It’s universal

Personal tax



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Victoria Todd discusses the impact for self-employed people of the move from tax credits to universal credit

Key Points

What is the issue?

At present, self-employed individuals are able to claim working tax credit providing they meet the relevant conditions. However, tax credits are gradually being replaced by universal credit (UC). Eventually all existing tax credit claimants will be moved to UC.

What does it mean to me?

Self-employed claimants will face new monthly reporting requirements, a stricter test establishing whether they are self-employed, possible imposition of a notional level of earnings as well as a different way of calculating income under UC.

What can I take away?

If you have clients who are currently claiming tax credits you will need to understand the self-employment rules under UC as well as the new in-year finalisation process that is used when someone moves from tax credits to UC.

Self-employment and Universal Credit – an update

At present, self-employed individuals are able to claim working tax credit providing they meet the relevant conditions. These conditions include age and weekly working hour requirements and, since April 2015, the additional requirement that their activities are undertaken on a commercial basis with a view to making a profit and are organised and regular. They may also be able to claim child tax credits, housing benefit and council tax support.

Calculating self-employed income for tax credit purposes is relatively straightforward for most self-employed people as they simply use the same figure as

they use for their tax self-assessment. This figure may then be adjusted for things such as pension contributions, carried forward trading losses as well as gift aid contributions. The rules are slightly more complex for those who use averaging (such as farmers) as that is not allowed for tax credits.

Tax credit awards are set for a tax year on a provisional basis. After the tax year ends, HMRC send out a renewal pack which has a dual purpose: to finalise the tax year just ended, and to claim for the new tax year (if appropriate). In order to finalise the claim, HMRC need to know the claimant's income for the tax year just ended. If the claimant has not completed their tax self-assessment return, they must give HMRC an estimate of their income by 31 July and then confirm their actual figure by the following 31 January. If the self-employment generates a loss, that loss can be set off against any other income of the claimant or their partner in that year and any surplus carried forward to set against future profits of the same trade. Information about losses can be found on form TC825.

The roll-out of universal credit

Universal Credit (UC) will eventually replace six benefits including working tax credit and child tax credit. It is administered by the Department for Work and Pensions (DWP) rather than HMRC. The main differences when compared to tax credits are:

- UC is a monthly assessed and paid benefit compared to the annual tax year period for tax credits.
- There are no hours thresholds in UC like there are in working tax credit – the amount you get is based on your income and circumstances.
- UC has conditionality rules. This means that, unless certain exceptions apply, claimants (including both members of a couple) will be expected to look for work until their earnings reach, in most cases, 35 hours x national minimum wage.
- UC is a digital by default benefit – in full (digital) service areas, the primary channel for new claims is online and claims are managed on an ongoing basis via an online work journal. There is a telephone helpline that can take new claims from those unable to use the digital channel.
- UC has capital rules – it is not available to those with capital of £16,000 or more and capital between £6,000 and £16,000 is converted into income by adding £4.35 of monthly income for each £250 (or part of) in excess of £6,000. Tax credits do not take account of capital per se, but any interest from the capital is

treated as investment income. (The first £300 of household income from savings and certain categories of other income is disregarded.)

UC was introduced in April 2013 in some pilot areas. Since then it has gradually rolled out across the UK. Due to some problems early in the roll-out with IT, there are currently two systems running side by side – a live service and a newer digital service (now called 'full service'). By April 2016, all postcode areas in Great Britain were covered by the live service, however only people who meet very strict gateway conditions are eligible to claim UC in those areas – meaning that it is mostly single jobseekers who can claim in the live service. From May 2016, the full (digital) service began to roll out to existing live service areas in Great Britain. UC claimants already claiming under the live service in these areas will eventually be transferred across to the digital service. This digital roll-out is expected to be complete by October 2018. UC full service is due to be introduced into Northern Ireland from September 2017.

Once that roll-out is complete, from July 2019, HMRC and DWP will begin migrating all remaining tax credit claimants to the full (digital) service. Separate arrangements will be made for those over state pension credit age (which is the same as state pension age).

In areas where full (digital) UC service is available, most people will not be able to make new claims for working tax credit and child tax credit and instead will have to claim UC. There are some exceptions to this rule. Claimants can find the latest position for their postcode using our postcode checker.

In-year finalisation of tax credit claims

Finalisation of tax credit claims for the self-employed is, as outlined above, fairly straightforward as in most cases it is done using the figure from the claimant's tax return. However, a new process called 'in-year finalisation' will be used for those who move to UC. The purpose of the new process is two-fold. First, it aims to give claimants a 'clean break' rather than waiting until after the end of the tax year to finalise their claim. Second, HMRC want to know the income of the person up until the point they move to universal credit, because from that point on they will fall under the monthly assessment periods of UC.

For the self-employed this means that they will need to calculate the 'actual or estimated taxable profits attributable to that part tax year'. The legislation (Tax

Credits Act 2002 and various regulations modified by the Universal Credit (Transitional Provisions) Regulations, SI 2014/1230, reg 12A) sets out a series of steps that must be followed requiring the self-employed person to carry out calculations that are more complicated than the current process.

The other notable difference is that claimants who have not completed their accounts by the date of finalisation will have to provide an estimate and there is no opportunity to provide an actual figure at a later date under the in-year rules.

In-year finalisation will create winners and losers because some people will be left with a tax credit overpayment and others will have an underpayment due to the change in income measure because their initial award for the tax year in which they move to UC will be set using the normal tax credit income rules. In-year finalisation only applies where a claim for UC is made, or treated as made, in the same tax year as the claimant has any entitlement to tax credits and DWP are satisfied that the claimant meets the basic conditions of UC (other than those relating to conditionality).

Self-employment under universal credit

The rules for the self-employed under UC are very different to those under working tax credit. LITRG have raised significant concerns about the design of UC for the self-employed since the Welfare Reform Bill was first published (which went on to become the Welfare Reform Act 2012). Although some minor changes have been made to the rules since then, without further changes there is a real possibility that the current rules will discourage people from starting self-employment and cause existing self-employed claimants to give up their work.

Calculating income

For UC purposes, earned income includes remuneration or profit derived from a ‘trade, profession or vocation’. This profit is treated as self-employed earnings for universal credit. Potentially the biggest difference between tax credits and UC is the annual assessment period versus the monthly assessment period because under UC, self-employed earnings must be calculated for each monthly assessment period.

The basic calculation is:

GROSS PROFITS minus INCOME TAX, NATIONAL INSURANCE CONTRIBUTIONS AND PENSION CONTRIBUTIONS

Gross profits are defined as ‘actual receipts’ for the assessment period minus ‘permitted expenses’ for that same assessment period. Permitted expenses are amounts paid out in that assessment period which the person has wholly and exclusively incurred for the purposes of the business, or an identifiable business proportion of any amount incurred for more than one purpose. They must have been reasonably incurred and the expenses must be allowable. Flat rate deductions are allowed for motor vehicles and use of the claimant’s home for business purposes. No deductions can be made for expenditure on non-depreciating assets (such as property) nor can any repayment of capital in relation to a loan taken out for the business be deducted (although loan interest of up to £41 can be deducted in each assessment period).

Note that there is no £1,000 ‘trading allowance’ for UC as is the case for income tax from 6 April 2017 (the legislation for which was delayed due to the General Election and is due to be introduced in the autumn 2017 Finance Bill). There is no de minimis for reporting self-employed income for UC.

The gainful self-employment test

All UC claimants must attend a gateway interview at which point a Jobcentre Plus adviser will assess whether the UC claimant is ‘gainfully self-employed’. If it is decided that:

- the claimant is carrying on a trade, profession or vocation as their main employment; and
- their earnings from that trade, profession or vocation are self-employed earnings; and
- the trade, profession or vocation is organised, developed, regular and carried on in expectation of profit

then the person will be treated as gainfully self-employed. If any of the bullet points do not apply, then the person cannot be treated as gainfully self-employed. If a person is not gainfully self-employed, their earnings from self-employment will still be taken into account and they may be subject to conditionality requirements – meaning they will have to look for additional work to bring their earnings up to the

relevant earnings threshold.

Minimum income floor

All UC claimants who are found to be gainfully self-employed receive a 12 month start-up period to allow their earnings to grow. After that 12 month period, the Minimum Income Floor (MIF) will apply. It is expected that people who have been trading for more than 12 months who are transferred from tax credits to UC will receive a six-month grace-period where the MIF will not apply.

The MIF is the most concerning part of the UC system for the self-employed. In any month in which the self-employed claimant's profit falls below the MIF, the UC award is assessed as if he/she had profits at least equal to the MIF. The level of the MIF is equal to the national minimum wage for the claimant's age group, assuming they work their expected number of hours each week. From this figure is deducted a notional amount for tax and national insurance. For most people, the expected number of hours will be 35 a week, although it may be fewer where a claimant has caring responsibilities or a physical or mental impairment. Those who are not subject to 'all-work' requirements will not have the MIF applied.

The main problem with the MIF is that it currently applies independently each month meaning that it impacts negatively on self-employed claimants who have fluctuating earnings and/or pay a large business expense in one month (rather than spread across the year). This leads to disparity between the employed and self-employed – it is possible for both to earn the same amount over a 12 month period but the employed person receives significantly more UC than the self-employed person.

One other point to note about the MIF is that it does not take account of pension contributions. It is explained above that when calculating income from self-employment for UC, deductions can be made for income tax, national insurance contributions and pension contributions. However, when calculating the MIF, only income tax and national insurance contributions are taken into account. This means that someone earning at or slightly above the MIF who makes pension contributions will in practice not actually get any relief for those contributions as they will be assumed to have earnings equal to the MIF. This puts self-employed claimants at a significant disadvantage when compared to similar earning employed claimants who can make pension contributions and have UC paid on the net amount.

Surplus earnings and losses

In order to address some of the problems caused by fluctuating earnings and the potential for self-employed (and employed) people to 'manipulate' their income to maximise UC entitlement, DWP introduced new legislation in 2014 (The Universal Credit (Surpluses and Self-employed Losses) (Digital Service) Amendment Regulations 2015). These surplus earnings rules have continually been delayed and are now expected to come into force from April 2018.

The basic premise of the legislation is that if someone has a UC award terminated (for example because their income goes up due to them getting a new job) a calculation will be done to work out their 'surplus earnings' for that month and the following five months. Surplus earnings are essentially the amount of income they have above the point at which their UC would reduce to nil plus a £300 de minimis. If the person then needs to claim UC again within that period, say because they lose their job after four months, the surplus earnings for those four months will be applied to their new claim as income. This means they will receive either a reduced UC award or a nil award. These surplus earnings will apply to both employed and self-employed claimants.

Alongside surplus earnings, a method of giving loss relief will also be introduced from April 2018, whereby a loss in one monthly assessment period may be carried forward over the 11 subsequent assessment periods. While better than no loss relief at all, as is currently the case, this method does not give full relief as each assessment period is still subject to the operation of the MIF.

Reporting requirements

Self-employed UC claimants must report their earnings every month – currently they can do this up to 14 days after the monthly assessment period has ended. This is likely to create a far more significant burden than the annual reporting requirement in tax credits.

You can find more detailed information on the roll-out of UC and self-employment under UC on our website for advisers, RevenueBenefits.