Tax credits and self-employment

June 2018

Child Poverty Action Group works on behalf of the one in four children in Scotland growing up in poverty. It doesn't have to be like this. We use our understanding of what causes poverty and the impact it has on children's lives to campaign for policies that will prevent and solve poverty – for good.

We provide training, advice and information to make sure hard-up families get the financial support they need.

Tax credits and self-employment is one of a series of Child Poverty Action Group in Scotland leaflets giving guidance to advisers and those working with families in Scotland about aspects of the tax credit system of particular concern.

Introduction

There are two types of tax credit; *child tax credit* and *working tax credit*. You may get either or both. Tax credits are administered by Her Majesty's Revenue and Customs (HMRC).

Tax credits are gradually being replaced by universal credit. If you are currently getting tax credits, you can continue to get them unless you make a claim for universal credit, and will be able to renew your claim until you are transferred onto universal credit. The process of transferring most people from tax credits to universal credit is planned to happen between July 2019 and 2023. See *Tax credits: moving on to universal credit* for more information.

Basic rules

To be eligible for child tax credit (CTC), you must meet the following condition:

- You are aged 16 or over and responsible for a child aged under 16, or aged 16 – 19 in full-time, non-advanced education or approved training.

To be eligible for working tax credit (WTC), you must meet any one of the following conditions:

- You are a lone parent, and you work at least 16 hours a week;
- You are disabled, aged 16 or over and work at least 16 hours a week;
- You are aged 60 or over and working at least 16 hours a week;
- You are a couple with children and your partner is disabled or a carer and you work at least 16 hours a week;
- You are a couple with children working at least 24 hours a week, with one of you working at least 16 hours. If only one of you works at least 24 hours a week, you will qualify;
- You are aged 25 or over and work at least 30 hours a week.

There is also a residence in the UK test and an immigration test for CTC and WTC.

This is a brief outline of the basic rules. See CPAG's leaflet, *Tax credits – the basics*, for more about how to qualify for tax credits, how to claim and how tax credits are assessed.

Self-employment

For self-employed workers, you must be carrying on a trade, profession or vocation, which must be organised and regular, on a commercial basis and with a view to making a profit.

There is no legal requirement to have registered with HMRC as self-employed for tax purposes, but this would usually be expected. If your declared profits are below the minimum wage for the hours you have reported, your claim may be subject to further investigation. You may be expected to have a business plan, work diary and accounts, but this should be realistic depending on your circumstances, see *VO v HMRC [2017] UKUT 343 (AAC)* for discussion. It is generally accepted that profits may be nil or low in the first year of a new business, but if this continues it may call into question whether you are self-employed with a view to making a profit. However, such a decision should not be made retrospectively, i.e. HMRC should not use hindsight to decide that you were not self-employed at the start of your claim just because your profits turned out lower than expected (see caselaw *MH v HMRC [2016] UKUT 79 (AAC)* for discussion).

If you are a self-employed European Economic Area national, there is a separate test that your work must be 'genuine and effective' for right to reside purposes.

Working hours and self-employment

Hours only count towards working hours if you expect to be paid for them. For an employee, the connection between hours worked and payment received may be straightforward. This is not so for the self-employed. Some activities may be necessary, but they are only indirectly connected with payment. HMRC says that you can include not only the hours charged to the customer but also time spent in necessary associated tasks, such as:

- Trips to wholesalers
- Visiting potential customers, networking and promoting business
- Book-keeping
- Some sorts of research work where it is necessary for your work
- Cleaning business premises or a vehicle used in the business (like a taxi or a driving school car)
- Time spent in advertising

In particular, when you are between contracts, you may need to work out how much time you spend on associated tasks to see if you continue to meet the 16, 24 or 30-hour threshold.

If your work is part time you may need to be careful that what you are doing is not classed as a hobby and not counted for WTC. On the other hand, you may regard what you do as a hobby while HMRC treats it as paid work. A key test is whether you are paid or have a real chance of being paid, rather than just hoping to make money.

If you disagree with HMRC's decision on whether your work counts for tax credit purposes, you can appeal within 30 days of the decision on the award, or up to a year later in special circumstances.

Working irregular hours

Being self-employed, you may work irregular hours. This can make it difficult to know if you have reached the 16, 24 and 30-hour thresholds for WTC. If your hours are different each week, but form a regular pattern, you should be able to average your hours over a couple of weeks to get a figure for your normal hours.

> **Example**
>
> Natalie works 20 hours one week and 15 hours the next week in a regular pattern. Her normal hours will be 17.5 a week.

If your hours do not form a regular pattern, it is a good idea to keep a record of all the hours you work – so that you can prove the position if needed.

Where your working hours cross the 16, 24 or 30-hour threshold (either going over or under the threshold), tell HMRC: call the Tax Credit Helpline. An additional element is payable if you work at least 30 hours a week. Keep a note of the date and time of your call and what was said.

Recording your partner's hours

Couples claim tax credits jointly. Recording your partner's hours, if they help you in the business and are paid for doing so, is important. Your combined hours may exceed 30 hours and enable you to claim the 30-hour element if you have a child.

If you already work 24 hours or more a week, recording your partner's hours may enable you to access help with childcare costs. Recording your partner's hours, you may find that he or she reaches the 16 hours necessary for a couple with children to access help with childcare costs.

Coping with multiple jobs

Some people who are self employed also work as employees. You may have a number of part-time jobs as an employee together with self-employed work. For tax credit purposes, you add together all the income from your different jobs. You also add together the hours you work in each job to make up the 16, 24 or 30-hour thresholds to qualify for WTC. If your total income falls by more than £2,500, you can tell HMRC via their Tax Credit Helpline and your award can be increased. You should also tell them if your current year's income increases compared to the previous year. Tell them straightaway if the increase is more than £2,500 because your award may need to go down. Give them an estimate of current year's income before 5 April if the increase is less than this so HMRC can pay you the right amount on next year's award from the start.

Extra help if you work longer hours

If your hours increase so that you are now working 30 hours or more, then you are entitled to more tax credit – you get a 30-hour element included in your award. You should phone the Tax Credit Helpline to let them know. You need to do this within one month of the change to make the most of your claim.

If you are making a joint claim and have children, you can get the 30-hour element if you and your partner together work 30 hours or more ie, you can combine your hours. If you do not have children, you cannot combine your hours to reach the 30-hour threshold.

Time that counts as working hours

Normal holidays are ignored for calculating hours worked. Time off for meals, refreshments and hospital visits only count if you expect to be paid for them. Time you are off work ill is usually treated as working hours for the first 28 weeks, so long as an employee in the same circumstances would be entitled to a benefit such as statutory sick pay or to National Insurance credits.

Income and self-employment

Tax credits are means-tested. The amount you get depends on the level of your income. Couples claim jointly and both incomes are taken into account. For self-employed claimants, it is your taxable profits in the relevant year. New Enterprise Allowance weekly payments made to self-employed participants are exempt from income tax. They should therefore be excluded as income for the purposes of calculating the trading profits.

Tax credit awards run from year to year. The tax credit assessment is based on income in a full year (6 April in one year to 5 April in the next year). At the start of your claim, HMRC asks for income in the previous year and bases your initial award on that income. The initial award is an estimate until entitlement is finalised at the end of the year. At the end of the tax year, HMRC sends you an Annual Review form and an Annual Declaration form to complete. HMRC checks your income to finalise your entitlement. If your income has changed, it affects your award as follows:

- If your income has gone *up* by more than £2,500 compared to the previous year, your award is revised based on your current year income *minus* £2,500.

- If your income has gone *down* by more than £2,500 compared to the previous year, your whole award is revised based on the lower current year's income *plus* £2,500.

This can result in an overpayment or an underpayment. To reduce the risk of being underpaid or overpaid, you can provide an estimate of current year's income at any time during the award. The Annual Declaration also acts as a renewal claim.

Your accounting year-end

For tax credits, previous year's income means taxable profits for the accounting year that ends in the tax year, 6 April to 5 April, before the year of your tax credits award. For current year's income, you take the accounting year that ends during the year of the tax credits award.

You can make up your accounts to any date. But, if you claim tax credits, a 31 March or 5 April year-end is safest. That way, your tax credit award can respond to changes in your income more quickly. If you make accounts up to a date earlier in the tax year, like 30 April, you could be in difficulties if income starts to fall. You will be faced with high tax bills, low income and low tax credit entitlement – and there may be little you can do to change the position.

If you have an accounting year-end other than 5 April or 31 March, consider changing it. It could take a number of years to do this. You may need help. If you do not have an accountant, you can ask for help at any Tax Office or contact TaxAid for independent advice (see page 8). A year-end of 30 September can be a good compromise solution. It enables you to work out your income tax liability before payments on account are due, while reducing your risk for tax credit purposes.

Example

Gina runs an advertising agency. She has three children. She is self-employed and has a 30 April year-end. She is claiming tax credits in 2018/19.

- In the year to 30 April 2017 she makes a profit of £17,300 – this is her previous year's income

- In the year to 30 April 2018 she makes a profit of £17,600 – this is her current year's income

In May 2018 she loses a big contract and expects to make only £9,000 in the year to 30 April 2019. She would like to increase her entitlement to tax credits to compensate for the fall in profits.

HMRC bases her award for 2018/19 on £17,300 (previous year's income) even though her actual income is now £9,000 a year. Her tax credit award do not go up to reflect her reduced profits until it is renewed from 6 April 2019.

From high to low profits, and low to high

The income of some self-employed people varies a great deal from year to year – and even within a year. Taxable income may be high one year and very low the next or the other way around. This can happen for example, because:

- That is the nature of your business (such as farming or writing)
- You have purchased expensive equipment for the business in one year only
- Your business has run into difficulties

For income tax purposes you may be allowed to average these years. You cannot do this for tax credit purposes. However, if your business has made a loss, your self-employed income is nil for that year for tax credit purposes. If you or your partner have other taxable income eg, earnings from employment, you should deduct the loss from that income. Any amount left over should be deducted from profits of the business in the following year(s).

If your business goes from high to low profits, there are special tax credit issues. Because tax credit awards are initially made on the basis of the previous year's income, if previous year's income was high, your initial award may be very low or even nil. You may not even consider applying for tax credits. When you start a new business your profits may go from low to high.

If you applied for tax credits, received a nil or low award and profits fall, you should phone the Tax Credit Helpline and give an estimate of your current year's income. Your award can then be increased to reflect a fall in income of more than £2,500 (but see 'Your accounting year-end' above). Take care when giving an estimate. If your estimate turns out to be too low, you will be overpaid tax credits. If your award is based on an estimate for the current year and you later give a higher estimate, the award will be revised based on the higher estimate (the £2,500 disregard only applies where current year's income is higher than previous year's income, not to increases in estimated income during the current year). Remember to budget. With the £2,500 disregard, your profits can rise by this amount without affecting your current year tax credit award. But next year's tax credit award will be affected and could fall. Your tax bill may rise and tax credits may fall dramatically.

Protective claims

If you have not applied for tax credits, you can consider making a tax credit claim to protect any potential entitlement you might have. The reason for making such a claim is that you can only backdate new claims for 31 days, so if you do not claim within the first 31 days of the tax year you might lose some of your entitlement. This type of claim is sometimes called a protective claim. You make it to protect any entitlement you may have when there is uncertainty about your level of income. You cannot make a new claim for tax credits once the universal credit full service has been introduced for your area, unless you have three or more children or you or your partner are over pension credit age. If you claim tax credits within three weeks before the date the UC full service is being introduced, your claim can be taken by phone.

Estimating your income

To avoid overpayments and underpayments of tax credits during the year, you may need to give HMRC a good estimate of your income for the current year of your claim. If your estimate is too high, then you will be underpaid tax credits. If it is too low you risk being overpaid. In view of the difficulties some people have repaying overpayments, it is probably better to estimate slightly on the high side for your income figure. HMRC checks during the Annual Review at the end of the tax year whether your estimate was correct or not and revises your award accordingly.

When you are self-employed, it can be very hard to know what your income is during the year. If you have a regular pattern of paying your bills and collecting money due to you – and if you take a regular amount from the business for yourself, this should help you estimate your income.

As a self-employed person, your income for tax credits purposes is your taxable profit. This may be very different from the amount of money you take out of the business for private purposes. It is also different from your accounts profit. To make an accurate estimate of your self-employed income it is necessary to take the following things into account:

- Your accounting year. Taxable profits are based on your accounting year. Often your accounting year-end will be 5 April. If it isn't, remember to choose the right 12-month period when you estimate your income.

Example
Stellene started in business as a hairdresser on 4 September 2013. She makes her accounts up to 30 September each year. To estimate her taxable profits for the current year of the tax credits award 2018/19, she will need to estimate her income for the 12 months to 30 September 2018.

- Profits not cash. Your tax credit income is the profit earned, rather than the cash the business makes or the amount of money you take for yourself. Watch out for changes in the bank balance, changes in what you owed or are owed, purchases of vehicles or equipment and changes in stock.

- Taxable profits, not accounting profits. Your accounting profit is unlikely to be the same as your taxable profit. Check the notes that come with the self-employment pages of your tax return for details here.

Telling HMRC about changes in your income

You need to keep HMRC up to date with changes in your income and circumstances. You can do this by phoning the Tax Credit Helpline (0345 300 3900, text phone 0345 300 3909).
Keep a note of the date and time of your call and what was said.

Income you can be treated as having – even when you don't

Under tax credit rules, some things can be treated as your income, even though you wouldn't think they are. This is called 'notional income' and includes:

- Sums which tax law treats as income (eg, if you repeatedly build your own home and sell it at a profit)
- Income you have deprived yourself of, in order to get more tax credits (perhaps by shifting income from one tax year to another)
- Income you would be entitled to if you claimed it (but you are not expected to claim a personal pension if you do not want to)
- Earnings waived or reduced, when the person receiving them can afford to pay the full rate (eg, barter or working at a lower rate for a friend; charities are exempt from this requirement)

Further information and advice

Child Poverty Action Group in Scotland

0141 552 0552 advice line for advisers on benefits and tax credits,
Monday to Thursday 10am to 4pm, Friday 10am to 12 noon

Email: advice@cpagscotland.org.uk
email advice for advisers on benefits and tax credits

Website: www.cpag.org.uk/scotland/taxcredits
for more tax credit leaflets from CPAG in Scotland

CPAG publishes the *Welfare Benefits and Tax Credits Handbook*, a comprehensive guide to benefits and tax credits for claimants and advisers.

CPAG in Scotland's advice line is only for advisers. If you are having problems with your own tax credit or benefit claim and are in need of advice you should contact your citizens advice bureau or other local welfare rights service.

HM Revenue and Customs

Tax Credit Helpline 0345 300 3900
(textphone 0345 300 3909)

Website: www.gov.uk/benefits-credits/tax-credits

TaxAid

Free, independent advice for people on low incomes with tax questions
Helpline 0345 120 3779 Monday to Friday, 10am to12pm.

Website: www.taxaid.org.uk

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