

HOW A SOLE TRADER OR PARTNERSHIP IS TAXED

This is a guide to how a unincorporated business - a sole trader, partnership or LLP - is taxed. It does not cover Limited Companies.

The guide refers to a sole trader – partnerships and LLPs are simply multiple sole traders, and the only extra feature is the division of profits between each partner.

Key to understanding how a sole trader is taxed is to realise that as a sole trader your business accounts are considered to be an extension of your personal affairs.

Business Accounts

Although profit and loss figures can be entered directly on to a tax return, it is best practice for a statement of accounts to be drawn up separately – either just a profit and loss account, or a profit and loss account and balance sheet. The statement of accounts, as well as being used to settle tax liabilities, help you to gauge and compare business performance and assist with matters like raising bank finance or mortgages.

Tax Adjusted Profits

The tax liability for a year is based on tax adjusted profits. These are the accounts profits adjusted for disallow expenses, capital allowances and similar.

The accounts profit is then added on to other income for the year, and Income Tax and National Insurance calculated at normal rates – Income Tax is at 10%, 22% or 40% as applicable, and Class 4 NI will be due. If any tax is paid at source, eg under CIS, then this is deducted from the tax bill.

One of the common misconceptions with the accounts of an unincorporated business is that tax is linked to monies taken from the business. This is not so. If a businesses profits are £20,000 then whether the proprietor draws £10,000 or £30,000 is not relevant – tax is based solely on £20,000.

The Appendix gives the example of a simple set of accounts for a small business, where the owner also has some rental income.

Updated: March 2006
© Garbetts Limited

APPENDIX – ACCOUNTS FOR A SOLE TRADER

**JOHN SMITH
T/A JOHN SMITH SERVICES**

Profit and Loss Account

For the year ended 5 April 2006

	<u>2006</u> £	<u>2005</u> £
WORK DONE	<u>52,500</u>	<u>18,000</u>
EXPENSES		
Materials, tools and consumables	18,000	2,000
Motor expenses	2,500	700
Wages and sub contract	8,000	2,000
Travel and subsistence	100	100
Telephone	250	100
Depreciation	500	300
General expenses	200	250
Insurance	850	1,100
Accountancy	550	500
Bank Charges	100	-
H P Interest	<u>50</u>	<u>150</u>
Total	<u>31,100</u>	<u>7,200</u>
NET PROFIT	<u><u>21,400</u></u>	<u><u>10,800</u></u>

APPENDIX – TAX COMPUTATION FOR A SOLE TRADER

JOHN SMITH

INCOME TAX COMPUTATIONS 2005/06

Schedule D Case I

		£
Profit per accounts		21,400
Addbacks	Depreciation	500
	Private motoring (10%)	250
	Private telephone (50%)	175
	Cas	(328)
		21,998
		21,998

No adjustments necessary. Entries in the accounts are business proportions only.

Capital Allowances

	<u>Pool</u> £	<u>Car</u> £	<u>Claim</u> £
B/fwd	300	500	
Disposals	-	-	
Additions - FYA 40%	350	-	Private Use
WDA cars	-	(125)	10.0% 113
FYA 40%	(140)	-	0.0% 140
WDA other	(75)	-	0.0% 75
	435	375	328
WDA C/fwd	435	375	328

JOHN SMITH

Tax Due

	2005/06 £
Profits	21,998
PAs	4,895
Less used elsewhere - Rental Income	(6,000)
Taxable	23,103
Taxable @10%	209
Taxable @22%	4,623
Taxable @40%	-
Tax deducted under CIS	(250)
	4,582
Tax total	4,582
NIC	
Charged on	21,998
Lower limit	4,895
Charge	1,368
Total Liability	5,950