AF1 Income Tax 2023/24
Part 2: Employed or self-employed?

HMRC classify everyone who earns income from work as either being **employed** or **self-employed**. This status does not affect tax rates or bands but it will affect:

- The calculation of non-savings income.
- The way in which tax is paid
- The level of National Insurance Contributions.

The milestones for this part are to understand:

- How HMRC establish whether an individual is employed or self employed
- The trading exemption
- The impact of "disguised self-employment" and the IR35 rules
- The difference between traditional and cash based accounting.

National insurance and the different ways in which tax is paid will be considered in later parts.

Employed or Self-Employed?

Stripped of legal jargon, employed individuals work for a business or another person who in return pays them a regular wage or salary and possibly other benefits.

Self-employed individuals do not have an employer being either sole traders or partners in a partnership. They don't receive a regular salary but endeavour to make a profit which is then taxed by HMRC. The owner and the business are treated by HMRC as one and the same.

If the business is set up as a limited company the company's profits and a director's remuneration are treated separately. Profits are subject to Corporation Tax and a director's salary and dividends are subject to income tax. A director is always an employee and never self-employed.

An employee has a contract **of** service whereas the self-employed have a contract **for** service. The difference will often be apparent but at other times it is not so clear cut.

HMRC considers individuals to be self-employed if they:

- exercise a high degree of control over their work. They can choose what work to take and when to do it.
- carry the business risk. They are responsible for unpaid bills or other debts. They are also financially responsible for any losses, breakages or cost overruns in carrying out their work.
- have to provide own tools and equipment

- can subcontract work to another person.
- work for more than one client
- do not get employee benefits such as holiday or sick pay

If you reverse these tests, i.e. if someone has to work set hours and doesn't carry the business risk, it is a reasonable test of employment.

An employer is legally obliged to deduct income tax from each employee. Individuals who work on a self-employed basis must register with HMRC if their annual income is more than £1,000. The deadline for registering is 5th October in tax year after they start trading.

This can be done online and HMRC will issue the applicant with a 10 digit Unique Taxpayer Reference (UTR) and set up an account for self-assessment.

Calculating a self-employed person's non-savings income.

Employed individuals receive regular weekly or monthly payments and tax is deducted at source. In an exam question you should enter their total salary (P60) plus any taxable benefits in kind (P11D). Other than pension contributions there are very few allowable expenses that can be offset against their income. The main ones are:

- Professional subscriptions
- Specialised clothing and equipment that they buy for themselves.

The self-employed pay tax on the annual profits made by their business. In simple terms this is the difference between income from the sales made or services provided by the business and its costs and expenses. The profit is classed as non-savings.

If a loss has been made no tax will be due but if it is a trading business, that loss can be offset against any profits made in a future year.

What an accountant calculates as profit may differ from the Revenue's definition. Taxable profit is the difference between income and allowable expenditure. If HMRC don't class an expense as allowable it can't be offset.

Allowable expenses must conform to two key rules:

- They must relate to income and not capital unless it comes under **the Annual Investment Allowance.**
- They must be wholly and exclusively relate to the business

A self-employed café owner can offset the costs of buying food and insurance since these relate to income. However, the purchase of new kitchen equipment would be a capital expenditure and could not normally be offset against income unless it comes under the **Annual Investment Allowance (AIA).**

The AIA is currently £1million. It was reviewed annually but the government has stated that it will continue at this level until further notice. The AIA cannot be used to purchase motor vehicles.

The second rule is self-explanatory in that you can't offset a cost if it doesn't relate wholly to the business. Where the distinction between private and business use isn't clear, HMRC will usually only accept part of the cost. For example, if a self-employed individual has a mobile phone for both business and private use, HMRC will only allow the cost of business calls to be offset as an allowable expense.

The Trading Exemption

Individuals can be both employed and self-employed. For example, a teacher who offers private tuition is employed for their main work and self-employed for the private work.

HMRC have always been concerned that in such situations there is a temptation to work "cash in hand" which of course is tax evasion.

The Government has recognised that with the growth of the online economy, some individuals could have small amounts of self-employed income from for example:

- Trading on Ebay and similar platforms.
- Casual services such as pet sitting or private tuition.
- Working as an Uber driver.

If **income** (not profits) is less than **£1,000** it is exempt from income tax and the individual does not need to register as being self-employed.

Dan is a teacher and offers private tuition on a self-employed basis. His income from this is £850 a year so is exempt and does not need to be declared. He must, however, keep records of what he receives.

This is termed **full relief.**

If the income is more than £1,000 an individual has two choices:

- Elect to be taxed on the business's profits and forgo the £1,000 exemption.
- Elect for **partial relief**. This means you can deduct the £1,000 exemption but not any other expenses.

Ellen runs a cake making service. Her income is £2,400 and has expenses of £1,200. By deducting the expenses her profits will be £1,200 and these will be taxable. If she were to elect for partial relief she would be taxed on £1,400 Ged works as a self-employed tutor. His fees total £1,800 and has expenses of £400. He elects for partial relief and therefore pays tax on £800 rather than £1,400

A different choice can be made each tax year.

The trading exemption won't apply if income came from employment.

Kate supplements her income by working at the weekend as a pool attendant at her local leisure centre. Her total earnings for the year are £680. This would all be taxable

"Disguised" self-employment and IR35

In recent years HMRC have been concerned that businesses have entered into arrangements that turn an employee into a self-employed contractor, usually by being paid through their own limited company. This is referred to as a Personal Services Company

This is beneficial to the business because:

- It pays no National Insurance on the money they pay to the contractors.
- It does not need to give sick or holiday pay.
- It does not need to make pension contributions under auto-enrolment

The individual contractor also benefits:

- No tax or NI will be deducted at source. They can take part of their income as dividend which is taxed at a lower rate than non-savings and they can use the £2,000 dividend allowance.
- The business can offset expenses

IR35 has been in force since 2000 and its purpose is to prevent "disguised employment", in which a worker receives payment from a client through an intermediary but whose relationship with the client is such that had they been paid directly they would be employees of the client.

If a worker is subject to IR35 the company (the engager) or agency using their services must deduct tax and NI contributions at source.

The key tests that HMRC will apply are similar to the tests to establish if a worker is employed or self-employed. These are:

- **Control:** what degree of control does the client have over what, how, when and where the worker completes the work?
- **Substitution**: is personal service by the worker required, or can the worker send a substitute in their place?
- **Mutuality of obligation**: is the employer obliged to offer work, and the worker is obligated to accept it?

From tax year 20/21 it became the responsibility of any organisation engaging the worker or the agency if they use one, to assess if the worker is subject to IR35. In practice most will tend to err on the side of caution and class the worker as being subject to IR35

Traditional versus cash based accounting.

The normal way of calculating a business's profits is to book income when the service or product is delivered. With expenses these should be booked when it is invoiced even though the payment has not yet been made. This is known as the **accrual basis**.

Camilla is a self-employed trainer whose trading year is the same as the tax year. In March 2023 she delivers a training programme for a large firm and bills them £5,000. This is paid in May 2023. For tax purposes this is counted as being received in 2022/23 rather than 23/24

Abdul runs a café on a self-employed basis. In March 2023 he is invoiced for some repairs a but doesn't pay until May 2023. This expense falls in the 22/23 tax year

With a **cash basis**, income is only booked when money is received or paid out and expenses when they are paid rather than invoiced. This means if Camilla used cash based accounting her fee would be booked in 2023/24. This method is simpler but only available if the turnover is less than £300,000. If turnover increases they can continue to use the cash basis until it reaches £600,000 when they must return to the traditional method.

If a business wishes to switch to a cash basis they will have to make some adjustments in their tax return for the year of the switch.

That concludes this part, so you should now understand:

- How HMRC establish whether an individual is employed or self employed
- The trading exemption
- The impact of "disguised self-employment" and the IR35 rules
- The difference between traditional and cash-based accounting.

Sources and further reading

https://www.gov.uk/set-up-sole-trader
https://www.gov.uk/expenses-if-youre-self-employed
https://www.litrg.org.uk/tax-guides/self-employment/what-trading-allowance
https://www.gov.uk/guidance/ir35-find-out-if-it-applies
https://www.litrg.org.uk/tax-guides/self-employment/working-out-profits-losses-and-capital-allowance/what-cash-basis
http://www.hmrc.gov.uk/courses/SYOB3/syob_3_exps/html/syob_3_exps_menu.html?&utm_source=HMRC-DCS-Apr-10&utm_campaign=DCS-Campaign&utm_medium=email