Managing Income & Tax

with Dan Hill at MyDriveTime

Knowing what to do with the money you receive is fundamental to stress-free business *and* personal financial management.

In this document, we're providing guidance on how you can;

- store your income effectively;
- plan and save for your tax bill;
- pay yourself a regular amount each month to help you budget.

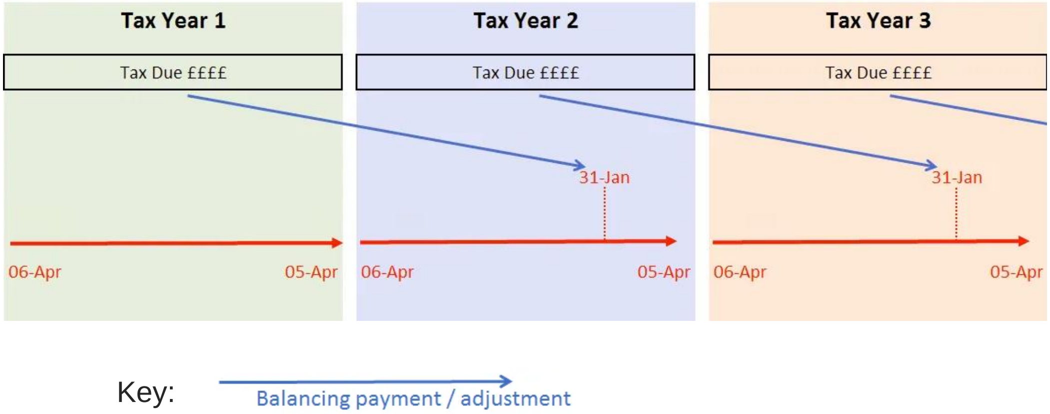
Let's start with the HMRC and their role in this:

- Her Majesty's Revenue & Customs (HMRC) is in charge of collecting income for the Treasury. For us, that predominantly means **collecting tax on the income we earn**.
- You **register as self-employed**, so they know you'll be paying your tax yourself, rather than through an employer.
- HMRC asks you to **declare your income, expenses** and, thus, your **profit** each year from all sources, e.g. working, inheritance, property rental, savings, capital gains & pensions.
- **Be honest and accurate**, as falsifying your income is a crime.
- **Making Tax Digital** (MTD) will change the method and frequency of supplying records.
- The **traditional tax year** runs from 6th April to 5th April the following year.
- You must submit your tax return (online) & pay tax due by the **31st January** the following year.
- Different rules apply to Limited Companies, who have a different structure.

Paying your tax & the 'curse' of Payments on Account:

- Payments on Account affects most self-employed people and applies if;
  - Your last tax return tax bill was higher than £1,000;
  - If you have not already paid more than 80% of your tax through other means (i.e. PAYE).
- If it applies to you:
  - You pay 150% of your last tax bill in January – 100% for Year 1 and 50% for Year 2.
  - You pay the remaining 50% for Year 2 in July.
  - You pay a 'balancing payment' for Year 2 next January, plus 50% for Year 3.
  - You pay the remaining 50% for Year 3 in July.

- Timeline if you **DON'T** pay on account:



- Timeline if you **DO** pay on account:

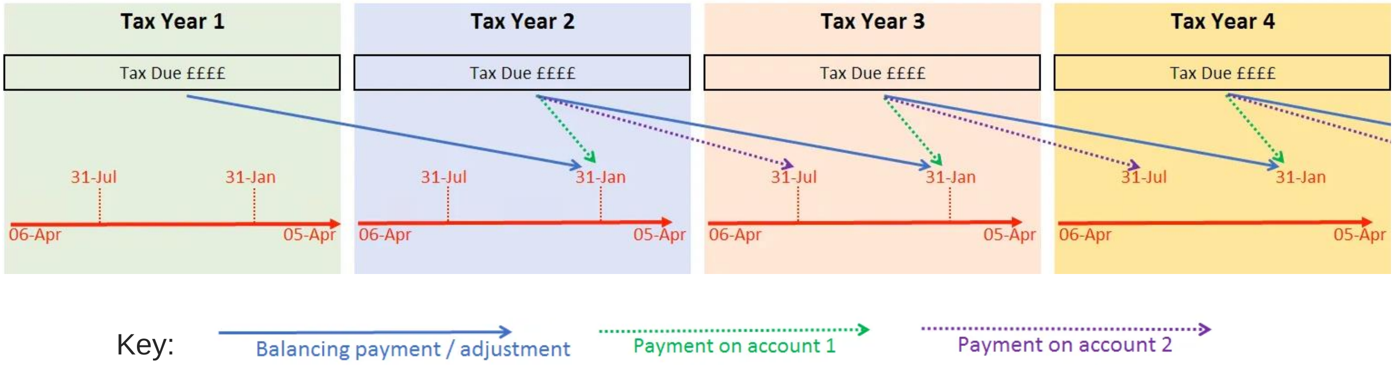


Diagram Credit: John Falcon, JF Financial

Paying tax can cause stress & anxiety, but not if you plan for it. How do we do that?

First, we understand how tax is calculated when you're self-employed;

- In respect of the money you earn from your driving business, it boils down to three things;
  - money you've been paid by customers for your service – your **income**;
  - money you've paid out to provide your service – your **expenses**; and
  - what's left when you've deducted your **expenses** from your **income** – your **profit**.
- What is deductible and what isn't can be complex. We recommend using an accountant!
- HMRC will ask you to pay income tax on part of your **profit**.
- You can keep the first £12,500 of profit tax free. This is your 'personal allowance'.
- From £12,500 to £50,000, you pay the basic rate of 20%. Above £50k is 40% (higher rate).
- You also pay Class 2 and Class 4 National Insurance if your profits exceed £6,475 / £9,501 respectively, often added to your income tax bill.
- The above rates and amounts are for the 2020-2021 tax year and will change.

Here's a very basic example for a self-employed instructor with no addition income streams:

- Your **income** for the tax year was £35,000
- The **expenses** you incurred to earn that income totalled £15,000
- Deducting your expenses from your income leaves you with £20,000 **profit**
- You keep £12,500 as your personal allowance, leaving £7,500 of taxable profit.
- HMRC asks for 20% of your profit, totalling £1,500. This is your **income tax**.
- You will also pay around £650 in **National Insurance Contributions** (NIC).

We don't want to face a £2,150 tax bill with no way to pay it, so we need to save as we earn. Here's how;

- At the end of each month, work out your profit.
- Put away **15%** of your profit into a **separate 'tax savings' account** <u>before</u> you pay yourself.
- When your tax is due, you'll have enough saved to pay it from your savings.
- Any surplus, come year end, can be saved for future years or paid into your **personal account** as a bonus. It's better to save too much than end up with a shortfall.
- Doing this eliminates the worry of future tax bills – you'll already have it ready and waiting.

Remember that typically, the tax man considers the income you've received into your business as earned, and will want to tax you on it, wherever that money sits; be it your business account or your personal account.

You can declare income as not having been earned yet, but it helps to store and manage income correctly, both for proving this and for your own organisation. Here's my preferred method;

- Set up the following accounts:
  - A **business current account** for storing earned income & paying expenses
  - A **savings account** for storing **payments** received from your customers
  - A separate **savings account** to store your future **tax** liability
  - A **credit card** for paying expenses that can be paid for in this way.
- Ask students to pay by bank transfer into your 'payments' savings account.
- From time to time, calculate how many **hours** you've worked since you last did your banking. Multiply that by your approximate **average hourly rate** and transfer that **amount** from your 'payments' savings account into your business current account.
- At month end, once you've completed the above step, pay off your credit card in full, from your business current account.
- The business current account balance will be close to your profit for the month.
- Transfer 15% of the current account balance into your 'tax' savings account.
- You can pay yourself the balance as your 'wages' (known as drawings) for the month.

That process ensures;

- you're only paying yourself what you've earned;
- you're not risking pre-paid income which may be clawed back;
- you never have to worry about your tax bill;
- you're not paying for certain expenses before you have to. You're also benefitting from protection from your credit card provider on the purchases you make.

How much you pay yourself each month will be dependent on the hours you've worked, which will fluctuate.

It's tough for your household to budget based on fluctuations in income.

Avoid peaks & troughs by forecasting; calculating what a typical month should look like. First, let's estimate your profit:

- How many hours will you work each week? *30 hours*
- How many weeks will you work per year, allowing for time off? *46 weeks*
- Calculate the average number of hours you'll work each month. Multiply hours per week by weeks per year, then divide by twelve. *(30 x 46) / 12 = **115 hours per month***
- Next, calculate your monthly **income**. Multiply your hours per month by your average hourly rate, allowing for your full rate as well as pre-paid discounts. *115 x £25/hr = **£2,875 per month***
    - Remember, this is planning for consistency. If you make more, then that's a bonus!
- Calculate your typical **expenses** over the course of a month;
    - Easy for recurring outgoings; car, franchise, insurance, association fees, MyDriveTime… *Estimate **£500 per month***
    - More difficult for fuel, but with some tracking, it is possible. I'll estimate £3 per hour… *Estimate 115 hours x £3 = **£345 per month***
- Deduct your total monthly expenses from your income to arrive at your **profit**. *£2,875 - £845 = **£2,030 per month***

Before you can spend that, you'll need to plan for tax:

- First, calculate your total profit for the year. *£2,030 x 12 = **£24,360 per year***
- Deduct your personal allowance, which is yours to keep. *£24,360 - £12,500 = **£11,860***
- Multiply what's left by 20% to determine how much tax you'll have to pay for the year. *£1,828 x 20% = £2,372.* Looks like you'll be paying on account…
- Divide that by 12 months to determine how much you'll be saving for income tax. *£2,372 / 12 = **£198 per month**.*
- Hold on… Don't forget about National Insurance Contributions. I recommend allowing 50% of your income tax total for NIC. Add that to the income tax total, and that'll be what you're saving for tax. *£198 + £99 = **£297 per month***

Here's a quick summary of **your typical month**:

• Total income (earned)	£	2,875
• Minus expenses	- £	845
• **Total profit**	**£**	**2,030**
• Minus income tax	- £	198
• Minus national insurance	- £	99
• **Total available to you**	**£**	**1,733**

Again, these totals will fluctuate month by month, so:

- In a **good month**, where you earn more, still **pay yourself the normal amount** and retain the surplus in your business current account. Be disciplined.
- In a **bad month**, you can rely on the surplus you built up in good months to top up your earnings to **pay yourself the normal amount**.
- Consider creating another savings account as a 'contingency fund' and place any surplus there to avoid it being considered in day-to-day cashflow.
- Aim for three months of drawings as a contingency.
- If you feel your projections don't reflect reality, don't feel afraid to change them immediately and adjust how much drawings you take for yourself each month.
- If you build up a sizeable surplus, and you're comfortable with paying yourself a bonus, go right ahead!

Remember, it's not about the amount of money you have in your account at any given time. It's about setting reasonable estimates, saving for tax and basing your 'pay' on hours worked.