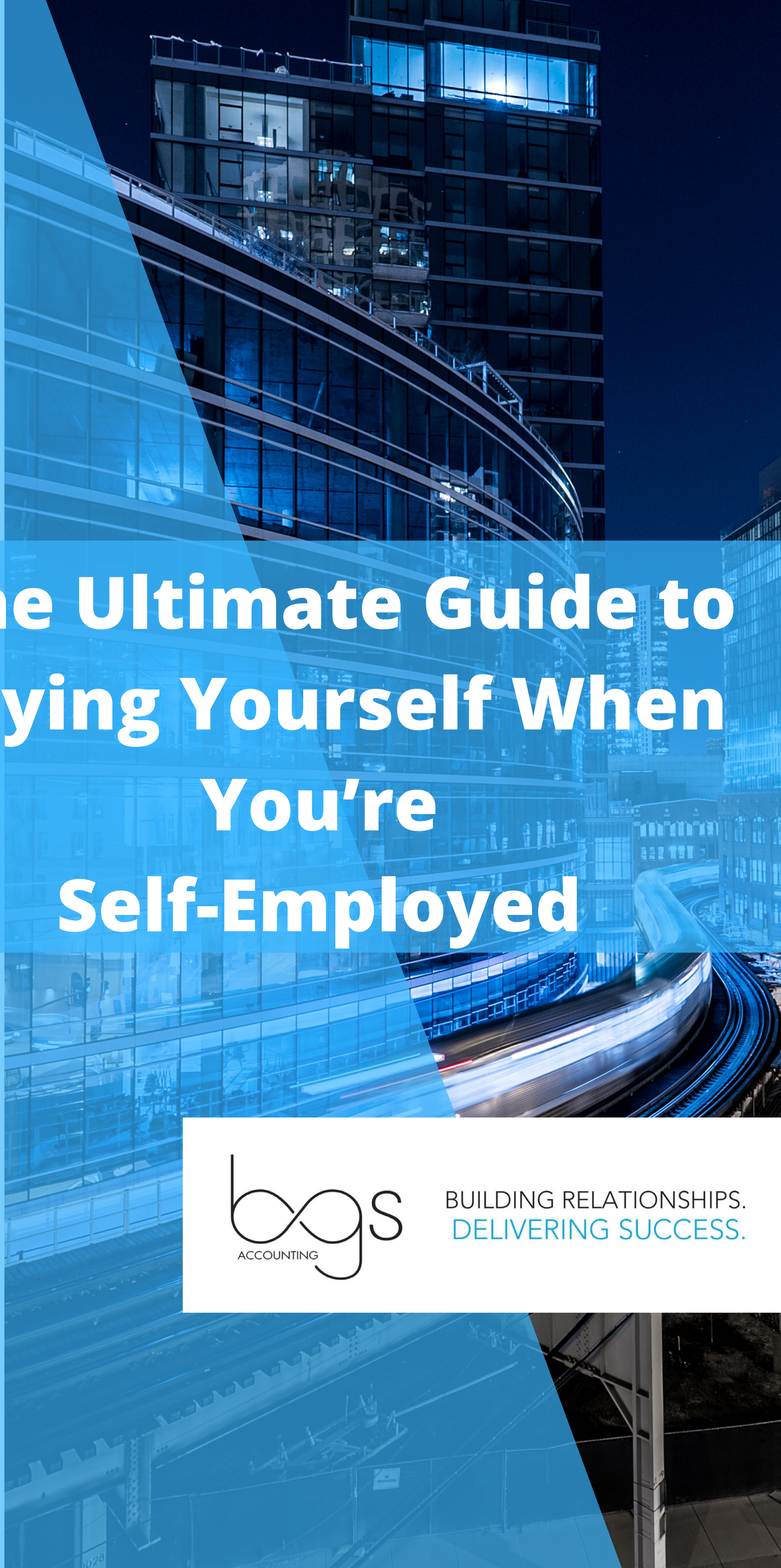

The Ultimate Guide to Paying Yourself When You're Self-Employed

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Introduction

Making the leap from being an employee to going self-employed is a big decision. Leaving behind the security of a full-time job and regular, predictable pay cheque can be daunting, but the rewards are also tremendous. As a self-employed person, you're in charge of your own destiny.

So first of all, congratulations on embarking on this fantastic journey!

If you're feeling nervous, that's completely normal. There's a lot to get your head around when you start working for yourself. That's why we've compiled a series of guides to help you.

In this guide, you'll learn all about paying yourself when you're self-employed.

As always, if you have any doubts, you should speak to a qualified accountant. Here at BGS Accounting, we're equipped to take care of all your small business finance needs, so do get in touch!

Limited Company or Sole Trader?

There are two main types of self-employment in the UK: operating as a sole trader, or setting up your own limited company.

What's the difference?

The main difference is that as a sole trader, there is no legal distinction between you and your business. You are the business and you assume responsibility for all activities including any financial obligations or debts. As a sole trader, you "draw" from the business to pay yourself and then pay Income Tax and National Insurance based on your annual profit.

A limited company is a separate legal entity. The full name for this type of business is a Limited Liability Company or LLC. You are considered a Director, shareholder, and employee of the company (you may be the only employee, or you may also employ other people.) Your liability for the company's activities and debts is limited (hence "limited liability,") which offers some legal protection to you and your personal assets. You pay yourself a combination of a salary and dividends.

What are the advantages of each?
There are pros and cons to each system.

As a sole trader, your start-up costs are negligible and it's easy to get set up. All you need to do is inform HMRC that you're self-employed, which you can do by filling in a simple form on the HMRC website. You also get to keep all the profits after tax. You have more privacy as a sole trader because you do not need to register with Companies House.

The main downside, apart from the unlimited liability we explained in the previous section, is that operating as a sole trader tends to be less tax-efficient. Some clients may also be less quick to trust a sole trader as opposed to a company.

Aside from the limited liability, the biggest advantage of operating as a limited company is that it is often more tax-efficient. This is because there are several legal ways to maximise your tax-free income and reduce your tax liability that are not available to sole traders. You can also benefit from the perception that a limited company is more professional, allowing you to bring in more business and more prestigious clients.

The downsides are that setting up a limited company is complicated and time-consuming. You are also likely to have shareholders, giving you less control over how things are run (and meaning that you do not take home 100% of the profits.) You will have to maintain complicated accounts, which probably means incurring additional costs by hiring an accountant.

You must assess the benefits and pitfalls of each system to decide which is right for you.

Do I Really Need a Business Bank Account?
Yes.

If you're running a limited company, it is a legal requirement to keep business assets and personal assets separate. This includes using a business bank account.

But you should also get a business bank account if you are a sole trader. Separate accounts allow you to clearly and easily distinguish between business and personal expenses when it comes to tax return time.

In addition, most banks and building societies frown upon customers running a business through a personal account. This may be against the terms of service you agreed to when you opened your account.

Opening a business bank account should be one of the first things you do when you decide to go self-employed. You will usually have to pay a small monthly fee for your business bank account, but many banks have an introductory offer where you can get the first six months or year for free. Shop around for the best deals before you open your account.

Paying Yourself as a Sole Trader

If you own or plan to set up a limited company, you can skip this section. If you're going to operate as a sole trader, read on!

Paying yourself as a sole trader is as simple as drawing money from your business bank account into your personal account. Keep a record of all the money you draw out along with the rest of your income and expenditure.

Paying Tax as a Sole Trader

As a sole trader, you'll need to submit a tax return to HMRC and pay any taxes you owe at the end of the financial year. You'll be taxed on your final profit; that is, the total amount you earned minus any allowable business expenses. We'll cover business expenses in more detail later.

Every individual can earn a certain amount before paying any Income Tax. This is called the personal allowance and is set at £12,500 for the 2020/21 tax year as long as you earn less than £100,000 in total. If you earn more than that amount, your personal allowance decreases by £1 for every £2 you earn over £100,000. The personal allowance increases incrementally every one or two years to account for inflation and cost-of-living rises.

You'll pay 20% on everything you earn from £12,500 - £50,000, 40% on everything from £50,001 - £150,000, and 45% on everything over £150,000. (These figures apply to England, Wales, and Northern Ireland. Rates differ slightly if you live in Scotland.)

We recommend setting aside 25% of your earnings to cover your Income Tax and National Insurance bill (or more if you are earning more than £50,000 per year.) Put this money in a savings account until it's time to settle your tax bill.

What is a Self Assessment Tax Return?
A Self Assessment Tax Return is a form you must complete through the HMRC website. It must be completed after the end of the tax year (5 April) and before 31 January the following year (i.e. for 2020/21, you'll need to fill in your return between 5th April 2021 and 31 January 2022.

Be aware that 31 January is also the payment deadline, and HMRC can issue a fine starting at £100 if you do not complete your return and pay your taxes on time.

What if I have other income, such as from dividends or a part-time job?
Many sole traders have other sources of income. Perhaps you work part-time for an employer, or earn dividends through shares in a company. You'll need to declare this income on your tax return.

If you work for an employer, the tax you owe should have been deducted automatically through the Pay As You Earn (PAYE) scheme. You'll need to declare this as Income Tax you've paid when you fill in your self-assessment tax return. You can find this information on your P60 form, which your employer is legally required to give you at the end of every tax year.

Any dividends or other income you receive (such as if you own a property from which you earn rental income) must also be declared in the relevant sections on your tax return. HMRC will take these into account when calculating the total amount of tax you owe.

What is a Payment on Account?
If your Self Assessment tax bill comes to more than £1,000, you'll have to pay something called a Payment on Account. This is essentially a down payment towards the following year's Income Tax. This is a way for HMRC to ensure tax is paid regularly. The remaining balance will then be due by 31 July.

If you expect to earn significantly less profit (and therefore owe less tax) the following year, speak to an accountant or HMRC for advice.

If you overpay tax as a result of a Payment on Account, HMRC will take this into account when you submit your next return and offset it or refund you accordingly.

Paying Yourself as the Owner of a Limited Company

If you're operating, or planning to operate, as a sole trader then you can skip this section.

Getting your head around all the legal and financial implications is one of the most difficult things about setting up a limited company - and why so many self employed people don't bother. But as you've seen, the benefits can be substantial.

Let's look more closely at the two ways you can pay yourself as an owner/Director of a limited company: taking a salary, and paying yourself in dividends. In most situations, you'll do a mixture of both.

Paying Yourself a Salary

Taking a salary means that a predetermined amount is paid from your company to you - just like a salary for any other employee. Paying yourself a salary constitutes an allowable business expense, which reduces the company's total Corporation Tax bill.

You will be liable for Pay As You Earn (PAYE) Income Tax on your salary if it is above the personal allowance (£12,500 for 2020/21.)

Taking a low salary

You might be surprised to hear that one of the best ways to maximise tax efficiency is to pay yourself a very low salary. If you're considered an "office holder" (someone who has a role in a company but does not receive regular payments or have a contract of employment) then there is no requirement that you earn at least the National Minimum Wage.

If you pay yourself a salary that is above the National Insurance Contributions "Lower Earnings Limit" (£6,240 per year for 2020/21) but below the "Primary Threshold" (£9,500 per year for 2020/21,) you will not be liable for any National Insurance Contributions. However, each year will still count towards your State Pension contribution record.

There are also disadvantages to taking a low salary. Namely:

- You might miss out on part of your personal tax-free allowance.

• You may struggle to secure a mortgage or other loan as these are assessed on salary. However, you can usually get around this problem by using a broker who specialises in finance for self-employed people.
• You cannot legally earn below the National Minimum Wage if you want to have a contract of employment.
• Some insurance policies - including health, critical illness, and personal accident cover - are calculated based on salary, meaning you could end up with reduced cover.

It is up to you to decide whether drawing a low salary for the purposes of tax efficiency is a good decision. An accountant can advise based on your individual circumstances.

Paying Yourself in Dividends
Dividends are payments made to company shareholders - including you - out of the total profits after Corporation Tax has been paid. Earning most of your income through dividends is usually the most tax-efficient way to pay yourself when you own a limited company.

Dividends are distributed according to who owns what percentage of shares in the company. If you own a 50% share, you'll receive 50% of the total dividends paid. If you are the sole owner, you'll receive 100% (though you can choose to take less than this and keep the rest in the business as "retained profits," which can be paid out at a later date.)

Of course, paying yourself in dividends relies upon your company earning sufficient profit each year. It's illegal to pay out dividends, including to yourself, that amount to more than the total annual profit.

How are Dividends Issued?
To issue a dividend, including to yourself, you need to "declare" it at a meeting of all the company Directors (which must be minuted and records kept.) The following information needs to be recorded for every dividend paid:

• Company name.
• Date.
• Name of the payee.
• Total amount being paid out.

All dividend recipients will need a receipt. You should also keep a copy in your company's financial records.

If you are the sole Director, then you will need to fill in appropriate paperwork to keep a record of the dividend payout.

Tax on Dividends

The company is not liable for any tax on dividends paid. However, dividend payouts do not constitute an allowable business expense for tax purposes, so all Corporation Tax must be paid before dividends can be issued.

You'll need to declare any dividends you receive on your Self Assessment Tax Return. You can earn up to £2,000 in dividends tax-free each year, which is not counted as part of your personal allowance (£12,500 for 2020/21.) After that, you'll pay tax on any dividends which take your total earnings over and above your personal allowance at the following rates:

Band (total dividend payment)	Tax rate
Basic (£2,000 - £37,500)	7.5%
Higher (£37,501 - £150,000)	32.5%
Additional (£150,000+)	38.1%

No National Insurance Contributions are payable on company dividends. It's easy to see why drawing a low salary and paying yourself in dividends can be much more tax efficient than taking a higher salary, for both your company and personal finances.

National Insurance for Self-Employed People

National Insurance is a payment to the government, separate from Income Tax, which acts as a type of social security. National Insurance Contributions (NICs) are a determining factor in entitlement to various state benefits.

National Insurance as a Sole Trader

As a sole trader, you'll have to pay Class 2 NICs at a flat rate of £3.05 per week, or £158.60 per year, if your profits exceed the Lower Earnings Limit (£6,240 for 2020/21.) You can pay this directly to HMRC through a direct debit.

If you also work for an employer, you'll pay Class 1 NICs through Pay As You Earn. Class 1 NICs are usually charged at 12% on earnings between £792 and £4167 per month, and 2% on all earnings above that amount (figures correct for 2020/21 tax year.) If you pay the maximum amount of Class 1 NICs through your employer, you may not be liable for Class 2 contributions. Check with HMRC or your accountant if you're not sure.

If you earn more than £9,501 in total annual profits from your self-employment, you'll also be liable for Class 4 NICs. These are charged at 9% on profits from £9,501 to £50,000, and 2% on all profits over £50,000.

All your self-employed NIC contributions will be worked out when you fill in your Self Assessment Tax Return.

National Insurance for Limited Companies

As a Director, you'll be classed as an employee of your company for National Insurance purposes. Therefore, you'll pay Class 1 NICs at 12% on all salary and bonus payments above £9,500. NICs are not payable on dividend income.

Your company is also liable for Class 1 Employer NICs on salaries paid to all staff, including you and any other Directors. The Employer NIC rate for 2020/21 is 13.8% on salary and bonus payments at or above £169 per week. Employer NICs are also due on certain taxable Benefits-in-Kind.

Business Expenses for Self-Employed People

Both sole traders and limited companies are permitted to offset certain expenses against taxes. These are called "allowable business expenses."

As a sole trader, you only pay tax on your total profits. So if you made £50,000 but spent £5,000 on allowable business expenses, you'd pay tax on £45,000 less your personal allowance.

The rules are very similar for limited companies. Corporation Tax is only payable on profits, after all expenses have been deducted.

We won't get into all the intricacies of what is and is not an allowable expense for tax relief purposes here, but we have produced a separate guide to help you work out what expenses you can claim for [link.] Just a few examples of the things you can often claim for include:

- Travelling for business, including transport, accommodation, and subsistence.
- Office supplies.
- Necessary tools and equipment.
- Staff salaries for limited companies. This includes your own salary if you are a Director of your own limited company.
- Membership to professional bodies and organisations.

Where to Find Further Information

We've produced a number of guides on different aspects of finance for self-employed people and small business owners. You can find them all on our website. www.bgsaccounting.co.uk

You can find more information about financial regulations and tax liabilities on the HMRC website, including up-to-date figures and threshold information.
If you are in any doubt about any aspect of your business finances, you should always consult a qualified accountant.

We hope this was helpful!

If you need any further advice, our friendly team would love to talk to you about how we can help you maximise your earnings through your self-employment or small business. Give us a call on 07816 130053 to have a chat about how we can help you.