return for the final year of the business and could increase the tax payable on the business profits.
- If the accounting date of the business is 31 March, then a business that ends on 31 January 2011, for example, would be taxed as follows:
 - The assessment for 2009/10 will be on the profits of the year ended 31 March 2010.
 - The assessment for the final tax year, 2010/11, will be on the profits earned in the ten months from 1 April 2010 to 31 January 2011.
 - So the taxpayer can never be taxed on more than 12 months' income.
- For partnerships, an accounting date of 31 March or 5 April makes the calculations much easier when partners join or leave the firm, and avoids the need to include estimated figures in tax returns.
- There are some disadvantages of an accounting date ending late in a tax year, for example, 31 March:

- There may be only seven months from the end of the accounting period up to the date the tax return has to be sent to HMRC (ten months for internet filing).
- In contrast, a business with a 30 April year end will have at least 19 months to complete tax returns.
- Similarly, tax is payable sooner after the profits have been earned, giving a cashflow disadvantage if profits are rising.
- It is more difficult to decide whether to request a reduction in payments on account before the payments are due, because the amount of profits will not be known in time.
- The annual limit on contributions to registered pension schemes is 100% of earnings of the year (or £3,600 if greater). Anyone who wants to maximise their pension contributions needs to know the amount of earnings before the end of the tax year.
- The opportunity to claim child tax credit and working tax credit may be missed. Entitlement to these credits is based on income of the tax year, but claims cannot be backdated by more than three months. A taxpayer with a late accounting date may not realise that a claim is worthwhile until late in the tax year. It is possible to make annual claims regardless of income, just to protect the right to a tax credit award if income turns out to be low enough, but this obviously involves extra work.
- A late accounting date also makes it more difficult for a claimant to provide confirmation of income after the end of the tax year by the due date of 31 July, but estimates can be used and the final figures provided later.

Minimising tax

There are a number of ways of reducing tax, especially at the start of the business, when cashflow might be tight.

- If the accounting date is not at the end of the tax year, some of the profits of the first accounting period are taxed twice. In these circumstances, it can be advantageous to maximise expenditure deductible against income during the first period of trading so as to minimise the profits.
 - An individual could employ a spouse for the first year, and also perhaps pay a pension premium for their benefit.
 - The remuneration paid to the spouse must be justifiable in relation to the duties performed, and the spouse's own tax position must be considered.
 - Up to £50,000 a year of expenditure on most types of business equipment is deductible in full against profits – the annual investment allowance (AIA). Making such purchases in the first year can increase the amount of income relieved.
 - Where capital allowances are only given at 20% or 10%, for example, on most cars, or where financial considerations do not permit purchase of expensive equipment in the first year, the business could lease assets rather than buy them outright.
 - For cars leased from 1 April 2009, the whole leasing cost may be deductible from taxable income, subject to a disallowance of 15% of the lease rental payments on cars with carbon dioxide (CO₂) emissions above 160g/km.
- Making payments into registered pension schemes will reduce the tax liability of any individual subject to higher rate tax – see page 12, "Pensions and private insurance".

Pre-trading expenditure

Costs will often be incurred before the business has started trading.

- Income tax relief is given, provided the expenditure is of a revenue nature and incurred for the business within seven years before starting to trade. It is therefore important to keep a record of such expenditure.
- Pre-trading expenditure is deducted as an expense on the first day of trading.

Introduction of private assets

Where an individual introduces private assets into a business, the appropriate tax relief is available.

- Where the assets become trading stock, they should be introduced at their market value. This could exceptionally give rise to a capital gains tax (CGT) charge and advice should be taken.
- Capital allowances are available on a car previously used privately. Normally the car is introduced into the business at its market value at the time and the allowances calculated accordingly.

Goods for own use

If a self-employed person takes business goods for their own use, the correct accounting treatment is to include as income their cost price or the amount the person pays to take the goods out of the business.

- For tax purposes, the trading profit must be adjusted to replace the figure included in the accounts by the market value of the goods.
- If significant amounts are involved, for example, if a builder constructs or renovates a property for their own use, it is advisable for all costs to be met privately, rather than through the business. Any labour diverted from the business should be paid for at market value.

In all cases, the VAT implications must also be considered.

National insurance contributions

A self-employed individual or partner is liable to both Class 2 and Class 4 contributions.

- Class 2 contributions are a flat rate of £2.40 a week for 2009/10, payable by monthly direct debit or quarterly bill. If profits are expected to be below the small earnings exception limit (£5,075 a year for 2009/10), contributions do not have to be paid. Individuals over state pension age do not pay Class 2 NICs.
- Class 4 contributions are based on taxable profits and are payable for 2009/10 at 8% on profits between £5,715 and £43,875 and 1% on profits above this. They are payable with the income tax for the year, and the liability is included on the tax return.
- Self-employed NICs give entitlement to the basic state pension but not to the State Second Pension (S2P). A person in business should consider making personal pension payments.
- Self-employed NICs do not give entitlement to jobseeker's allowance or more than a flat rate incapacity benefit. Therefore separate insurance cover should be considered.

Losses in early years

Special tax relief is available where a business incurs a loss in any of its first four tax years.

- The loss relief is given against the income of the previous three years of assessment. Thus losses incurred in the trade can be carried back and set against earned or unearned income of earlier years.
- The losses are carried back against the income of the earliest year first.
- This relief is an alternative to the general relief that allows a loss to be offset against other income of the tax year in which the loss occurred or carried forward, and to the temporary extended loss relief which has been introduced recently, under which losses of up to £50,000 can be carried back up to three years.

The best way of relieving any loss will depend on the individual's or partner's personal circumstances. The claim must be made within 12 months after 31 January following the year of the loss.

Partnerships

Individual partners are treated in effect as if they are sole traders.

- They must register with HMRC if they join a partnership and pay their own Class 2 NICs.
- They must declare their share of the partnership profits on their tax returns and calculate and pay their own tax and Class 4 NICs.
- The partnership must complete partnership returns showing partnership income and expenditure, and profit allocations.

Capital allowances

Some types of capital expenditure can benefit from tax relief by means of capital allowances. The most important allowances are for plant and machinery, which includes fixtures and fittings and motor vehicles.

- Up to £50,000 a year of expenditure on most types of plant and machinery is deductible in full against profits. This is the annual investment allowance (AIA).
- A business that spends more than £50,000 on equipment can claim a first year allowance (FYA) of 40% on expenditure on general plant and machinery between 6 April 2009 and 5 April 2010.
- A writing down allowance (WDA) of 20% can be claimed on any balance of expenditure on plant and machinery brought forward from previous years and purchase costs in excess of the £50,000 AIA that do not qualify for the temporary FYA.
 - The balance brought forward is basically the original costs less the allowances previously given.
 - Balances brought forward of £1,000 or less can be deducted in full.
 - Cars do not qualify for the AIA but do qualify for the 20% writing down allowance if their CO₂ emissions are 160g/km or less.
 - The rate of WDA is 10% instead of 20% for 'long-life assets', thermal insulation and equipment that is an integral feature of a building, for example, electrical and water systems.
 - The rate is also 10% for cars with CO₂ emissions above 160g/km.

- Where an asset, such as a car, is used privately as well as for business, only the business proportion of the capital allowances can be claimed.
- A FYA of 100% is available until 31 March 2013 for new cars that emit not more than 110g/km of CO₂ or are electrically propelled.
- A 100% allowance is also given on designated energy-saving equipment and on designated water-efficient equipment.
- Capital allowances are deducted as a trading expense in calculating taxable profits.
- Where capital expenditure is incurred before the business starts, the allowance is given as if the expenditure had been incurred on the first day of trading. The rate of allowance is determined by the date on which the expenditure was actually incurred.

Value added tax

It is important to understand the VAT rules in the very early stages of the development of the business.

HMRC leaflets, in particular, *Should I be Registered for VAT?* are recommended as introductory reading.

See also page 1, "General Principles of Value Added Tax".

Registration

VAT is a tax on business turnover. Every business must register for VAT if its taxable supplies (ie business income on which VAT would have to be charged, including zero rated supplies) are more than the registration thresholds. These thresholds are normally increased in line with inflation each year. Since 1 May 2009, the registration limit has been £68,000.

Normally a business has to consider its taxable turnover over the previous 12 months, unless at any time taxable supplies are expected to be more than £68,000 within the following 30 days.

Registration is compulsory if:

- At the end of any month, the total value of taxable supplies made in the past 12 months or shorter period is more than £68,000. In that case, a form VAT1 must be completed and sent to HMRC within 30 days. The date of registration is the first day of the second month following the month in which the turnover limit was exceeded.

Example

Limit exceeded in month ending	Notify on VAT1 by	Registration date
31 January	2 March	1 March
31 August	30 September	1 October

- At any time there are reasonable grounds for believing that taxable supplies of more than £68,000 will be made within the next 30 days. The date of registration is the date when it is known that the limit will be exceeded.

Some VAT incurred on purchases before registration can be reclaimed, and it is important to identify this. In particular, tax on services that have been bought can only be reclaimed if they were supplied no more than six months before the date of registration.

Penalties

Every non-registered business must watch the threshold very closely. If a business should have been registered at an earlier date, HMRC will levy VAT on the business turnover from the date it should have been registered, less any allowable VAT incurred on purchases.

A penalty might be charged as well, unless the business has a reasonable excuse for its failure to register. Ignorance of the VAT rules is not an excuse.

Voluntary registration

If a business with a turnover of less than the registration limit wishes to register, then it can usually do so. An obvious advantage of 'voluntary registration' is that VAT on purchases can be recovered, whereas an unregistered business can only obtain relief if the cost of VAT can be deducted when calculating taxable profits.

- In general, when supplying goods and services to the public, non-registration will give a competitive edge and might increase profits, although this depends on the amount of VAT on purchases that cannot be reclaimed.
- Goods and services from non-registered suppliers might not be attractive to VAT-registered customers, because this will normally increase the cost to them. The reason is that the non-registered trader's prices will have to take account of the VAT on purchases that cannot be reclaimed.
- Non-registration also indicates that the business is small and might reduce credibility.

Accounting for VAT

Every VAT-registered person must account for 'output' VAT on the value of their taxable business supplies.

- Most outputs are standard rated. VAT was charged at 17.5% up to 30 November 2008 and at 15% after that date. The standard rate will revert to 17.5% on 1 January 2010.
- A few outputs are rated at 5%, for example, certain residential property renovations.
- Some outputs are zero rated. They are still taxable but at the zero rate of VAT.
- Other outputs are exempt from VAT. This means that no VAT is charged.

The important distinction between an exempt output and a zero rated output is that VAT on purchases can be recovered if they relate to zero rated supplies, because they are taxable, but not if they relate to exempt outputs.

It is important that every business determines the correct rate or rates of VAT on its outputs at an early stage, so that it charges all the VAT it must pay to HMRC, and restricts its claims for input VAT to the portion reclaimable.

There are penalties for large under-declarations of VAT, unless there is a reasonable excuse. There are also interest charges where VAT is paid late.

The VAT return

A return of the value of outputs less inputs must normally be completed on a quarterly basis and sent in within a month of the end of the quarter. Businesses can submit VAT returns online. If they do so, the filing deadline is up to seven days later. Online filing will be compulsory from 2010 for all businesses with turnover over £100,000 and all newly registered businesses. There is further information about online filing at www.hmrc.gov.uk/vat/ret-online.htm.

Where output VAT exceeds input VAT, the balance must be paid to HMRC within a month of the end of the quarter, or up to seven days later if paying electronically. Businesses that file VAT returns online must pay electronically. There is a penalty system if returns or payments are late. HMRC will accept monthly, rather than quarterly, returns provided this is agreed with them in advance.

The extra paperwork can be worthwhile if the business consistently reclaims VAT. This would occur where a business mainly makes zero rated supplies, so that the value of inputs is more than the value of output VAT on any standard rated sales.

Small businesses – annual accounting

Small businesses with a turnover of up to £1,350,000 can use an annual VAT accounting system. Nine equal monthly payments are made by direct debit (based on an estimate of the total VAT due) and the tenth payment, to balance the account, is sent in with the annual return.

Cash accounting

Small businesses can account for VAT on a cash paid and received basis, rather than on an accruals basis, if their turnover is likely to be not more than £1,350,000. Where a small business has to wait a considerable period to be paid by its customers, this method of accounting might be beneficial.

Flat rate scheme

An optional flat rate VAT scheme is available for businesses with taxable turnover of up to £150,000. The scheme allows businesses to pay VAT at a flat rate on the whole of their turnover. The rate is determined by trade sector.

- The advantage to businesses is that it simplifies accounting for VAT.
- However, some businesses will inevitably pay more VAT under the scheme. Whether it is beneficial for a business to adopt the scheme should be considered in the light of the taxable and exempt turnover of that business, the VAT on expenditure that could otherwise be offset, and the relative importance of the administrative convenience.

Special schemes

There are several special schemes which retailers can use to apportion sales that are both standard rated and zero rated. Discussion of the schemes themselves is outside the scope of this section – refer to VAT Notice 727.

Partial exemption

A business that makes both exempt and taxable supplies has to make sure that it keeps adequate records of its supplies and purchases.

- The book keeping system should allow for purchases to be segregated into those relating to exempt supplies and those relating to standard rated or zero rated supplies.
- Only input VAT on supplies directly attributable to taxable outputs can be reclaimed.
- Where the input VAT relates to a general supply and cannot be directly attributed, only a proportion of the VAT can be reclaimed.
- The full VAT can be recovered where the VAT relating to exempt supplies is not more than £7,500 a year, and at least 50% of the total input tax incurred relates to taxable supplies.

This is explained in more detail in VAT Notice 706, *Partial Exemption*.

Buying an existing business

There are special VAT rules where an individual starts up in business by taking over an existing concern.

- If various conditions are satisfied, VAT will not be charged on any of the assets purchased.
- HMRC will allow the new owner to take over the previous owner's VAT registration number.
- This should normally be resisted because the new owner takes over not only the VAT number, but also the previous owner's liabilities to HMRC.
- The new owner should ask for a new VAT registration number. Further information can be found in VAT leaflet, *Transfer of a Business as a Going Concern*.

Taking on employees

If a new business takes on employees, it is important that the employer appreciates the burden of complying with the PAYE regulations.

Complying with PAYE

Employers must deduct income tax and employee's NIC from salaries, and account for this to the Collector of Taxes, together with employer's NIC.

- Amounts must be paid 14 days after the end of each tax month, ie by the 19th of each month, with an extension to the 22nd if paying electronically.
- Interest can be charged on amounts paid later than 19 April following the tax year (22 April for electronic payments).
- If the employer fails to deduct the full amount of PAYE tax and NIC that is due, the employer will still have to pay the full amount to HMRC and might not be able to recover it from the employee.
- If the monthly payments of tax and NIC average less than £1,500 a month, the employer can pay quarterly.
- Annual PAYE returns must be made by 19 May following the tax year, with automatic penalties for non-compliance. Returns of benefits in kind provided for employees and expenses paid to them (P11Ds and P9Ds) are due by 6 July and penalties can be levied for lateness and errors, up to £3,000 for each incorrect form.
- All employers will have to file annual PAYE returns electronically by 2010 and there will be a penalty of up to £3,000 for failing to do so (on top of the existing late filing penalties). Employers with 50 or more employees must already file electronically.
- Employer's NIC on benefits in kind is due by 19 July after the end of the tax year, with the return of benefits (form P11D(b)) due by 6 July.
- As HMRC conducts PAYE audits, any errors made by the employer are likely to be discovered eventually.

It is advisable to register as an employer with HMRC before taking on any employees. HMRC will then send all the necessary information to enable the employer to comply with the obligations.

Self-employed labour

One way to avoid PAYE and NIC regulations is to use self-employed labour, but this can involve complications and risks.

- HMRC will want to be satisfied that the self-employed people are indeed genuinely self-employed, and not employees in another guise.
- Employers could find it very difficult to convince HMRC that people are self-employed.
- If HMRC thinks that people are not self-employed, the employer could have to pay a considerable sum of income tax and NIC that should have been deducted under the PAYE system. The employer is unlikely to be able to recover it from the employee and might not even get credit for the tax the employee has paid on a self-employed basis unless the employee has given a written undertaking not to seek repayment of the self-employed tax from HMRC.

If there is any doubt whether a potential recruit should properly be treated as employed or self-employed, the employer should contact HMRC for a ruling.

Spouse as employee

It is normally worth ensuring that both husband and wife have income so as to make use of the personal tax allowances. For example, many self-employed business people pay their spouses a salary for help in running the business, if the spouse is not separately employed or self-employed.

- It is normally possible to justify an annual salary of, say, £3,000 for answering the telephone, making appointments, helping with administration, etc.
- HMRC does insist that the salary is actually paid to the spouse.
- Unless the spouse has other income, the salary would be covered by their personal allowance and will therefore save tax.
- A salary between the NIC lower earnings limit and the earnings threshold will not require any NIC payments but will give entitlement to benefits including the basic state pension and S2P. Furthermore, the S2P benefit will accrue as if earnings were £13,900 a year. For 2009/10, the salary should be between £95 and £110 a week.
- Where spouses are heavily involved in the business, it might be better to bring them in as partners so that they can share in the profits without the need to pay tax and NICs under PAYE, although they will of course have to pay tax and Class 4 NIC on their profit share and will not accrue S2P benefits.

Pensions and private insurance

Self-employed NICs give entitlement only to the basic state pension in retirement. It is therefore important to make additional provision.

Pension

Contributions to registered pension schemes receive favourable tax treatment.

- Individuals can contribute up to 100% of their earnings to their pension schemes each year up to a maximum of £245,000 in 2009/10. This limit will rise to £255,000 in 2010/11 and stay at that level for the following five years.
- People with little or no earnings can contribute up to £3,600 a year.

- There is a maximum permitted tax-exempt fund, or its equivalent in retirement benefits. This is called the lifetime allowance and is £1.75 million in 2009/10. It will rise to £1.8 million in 2010/11 and stay at that level for the following five years.
- Basic rate tax relief at 20% is normally given by deducting it from the pension payment. So a person who wishes to add £3,600 to a pension plan would pay £2,880. The pension administrator would then go to HMRC to recover the £720 deducted.
- Higher rate tax relief is given in the individual's self-assessment.
- Contributions are often paid without deducting tax to pension plans that started before July 1988. Basic and higher rate tax relief are given in the self-assessment.

Private insurance

Self-employed people, not being employees, are not covered under any employer's sick pay, medical insurance or group life schemes; and few state benefits are available to them. For these reasons, self-employed people should consider the following personal insurances when starting in business or at least as soon as profits and cashflow allow:

- **Term life insurance** This is the cheapest type of life cover and can be for any number of years, for example, 10 or 15 years. There is normally no tax relief on the premiums paid, even if the policy is part of an individual pension arrangement.
- **Income protection insurance** There is normally no tax relief on the premiums paid (but benefits are normally tax-free).
- **Private medical insurance** There is normally no tax relief on the premiums paid.

In addition, taxpayers should consider whether their spouses should be insured, particularly if they have young families.

Setting up an accounting system and debt control

Perhaps one of the greatest disadvantages of being self-employed is the amount of paperwork needed to comply with statutory regulations, for example, PAYE and VAT.

Accounts have to be prepared not only so that the tax return can be completed, but because the bank will want to see them if the business needs credit facilities, and generally so that the businessperson can see how well the business is doing and identify any areas that could be improved.

Accounting records

It is vital that a business sets up an accounting system that is suitable for its needs. It does not matter whether physical books are used or specialist accounting software, as long as all transactions are recorded accurately.

- From a tax point of view, it is a statutory requirement to keep adequate business records. In extreme cases, penalties of up to £3,000 may be levied for a failure to do so. Business records and associated personal tax records should normally be kept until five years after 31 January following the tax year.
- It is essential to separate business and personal finances. Except for the simplest forms of self-employment, a separate business bank account is a must.
- If records are kept on a computer, it is important to back up data regularly.

- Whatever books are kept, original invoices and receipts should also be retained as evidence. Where receipts are not available, for example, for small items of cash expenditure, details should be recorded as soon as possible after the expense.
- As an alternative to the more formal books of accounts detailed below, a business could operate quite efficiently by using, for example, the 'Simplex' range of books, plus a sound filing system for invoices so as to keep track of sales, statements, etc.
- Whatever system is adopted, it must be maintained regularly to provide accurate details of the trading performance.
- If the business deals in second-hand goods, a comprehensive stock book has to be maintained so that the correct amount of output VAT can be calculated (see page 1, "VAT Margin Scheme for Second-Hand Goods" and the relevant HMRC leaflets).
- For dealers specialising in low value bulk volume goods, for example, stamps, a method of global accounting has been introduced for VAT purposes.

A list of the main business books and their purpose follows. Alternatively, many different computer accounting packages are available, which incorporate the standard business books. You should discuss your business requirements with a specialist computer centre or your accountant.

Cash book

To record all payments made into, and amounts drawn from, the business bank account. The cash book should be reconciled regularly with the bank statements.

Petty cash book

To record all small amounts of cash expenditure. A float of money should be maintained and replenished at the end of each week or month as necessary.

Sales book

To record sales invoices or daily cash takings. This book can be used to note amounts banked and cash in hand.

Purchases book

To record all purchases.

Ledgers

Where the business is offering credit to customers, it should maintain a debtors' ledger, to record details of transactions with each customer – for example, invoices, credit notes and payments received. Similarly, a purchase ledger should be maintained if the business has several suppliers. These ledgers must be reconciled regularly with the sales and purchase day books.

Wages book

This is essential to maintain a record of all payments to employees, as well as details of deductions made.

VAT book

A record summarising the make-up of amounts included in each VAT return is helpful to satisfy HMRC that VAT has been accounted for correctly.

Debt control

Cashflow

Cashflow is one of the biggest problems encountered by small businesses, in common with many large concerns. The problem is particularly significant in the current deteriorating economic environment. If a small business allows its customers unlimited credit, it will soon collapse through lack of cash or because its debtors have become bankrupt. It is essential, therefore, that a new business establishes a system of debt control.

- The debtors' ledger is essential for debt control.
- Even more important is to establish the creditworthiness of potential customers. This may be done either by contacting a credit agency or by asking your bank to carry out investigations. Where possible, take up credit references.

Factoring

Businesses can consider 'factoring' to give a cashflow benefit.

- Factoring essentially means that a finance house or bank buys the outstanding debts of a business and collects them for itself.
- The factor will deduct a percentage of the total debt as a fee and the business is relieved of both the risk and effort associated with debt collection.

Bad debts

Specific bad debts are deductible in calculating taxable profits.

- The VAT element of the debt is normally paid to HMRC at the time of the original invoice. If the debt is still unpaid six months after payment is due, a claim for relief can be made.
- There is automatic relief where cash accounting is used, because the VAT element would not be paid to HMRC until the debt is paid.

Other issues

Government assistance

The Department for Business, Innovation and Skills (BIS) runs several small business advisory offices and these, together with various trade associations, can offer valuable assistance with the various government schemes that exist to help small businesses and advice on business planning generally. BIS was formed in June 2009 by merging the Department for Business, Enterprise and Regulatory Reform with the Department of Innovation, University and Skills. The nature and scope of grants and financial assistance potentially available is now very wide and may differ according to location. It is strongly advisable to obtain specialist local advice before starting in business, and before arranging any borrowings or starting any business projects.

The Grants and Support Directory (GSD) lists potential sources of help with starting up or business development. The database contains details of over 2,400 grant and support schemes from central and local government as well as private organisations. Some of the schemes offer financial assistance, while some offer free or subsidised services ranging from advice through to practical involvement with projects. It can be accessed at www.businesslink.gov.uk/bdotg/action/gsd?r.li=1078381472&r.l1=1073861197.

The Enterprise Finance Guarantee (EFG) scheme guarantees loans from banks and other financial institutions for enterprises that have viable business proposals but who have tried and failed to get a conventional loan because of a lack of security. The EFG scheme is open to businesses with

an annual turnover of up to £25m, seeking loans of £1,000 to £1m, repayable over a period of up to ten years. Many, but not all, business activities are eligible. The scheme guarantees 75% of the loan. The scheme, which replaced the Small Firms Loan Guarantee Scheme in January 2009, will operate until March 2010. The government has said it will put forward proposals for a post-March 2010 scheme later in 2009. Several banks participate in the scheme and applications should be made to them.

Regulatory matters

There are many other areas about which a small business needs to be aware, especially if it has an office or other business premises. They include:

- The requirement to provide employees with access to pension arrangements, where a business has five or more employees.
- Special tax rules for businesses involved in the construction industry.
- Business rates, payable to local authorities on business premises.
- Customs duties and regulations, where a business imports or exports.
- Data protection registration, if a business keeps information about people.
- Health and safety.
- Fire safety precautions.
- Protecting the environment.
- Employee rights under employment law.
- The national minimum wage.
- Laws against racial and sexual discrimination.
- Age discrimination in employment matters.
- The legal requirement for public liability and employer liability insurance.
- Consumer protection and fair trading regulations.
- Providing services and access to disabled people.
- Licences, copyrights, patent rights, etc.
- The requirement to display the owner's name and address at business premises if the business trades under a business name.
- Planning laws.
- The Electronic Commerce Regulations 2002, which govern business websites.
- Other laws and regulations that might affect particular businesses, for example, restaurants or agriculture.

Conclusion

Starting a business is an exciting challenge, but quite apart from the basic commercial risk, there are many pitfalls for the unwary. It is important to identify the potential problems, as well as the benefits, as early as possible, preferably in the business plan stage. It is essential to seek

professional advice on accountancy, tax and legal matters from the very start – preferably well before the start of trading.

HMRC has published a useful guide called *Starting up in business*, available from tax offices or on the HMRC website at www.hmrc.gov.uk/startingup/. There is also booklet SE1, *Thinking of working for yourself?*, and a new more comprehensive publication, *Working for yourself – The Guide*, which covers many aspects of running a business apart from tax, and contains a long list of sources of information.

HMRC has business support teams offering educational support to business enterprises and employers on how to comply with their tax and NIC obligations. Further information is at www.hmrc.gov.uk/bst/index.htm. Further information for small businesses can be found at www.businesslink.gov.uk.

This guide is for general information only and is not intended to be advice to any specific person. You are recommended to seek competent professional advice before taking or refraining from taking action on the basis of the contents of this publication. The guide represents our understanding of the law and HM Revenue & Customs practice as at September 2009, which are subject to change.