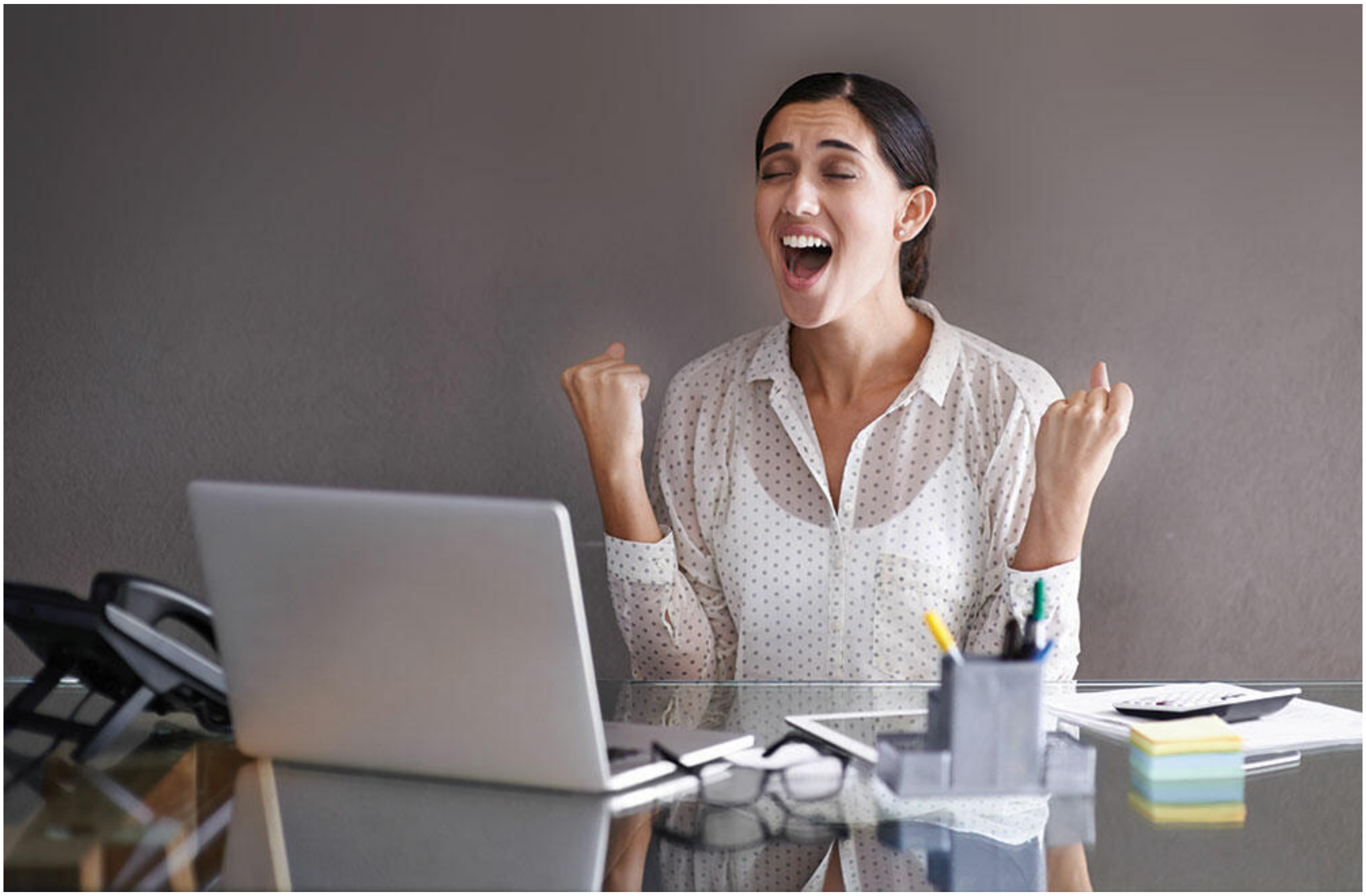
The feeling of relief

Personal tax



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Sharron West and Claire Thackaberry consider the traps open to self employed workers who have made losses, and how to maximise loss relief

Key Points

What is the issue?

Unfortunately, many self-employed businesses will have made losses recently, so maximising loss relief may be important for cash flow. Care needs to be taken when completing tax returns where coronavirus support payments have been received.

What does it mean for me?

The interaction between capital allowances, Class 4 NIC, self-employment income support scheme (SEISS) grants and losses may not be straightforward.

What can I take away?

When completing 2020/21 tax returns which include trading loss claims there are several interactions to consider, especially when SEISS grants are also received.

We know that for many unincorporated businesses the last tax year has been a tough period to have been trading. Depending on the business basis period, this could mean that there is a self-employed loss in the 2020/21 tax year.

This article highlights some areas to think about when considering how best to get tax relief for a self-employed trading loss in 2020/21.

Although LITRG focuses primarily on matters affecting those on low incomes, many of the issues raised here will be of interest to those dealing with unincorporated businesses of all shapes and sizes.

As readers will know, there are several different ways that income tax relief for losses can be given, including the new temporary carry back relief for 2020/21 and 2021/22, introduced by Finance Act 2021 s 18 and Schedule 2.

It should be noted that if self-employed accounts are prepared on a cash basis under Income Tax (Trading and Other Income) Act 2005 Chapter 3A Part 2, losses must be carried forward and set against future profits of the same trade (unless you cease trading in which case terminal loss relief may be relevant). Therefore, some self-employed businesses using the cash basis of accounting may benefit from changing to accruals accounting if they make a loss to maximise their options for obtaining income tax relief for the loss.

Capital allowances and losses

When considering the various loss reliefs available, there is often a need to strike a balance between the cash flow advantage of obtaining a tax refund and wasting some of the personal allowance. In some circumstances, it might be possible to tip the scales more in favour of claiming to offset the loss by adjusting – or perhaps disclaiming altogether – capital allowances in the loss-making period.

For example, suppose Jane is a self-employed football coach. Her turnover is usually around £20,000 per year, and her annual taxable profit is usually in the region of £12,000 to £15,000. In the year to 31 March 2021, her gross income was only £4,000, due to the pandemic restrictions. Her allowable business expenses in the year to 31 March 2021 were £7,985, including £1,500 on new equipment.

Jane's net loss from her self-employment, after claiming the annual investment allowance (AIA) in respect of the equipment, is £3,985.

Jane is also employed part time as a PE teacher, and in 2020/21 her salary was £14,800 (tax paid of £460).

Jane claims to offset the loss against her other income for the 2020/21 tax year under Income Tax Act 2007 s 64.

Her tax calculation for 2020/21 is as follows:

Employment income	£14,800
Less: self-employed loss	(£2,485)
Less: AIA	(£1,500)
Taxable income	**£10,815**

As the taxable income is below the personal allowance of £12,500, the tax deducted from Jane's PAYE income of £460 will be repaid. (Naturally, if a BR code had been in operation against Jane's employment income, the refund would be greater.)

However, if Jane does not claim AIA for her new equipment costs and instead claims writing down allowances in respect of the expenditure in the 2021/22 tax year, her loss for 2020/21 becomes £2,485.

If she offsets this against her PAYE income as before, the 2020/21 calculation becomes:

Employment income	£14,800

Less: self-employed loss	(£2,485)
Taxable income	**£12,315**

The taxable income is still below the personal allowance of £12,500, and so the tax deducted from Jane’s PAYE income of £460 will be repaid. However, £1,500 less of her personal allowance is wasted and capital allowances can be claimed in future tax years in respect of the new equipment.

Class 4 National Insurance and losses The rules for relieving trading losses for National Insurance contributions (NIC) purposes are separate to those relating to income tax relief and can be found in Social Security Contributions and Benefits Act 1992 Schedule 2 para 3.

To the extent that the income tax treatment of the loss means it is offset against income which is not liable to Class 4 NIC, then there has been no relief for Class 4 NIC purposes. In these circumstances, the relevant amount of the loss should be carried forward and set off against the first available profits in a subsequent tax year, thereby reducing the Class 4 NIC liability in the later tax year.

For example, Hameed, who lives in Leeds, was employed until March 2019 when he decided to set up his own window cleaning business. Hameed’s only income since March 2019 has been from his self-employment as a window cleaner.

In the 2019/20 tax year, he made a profit of £10,000 but his accounts for the year to 31 March 2021 show a loss of £4,000. He was unable to claim the first three self-employment income support scheme (SEISS) grants as he only started his business in 2019/20.

He decides to make a claim to carry back the loss of £4,000 to the 2017/18 tax year under the ‘opening year losses’ provisions in Income Tax Act 2007 s 72 and offset it against his employment income in that year of £20,000. This will generate a tax refund to claim on his 2020/21 tax return of £800 (£4,000 x 20%). The loss of £4,000 remains unrelieved for Class 4 NIC purposes.

Hameed is predicting that his profits for the year ended 31 March 2022 will be in the region of £14,000. Therefore, Hameed’s Class 4 NIC liability for the 2021/22 tax year will be based on profits of £10,000 (£14,000 - £4,000).

Incidentally, although Hameed will not be liable for Class 2 NIC for 2020/21 (as the loss means he is clearly below the small profits threshold), he may decide to pay the contributions voluntarily to maintain his National Insurance record and so protect his entitlement to state benefits such as state pension. He can elect to do this on his 2020/21 tax return.

Interaction of losses with coronavirus support payments

The 2020/21 tax return requires coronavirus support payments such as local authority grants, Job Retention Scheme grants and Eat Out to Help Out payments to be included in 'other business income' in the self-employed section of the 2020/21 tax return, rather than in turnover. This may mean the grant payments need to be stripped out of the accounts to enter in the relevant box of the tax return and so will be declared on the same basis as the accounts figures; i.e. according to the accounts basis period.

However, SEISS grants are treated differently. SEISS payments still need to be excluded from the turnover figure in the tax return, but Finance Act 2020 Schedule 16 para 3(3) specifically provides for the first three SEISS grant payments to be liable to tax and self-employment National Insurance in the 2020/21 tax year by expressly treating them as receipts of a revenue nature for that year, regardless of the basis period for 2020/21. (The only exception to this is SEISS grants paid into a partnership and then distributed to all partners; for example, in accordance with the partnership agreement.) In practice, this means the SEISS grant payments are automatically added to a self-employed profit or offset against a self-employed loss in the 2020/21 tax year. This is illustrated below.

Marco is a self-employed baker and has been supplying his local café with cakes and pastries on a daily basis for the past five years. Marco makes up his accounts to 31 December each year. During the year ended 31 December 2020, the café was closed for several months due to the lockdown restrictions so Marco's sales income reduced dramatically. The only government support he claimed during the pandemic were grants under the SEISS and he received the following payments:

- First grant: £4,800 (received 25 June 2020)
- Second grant: £4,200 (received 30 September 2020)
- Third grant: £4,800 (received 12 January 2021)

Marco’s self-employed accounts for the year ended 31 December 2020 showed a loss of £3,310.

Therefore, Marco’s 2020/21 tax return will show the following entries in the self-employed section:

Net loss from self-employment	(£3,310)
SEISS grants	£13,800
Total taxable profits from self-employment	**£10,490**

As the above shows, without offsetting the loss there would have been a small taxable profit of £1,300 (£13,800 - £12,500), so by offsetting the loss automatically, tax of £260 is saved (£1,300 x 20%).

Unfortunately, it is not possible to make a separate loss relief claim in respect of the loss of £3,310 in isolation; for example, claiming carry-back relief under Income Tax Act 2007 s 64 to obtain full tax relief for the loss and thereby save tax of £662 (£3,310 x 20%). The tax cost of the automatic offset is therefore £402 if basic rate relief might instead have been obtainable through carry back to an earlier year.

With regard to Class 4 NIC, this is calculated based on profits of £10,490, as the loss of £3,310 is offset against SEISS grant income which is chargeable to Class 4 NIC.

It is also worth noting that this automatic offset of the loss against the SEISS grant wastes £2,010 of the 2020/21 personal allowance of £12,500.

Final thoughts

If a client makes a loss from their self-employment, the following issues might also arise:

- The presumption might be that they have no tax to pay for the tax year. However, this will not always be the case. For example, if they have made charitable payments under Gift Aid during the tax year, the basic rate tax relief given at source on the payments will be clawed back via the self assessment tax return. Note, however, that there is no similar clawback for tax relief on pension contributions made to a relief at source scheme.
- They may be expecting a tax refund following a loss relief claim. However, if they owe HMRC tax for a previous period it is unlikely HMRC will issue the

refund. Rather, HMRC will offset the refund against the arrears to reduce any debt, which may well disappoint the client.

- If they are receiving universal credit or tax credits, this may impact on their benefits payments. There are different rules for dealing with trading losses for both tax credits and universal credit purposes. There is more information on the LITRG website at bit.ly/3qMKjhG.