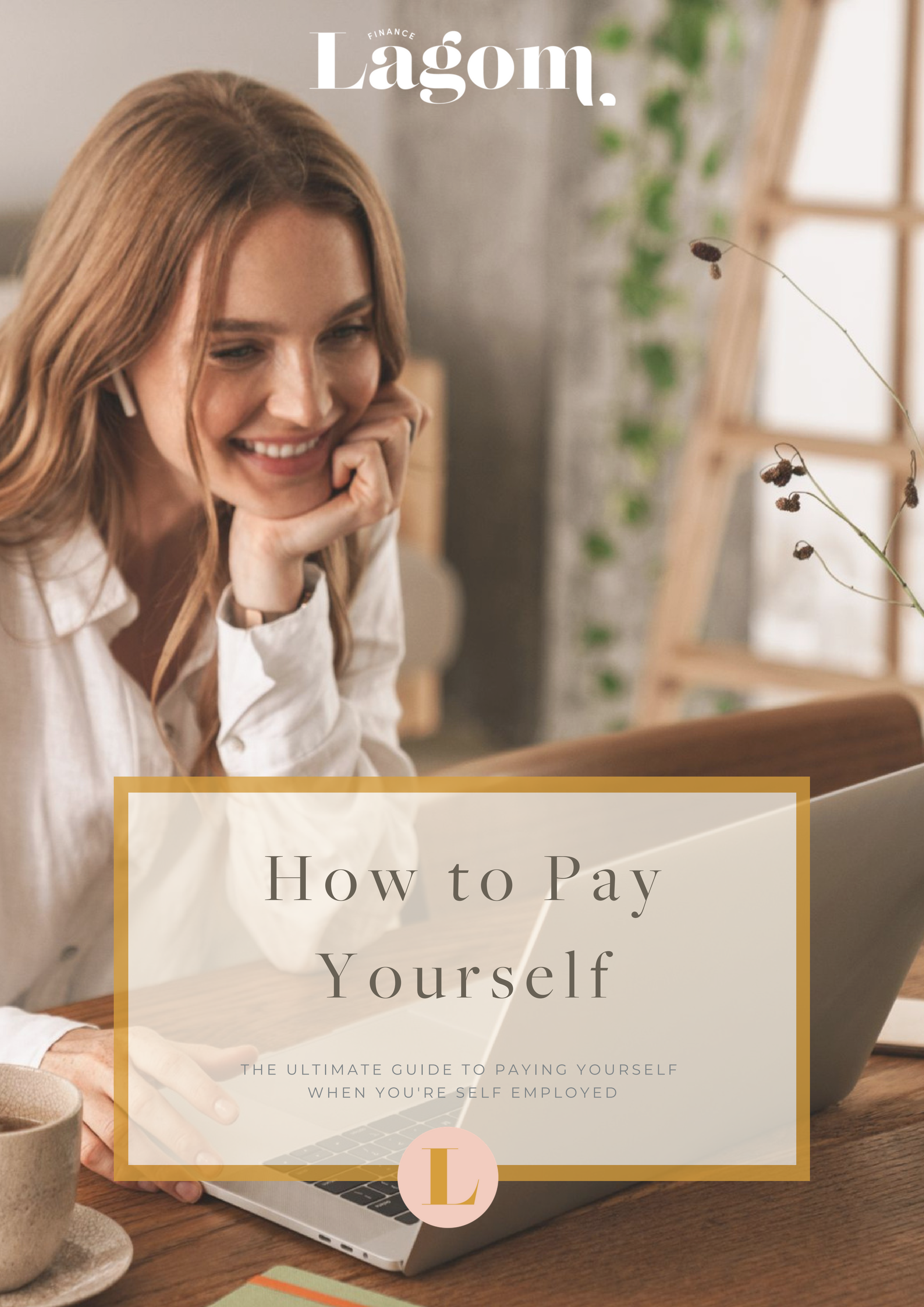

How to Pay Yourself

THE ULTIMATE GUIDE TO PAYING YOURSELF WHEN YOU'RE SELF EMPLOYED

Welcome

So you're self employed, but have absolutely no idea how to pay yourself. Good news, you've come to the right place. This is the ultimate guide to teach you all you need to know about how to pay yourself.

ABOUT

A bit about me. I trained and qualified as an accountant in 2010 whilst working for traditional firms, which I quickly learnt weren't for me.

I didn’t have time to get to know my clients, or give them the timely advice they really needed. I didn’t want to charge by the hour or provide clients with ‘archaeological accounting’.

So I built something better — an accountancy practice built around real, inspirational businesses. Welcome to Lagom Finance.

LETS' CONNECT!

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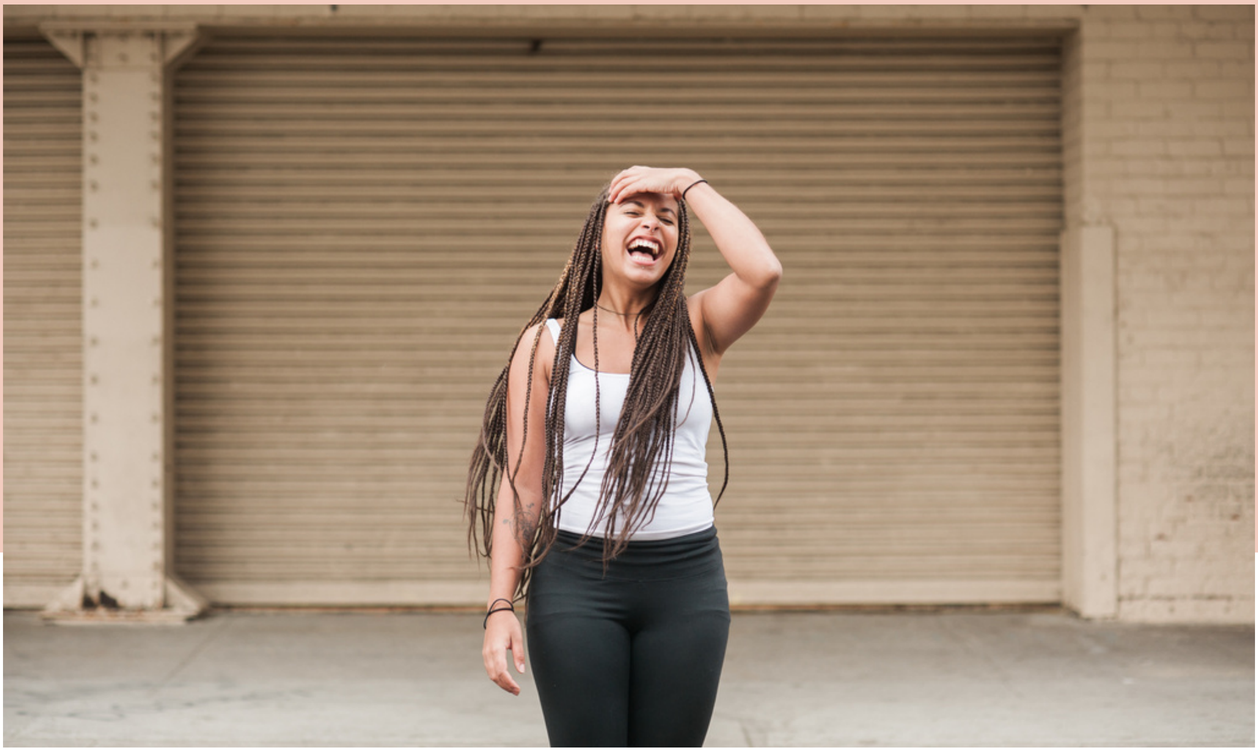
Becki

01

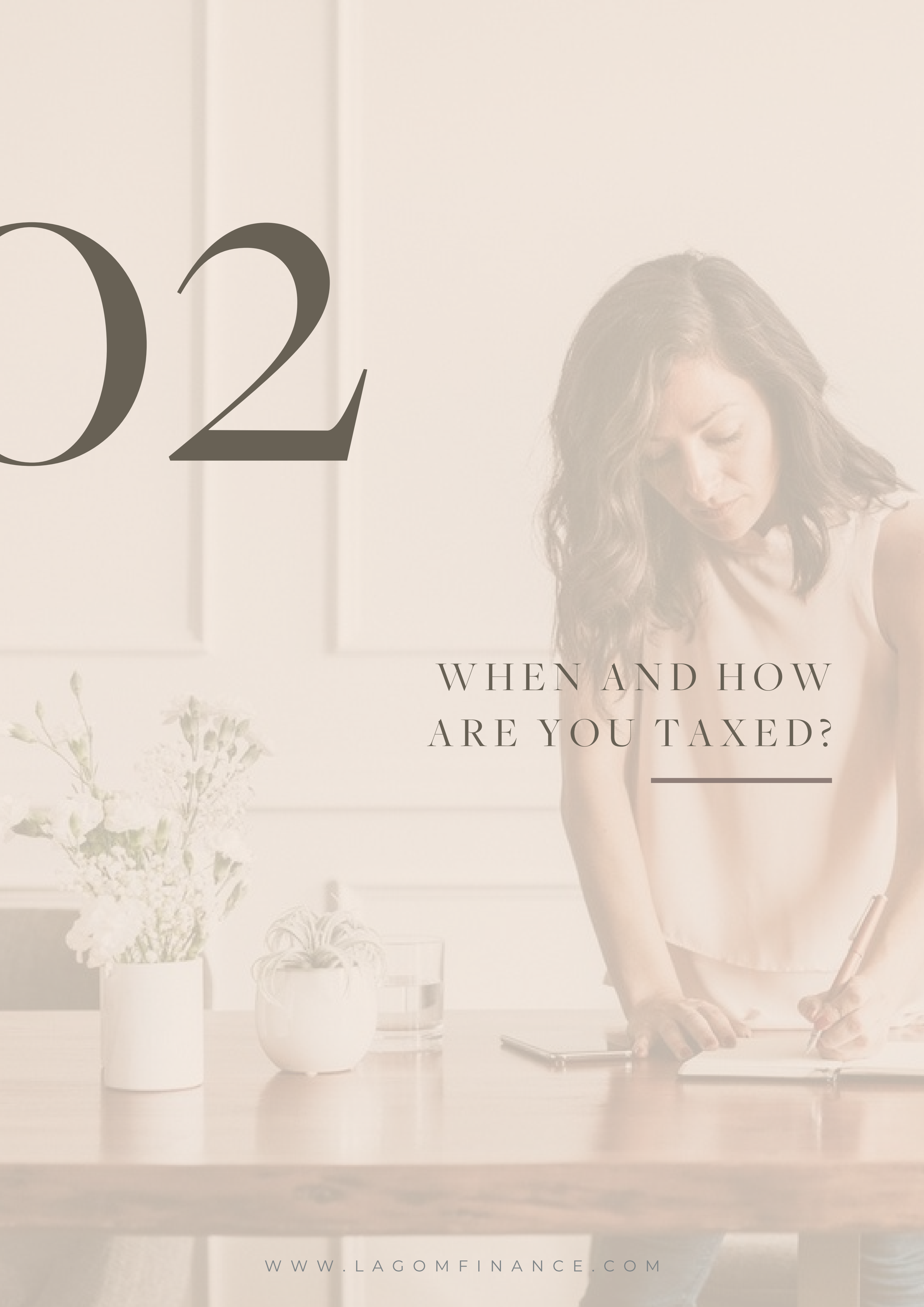
HOW DO YOU PAY YOURSELF AS A SOLETRADER?



1: HOW DO YOU PAY YOURSELF AS A SOLETRADER?

First things first, I hope you have opened a separate business bank account. If you haven't I strongly suggest you do! I recommend Starling, Monzo for business or Coconut as they're low cost (or free!) and have great functionality for managing your finances. It helps to keep your business expenditure separate and avoid any accidental claiming for that late night deliveroo you ordered.

- As a sole trader you can simply take money from your business bank account to pay yourself as and when you want, it's your money.
- If you use one of the bank accounts mentioned above they let you categorise your spending so you can tag any withdrawals you make.
- Remember you need to pay your tax bill, don't fall into the trap of spending all your money and then begging HMRC not to penalise you as you spent your tax money on that new Louis Vuitton handbag, they will not be forgiving.



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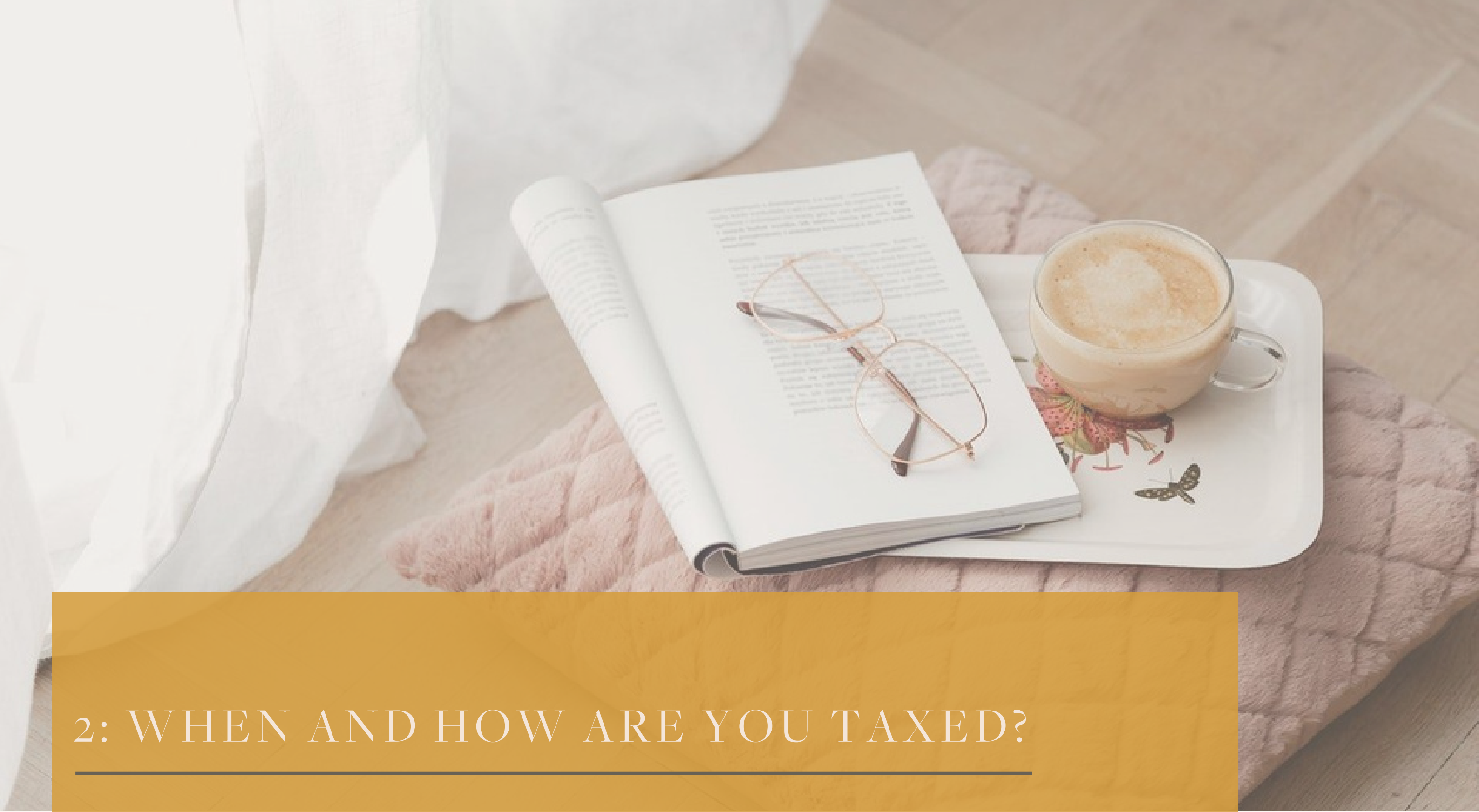
WHEN AND HOW ARE YOU TAXED?



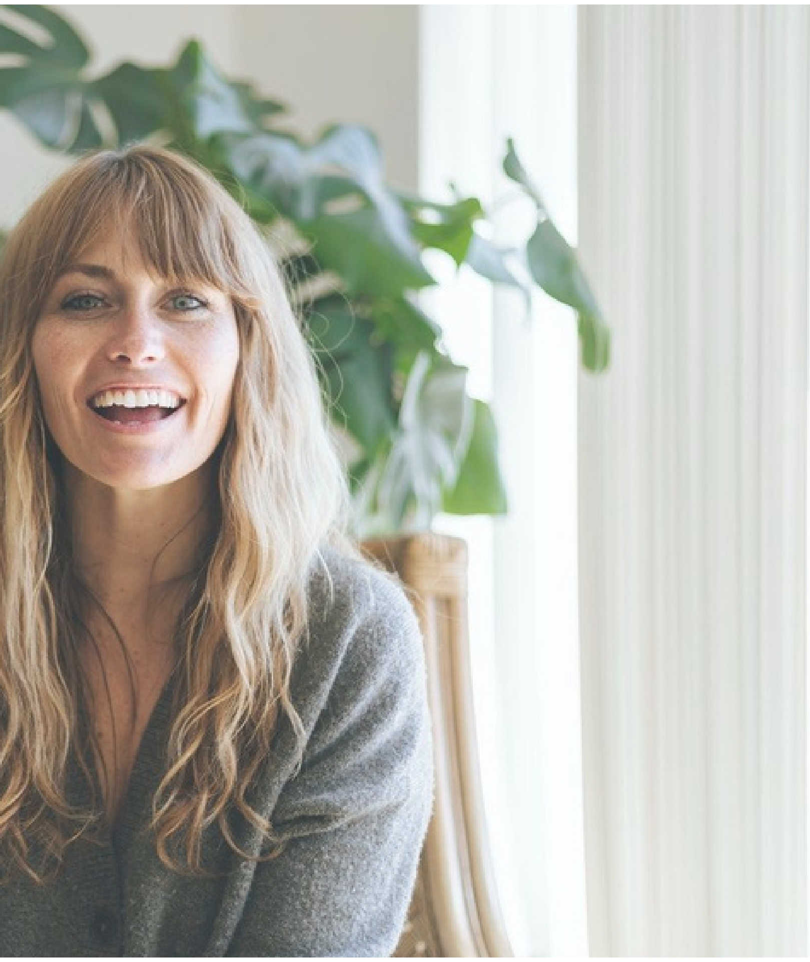
2: WHEN AND HOW ARE YOU TAXED?

- As a sole trader, you're taxed on the profits that your business makes through your annual Self Assessment tax return. Essentially, your profit is the income that your business receives, minus the allowable sole trader business expenses incurred. These expenses must be wholly for business, and must not include any personal expenditure, such as that spotify subscription or that teeth whitening treatment you had (Someone once tried to claim that they needed white teeth to impress their clients.. It's not going to fly I'm afraid).

- The more profit you report, the higher your tax liability will be. I recommend you set aside the following amounts from your regular drawings to settle your Income Tax and National Insurance liabilities each year:

  *If your profits are over 35K it's worth chatting about setting up a limited company as there could be tax advantages as well as other benefits.

Profits per annum	*% set aside for tax and NI*
Up to £50k	25%
Up to £100k	40%
between £100k to £150k	45%



When you're a sole trader, as far as the law is concerned, there's no legal difference between you and your business. You receive the income and pay your expenses, including your tax liability.

So many people fall into the trap of spending their tax money because there can be a time lag between receiving income from your customers and paying the personal income tax you owe on your trading profits. Monzo & Starling have a good 'pots' feature for putting aside your tax money.

Still got employment income as well as your business?

Go you! Juggling is hard but often pays off and gives you that extra bit of security whilst getting your business up and running.

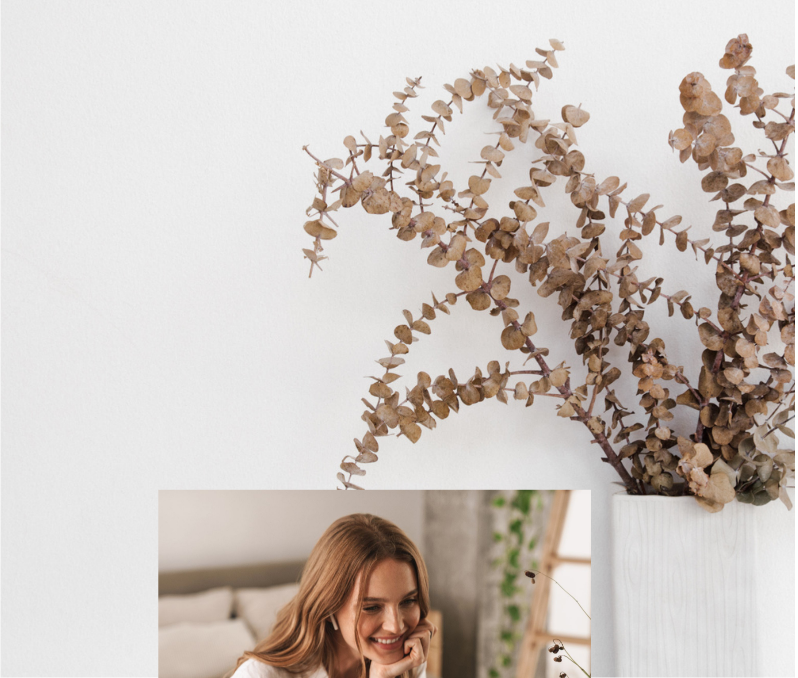
If you have income from employment as well as your self-employed income, you'll need to declare both on your annual Self Assessment tax return. Your employer should have deducted the Income Tax and National Insurance due through the Pay As You Earn (PAYE) scheme. You can see this information on Form P60, which your employer must give you at the end of the tax year. If you leave your job before the 5th April you will receive a P45 instead.

You include the Income Tax deducted by your employer on your Self Assessment for the same tax year and HMRC will calculate any additional Income Tax or Self-Employed National Insurance due.

Similarly if you're lucky enough to have additional sources of income such as dividends, property rental income or thousands of pounds in interest coming in you need to declare these on your self assessment too.

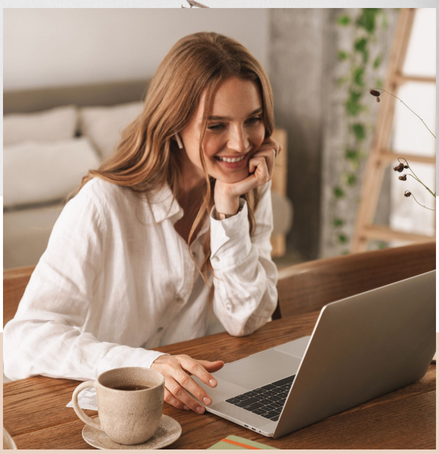
Your Self Assessment must be filed and all taxes you owe must be paid before the 31st January each year. Otherwise, HMRC will fine you, with penalties starting from £100..they give you a whole 9 months following the end of the tax year so there really is no excuse!

"I'VE HEARD IF YOU'RE SELF EMPLOYED YOU NEED TO PAY IN ADVANCE"



This one catches a lot of people out and if you don't budget for it then it can come as a surprise!

If your tax bill is more than £1,000 for the year (and the majority of your income is from self employment) then you'll be required to make a Payment on Account. This is HMRC's way of ensuring tax is paid regularly and it goes towards your next year's Self Assessment.



There are two payments made towards the Payment on Account: the first must be made by 31st January and the second is due on or before the 31st July each year. If you believe that you won't have as much sole trade profit in the next tax year, you should speak to HMRC or your accountant as you may be able to reduce your Payment on Account to HMRC.

It really only feels like you're double paying the first year. For example:
Year 1: You start your business and finish the first tax year (ending 5th April 2021) making a profit of £20K which gives you a tax bill of let's say £2.6K.

Not only will you be expected to pay the £2.6K by 31st January 2022 but you will also be expected to pay £1.3K (50% of your previous tax bill) by 31st January towards next year AND as if that wasn't enough you will also have to pay £1.3K by 31st July 2022 towards the following year.

If the following year you end up earning less, you would be due a refund. If you earn exactly the same, then congrats you have fully paid your tax bill in advance.

Top tip! Even though things might seem simpler being a sole trader, I highly recommend keeping your records in software. There are plenty of free options out there or some of the bank accounts I have recommended also let you upload receipts & create invoices.

The main reason people delay doing their tax return because they haven't kept good records and dread sorting through hundreds of paper receipts - don't be that person, you're better than that!

I'M OPERATING AS A LIMITED COMPANY - HOW DO I PAY MYSELF?

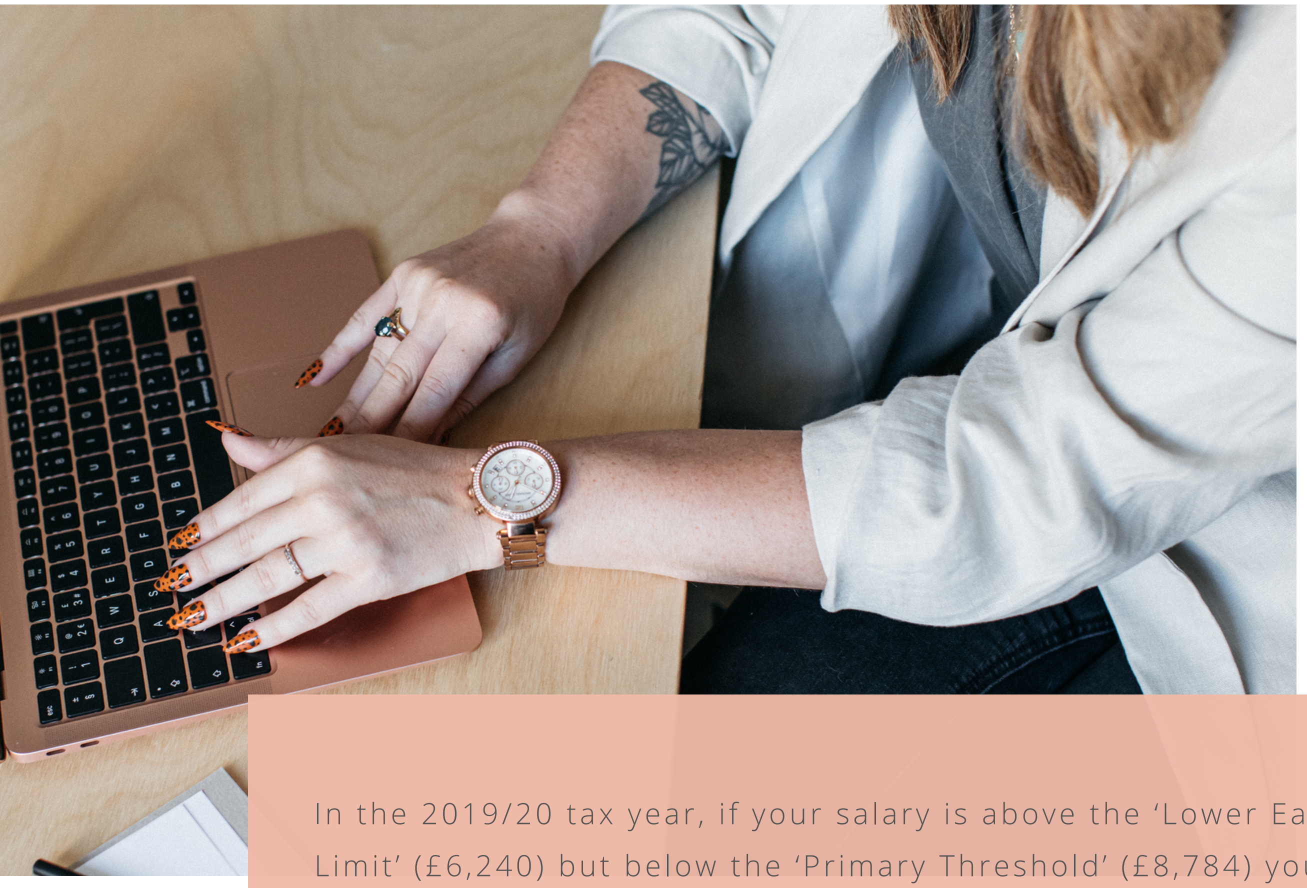
This is the question I get asked the most and I have to admit, it is not an easy one to explain! Forming a company is often a tax efficient way of managing your income if you're earning over around 35K profit a year (depending on your circumstances).

If all of your income is from your company, then 'employing yourself' is usually the best option. I recommend taking a salary from your limited company in the same way as a regular employee. There are two main reasons to take a salary from your limited company:

1. It's counted as an allowable business expense, which means it lowers the amount of Corporation Tax your company pays
2. If the salary is above the Lower Earnings Limit (£6,240 for the 2020/21 tax year) you accrue qualifying years towards your state pension but don't have to physically pay national insurance (win, win right?)

Wait, why would I want to take a low salary? I need more money for shoes!

As a UK taxpayer in the 2020/21 tax year, you'll have a personal allowance of £12,500. This means you can earn this much each year without paying Income Tax. There's also a National Insurance Contribution (NIC) threshold, but this is set at a slightly lower level before you pay anything to the government. A very low salary can be paid which means you do not physically pay National insurance but still qualify for state aid such as statutory sick pay & maternity etc.

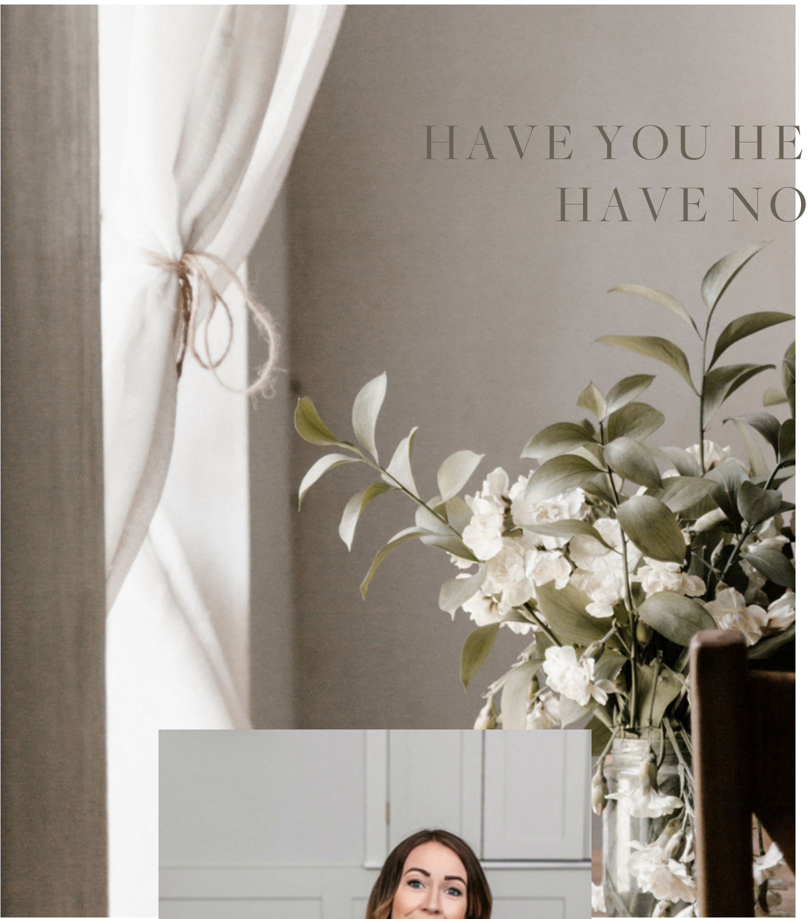


In the 2019/20 tax year, if your salary is above the 'Lower Earnings Limit' (£6,240) but below the 'Primary Threshold' (£8,784) you don't pay National insurance, but you do retain your State Pension contribution record. #winning.

But I want to earn more money than just £8784 a year?

And why wouldn't you? But as the tax on dividends is lower than the tax on PAYE employment income it's often better to take a minimal salary and the rest of your income in dividends.

There are exceptions to that so it's best to chat to an accountant to find out what is right for you. Things such as getting a mortgage, spending a lot of your time on research and development and applying for personal loans can all be reasons to adjust your remuneration plan via your company.



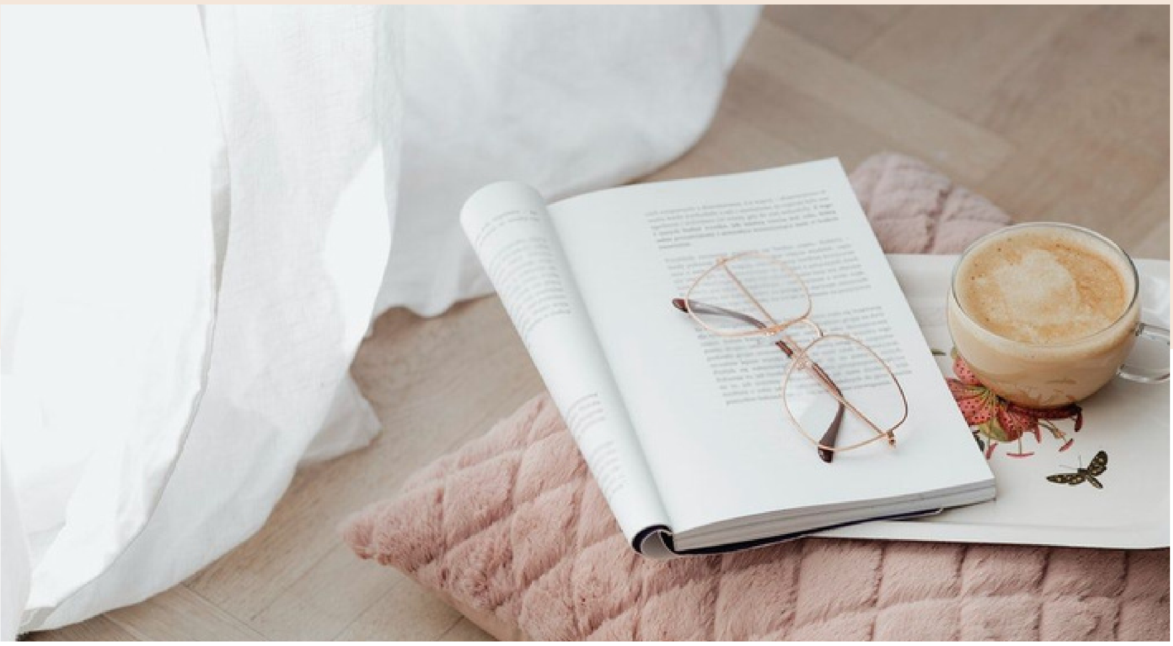
HAVE YOU HEARD OF DIVIDENDS BUT HAVE NO IDEA WHAT THEY ARE?

Dividends are payments made to company shareholders from the profits of a company after Corporation Tax. When operating your business as a limited company, the most tax-efficient way of extracting money from your company is usually via dividends. If your limited company has made a profit, it can distribute these earnings to shareholders (note shareholders NOT directors..they are not the interchangeable terms.) by way of a 'dividend'.

Profit is the money the company has remaining after paying all business expenses and liabilities, plus any outstanding taxes (such as Corporation Tax and VAT). It's important to remember that dividends cannot be counted as a business expense when calculating your Corporation Tax, and that it's illegal to pay a dividend if your company does not have sufficient profit after tax available to cover the dividend amount.

For example if your company has made a loss for the year and you've taken out money during that year, chances are you've spend company money which needs to be used on something else, meaning you'll owe that back to the company, therefore it's classed as a loan.

Any 'retained profit' in a limited company could have been accumulated over a number of months or years. If the director(s) choose not to distribute any excess profits as dividends at the end of the company's financial year, then they remain available to distribute at a later date.



OK...I THINK I GET IT, I'VE MADE SOME MONEY, SO HOW DO I ACTUALLY ISSUE A DIVIDEND THEN?

If you want to issue a dividend, then technically you need to hold a meeting of directors to “declare” the dividend. The meeting needs to be minuted and a record kept of it. This is the case even if you are the sole director of your limited company, so have that coffee with yourself and ask yourself how much you should get paid.

In *reality* though what happens is you as the shareholder/director take money out of your company as well as lend money to your company which all goes through your directors loan account (more on this in a minute!) and at the year end your accountant checks to see if you took more or less than the amount of dividends you had available to declare, if you’ve taken more than the profits available, then you will have to pay some back, and if it’s less than wahey you can withdraw the remaining amount! Treat yo’self.

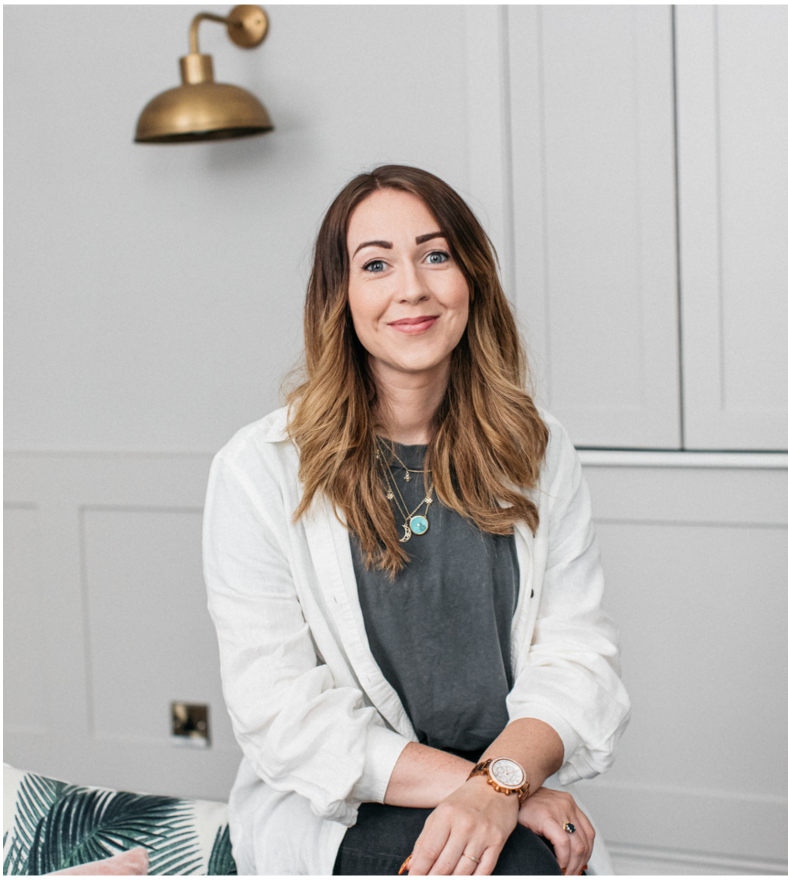
Dividends should usually be distributed according to the percentage of company shares owned by each shareholder. So, if you own half the company’s shares, you should receive 50% of each dividend distribution.

HOW ARE DIVIDENDS TAXED?

Your company does not need to pay tax on any dividend payments it issues, but the shareholders may have to pay tax on the dividends they receive based on their personal circumstances, through their annual Self Assessment (yes sorry, self assessments never go away even if you form a limited company).

You can earn up to £2,000 in dividends in the 2020/2021 tax year before you pay any Income Tax on your dividends, this figure is over and above your personal allowance of £12,500. Dividend Tax Rates for the 2020/21 tax year (and the previous three tax years):

- Basic-rate taxpayers pay 7.5%
- Higher-rate taxpayers pay 32.5%
- Additional-rate taxpayers pay 38.1%.



So let's take a real example:

You're following my advice and taking a minimal salary of £8784 during the 20/21 tax year.

You get to the end of your financial year and realise you have £20,000 available profit to give yourself a dividend, you own the company 100% so you go for it!

This means your total income for the 20/21 year is £28,784 (Salary + Dividends… with me so far?).

The first £12,500 of this is tax free as this is your personal tax allowance for the year.

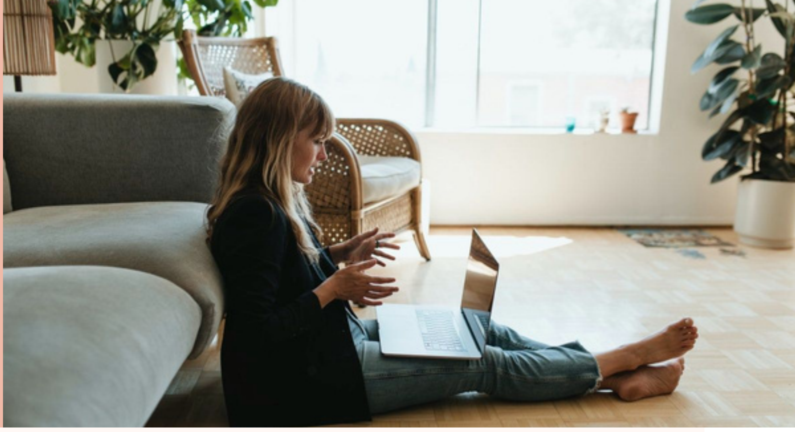
Great! So what about the remaining £16,284?

Well…

The first £2,000 in dividends are tax free = Still no tax bill for you!

And the remaining £14,284?

You would pay tax on the remaining dividends at 7.5% making your total tax bill £1071.30



I'VE HEARD OF A DIRECTORS LOAN ACCOUNT, WHAT IS THIS?

Although the money in your limited company bank account doesn't technically belong to you, you do have access to it through something called a director's loan.

Essentially, HMRC defines a director's loan as money taken from your company that isn't either:

- A salary, dividend or expense repayment
- Money you've previously paid into or loaned the company.

Chances are you are both a director and shareholder of your company. The easiest way to think of a directors loan account is a pot which includes all transactions between you and the company from the company's point of view. Here are some scenarios:

1. You just started a company and you put in £2000 into the company account to get you started:
   Directors loan balance = 2000 as the company owes you that money back.

2. You withdraw £2,500 from the company account.
   Directors loan balance = -500 you now owe the company £500.

3. You buy a new laptop for £1000 but you only had your personal credit card on you so you used that. The company now owes you that back.
   Directors loan balance = 500 the tables have turned and now the company owes YOU £500.

4. The company declares a dividend at the year end of £30,000.
   Directors loan balance = £30,500 The company now owes you £30,500 (the remaining money for the laptop + your dividends).

HELP ME FORM A COMPANY

Some important things to note about a directors loan account:

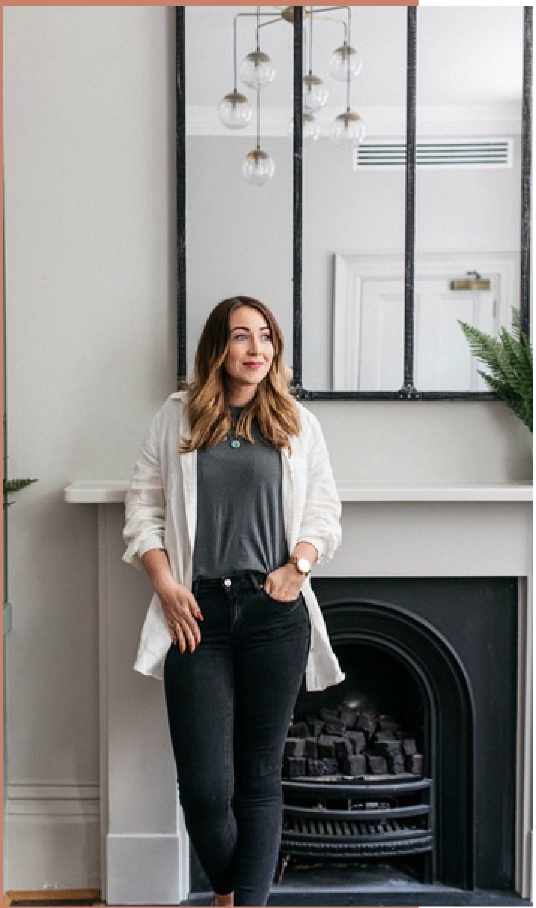
It is completely normal for you to owe the company money for the entire year.

If at any point you owe the company more than £10,000 during the tax year, this is classed as an interest free loan which HMRC deems to be a benefit and you have to pay a bit of tax and national insurance on this personally (as well as your company paying a bit of employers national insurance on this).

If you still owe the company money 9 months after your year end the company will have to pay tax (known as S455 tax) of 32.5% of the balance as of the year end. Eg your company financial year end is December and you owe £10,000. If you haven't repaid this by 30th September the following year, the company will need to pay £3250 to HMRC with the corporation tax payment.

So how do I keep track of all this?

I recommend using software to track your incomings and outgoings for the company. I offer all of my clients a Xero account and most of the time clients choose the full package where I keep the bookkeeping up to date weekly. This means that at any point in time you can see exactly what your directors loan balance is, no surprises, no fuss just pure transparency.



HOW CAN I HELP?

LET'S CHAT!

Sound like you need a bit of hand? Get in touch now for a free consultation and see how I can help.

Becki

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