Introduction

Income tax is a tax on income. If something is not income, it cannot be charged to income tax, although it may be liable to some other tax. It is possible that it could be not taxable at all. The Acts of Parliament that charge income tax do not contain a general definition of income. The courts, when they have been called upon to interpret tax legislation, have developed the principle that in order for something to be income it must have a source. Justice Rowlatt considered that income was "something which is in the nature of interest or fruit as opposed to principal or tree".

So, for example, the source of interest may be a bank or other investment account, the sources of earnings may be an employment, office, self-employment or partnership and the source of rental income will be land or property.

- Identification of the source is important in order to establish how income is taxed, as there are different rules for taxing different types of income.
- If no source can be identified then, unless the item is specifically deemed to be income by statute, it will not be taxable.

So, for example, it has been held in court that a gambler will not be taxed on their winnings as gambling is not sufficiently organised to be a trade, nor does it have any other source that is liable to income tax.

This section outlines:

- The different sources of taxable income and the rules for determining the amount of taxable income or profits from each source.
- How an individual's total income is taxed.
- The various tax allowances and deductions and the ways in which tax relief is given for them.
- How income tax is calculated.
- How tax is paid.
- Some basic tax planning.

Income tax is charged for each tax year. A tax year runs from 6 April to the following 5 April.

In April 2005 the Inland Revenue merged with HM Customs and Excise to form HM Revenue & Customs (HMRC), which is now in charge of administering income tax as well as value added tax (VAT) and customs duties. Some older tax forms and publications still refer to the 'Inland Revenue'.

All the tax rules are stated as they apply to individuals who are resident and domiciled in the United Kingdom.

This section can only give an overview of this huge subject. More details of many of the areas mentioned can be found in the sections devoted to specific aspects of taxation.

Types of income

Different types of income have their own rules for calculating the amount of income that is taxable. The main categories of income for this purpose are:

- Income from land and buildings.
- Employment and pension income.

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- Income from trades, professions and vocations (self-employment and partnerships).
- Savings and investment income, including dividends and interest.
- Miscellaneous income that does not fall within any of the above categories.

Land and buildings

Profits from letting land and buildings are calculated by using ordinary accounting principles. Income from all land and properties is added together, regardless of the type of lease and whether the property is furnished or unfurnished. As well as rents, property income includes a proportion of premiums received for a lease of less than 50 years, payments for the use of furniture in a let property and for providing services to tenants and other payments to occupy or use land or to use any rights over the land, including car parking and filming rights.

For full details, see the separate topic 'Property letting'.

Employment income

Income received from an employment or the exercise of an office is taxable under the Income Tax (Earnings and Pensions) Act 2003.

Income from an office includes remuneration for acting as a company secretary or director. Such office-holders are not necessarily employees, but their income is taxable under the same rules as employment earnings.

Employed or self-employed

Sometimes it is not clear whether an individual is an employee or self-employed.

Many disputes over employment status have gone to court over the years, and HMRC and others have published extensive guidance on the distinction between a contract of service (employment) and a contract for services (self-employment).

Generally, no single factor is conclusive but relevant matters include:

- Whether the worker can be said to be 'in business', taking business risks and able to profit from working more efficiently.
- The degree of control that the 'employer' exercises over the worker. High control is indicative of employment.
- Whether the worker can sub-contract the work to another person (indicative of self-employment) or must carry out the services personally (employment).
- Whether the worker works wholly or mainly for one employer.

What payments are taxable?

Taxable employment income includes not only regular salary but also other cash payments, such as bonuses and sick pay, most lump sum payments to employees and the value of most benefits in kind.

For full details, see the separate topic 'Tax and NIC on income from employment'.

How employment income is taxed

Employment income is taxable in the tax year in which it is received.

All cash payments, other than reimbursement of business expenses, and some non-cash payments are taxed under the PAYE system.

See the separate topic 'Tax and NIC on income from employment'.

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Pensions

Pensions from statutory pension schemes and pension arrangements registered by HMRC are taxable in the same way as employment income, and there are no deductions for expenses. See separate topic.

Lump sum payments from such schemes are generally not taxable.

Income from trades, professions and vocations ('trading income')

Income tax is charged on the profits earned in a 'period of account' (the period for which the accounts are drawn up). The term 'accounting period' is reserved in tax legislation for company accounts. Trades, professions and vocations are taxable under very similar rules. In the rest of this subsection 'trade' should be taken to include professions and vocations.

Profits are calculated by using ordinary accounting principles. Accounts must be drawn up on an accruals basis. Accounts can be drawn up to any date in the year. Periods of account are normally 12 months, but a shorter or longer period of account can occur at the start or end of trading and when a trader makes a permanent change to their accounting date.

Most revenue expenses are deductible if they are incurred wholly and exclusively for the purposes of the trade. Loan and overdraft interest are generally deductible.

The costs of entertaining and gifts are not deductible.

Private expenditure is not deductible. Examples are ordinary clothing such as business suits and the trader's meals, except in conjunction with travel requiring overnight absence.

For further details, see the separate topic 'Taxation of benefits in kind'.

Basis of assessment

A self-employed individual is normally taxed or assessed on the profits of the period of account ending in the tax year. For example, a person who draws up accounts for the 12 months to 30 June 2011 is taxable on the profits of those accounts in the tax year 2011/12.

The rules are modified when a person starts and ends self-employment.

For further details, see the separate topic 'Residence and domicile and the taxation of overseas income'.

Trading losses

If a trader makes a loss in an accounting period, the assessment for the tax year in which that accounting period ends will be nil. The amount of the loss may in certain circumstances be deducted from other income of the same tax year, carried back to previous tax years, or carried forward to subsequent tax years.

See the separate topic 'Company year end tax planning' for details on the treatment of trading losses.

Savings and investment income

Savings and investment income includes:

- Bank and building society interest.
- Dividends from UK and overseas companies.
- Interest from fixed interest unit trusts.

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- Interest from government securities (gilts) and corporate bonds.
- The interest content of purchased life annuities.

The full amount of income is taxable without any deductions for expenses. Interest is taxable in the year in which it is received or credited to an account.

Most savings income arising in the UK, though not dividends, has tax deducted at 20%, so that the recipient receives 80% of the gross income. However, in some cases interest is normally paid without tax deducted. Dividends from UK companies, UK investment trusts, most unit trusts and open-ended investment companies (OEICs) and almost all foreign dividends come with a tax credit equal to one-ninth of the net dividend payment. This is equivalent to 10% of the dividend plus the tax credit. The tax credit on dividends cannot be reclaimed should it exceed the income tax owed for the year.

The dividend and tax credit together form the gross taxable dividend income. Dividends are taxed in the tax year in which they arise.

For further details, see the separate topic 'Taxation of investment'.

Other income

There are all sorts of other receipts of income that do not fall within the categories mentioned so far, but are nevertheless taxable. These items of income are referred to in the Taxes Acts as 'miscellaneous income', but are sometimes still known as 'Schedule D Case VI income' as this was the Case and Schedule under which they used to be taxed before the income tax legislation was rewritten.

Examples are:

- Payments of commission where the recipient is not carrying on a trade or profession of which they would be income.
- Payments for services provided otherwise than in the course of a trade, profession or employment.
- Certain non-trading income from intellectual property.
- Gains on some offshore life insurance policies.
- Beneficiaries' income from estates in administration.
- Income taxed under various provisions against tax avoidance, for example, the pre-owned assets tax that targets inheritance tax (IHT) avoidance.

In general, miscellaneous income is taxable in the tax year in which it arises, on the full amount with no deductions allowed. In the case of income from intellectual property, however, expenses are generally allowable.

Taxable income

After calculating the taxable income from each source in the tax year, one must:

- Add all the different amounts of income together, giving total income.
- Deduct those amounts for which tax relief is given by deduction from income.
- Deduct personal allowances.

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Some tax reliefs are not given as a deduction from total income but in the course of calculating the tax. See the separate topic 'Income tax basics: types of tax and income'.

Deductions from income

The main deductions from total income are:

- Trading losses where a claim is made to set them against other income.
- Capital allowances to the extent that they exceed letting income. These will generally be for flat conversion allowances, which are due to be abolished from a date to be announced that will be after 2012.

  Eligibility for these allowances is covered in the separate topic 'Property letting', the separate topic 'General principles of value added tax'.
- Qualifying interest payments (see below).
- Contributions to former retirement annuity plans where the provider does not operate tax relief at source (see below).
- Gifts to charities of land, buildings, shares and securities. The value of the donated asset is deducted.
  - ➢ Shares or securities must be listed or dealt in on a recognised stock exchange, including the Alternative Investment Market (AIM), or investments in authorised unit trusts or OEICs, or holdings in foreign collective investment schemes.
  - ➢ Land and buildings must be in the UK and may be freehold or leasehold.

Qualifying interest payments

Interest can be deducted from income if the loan is taken out for a qualifying purpose. It is the purpose of the loan that is important, not the asset on which it is secured.

The main qualifying purposes are:

- Purchase of shares in a close company or to finance loans to a close company.
  - ➢ Broadly a company is 'close' if it is controlled by five or fewer shareholders, or by its directors regardless of their number.
  - ➢ The borrower (either alone or with one or more associates) must own more than 5% of the ordinary shares or be entitled to more than 5% of the assets available for distribution in the event of a winding-up, or own some part of the ordinary shares and work for the greater part of his or her time in the management of the company's business, or both.
  - ➢ Tax relief is not given for interest if the loan is used to buy shares on which enterprise investment scheme (EIS) relief is claimed (see the separate topic 'Income tax basics: types of tax and income').
- Buying an interest in, or making a loan to, a partnership. The borrower must (except in certain limited circumstances) be or thereby become a partner.
- To buy plant and machinery for use in a business or employment. However, in the case of an employment, it is a condition that the employee be entitled to a capital allowance for the plant or machinery, so that, for example, interest on a loan to buy a car is not eligible.

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- To buy shares in an employee-controlled company. The company must have become an employee-controlled company no earlier than 12 months before the shares are acquired, or after they are acquired.
- Payment of IHT.
    - ➢ Tax relief is given only for interest paid in the year following the making of the loan.
    - ➢ The borrower must be a personal representative of the deceased.

Interest on loans to buy let property is deductible directly from letting income. Similarly, interest on money that a trader borrows for use in a trade is a trading deduction.

Pension contributions

Most individuals aged below 75 can make single or regular tax-relievable contributions into a personal pension.

For details, see the separate topic 'Pensions tax rules'.

Tax relief for pension payments is given in three ways.

- An employee's payments to the employer's registered occupational pension plan are normally deducted from pay before calculating tax, and so the employee does not have to claim tax relief on them.

  Rarely, an employee might make payments that exceed earnings from that employment for the year. Tax relief for the excess is given by deduction from total income.
- Most payments to personal pension schemes are paid net of 20% tax. This gives basic rate tax relief at source. Any higher rate tax relief due is given in the course of calculating the tax. See below under the separate topic 'Income tax basics: types of tax and income'.
- Most providers of former retirement annuity contracts do not operate tax relief at source, and contributions to them are deducted in arriving at total income. Retirement annuity contracts were pension plans that started before 1 July 1988. They are now generally subject to the same rules as personal pensions.

Personal allowances

All UK residents and certain non-residents are entitled to deduct the basic personal allowance from their income, regardless of age.

For 2011/12, the allowance is £7,475.

However, for individuals with 'adjusted net income' (broadly total income less certain deductions) over £100,000, the allowance is reduced by £1 for each £2 of income over £100,000. As a result, individuals with adjusted net income of over £114,949 have a zero personal allowance.

The Government has said that the personal allowance will go up to £8,105 in 2012/13.

Age allowances

The personal allowance is increased for taxpayers who are 65 or over at any point in the tax year, subject to an income limit.

For 2011/12, the allowances are:

- Age 65 to 74: £9,940.
- Age 75 and over: £10,090.

- The portions of these allowances in excess of the basic allowance are reduced by £1 for every £2 of total income over £24,000 in 2011/12.
- Total income has a modified meaning for this calculation. It is income from all sources less:
  - The deductions listed on the separate topic 'Income tax basics: types of tax and income' under the separate topic 'Income tax basics: types of tax and income' above.
  - The gross amount of any donations to charity under gift aid. The payment to the charity will be the gross donation less 20% basic rate tax, but it is the full gross amount that is deducted here.
  - The gross amount of any pension payments where relief at source is given. The payment into the pension plan is the gross amount less 20% basic rate tax.
- The result of this calculation is that a 65-year-old will receive only the basic personal allowance if total income is £28,930 or more, and none at all if the individual's adjusted net income is more than £114,949 in 2011/12.
- For a 75-year-old the personal allowance is reduced to the basic £7,475 once total income is £29,230 or more, and to zero if the individual's adjusted net income is more than £114,949 in 2011/12.
- The withdrawal of the age allowances is equivalent to an effective tax rate of 1.5 times the normal rate on income in the withdrawal band.

Blind person's allowance

Registered blind people are entitled to deduct an allowance of £1,980 (2011/12) in addition to their personal allowance.

Married couple's and civil partners' allowances

Allowances for married couples and civil partners (where at least one partner was born before 6 April 1935) are given in the course of calculating the tax (i.e. as a tax credit).

The married couple's allowances, which are also available to registered civil partners, are being phased out. They are now only available to couples where at least one partner was born before 6 April 1935.

The allowance is available where at least one member of the couple is aged 75 or over at some time in the tax year, but it is subject to an income limit. The allowance for 2011/12 is £7,295. Note that there is no longer a separate, lower allowance for people aged 65 to 75 because all married couple's allowance claimants born before 6 April 1935 are now over 75.

This allowance is reduced by £1 for every £2 of total income over £24,000. Total income in this calculation is measured in the same way as for the personal age allowances. The allowance cannot be reduced below a minimum amount of £2,800.

For couples who married before 5 December 2005 the reduction is by reference to the husband's total income.

For civil partners and for couples who married after 4 December 2005, the reduction is by reference to the income of the higher earner.

The reduction of the couple's allowance is made after the reduction to the personal age allowance. Therefore an individual who is entitled to the personal age allowance and the couple's allowance will normally only start losing the higher rate of couple's allowance when total income is more than £29,230.

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For couples who married before 5 December 2005, the married couple's allowance belongs to the husband, but it can be transferred to the wife if the husband does not have enough tax liability to use it himself.

For couples married after 4 December 2005 and civil partners, the allowance is given to the higher earner. It can be transferred to the lower earner if the higher earner does not have enough income to use it.

The whole of, or half of, the basic allowance can be transferred to the lower earning partner (or wife for pre-5 December 2005 couples) by election.

Couples married before 5 December 2005 can elect irrevocably for the new rules to apply to them from a specified tax year (not before 2006/07).

Tax relief for the married couple's allowances is given at 10% by reducing the individual's income tax liability by the tax value of the allowance, i.e. 10% of the amount of the allowance (but not so that the allowance produces a tax repayment). The maximum tax reduction conferred by the couple's allowance is thus £729.50 in 2011/12.

Calculating income tax

The following section describes how income tax is calculated in a number of circumstances. Although at first sight the calculation may appear complex, an understanding of the essential structure will soon make things clear.

Tax rates

The rate at which tax is charged depends on:

- The nature of the income.
- The amount of total income.

In the tax year 2011/12, there are seven rates of income tax:

- The starting rate of 10%.
- The basic rate of 20%.
- The higher rate of 40%.
- The additional rate of 50%.
- The dividend ordinary rate of 10%.
- The dividend upper rate of 32.5%.
- The dividend additional rate of 42.5%.

Savings income

Savings income other than dividends is taxable at four rates:

- The starting rate of 10%.
- The basic rate of 20%.
- The higher rate of 40%.
- The additional rate of 50%.

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Dividend income

Dividend income is taxable at three rates:

- The dividend ordinary rate of 10%.
- The dividend upper rate of 32.5%.
- The dividend additional rate of 42.5%.

Non-savings income

Non-savings income (e.g. income from employment, business income, property income) is taxable at three rates:

- The basic rate of 20%.
- The higher rate of 40%.
- The additional rate of 50%.

The starting rate and the starting rate limit

The starting rate limit in 2011/12 is £2,560. The starting rate of tax (10%) applies solely to savings income (other than dividend income) that falls within the starting rate band, which is the amount of income above the personal allowance that does not exceed £2,560. However, non-savings income (e.g. pensions, employment earnings) takes priority over savings income in the allocation of income to tax bands. So if a person has non-savings income of £2,560 more than the personal allowance, all the savings income will be above the starting rate limit.

If, say, non-savings income is £1,000 more than the personal allowance, savings income of up to £1,560 (£2,560 − £1,000) is taxed at 10%.

The basic rate and the basic rate limit

The basic rate limit (the limit at which income begins to be charged at the higher rate or the dividend upper rate, as the case may be) is £35,000 in 2011/12.

Non-savings income up to the basic rate limit and savings income between the starting rate limit and the basic rate limit is taxed at one of two rates.

- Dividends are taxed at the dividend ordinary rate, which is 10%. The dividend tax credit is equal to the dividend ordinary rate, so there is no further tax to pay on UK dividend income that falls below the basic rate limit (including such income that falls below the starting rate limit).
- Other income is taxed at the basic rate, which is 20%. Where tax is deducted at source from savings income, the deduction is equal to the basic rate tax, so there is no further tax to pay on this income. If no tax has been deducted at source, the recipient must pay the 20% tax to HMRC, either through PAYE or self-assessment.

The basic rate limit can be increased by certain payments, as explained with regard to personal pension payments below.

The Government has said that the basic rate limit will fall to £34,370 in 2012/13.

The higher rate and the higher rate limit

The higher rate limit for 2011/12 is £150,000.

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Income that falls between the basic rate limit and the higher rate limit is taxed at one of two rates:

- Dividends are taxed at 32.5%. The tax credit covers 10%, leaving 22.5% to pay.
- All other income is taxed at 40%.

The additional rate

Income that falls above the higher rate limit is taxed at one of two rates:

- Dividends are taxed at 42.5%. The tax credit covers 10%, leaving 32.5% to pay.
- All other income is taxed at 50%.

Order of taxing income

Because of the different tax rates that apply to different types of income, there are rules for:

- Determining the amount of total income of each type after deducting reliefs and allowances.
- Allocating the different elements of total income to each tax band.
- Deductions from total income are made from the different types of income in the following order:
    - Income other than savings and dividend income.
    - Savings income.
    - Dividends.
- Income is then allocated to the starting rate band (where possible), then the basic rate tax band and the higher rate band in the same order. Any income left over is taxed at the additional rate or the dividend additional rate.
- As already stated, only if savings income falls within the first £2,500 of income is it taxed at 10%.

See Tax calculation examples, the separate topic 'Income tax basics: types of tax and income'.

Increasing the basic and higher rate limits

There are two instances in which the basic and higher rate limits are increased. This is where the taxpayer makes:

- Pension contributions to a registered pension scheme, or
- Qualifying gift aid donations (see below).

In such cases, the basic rate limit and higher rate limits are increased by the gross amount of the contributions or donations. In either case, the effect of increasing the limits is to give the taxpayer relief at the higher (or additional) rate for the payments, while taking into account the 20% relief already given at source.

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Example 1.1 – Basic and higher rates

To see how this works, consider two individuals, David and Nick. Both have taxable income (after allowances) of £45,000, but Nick also makes pension contributions of £4,000, which is equivalent to £5,000 less basic rate relief of 20% (£1,000). Neither has any savings income.

David will pay tax of (£35,000 × 20%) + (£10,000 × 40%) = £11,000.

Nick, on the other hand, pays tax of ((£35,000 + £5,000) × 20%) + (£5,000 × 40%) = £10,000.

The difference is £1,000, which is the higher rate relief (40% minus 20% already given at source) on Nick's grossed-up pension contributions of £5,000.

The principle is the same in relation to income tax on dividends, but the tax rates are different.

Where the extension to the basic rate limit from payment of a pension contribution results in dividends being taxed at 10% instead of 32.5%, the total tax relief is 42.5%, consisting of 20% tax deducted at source plus the 22.5% reduction in tax on the dividends. Although in theory the extension to the additional rate limit could result in tax relief of 52.5% on a pension contribution (20% deducted at source plus the difference between 42.5% and 10% tax on the dividends), this would only be achieved by a taxpayer whose income in excess of the normal basic rate limit consists entirely of dividends.

For further details on pensions taxation, see separate topic, the separate topic 'Pensions tax rules'.

Donations to charity

Tax relief is available on donations to charity under gift aid.

Any donation to a charity established in the United Kingdom will qualify if the donor makes a declaration that the gift is being made under gift aid and does not receive excessive benefits in return for the donation.

Tax relief at the basic, higher and additional rates is given in the same way as for personal pension contributions. However, there is one important difference. Donors must have a UK tax liability of at least the amount of the basic rate tax deducted from the donation, otherwise they will have to pay the excess tax deducted to HMRC.

Tax relief is normally given against income of the year in which the donation is made. However, donors can claim relief against the previous year.

This gives donors with fluctuating income, who pay higher or additional rate tax in only some years, a choice of two years in which to claim higher or additional rate tax relief.

It also helps donors who do not have a UK tax liability in all years of at least the amount of the basic rate tax deducted from the donation.

The carry-back claim has to be made in a tax return that is filed on or before 31 January after the tax year.

Maintenance payments

A separated or divorced spouse (or civil partner) may have to pay to maintain an ex-partner or children. In most cases there is no longer any tax relief for such payments.

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A limited amount of tax relief is available where either the payer or the payee was born before 6 April 1935.

- The payments must be made to a separated or former spouse or civil partner (not to a child) and be enforceable under an EU court order or written agreement.
- Tax relief is given at 10% on payments of up to £2,800. Relief ends if the payee remarries or enters into a new civil partnership.
- The relief is given as a deduction from tax liability. All maintenance payments are tax-free for the recipient.

Enterprise investment scheme and venture capital trusts

Income tax relief in 2011/12 is given at 30% on subscriptions to shares under the enterprise investment scheme (EIS) and on venture capital trust (VCT) investments.

Under the EIS, one invests directly into newly issued shares in an unlisted company (the company can be listed on the Alternative Investment Market (AIM)).

VCTs are similar to investment trusts, so the risk is spread.

- The tax relief is given as a deduction from tax liability.
- The maximum investment under the EIS is £500,000 in a tax year. The Government has proposed to increase the maximum investment to £1 million from 6 April 2012. The minimum investment is £500.
- Investors must not be connected with or employed by the company.
- The maximum investment in a VCT is £200,000 in a tax year.
- Dividends from a VCT are not taxable.
- An EIS investment must be held for at least three years.
- A VCT investment must be held for at least five years (three years for shares issued before 6 April 2006).
- There are also capital gains tax (CGT) advantages to these investments.

The tax calculation summarised

As has been explained, the full tax calculation consists of the following stages:

- Calculate all the income for the tax year from the various sources.
- Deduct the tax reliefs and allowances.
- Calculate the gross amount of pension payments where relief is given at source, and donations to charity under gift aid. Add them to the basic and higher rate limits.
- Calculate tax on the total income less reliefs and allowances at the appropriate tax rates:
    - Any savings income that falls within the first £2,560 of income is taxed at 10%, bearing in mind that non-savings income takes priority over savings income in the allocation of income to tax bands.
    - The first £35,000 (or for savings income the next £32,440 above the starting rate limit) plus the amount of any addition to the basic rate limit is taxed at 20% or 10% (dividends).

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- ➢ Income above the basic rate limit but below the higher rate limit is taxed at 40% or 32.5% (dividends).
- ➢ Income above the higher rate limit (£150,000 plus the amount of any addition to it) is taxed at 50% or 42.5% (dividends).

- Deduct the tax relief value of couple's allowance, maintenance payments, and EIS and VCT investments.

The result of this calculation will be the individual's tax liability.

This is unlikely to be the amount that the individual will owe HMRC, because some tax will have been deducted at source, for example, from interest or salary, or will be covered by tax credits on dividends.

See the examples below.

Tax calculation examples

Example 1.2 – Harriet

For 2011/12, Harriet has a salary of £38,500, bank interest of £2,400 (after deduction of £600 tax at source), and UK dividends of £1,800 (with tax credits attached of £200). She is not entitled to any tax deductions other than the personal allowance.

Her income tax calculation is as follows:

- The personal allowance of £7,475 is deducted from Harriet's salary, leaving £31,025 taxable. This is taxed at 20%, giving tax of £6,205.
- This leaves £3,975 (£35,000 – £31,025) of the basic rate band unused.
- The next type of income to be taxed is the bank interest of £3,000. This is less than the unused part of the basic rate tax band, so the whole of the interest falls below the basic rate limit. The basic rate tax of 20% is equal to the tax of £600 deducted at source.
- There is still £975 (£3,975 – £3,000) of the basic rate tax band left. This means that £975 of the gross dividends falls below the basic rate limit and £1,025 falls above.
- The dividends below the basic rate limit are taxed at 10%, which is equal to the tax credits on these dividends.
- The remaining £1,025 is taxed at 32.5%, but 10% is covered by the tax credits. The additional tax on this income is therefore 22.5%.

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The calculation can be better visualised in tabular form as follows:

	Salary	Savings	Dividends	Total
	£	£	£	£
	38,500	3,000[1]	2,000[2]	43,500
Less personal allowance	(7,475)[3]			(6,475)
Taxable	31,025	3,000	2,000	37,025
Taxed as follows				
£34,025[4] @ 20%	6,205.00	600.00		6,805.00
£975[4] @ 10%			97.50	97.50
£1,025[5] @ 32.5%			333.12	333.12
Total tax due	6,205.00	600.00	430.62	7,235.62
Less paid at source:				
PAYE	(6,205.00)[6]			(6,205.00)
Deducted at source by bank		(600.00)		(600.00)
Dividend tax credits			(200.00)	(200.00)
Tax payable	0.00	0.00	230.62[7]	230.62

1: The £600 tax deducted at source must be added back to the £2,400 actually received by Harriet for the purposes of the tax computation. This is called ‘grossing up’. The £600 represents tax of 20% on the grossed-up total of £3,000.
2: Similarly, the £1,800 of dividends actually received by Harriet must be grossed up by tax credits of £200, representing 10% of the grossed-up total of £2,000.
3: The personal allowance should always be deducted in the first instance from non-savings income, as this produces the greatest benefit to the taxpayer.
4: The basic rate limit is £35,000, and income is allocated to it in the following order: non-savings income, savings income other than dividends, and dividends. Another way of looking at it is to say that savings income is the top slice of taxable income, and dividends are the top slice of savings income. Non-savings income is £31,025, so £3,975 remains, to which the bank interest is allocated in preference to dividends, leaving £975 of dividends taxable at 10% (the dividend ordinary rate).
5: The remaining £1,025 (£2,000 — £975) of dividends is therefore taxable at the dividend upper rate of 32.5%.
6: It has been assumed for this example that the correct amount has been deducted via PAYE. In practice, this is often not the case. Any shortfall can be ‘coded out’ (by adjusting the employee’s PAYE code for the following year down by the appropriate amount) or paid together with any balance of tax payable elsewhere (in this example, the £230.62 of higher rate tax on Harriet’s dividends). Where too much tax has been deducted through PAYE, the balance can be repaid or set against any outstanding liability on another source.
7: This represents 22.5% (32.5% — 10%) payable on the £1,025 of dividends falling outside the basic rate band.

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Example 1.3 – Theresa

Theresa, aged under 65, has the following income in 2011/12:

	£
Salary	48,000
Rental income	5,000
Building society interest (gross)	4,000[1]
Dividends (including tax credits)	1,000[1]

1: Theresa actually received net building society interest of £3,200 and dividends of £900.

She spent £8,000 on renovating qualifying flats above a shop. This expenditure qualifies for flat conversion allowance.

She has also paid £4,000 gross into a personal pension (actually paying £3,200 net) and invested £1,000 in a VCT.

Theresa's income tax is calculated as follows:

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	Salary	Rental income	Savings income (non-div.)	Divs.	Total
	£	£	£	£	£
Total income	48,000	5,000	4,000	1,000	58,000
Less flat conversion allowance[1]	(3,000)	(5,000)			(8,000)
Less personal allowance	(7,475)				(7,475)
Taxable income	37,525	0	4,000	1,000	42,525
Taxable at 20%	37,525	0	1,475	0	39,000[2]
Taxable at 40%			2,525		2,525
Taxable at 32.5%				1,000	1,000
Total					42,525
Tax @ 20%	7,505.00	0.00	295.00	0.00	7,800.00
Tax @ 32.5%				325.00	325.00
Tax @ 40%			1,010.00		1,010.00
Total	7,505.00	0.00	1,305.00	325.00	9,135.00
Tax paid at source					
PAYE[3]	(7,505.00)				(7,505.00)
Tax deducted from building society interest (£4,000 × 20%)			(800.00)		(800.00)
Dividend tax credits (£1,000 × 10%)				(100.00)	(100.00)
Tax payable	0.00	0.00	505.00	225.00	730.00
Less:					
VCT relief (£1,000 at 30%)					(300.00)
Tax payable					430.00

1: The flat conversion allowance of £8,000 at 100% is deducted in the first instance from rental income of £5,000 and the balance (£3,000) from Harriet's salary.
2: The gross personal pension payments increase the starting point for the higher rate of tax to £39,000 (£35,000 + £4,000).
3: Again, for the sake of simplicity, it is assumed that the correct amount of tax has been deducted by PAYE. However, in reality, it is very unlikely that Theresa would have asked HMRC to give relief in her PAYE code for the £3,000 of flat conversion allowance not relievable against her rental income.

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Example 1.4 – Krishnan

Krishnan is self-employed. He always prepares his accounts up to 30 June. In the year ending on 30 June 2010, he made a loss of £10,000, for which he did not claim tax relief against other income of the year.

In the year ending on 30 June 2011, he makes a profit of £65,000 (both figures are after making all necessary adjustments for tax purposes to the profit shown in the accounts). His other income of 2011/12 consists of £2,800 net building society interest and £450 UK dividends.

He paid £5,000 gross into his retirement annuity plan, which does not operate tax relief at source, invested £10,000 in an EIS company and made a donation to charity under gift aid of £1,600 (actual payment).

His tax computation for 2011/12 can be set out as follows:

	Earned income	Savings income	Divs.	Total tax
	£	£	£	£
Trading income	65,000			
Less losses brought forward	(10,000)			
	55,000			
Savings income (gross)		3,500[1]		
Dividends (gross)			500[2]	
Deduct retirement annuity premium	(5,000)			
	50,000			
Deduct personal allowance	(7,475)			
	42,525			
Taxable as follows				
£37,000[3] at 20%	7,400.00			7,400.00
£9,025[4] at 40%	2,210.00	1,400.00		3,610.00
£500 at 32.5%			162.50	162.50
Total				11,172.50
Less 30% tax relief on EIS investment				(3,000.00)
Tax due				8,172.50
Less tax credits and tax deducted from interest				(750.00)
Tax payable				7,422.50

1: Net interest of £2,800 + £700 (20%) tax deducted at source.
2: £450 net dividend + £50 (10%) tax credit.
3: The basic rate limit of £35,000 is extended by £2,000, represented by the net donation to charity of

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£1,600 plus basic rate tax of £400, together making a grossed up donation of £2,000 (£400 is 20% of £2,000).
4: Consisting of £5,525 of earnings and the £3,500 of building society interest.

Example 1.5 – Euan

Euan is managing director of a green energy company and his director's salary and bonuses amount to £175,000 in 2011/12. In addition, he has £10,800 of dividends. He makes charitable donations of £3,000 and has made pension contributions of £12,000 for the past four years.

His income tax calculation for 2011/12 is as follows:

	Earned income	**Dividends**	**Total**
	£	**£**	**£**
Employment as director	175,000		175,000
Dividends (gross)		12,000[1]	12,000
Taxable income[2]	175,000	12,000	187,000
Taxable as follows:			
£53,750[3] @ 20%	10,750.00		10,750.00
£115,000[4] @ 40%	46,000.00		46,000.00
£6,250[5] @ 50%	3,125.00		3,125.00
£12,000 @ 42.5%		5,100.00	5,100.00
Income tax due	59,875.00	5,100.00	64,975.00
Less tax deducted through PAYE[6]	(59,875.00)		(59,875.00)
Dividend tax credits: £12,000 × 10%		(1,200.00)	(1,200.00)
Income tax payable	0.00	3,900.00	3,900.00

1: Consisting of £10,800 net + £1,200 tax credits.
2: As Euan's adjusted net income is £175,000 – £3,750 – £15,000 = £156,250, his personal allowance is withdrawn entirely (it is withdrawn by £1 for every £2 that the adjusted net income exceeds £100,000).
3: The basic rate limit of £35,000 is extended by the grossed up amount of the pension contributions (£15,000) and the charitable donations (£3,750).
4: Higher rate tax is payable on the difference between the extended higher rate tax limit (£150,000 + £15,000 + £3,750) and the extended basic rate tax limit (£35,000 + £15,000 + £3,750), namely £115,000.
5: The balance of the director's remuneration (£175,000 – £53,750 – £115,000 = £6,250) is taxed at 50%.
6: As in the previous examples, it is assumed that Euan's tax code resulted in the correct amount of tax being deducted under PAYE.

Payment of tax

Tax is paid in three ways:

- Employees, including directors, have tax deducted from their remuneration under PAYE. By adjusting the employee's tax code, HMRC can also use the PAYE system to collect tax on

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benefits in kind and small amounts of other income. The PAYE tax code is also the means of giving certain tax reliefs and allowances to employees, such as the personal allowance and relief for pension payments.

- Tax at 20% is deducted at source from most savings income, and the tax credit attached to UK dividends covers the ordinary rate of tax on dividend income (10%).
- Self-employed people, and anyone else who has more tax to pay than the amounts already deducted from income, have to pay tax under self-assessment.
  - ➢ The tax return form, normally issued immediately after the end of the tax year, incorporates the self-assessment.
  - ➢ The 2010/11 tax return must be filed by 31 January 2012 if filed online or by 31 October 2011 if filed on paper.
  - ➢ A tax return issued within three months before the appropriate filing date must be filed within three months of issue.
  - ➢ An employed taxpayer can choose to pay balances of less than £2,000 through PAYE by adjustment to the tax code for 2012/13, but has to file the tax return by 30 December 2011 online or 31 October 2011 on paper.
  - ➢ Where a return is filed on paper by 31 October 2011 HMRC will calculate the tax in time for the due date for payment.
  - ➢ Many taxpayers have to make payments on account. Each payment on account is equal to half of the income tax payable under self-assessment for the previous year. The payments are due on 31 January in the tax year and 31 July after the end of the tax year.
  - ➢ No payments on account are needed if the tax payable under self-assessment for the previous year was less than £1,000 or if more than 80% of the previous year's tax liability was paid by deduction of tax at source (PAYE or from savings income), or from dividend tax credits.
  - ➢ The balance of tax due for the year has to be paid by 31 January following the tax year (so 31 January 2013 for 2011/12).
  - ➢ Tax return filing and payment deadlines are strictly enforced by means of automatic interest, surcharges and penalties.
  - ➢ Taxpayers who have to pay tax under self-assessment must keep accurate records of their income and all other matters relevant to their tax liability.

Tax planning key points

There are a number of fairly straightforward ways in which individuals can reduce their tax liabilities. However, you should never forget that tax is not the only consideration. For example, an investment might have tax advantages but be a poor investment. And transferring investments to a spouse might reduce tax on the income that is generated, but might cause difficulties if the marriage breaks up. Income tax planning should also take into account the effect on other taxes, such as capital gains tax and inheritance tax.

Basic income tax planning is likely to cover the following areas:

- If you are in a position to control the timing of your income, for example, if you are a director/shareholder, you should try to ensure that your personal allowances and basic rate

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tax band are not left unused in one tax year while your income is taxed at higher rates in another year.

- Some couples find that one spouse pays higher or additional rate tax, while the other does not have enough income to use up the whole of the personal allowance and basic rate tax band. There are several ways of transferring income between spouses:

    - ➢ If you are in business, you could employ your husband or wife at a salary, provided it can be commercially justified for the work carried out. You may have to deduct tax and national insurance under PAYE.

    - ➢ The business could also make employer's pension contributions for the employed spouse.

    - ➢ You might be able to run a business in partnership and share your profits equally. Both of you must be genuinely involved in the business.

    - ➢ A couple could jointly own an incorporated business, so that you can both receive dividends from the company. The tax credit on the dividend cannot be recovered, so you would both need some other income to benefit from your personal allowances.

    - ➢ In some circumstances HMRC has tried to use complex anti-avoidance legislation to tax dividends paid to a non-working spouse as if they had been paid to the spouse working in the company (and generating its profits). It is therefore important to take especial care in this area.

    - ➢ Married couples and registered civil partners can transfer assets between one another free of capital gains tax, so they could ensure that investment income arises in the hands of the individual who will pay less tax on it. Alternatively they could hold investments jointly.

- Where possible, it is worth claiming tax deductions in the years for which they give rise to tax relief at the highest rates. For example, if you have fluctuating income so that in some years you are a higher rate taxpayer and in others you are a basic rate taxpayer, or in some years you are an additional rate taxpayer and in other only a higher rate taxpayer, it may be worth contributing to a pension scheme in those years in which you pay more tax.

- You should undertake major expenditure that qualifies for 100% capital allowances, such as on qualifying flat conversions, or make full use of the 100% annual investment allowance of £100,000 in 2011/12 and £25,000 from 2012/13 in those years when your tax rate is highest.

- You should remember that you can suffer high marginal rates of tax on allowances and tax credits that are withdrawn gradually once your income exceeds a specified level. Examples include the personal allowance (where income is over £100,000) age allowances and child tax credits. The high marginal rates increase the value of any tax reliefs that reduce your income within the withdrawal band. For example, if you are entitled to age allowance, but you have dividends of £2,000 above the age allowance limit, you could pay a pension contribution and benefit from an effective rate of tax relief of 30%. This is because your age allowance will be reduced by £1 for every £1 that your income is above the age allowance limit.

- Most individuals aged under 75 can pay up to £3,600 gross into a personal pension plan and obtain tax relief at 20% regardless of earnings. You could fund pension payments for a non-earning spouse and even for children.

There are many other opportunities for tax planning, depending on your circumstances and the types and sources of your income.

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