

# The Emergency Budget

## What it means for freelancers



**An analysis for PCG by**

**Professor Anne Redston, LLB, MA(Oxon), FCA, CTA(Fellow)**



**The voice of freelancing**

## Introduction

Today's Budget was the most significant for 20 years. It made significant changes to the tax system and radically pruned benefits. The coalition has also promised to review the taxation of small business, including IR35, and to reform the way tax policy is made. Some of the measures announced as recently as this March have been ditched, while others are on the way out. Spending has been cut back hard, with serious implications for freelancers, at least in the short term.

This Briefing summarises the key Budget tax announcements as they affect PCG members.

### Corporation tax rate

The small business rate of corporation tax will go down by 1% from April next year, from 21% to 20%. This is a real win if you have your own company and pay yourself a small salary with the balance in dividends.

It also marks a decisive shift away from Labour policies: the last government planned to increase the small company rate to 22% and even 23%.

### IR35

IR35 brought PCG into existence over ten years ago, and remains a significant issue for many freelancers.

The Chancellor didn't mention it in his speech, but the Budget documents stated 'the Government remains committed to a review of IR35 and small business tax and will release further details shortly.'

Mark Prisk later expanded on this, saying that the government wants:

'to undertake a comprehensive review of small business taxation in a way that makes the need for the current IR35 legislation redundant. "But we want to make sure whatever we change is a lasting settlement. One of the problems with IR35 is that it's a constantly changing set of rules.'

Engagement with this review is possibly the most important task facing PCG, as the new regime will affect all freelancers for the foreseeable future.

### Income tax

An increase of £1,000 in the personal allowance will take effect from next year. This sounds like good news, but for most PCG members, it will make little or no difference.

This is because the personal allowance will interact with other parts of the tax system so higher rate taxpayers won't see a tax reduction despite the increased allowance.

Furthermore, the point at which higher rate tax becomes payable will be frozen for at least some of this parliament. So even if you're not a higher rate taxpayer now, the failure to take proper account of inflation means you are more likely to become one.

For those who are interested in the mechanics, both these points are explained in more detail at the end of this note.

### National Insurance Contributions (NICs)

The last government announced a 1% increase in employers and employees NICs. Many people hoped this increase would be cancelled by the coalition, but the Budget has left it almost unchanged, apart from some limited adjustments to employer contributions.

### Employee NICs

Employee contributions will rise by 1%. You will pay 12% on earnings up to the higher rate

threshold and 2% on earnings above that. The level of the higher rate threshold is expected to be set later in the year. For 2010/11, the threshold is £43,875 a year, or £844 a week.

### *Employer NICs*

These will also increase by 1%, to 13.8%. However, there are two new reliefs:

- the threshold at which employer NICs is payable will be increased by £21 a week above indexation; and
- new businesses in areas other than London and SE England will not have to pay the first £5,000 of NICs for each of their first 10 employees. This relief, called 'Regional Employer NICs Holiday for New Businesses', is expected to begin in September this year, and continue for three years.

### *Impact on freelancers*

If you are running your own business outside IR35 and pay yourself a salary higher than the personal allowance, you will be affected by the increased NIC costs. Those with engagements within IR35 have no flexibility to reduce the double hit - you will suffer a total of 2% on your deemed employment income.

It is not clear whether new freelance businesses can take advantage of the NICs holiday. A terse statement in the Budget documentation says 'individuals employing staff, e.g. for personal services...will not be eligible.'

Specifically excluded from the new relief are businesses within either IR35 or the managed service company rules - presumably because these individuals are regarded as 'disguised employees' of their clients, and the clients haven't started a new business.

If you can take advantage of the holiday, the key question is what constitutes a 'new business'. The government is likely to find it difficult to prevent existing businesses from starting up another company and winding down the old one. The Budget documentation indicates that they are aware of the problem: it says 'the Government will take steps to ensure that only businesses which undertake a sufficient degree of new economic activity will benefit.'

For more on the NICs holiday, see [www.hmrc.gov.uk/budget2010/nics-hol-qa-7076.htm](http://www.hmrc.gov.uk/budget2010/nics-hol-qa-7076.htm)

## **Capital Gains Tax (CGT)**

### *The rate*

CGT increased to 28% for disposals by higher rate taxpayers which take place on or after 23rd June 2010. This is a 10% increase over the current rate of 18%. Basic rate taxpayers still pay 18%.

#### ■ **Example 1: basic rate taxpayer**

Jessica is a student with total income of £11,000 a year. She sells a picture she found in a car boot sale, and makes a gain of £5,000 after all reliefs and exemptions. This brings her total income to £16,000, well within the basic rate band, so the extra £5,000 is taxed at 18%.

#### ■ **Example 2: higher rate taxpayer**

Omaar has total taxable income of £50,000 in 2011/12. He sells his share portfolio and makes a capital gain of £15,000 after all reliefs and exemptions. He is a higher rate taxpayer, so this gain will be taxed at 28%.

#### ■ **Example 3: taxpayer on the borderline**

Patrick's total income in 2010/11 is £30,000 of which £7,475 is his personal allowance, leaving taxable income of 22,525. He also realises a gain of £15,000 after all reliefs and exemptions.

Assuming the basic rate band is £35,400, he has already used £22,525. He thus has a balance of £12,875. So £12,875 will be taxed at 18%, and £2,125 at 28%.

### *Inflation*

CGT has been set at a lower rate than income tax:

- for basic rate taxpayers, the income tax rate is 20%, so the CGT rate is 2% less;
- higher rate taxpayers pay either 40% or 50%, so the 28% CGT rate is a considerable reduction.

One of the justifications for the lower rate is to provide a rough and ready compensation for inflation. It is a crude tool, so it doesn't distinguish between short and long-term gains.

If you have held an asset for a long time, much of your gain may simply be the result of price increases generally, rather than because the asset has really become more valuable. On the other hand, if you have held the asset for only a week, you can still benefit from the lower CGT rates.

The Chancellor said that he had considered a more sophisticated system, but decided it would be too complicated. He was probably right.

### *Entrepreneur's relief*

Currently, a gain of up to £2m on the sale of your business is taxed at only 10%. From 2011 entrepreneur's relief will be raised to £5m. The increased threshold will benefit freelancers with larger businesses.

The relief is a lifetime limit; it doesn't apply to each disposal. So if you have already made a gain of £500,000 and received entrepreneur's relief, your lifetime limit reduces to £4.5m.

Care is needed with the entrepreneur's relief, and advice should be taken from a tax specialist. A particular danger is selling parts of your business, such as your premises, separately from the rest of the trade: if you get the timing wrong, you may not qualify for the relief at all.

For more on the CGT changes, see [www.hmrc.gov.uk/budget2010/cgt-qa-1015.htm](http://www.hmrc.gov.uk/budget2010/cgt-qa-1015.htm)

### *Other reliefs and allowances*

Don't forget that CGT doesn't apply at all if your gains are £10,100 or less each year.

#### ■ **Example 4: single taxpayer, single tax year**

Marion owns shares which have increased in value by £40,000. She sells them on 1 May 2011. As she is a higher rate taxpayer she pays CGT at 28% on £29,900 ( $£40,000 - 10,100$ ) = £8,372.

#### ■ **Example 5: split shareholding, split tax years**

Cathy also owns shares which have increased in value by £40,000. In 2009 she gave 50% of the shares to her husband, Jack. They both sell half their shares on 4th April 2011 and make a gain of £10,000 each; they sell the other half on 6th April 2011 and make a further gain of £10,000 each.

The first gains fall into the tax year 2010/11, and the second into the tax year 2011/12. Cathy and Jack each have annual allowances of £10,100 for both years, so no CGT is payable.

## VAT

VAT will go up to 20% from 4 January 2011.

### *How does this affect invoices?*

If you invoice after 4 January for services you supplied before the change in rate, you can choose to invoice at 17.5%. If you do, there is no need to tell HMRC.

#### ■ **Example 6: all work done before the change**

Helen is a computer consultant who works through her own service company. She invoices her clients monthly. On 15th January she issues an invoice for work done in December. She can decide whether to add 17.5% VAT or 20% VAT.

If the period of your invoice includes the 4th January, you can choose to split it, so that the part before 4 January is at 17.5% and the balance is at 20%

#### ■ **Example 7: work continuing through the change**

Jason is an engineer in the oil industry. He has an emergency job over the Christmas and New Year period. It begins on 15 December and finishes on 5 January. He works every day, for ten hours a day.

When he issues the invoice, he can decide whether to bill the whole period at 20%, or to split the invoice, so that the 20 hours worked on 4th and 5th January are at the new rate, and the rest are at 17.5%.

For more on invoicing, see [www.hmrc.gov.uk/vat/forms-rates/rates/rate-rise-guidance.pdf](http://www.hmrc.gov.uk/vat/forms-rates/rates/rate-rise-guidance.pdf)

### *What about the flat rate scheme?*

If you use the flat rate scheme, the percentage that applies to you will also change from 4 January 2011. HMRC say that the new figures should give the same outcomes for businesses.

For computer and IT consultancy, the new percentage is 14.5%, up from 13%; the percentages are the same for structural and civil engineers and providers of labour-only building services. Management consultancy is now 14%, previously 12.5%.

For other types of business, the new percentages can be found at Annex D of this document [www.hmrc.gov.uk/vat/forms-rates/rates/rate-rise-guidance.pdf](http://www.hmrc.gov.uk/vat/forms-rates/rates/rate-rise-guidance.pdf). Those currently in force, together with some general guidance on the flat rate scheme, are at

[www.hmrc.gov.uk/vat/start/schemes/flat-rate.htm](http://www.hmrc.gov.uk/vat/start/schemes/flat-rate.htm).

## Capital allowances

The capital allowances regime has changed so often that it has become almost impossible to remember what you can claim and when. This Budget introduced yet further reforms.

The key point to remember is that for this year and next, assets qualifying for capital allowances (other than cars) can be deducted from profits as long as their total cost is not more than £50,000. In 2012, this will drop to £25,000.

### *Implications for freelancers*

If you are planning major capital investments, take advice as to the timing of purchases so you maximise your tax reliefs. It may make sense to spend the money a little earlier, and benefit from the higher allowance.

## Pensions

The last government introduced a restriction on tax relief for pensions for individuals with taxable income of £150,000 a year or more

This has proved to be very complicated to implement, as contributions by employers to final salary schemes have to be valued, which is both expensive and difficult.

This government announced that while it 'will continue with plans it inherited to raise revenues from restricting pensions tax relief', it plans to change the method. Instead of complex valuations, it is considering introducing a significantly reduced annual allowance.

In the current tax year, you can put the lower of your earnings and £255,000 into your pension, as long as the total pension pot does not exceed the lifetime allowance of £1.8m. (Note that this was also subject to transitional reliefs so some people were allowed to keep higher pension pots).

The new proposal is that the maximum annual contribution will shrink back from a maximum of £255,000 per annum to somewhere between £30,000 and £45,000.

### *Implications for freelancers*

If you have your own company, it can make contributions to your pension scheme. These contributions are free of NICs as well as income tax, as long as your total income is below the £150,000 threshold discussed above. Given the planned reduction in limits, this may be your last chance to put a significant sum of money into your pension.

Note that the rules are more complex than indicated here, and advice should be taken from an adviser knowledgeable about both tax and pensions. But with a little forward planning, significant savings are possible.

### **Tax policy-making**

All freelancers know that IR35 was introduced without any consultation, and then tweaked to make it marginally less unacceptable. Many will remember the zero percent corporation tax, which was hurriedly withdrawn, only to be replaced by the complicated non-corporate distribution rate. This in turn lasted only two years, before being unceremoniously dumped.

This sort of policy-making, on the hoof and without proper planning, may be a thing of the past. The coalition government has said that it is aiming for 'predictability, stability and simplicity in the tax system', and that it will:

- make fewer piecemeal changes to the tax code and slow down the rate of change;
- establish a new convention, that the majority of changes to tax law are confirmed no later than three months before the tax year in which they come into effect;
- take a 'more strategic approach to tax avoidance' including the possibility of having a general anti-avoidance rule; and
- create an independent Office of Tax Simplification, about which more will be announced shortly.

This is a refreshing start to the new parliament, and I certainly would welcome a less haphazard approach to tax policy-making.

For more on the proposed process, see

[www.hm-treasury.gov.uk/junebudget\\_tax\\_policy\\_making.htm](http://www.hm-treasury.gov.uk/junebudget_tax_policy_making.htm)

### **Spending**

Spending cuts are strictly outside the scope of this Briefing, but they form such a significant part of the Budget that it would be incomplete without some commentary.

In his Budget speech the Chancellor announced that the deficit would be plugged by a mixture of spending cuts and tax rises. The emphasis was on the former: Britain, he said,

had been over-spending, it was not under-taxed. Overall, around three-quarters of his deficit plug will be met by spending cuts; less than a quarter will be found by raising taxes.

Universities, social services, prisons and the police are expected to bear the brunt of the cuts. The detail won't be published until 20 October, but we already know that retrenchment in the public sector is expected to total a massive £113bn over the life of the parliament.

Staff numbers will have to be reduced, and freelancers are of course in the front line. But government departments also need to deliver services, or they will face criticism, even legal action.

If, as is likely, they have cut back too hard and are unable to meet their obligations, they are more likely to engage freelancers than permanent staff, who have ongoing pension and employment law complications.

So, in the medium term, freelancers may be re-engaged faster than other workers, but there is no escaping the short-term pain.

### **Other points of interest**

#### *Furnished holiday lets*

Freelancers who have properties let out as holiday homes were hit hard by the last government's withdrawal of key tax reliefs. The coalition promised to reverse this unpopular decision, but this Budget indicated that it won't be a simple matter of reinstating the past.

The new legislation, which has not yet been published, will increase the number of days properties have to be available for commercial letting, and the number of days they are actually let. Currently properties qualify for the reliefs if they are available for letting for 140 days and actually let for at least 70.

The good news is that the reliefs now extend to properties in the rest of the EEA, so if you let a holiday home in countries such as France, Spain or Greece, and these meet the qualifying conditions, you should qualify for these generous tax reliefs.

For more about furnished holiday lets, see

[www.hmrc.gov.uk/budget2010/fhl-qa-3755.htm](http://www.hmrc.gov.uk/budget2010/fhl-qa-3755.htm)

#### *Abandoned plans*

The March Budget announced both a landline tax to pay for the extension of broadband, and a tax relief for the video games industry. Both of these have now been scrapped.

No more has been heard about the proposals to change the status tests for construction workers, so it looks as if that too has been abandoned.

### **Postscript on the personal allowance**

#### *How the increased personal allowance works*

The £1,000 increase only benefits basic rate taxpayers. So if you are a higher rate taxpayer, this new allowance won't reduce your tax. Instead, the point at which higher rate tax becomes payable will be reduced.

This year, you will be a higher rate taxpayer if your total taxable income is more than £43,875. Total taxable income includes salary, dividends, interest and profits from property lettings.

### **■ Example 8: the position this year**

Colin's total income in 2010/11 is exactly £43,875. He has a personal allowance of £6,475, and pays tax on the balance, £37,400 at 20%. His total tax bill is thus £7,480.

But from April 2011, the government will adjust the top of the basic rate tax band, so higher rate taxpayers don't benefit from the allowance. This implies that higher rate tax will become payable when your total income goes over £42,875 (the personal allowance of £7,475 and a basic rate band of £35,400).

### ■ Example 9: the position next year

In 2011/12 Colin's earnings are exactly the same. His tax position now looks like this:

■ personal allowance	£7,475
■ tax on £35,400 at 20%	£7,080
■ plus tax on balance (43,875 - 7,475 - 35,400) x 40%	£400
Total tax: the same as in the previous year	£7,480

He thus gets no benefit from the increased personal allowance

The position may be slightly better than this, if the higher rate threshold is index linked next year to allow for inflation. But this won't be known for sure until mid-October, at the earliest.

### *The freezing of the band*

Higher rate tax thresholds normally move upwards each year by the retail price index. So if inflation is at 2%, the band should go up from £43,875 by £877 to £44,752. If it doesn't go up by inflation, more and more people will become higher rate taxpayers - not because they are really better off, but simply because of inflation. This is known as 'fiscal drag'.

The Budget documents says that the band will be frozen in 2013-14. It isn't clear what this means - is it simply a one-off freeze for that year? As discussed above, other Budget papers imply that the band may not be frozen in 2011/12. The picture is currently incomplete, and we will have to wait and see.

### **Overall conclusion**

The country has been living on borrowing for so long that it seemed like the real world. It wasn't. Coming down to earth will be painful.

Increased VAT makes almost everything more expensive, while tax rises mean we all have less to spend. Hardest of all, some current engagements will be terminated, and be very difficult to replace.

But the essence of freelancing is flexibility: most PCG members have already developed the skills needed to obtain work in the market place. You will be in a much stronger position than those newly redundant from a lifetime in the public sector.

In the short term, the review of small business is vital for freelancers: PCG is well-placed to put your perspective to government. In the medium to long term, Britain should emerge leaner and fitter, so that one day we may, once again, see a tax-cutting Budget.

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**Professor Anne Redston, Barrister, LLB, MA(Oxon), FCA, CTA(Fellow)**

Anne is a barrister and Visiting Professor in Law at King's College London. She is also a chartered accountant and chartered tax adviser. She is a member of the Tax Faculty's Technical Committee and Employment sub-committee. She sits on the Council of the Institute for Fiscal Studies (IFS) and is a member of its Executive Committee. In February 2009 she was appointed as a member of the new First-Tier Tax Tribunal.

She is consultant editor to Tolley's Yellow Tax Handbook ("The Yellow book"), the author of IR35, personal service companies and of numerous articles for professional journals. She is frequently quoted in the press and broadcast media and has lectured on tax issues to audiences across the UK.

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**For press enquiries please contact:**

Jim Cassidy  
Prima Communication & Media Limited

**T** 0141 530 8144 or 0777 595 3990

**E** jimcassidy@prima-media.co.uk

**About PCG**

PCG, the voice of freelancing, is the cross-sector association for freelancers, contractors and consultants in the UK, providing its members with knowledge, representation, community and insurance.

With around 20,000 members, PCG is the largest association of independent professionals in the EU.

It is PCG's fundamental belief that flexibility in the labour market is the key to ensuring Britain's future economic success.

PCG  
Heathrow Boulevard  
280 Bath Road  
West Drayton  
UB7 0DQ

**T** +44 (0)20 8897 9970

**E** admin@pcg.org.uk



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