

# AN INTRODUCTION TO TAX, NATIONAL INSURANCE AND VAT

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### Introduction

If you are starting up in business, there are a number of important tax-related regulations with which you will need to comply.

There are three main kinds of tax that are relevant to most businesses: Income Tax, National Insurance (NI) and Value Added Tax (VAT). Limited companies will also be liable to pay Corporation Tax.

This factsheet introduces these taxes, and explains how they will affect your business and what your obligations are under the law. More detail on each subject is contained in dedicated factsheets which are listed in the further information section.

### Income tax

If you are self-employed (as a sole trader or in a partnership), you must assess your own tax under 'tax self-assessment', complete a tax return and pay any tax due to HM Revenue & Customs (HMRC) by the required deadlines of 31 January and 31 July. Partnerships also have to submit a partnership tax return in addition to individual returns.

The amount of tax you pay is based on the profit that your business makes. (Some people will also be required to make two tax payments on account for the tax year before the return for that year is due, which means that it is important to have saved the money towards your likely tax bill well in advance.)

If you employ staff, your business is required to deduct income tax from their wages and salaries and pay this to HMRC (this is known as Pay As You Earn or PAYE).

### Self-assessment tax

Sole traders pay income tax on the profit that their business makes. In partnerships, the profit is divided between the partners (according to the terms agreed in their deed of partnership) and each is taxed on the portion of the profit that accrues to them. Drawings (the money that sole traders or partners take out of the business to live on) are simply an advance against profit and so are still taxable as income.

Profit is what remains of your business' income after all material costs, overheads, wages for employees and allowable business expenses are deducted. Capital allowances - based on the business' expenditure on capital assets - may also be deducted before profits are calculated. Your personal allowance (£6,475 for the tax year 2010/11) is deducted from this profit and the remainder is subject to income tax at the current rate.

For more details, see BIF 264, A Guide to Tax Self-assessment for the Self-employed; BIF 244, An Introduction to Tax Allowable Business Expenditure; and BIF 243, An Introduction to Tax Allowances for Capital Expenditure.

### PAYE tax

Under the PAYE scheme, an employer must deduct income tax and NI from their employees' earnings and pay these deductions to HMRC each month. Where the combined bill for PAYE and NI contributions is less than £1,500 per month, you can make payments quarterly. See BIF 53, A Guide to Setting up and Running a Payroll System for more information.

### Corporation tax

If your business is registered as a limited company, it is liable to pay corporation tax on any profits the company makes. The directors of the company pay income tax on their salaries, as do any other employees.

There is a main rate of corporation tax. For the financial year starting 6 April 2010, this rate stands at 28%. For profits up to £1.5 million there are two different rates:

Taxable profit	% tax rate
£0 - £300,000 (small companies rate)	21
£300,001 - £1.5 million (marginal rate)	29.75
£1.5 million +	28

If profits are over £1.5 million, corporation tax is charged at the main rate for the whole amount.

If there is sufficient profit, companies can pay dividends to the shareholders. It can be advantageous for shareholders who also work in a company to take a lower salary and a higher dividend, as dividends do not attract NI contributions. BIF 252, A Guide to Corporation Tax covers this topic in more detail.

### National Insurance

NI is a contribution towards state benefits such as retirement pension, unemployment and incapacity benefits. Businesses that employ staff must ensure that employers' and employees' contributions to NI are paid, while self-employed people have a separate contribution structure. The amounts involved can be significant and may be a factor in helping you decide whether to set up as a sole trader/partnership or limited company, as the tax structures differ and one format may be more advantageous to you than another.

There are four classes of NI:

#### Class 1 Contributions

Class 1 NI Contributions (NICs) apply to employed people and are paid by both the employer and the employee. They are calculated as a percentage of gross pay. It is the responsibility of the employer to pay both contributions, deducting the employees' contributions from their salary through the PAYE scheme.

#### Class 2 Contributions

Class 2 NI is a flat rate paid by all self-employed people, whether sole traders or partners. This is £2.40 per week in 2010/11. If earnings are below £5,075 per year, you may be entitled to an exemption or refund, although this may affect your entitlement to benefits. Exemptions from paying Class 2 NI may be made for individual weeks if you are unable to work due to illness or other forms of incapacity.

#### Class 3 Contributions

These are voluntary contributions, set at £12.05 per week in 2010/11, which allow people to protect their right to contributory benefits even if they are not liable to NICs under Class 1 or 2, or have not paid enough contributions in the past to qualify for benefits.

## Class 4 Contributions

Class 4 NICs are payable by the self-employed. They currently amount to 8% of profits between £5,715 and £43,875 and 1% on profits above this upper level, and are paid to HMRC at the same time as income tax. Class 4 contributions do not count towards benefits.

See BIF 239, A Guide to National Insurance for more information.

## Regional employer NIC 'holidays' for new businesses

In the Emergency Budget in 2010 the Government announced it would implement a scheme to help new businesses in specific areas of the UK to receive reductions in their employer NICs.

Over a three-year qualifying period, new employers would be exempt from paying the first £5,000 of employer NICs for up to ten employees. For more details on the scheme go to [www.hmrc.gov.uk/pay/intro/nics-holiday/eligibility.htm](http://www.hmrc.gov.uk/pay/intro/nics-holiday/eligibility.htm).

## Value Added Tax (VAT)

VAT is a tax on most sales, services and imports, and is paid at each stage of the production and distribution chain. Some goods and services are VAT exempt, such as insurance and education. If your turnover is more than £70,000 a year (and your business does not exclusively sell goods or services that are exempt from VAT), your business is required to register with HMRC as a 'taxable person'. (The compulsory VAT registration threshold is usually raised each year.)

Registering for VAT requires your business to charge VAT on the products and services you sell (output tax). Once registered, your business is also entitled to claim back the VAT that it has paid for business supplies and services (input tax), which you deduct from the output tax before paying the difference to HMRC (or receiving a refund).

There are currently three rates of VAT:

- The standard rate of 20%. This covers all goods and services that are not exempt, zero or reduced-rated.
- The reduced rate (5%) is charged on domestic fuel and power as well as other domestic energy-saving products. The renovation and conversion of certain buildings is also subject to the reduced rate.
- The zero rate (0%) applies to specified categories of goods, including children's clothes, exports outside the European Union (EU), food (excluding fast food, restaurant meals or catering supplies), books and newspapers. The advantage to you of goods being zero-rated is that they are still included in your taxable turnover, so you can recover your input tax.

If your turnover is lower than the legal threshold for registration, you may register voluntarily if you want to reclaim input VAT. This needs to be weighed up against the time involved in collecting, calculating and paying VAT to HMRC.

Businesses with a turnover of less than £1.35 million can submit one annual return; otherwise returns must be submitted quarterly. Businesses already using the annual accounting scheme may continue to do so until their turnover reaches £1.6 million. See BIF 234, An Introduction to Value Added Tax (VAT).

## Hints and tips

- In the March 2010 Budget, the Government announced it would continue with the HMRC Business Payment Support Service which assists businesses in temporary financial difficulties by granting them an extension of time in which to pay their tax bills. For further information go to [www.hmrc.gov.uk/pbr2008/business-payment.htm](http://www.hmrc.gov.uk/pbr2008/business-payment.htm) and [www.hmrc.gov.uk/budget2009/bus-payment-support-582.pdf](http://www.hmrc.gov.uk/budget2009/bus-payment-support-582.pdf).
- Tax is a crucial source of public revenue, 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.
- If you need help, talk to an accountant immediately - before your tax-related problems grow.
- Keep slips and paper records of sales, purchases and wages for up to five years in case they are required for a tax inspection. From 1 April 2009 there are new rules governing HMRC's approach to tax inspections. See [www.hmrc.gov.uk/about/new-compliance-checks.htm](http://www.hmrc.gov.uk/about/new-compliance-checks.htm) for details.
- Incentives are available for electronic filing of documents. Filing will become mandatory in future, see [www.hmrc.gov.uk](http://www.hmrc.gov.uk).

## Further information

For practical start up and small business tips, ideas, know-how and news, go to:

Website: [www.enterprisequest.com](http://www.enterprisequest.com)

To access hundreds of practical factsheets, market reports and small business guides, go to:

Website: [www.scavenger.net](http://www.scavenger.net)

- BIF 32 Choosing the Right Legal Status for your Business
- BIF 53 A Guide to Setting up and Running a Payroll System
- BIF 234 An Introduction to Value Added Tax (VAT)
- BIF 239 A Guide to National Insurance
- BIF 241 A Guide for First Time Employers
- BIF 243 An Introduction to Tax Allowances for Capital Expenditure
- BIF 244 An Introduction to Tax Allowable Business Expenditure
- BIF 252 A Guide to Corporation Tax
- BIF 264 A Guide to Tax Self-assessment for the Self-employed
- BIF 474 A Guide to Meeting Tax Deadlines in 2011

## Useful contacts

There are many useful websites for tax and budget information. Most large accountancy practices produce 'Budget Briefings' which summarise the main points and implications of the Budget Statement for issues such as tax, NI and VAT.

HM Revenue & Customs (HMRC)  
Tel: 0845 010 9000 (VAT National Advice Service)  
Tel: 0845 714 3143 (Employers' helpline)  
Tel: 0845 607 0143 (Helpline for new employers)  
Tel: 0845 915 4515 (Helpline for the newly self-employed)  
Website: [www.hmrc.gov.uk](http://www.hmrc.gov.uk)

**CONTACT-**

**for further information.**

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