

STARTING IN BUSINESS AS A SOLE TRADER – A TAX SUMMARY FOR 2025/26

Key points

This factsheet sets out the key tax information you need to know as you begin your business as a sole trader.

You will need to notify HMRC that you have started a business, which can be done online.

Profits from the business will be subject to income tax and Class 4 NIC. Class 2 NIC is voluntary.

Profits and losses are calculated by adjusting the profit before tax figures in your accounts.

Unincorporated trading businesses are required to use the cash basis of accounting as a simpler way to calculate profits unless an election is made for the accruals basis to apply.

Registering for tax

You will need to notify HMRC that you have started in business via an online form (CWF1), which registers you for self-assessment. If you have never registered with HMRC before, the link will prompt you to set up a Government Gateway account.

Paying tax and NIC

Income tax is charged on the profits of the business for each tax year. Tax on trading profits is collected with other income tax charges by self-assessment.

If you make a loss, it may be possible to set off the loss against other income to reduce your tax bill.

It is important to budget for tax payments, especially when you first start the business, when there can be a long delay between making profits and paying the tax.

HMRC is introducing a new system known as 'Making Tax Digital' which could apply to you from 6 April 2026, depending on the scale of your business. We would be happy to discuss how these new rules may affect you.

National insurance contributions

Only Class 4 NIC is payable by sole traders. Class 2 NIC is voluntary and can be made to preserve access to certain benefits.

Class 4 NIC are calculated according to the level of the business' taxable profits and are paid through self-assessment. The rates are 6% for profits falling between a fixed lower and upper limit, and 2% on further profits.

VAT

For many new businesses, VAT will not be an issue due to the high registration threshold. You should be aware of the threshold though because if you do not register when you should, HMRC can charge a penalty.

The VAT registration threshold is £90,000. Registration is required if your sales for the previous 12 months are more than the threshold.

Registration is also required if there are reasonable grounds for believing that your sales in the next 30 days will be more than the threshold.

Calculating profits and losses

If you start your business after 5 April 2025, the taxable profits (or losses) for each tax year are those which arise in that year.

This means that the profits taxed for 2025/26 will be those for the period 6 April 2025 to 5 April 2026, the profits for the period 6 April 2026 to 5 April 2027 will be taxed for 2026/27 and so on.

Where the business is using the accruals basis for tax purposes, the starting point in calculating profits is usually the profit before tax figure shown in accounts are drawn up using standard accounting principles (known as GAAP).

That figure is then subject to tax adjustments to ensure that only taxable receipts and allowable expenses are included, which ultimately leads to the amount of the taxable profits or loss.

Alternatively, the business may calculate profits on the cash basis. This is the default method unless an election to use the accruals basis is made. The profit or loss is cash receipts received less cash expenses actually paid.

You will need to keep records of all business receipts and expenses so that profits can be calculated. These will also be needed if HMRC checks your tax position. We can advise you on setting up appropriate systems.

Allowable expenses

There is not a complete list of business expenses which are allowable, but some expenses, such as entertaining, are specifically disallowed. Common types of expenditure which may be allowed include:

- rent for business premises
- sales, advertising and marketing
- hiring vehicles, machinery, etc
- travel costs
- legal, professional and advisory fees
- employee costs

Expenses are allowed only if they are incurred 'wholly and exclusively' for the purposes of the business. Where an expense is only partly for the business, part of it is allowed where a business proportion can be identified.

Capital costs

Capital costs are not allowable expenses. These are the costs of buying things which you keep and use in the business, such as computers and cars. No deduction can be made for the depreciation in value of capital assets.

Instead, if the asset falls within a specified category, capital allowances can be claimed on the cost and deducted in calculating profits.

The rate of allowance depends on the type of asset.

Up to 100% of the cost of machinery can be deducted in the first year, but only 3% of the cost of commercial buildings can be deducted each year.

Different rules apply if the cash basis is used.

Employing family

Even if you operate as a sole trader, your spouse, civil partner or children can work in the business. Wages paid to family members are allowable only if they meet the wholly and exclusively test.

Given the close relationship between payer and payee, HMRC may challenge the deductions so it is important that you can demonstrate that the payments are justified based on the work done and a reasonable market rate of pay.

You may also need to operate PAYE in respect of the family members as employees.

Using the home as an office

If you intend to work from home, or even just carry out admin tasks there, a proportion of the home expenses may be deducted in calculating your profits.

HMRC operates an optional fixed rate deduction scheme which applies a sliding scale starting at £10 a month if you work 25 to 50 hours per month at home.

The monthly flat rate replaces any deduction for household running costs, including heat, light, power, cleaning and metered water charges.

It does not cover fixed costs such as mortgage interest, insurance, etc and telephone and internet costs. Separate deductions may be claimed for the business proportion of these expenses as appropriate.

In many cases, using actual costs will give a more beneficial result than the fixed rate deduction and we can calculate each of the options for you.

Using losses in the early years

If you make a loss in any of the first four tax years of trading, you can claim to set it off against your income of the three tax years preceding the year of the loss.

The whole loss is carried back and offset against earlier years first, relieving all income for each year in turn until the loss has been used up.

Further information

If you are thinking of starting in business, please get in touch on 01435 898180 to discuss all the above areas.