An Introduction to Tax, National Insurance and VAT

Business Information Factsheet

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Introduction

There are three main types of tax that are relevant to most organisations: income tax; National Insurance (NI); and Value Added Tax (VAT). Limited companies are also liable to pay corporation tax.

This factsheet outlines these taxes, explains how they affect different organisations and individuals, and outlines any obligations under the law.

Income tax

Sole traders pay income tax on the profit that their business generates. In partnerships, the profit is divided between the partners (according to the terms agreed in their deed of partnership) and each partner is taxed on the portion of the profit that is allocated to them.

Profit is what remains of a sole trader's or partnership's income after all material costs, overheads, wages for employees and allowable business expenses have been deducted. Capital allowances - based on expenditure on capital assets - may also be deducted before profits are calculated. A sole trader or partner's personal income tax allowance (£11,850 for the tax year 2018/19) is deducted from this profit and the remainder is subject to income tax at the current rate.

A sole trader or partner must assess their own tax under 'tax self-assessment', complete a tax return and pay any tax due to HM Revenue & Customs (HMRC) by the deadlines of 31 January and 31 July each year. Partnerships have to submit a partnership tax return in addition to individual returns.

If there is sufficient profit, limited companies can pay dividends to its shareholders. It can be advantageous for shareholders who also work in the company (usually directors of the business) to take a lower salary and a higher dividend, as dividends do not attract National Insurance Contributions (NICs). However, from 6 April 2016, HMRC introduced a new form of dividend taxation. There is now a £2,000 tax-free dividend allowance, but dividends above this level are taxed at 7.5% (for basic rate taxpayers), 32.5% (for higher rate taxpayers) and 38.1% (for additional rate taxpayers). If the directors of a limited company pay themselves a salary, they pay income tax on their salaries, as other employees do.

Employers are required to deduct income tax from their employees' wages and salaries and pay this to HMRC. (This is known as Pay As You Earn, or PAYE).

See BIF264, An Introduction to Tax Self-Assessment; BIF244, An Introduction to Tax Allowable Business Expenditure; and BIF243, An Introduction to Tax Allowances for Capital Expenditure, for more details.

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 NICs is less than £1,500 per month, payments can be made quarterly. See BIF053, A Guide to Setting up and Running a Payroll System, for more information.

Corporation tax

If a business is registered as a limited company, it is liable to pay corporation tax on any profits the company makes.

The rate of corporation tax for the financial year starting 1 April 2018 is 19%. The rate of corporation tax is to reduce to 17% from 1 April 2020.

See BIF252, An Introduction to Corporation Tax, for further information.

National Insurance

NI is a contribution towards state benefits such as Jobseeker's Allowance and State Pension. If an organisation employs staff, it must ensure that both employers' and employees' NICs are paid. Self-employed people have a separate contribution structure. The amounts involved can be significant and the different tax structures and advantages of one system over another can be a factor in helping business owners decide whether to set up their business as a sole trader/ partnership or limited company.

There are four classes of NI:

Class 1 contributions

Class 1 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 salaries through the PAYE scheme.

Class 2 contributions

Class 2 NICs are paid by all self-employed people, whether sole traders or partners. In 2018/19, they are set at a flat rate of £2.95 per week. If earnings are below £6,205 per year, it may be possible to claim for an exemption or refund, although this may affect any entitlement to state benefits. Exemptions from paying Class 2 NICs can be made for individual weeks if someone who is self-employed is unable to work due to illness or other forms of incapacity. Class 2 NICs will be abolished from April 2019.

Class 3 contributions

Class 3 NICs are voluntary contributions, set at £14.65 per week in 2018/19. They allow self-employed 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 state benefits.

Class 4 contributions

Class 4 NICs are payable by the self-employed. In 2018/19, they are set at 9% of profits over £8,424 and up to £46,350, and 2% of profits above this upper level. They are paid to HMRC at the same time as income tax. Class 4 contributions do not count towards state benefits.

See BIF239, An Introduction to National Insurance for the Self-Employed, for more information.

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, such as insurance and education, are VAT-exempt. If a business expects to turn over more than £85,000 a year (and the business does not exclusively sell goods or services that are exempt from VAT), the business is required to register with HMRC as a 'taxable person'. The compulsory VAT registration threshold is usually raised in April each year.

Registering for VAT requires a business to charge VAT on the products and services it sells (output tax). Once registered, the business is also entitled to claim back the VAT that it has paid for business supplies and services (input tax), which is deducted from the output tax before the business pays the difference to HMRC (or receives a refund).

There are currently three rates of VAT:

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

If turnover is lower than the legal threshold for registration, a business may register voluntarily for VAT in order to reclaim input VAT. The possible financial benefit of reclaiming input VAT needs to be weighed up against the time involved in collecting, calculating and paying VAT to HMRC.

VAT-registered businesses with a turnover of less than £1.35 million can submit one annual return; otherwise, returns must be submitted quarterly. VAT-registered businesses already using the annual accounting scheme may continue to do so until their turnover reaches £1.6 million. See BIF234, An Introduction to VAT (Value Added Tax), for more information.

Hints and tips

- Tax-related records must be well organised and payments should be kept up to date and made on time.

- It is advisable to talk to an accountant in order to fully understand any business or personal tax obligations.
- Slips and paper records of sales, purchases and wages should be retained and kept safe for up to five years in case they are needed for a tax inspection.

Further information

BIF032 Choosing the Right Business Legal Structure
BIF053 A Guide to Setting up and Running a Payroll System
BIF234 An Introduction to VAT (Value Added Tax)
BIF239 An Introduction to National Insurance for the Self-Employed
BIF243 An Introduction to Tax Allowances for Capital Expenditure
BIF244 An Introduction to Tax Allowable Business Expenditure
BIF252 An Introduction to Corporation Tax
BIF264 An Introduction to Tax Self-Assessment
BIF483 Tax Deadlines in 2018
BIF522 An Introduction to Registering for VAT

Useful contacts

HM Revenue & Customs (HMRC) is the government department responsible for the collection of tax. It also provides information and advice to individuals and businesses.
Tel: 0300 200 3211 (Helpline for new employers)
Tel: 0300 200 3504 (Helpline for the newly self-employed)
Tel: 0300 200 3700 (VAT National Advice Service)
Tel: 0300 200 3200 (Employers' helpline)
Website: www.gov.uk/government/organisations/hm-revenue-customs

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