Quick guide to income tax

What is taxed?

Income tax is generally charged on:

- earned income (such as salaries, commission etc)
- certain benefits of employment (such as company cars)
- social security benefits that replace income
- pensions, including state retirement pension
- profits from trading
- income from property (such as rent)
- income from investments (such as dividends on shares, and bank interest).

Income tax is generally not charged on:

- profits from selling an asset (which may be subject to capital gains tax)
- inheritances (which may be subject to inheritance tax)
- most gifts and prizes
- social security benefits that do not replace income
- winnings from gambling
- payments of compensation.

There are many other provisions that impose the tax, or exempt income from tax.

It should be noted that earnings from work and self-employment may also be subject to national insurance, as explained in *Quick Guide to National Insurance.*

Income tax is charged for a tax year that runs from 6 April to the following 5 April, for reasons explained in *Why 6 April?*

Who pays?

Income tax is paid by **individuals**, including members of **partnerships** and limited liability partnerships. Companies and other corporate bodies pay corporation tax instead.

Someone who us **UK-resident** is currently liable to pay income tax on all their income, wherever it arises in the world. If this is also taxed in another country, double taxation relief may be available.

Someone who is not resident in the UK is generally liable to pay income tax on:

- income earned in the UK, and
- income earned overseas and sent to the UK.

It should be noted that this is a sweeping summary of very complex provisions that are currently being reviewed. Advice should be sought on whether a non-resident is liable to UK income tax.

How much?

Most taxpayers are entitled to a **personal allowance**. For the year 6 April 2011 to 5 April 2012, this is £7,475. Anyone who earns less than this pays no income tax. Rates for earlier years are given in *Rates of income tax personal allowance.*

Older people and blind people may be entitled to other allowances. Taxpayers with earnings above £100,000 have their personal allowance reduced at the rate of £1 for every £2. So if someone earns over £114,950 (£100,000 plus twice £7,475), they have no personal allowance.

Income above this figure is then taxed at various rates. Like the personal allowance, these usually change each year. The current rates are:

- the first £35,000 is taxed at 20% (basic rate)
- the next £115,000 (to £150,000) is taxed at 40% (higher rate)
- anything above £150,000 is taxed at 50% (additional rate).

Rates for earlier years are given in *Rates of income tax.*

For example, a single man earns £200,000 a year.

His income tax is calculates as:	£
£7,475 taxed at 0%	0.00
£35,000 taxed at 20%	7,000.00
£115,000 taxed at 40%	46,000.00
£42,525 taxed at 50%	21,262.50
£200,000 taxed at	74,262.50

There are some exceptions to these rules. For example, people with small earnings just from savings may pay only 10% tax.

Dividends

Dividends are not taxed at the same rates as other forms of income. They are subject to a special dividend rate of income tax, as shown in this table:

Rate of tax	Normal rate	Dividends
Basic rate	20%	10%
Higher rate	40%	32.5%
Additional rate	50%	42.5%

The dividend is received with a tax credit equal to one ninth of the amount you receive. So if you receive a dividend of £90, you are regarded as having received a dividend of £100 on which you have paid £10 income tax.

If you are a basic rate taxpayer, that means you have no more tax to pay. Your grossed-up dividend of £100 is subject to 10% rate of tax, which you have already paid. You gross up by adding one ninth or 11.11%.

If you are higher rate taxpayer, you are liable to pay £32.50 tax on the £100, of this you have already paid £10, so you must pay another £22.50. A higher rate taxpayer must pay another £32.50.

Note that no-one has actually paid the £10 tax. The company has earned a profit, paid corporation tax, and from those post-tax profits pays dividends.

Also note that if you are not liable to pay income tax at all, you cannot claim back the tax credit. That is why people on low incomes may be best advised not to own shares at all.

Other savings income

For most other forms of savings income, tax is deducted at 20%. This includes interest on deposits with banks and building societies.

So if you receive £80 in interest, you are regarded as having received £100 interest and paid £20 income tax. So if you are a basic rate taxpayer, you have no more tax to pay.

If you pay income tax at a higher rate, you must gross up the amount received by one quarter, or 25%, and deduct tax at the appropriate rate.

Suppose someone pays the additional rate of income tax receives £80 in bank interest. The amount they received is grossed up to £100. On this 40% tax is payable. Of this £40, £20 has already been paid, so another £20 becomes payable.

Unlike the arrangement for dividends, the 20% tax *has* been paid. The bank, building society or other financial body has deducted the tax at source and passed it to HMRC.

There are a few forms of investments which pay tax gross (with no tax deducted), and a few that are not taxable.

Pensions

Income from a pension is subject to income tax. For occupational pension schemes and private pensions, this is deducted at source.

The state retirement pension, or old age pension, is also subject to income tax but, curiously, this is not deducted at source. Instead the payment is either collected through self-assessment or by adjusting a tax code for another pension.

Suppose someone receives £100 a week state pension and £100 from an occupational pension from their past employment. Suppose each is subject to 20% income tax (as would happen if the person had earnings from a current employment). Instead of receiving £80 from each pension, the person receives £100 state pension and £60 from the occupational pension. The person still receives £160 from the two pensions together, but the state pension looks bigger!

Some reliefs

Historically, you could claim tax relief on mortgage interest, **loan interest** and maintenance payments (such as to a former spouse). Most of these ceased to qualify for tax relief in 2000, but there are a few exceptions. You may still claim tax relief for a loan to buy a share of a partnership, for example. There is similar relief for buying shares in a close company, which is broadly one controlled by five or fewer people.

Payments to a **pension schem** usually do qualify for tax relief, up to a limit.

If you **rent a room** in your house, the first £4,250 a year (£81.73 a week) is tax free.

A gift to **charity** may be made under Gift Aid. For a basic rate payer, the charity collects the tax you paid to earn the amount you donated. So if you donate £80, the charity receives another 25% or £20. You had to earn £100 to receive £80 after tax. If you are a higher rate taxpayer, the difference between the higher rate and basic rate is refunded to you.

What expenses may I claim?

If you run a business, you may claim most of your business expenses. So items such as wages, insurance, stock, materials, stationery, audit, and rent are all allowable.

The expense must be wholly and exclusively for the business, so personal expenditure is not deductible from your profits.

If you have borrowed money for the business, you may claim back the interest that you pay.

Entertainment of customers is not allowable, but entertainment of staff usually is.

Fines for breaking the law (including parking tickets) are not allowable, but payments of compensation may be deducted.

If you buy something that you expect to last for at least two years, you cannot usually deduct the whole cost in the year of purchase. Examples include property, vehicles, machinery, plant, fittings and furniture. Instead you may be able to claim a **capital allowance**, which allows you to claim part of the cost each year you have this asset. Some items no longer attract any capital allowance.

If you make a loss, you may offset that loss against other profits:

- of the previous year;
- of any future year;
- in the current year against other profits or income;
- to another company in the same group; or

- for the last three years when the business ceases.

If you are an employee, you can claim very few expenses, as explained in the separate *Quick Guide to Employment Benefits and Expenses.*

Basis periods

Much income tax is paid from your wages, dividends or bank interest before you even receive them.

If it is not, most income is taxed for the tax year in which you are expected to receive the money.

If you run a business (which includes a vocation or profession), the tax is collected up to the date you make up your accounts. This can be any date you like. Once your business is established, you pay tax for your accounting period that ends in the tax year.

Suppose you decide to make up your accounts to 31 December each year. That means that your accounts for the period to 31 December 2011 are taxed in the 2011/12 tax year.

For the first year of trading, you are taxed for the profits from the day you start trading to the next 5 April.

In the final year of trading, you are taxed on the profits from the end of the previous period that was taxed.

Suppose you started a business on 1 July 2008 and finished it on 24 May 2013. These are the basis periods on which you are taxed:

Tax year	Basis period taxed
2008/09	1 July 2008 to 5 April 2009
2009/10	1 January 2009 to 31 December 2009
2010/11	1 January 2010 to 31 December 2010
2011/12	1 January 2011 to 31 December 2011
2012/13	1 January 2012 to 31 December 2012
2013/14	1 January 2013 to 24 May 2013

You will notice that the period from 1 January 2009 to 5 April 2009 has been taxed twice — once in each of the first two years.

The amount of tax that is taxed twice is known as **overlap relief.** In your final year (2013/14 in this example), you may deduct that relief from your taxable income. Overlap relief is not indexed, so the value of the relief in real terms may be much less than its value when paid.

Due date

Under self-assessment, tax is paid in two instalments with a possible third.

The first payment is due on 31 January in the tax year. The second is due on the following 31 July.

For the first date, you will not know how much you have earned, and may still not know by the second date. So the tax is calculated on the same amount as the previous year, unless you tell HMRC that your earnings that year are less.

By the following 31 January, you should have filed your tax return. Any overpayment or underpayment of tax is adjusted in the first payment you pay for the next tax year.

How is the tax collected?

Income tax is collected in three main ways:

- from earnings by PAYE
- from savings by deduction at source
- from other earnings by self-assessment.

The PAYE system applies to all forms of wages, salary, bonus, commission, honorarium, sick pay, maternity pay or other payments that arise from employment. The system is designed to calculate the exact amount of tax payable at source. The employer deducts this from the payslip before the employer receives the money. The amount is shown on a payslip. The total for the whole year is shown on a form P60 provided at the end of the tax year. Most employees do not have to be concerned about their income tax at all.

If you are a subcontractor in the building trade, you may have some of your tax deducted at sources under the Construction Industry Scheme.

Self-assessment applies in all other cases, such as if you are self-employed or if you have other income, or if your affairs are not straightforward.

If you have such income, you must notify HM Revenue and Customs. Do not think that you are excused paying income tax because you have not received a form!

If you fail to make a return when required, or if you are late paying your tax, you may be liable to a penalty. These are issued automatically by computer. You have a short while in which to make any appeal if you believe you have reasonable excuse. If you are late paying your tax, you are also liable to pay interest.

Almost all tax returns are now filed on-line. You must register with HMRC to obtain a 16-digit Gateway code, and a separately notified password. The HMRC password is a random selection of letters and digits that you can change to something more memorable. It can take a week to register, so this should not be left to the last minute.

The tax year runs from 6 April to the following 5 April. So the 2011/12 runs from 6 April 2011 to 5 April 2012. Your tax return for that period may be filed on-line at any time from 6 April 2012 to 31 January 2013.