TOPIC 3

UK taxation I

LEARNING OBJECTIVES

In this topic we begin to look at the main taxes relevant to financial services in the UK, starting with income tax. In particular, we will look at income tax on earned income and savings. In later topics we will look at how income from investments such as shares and unit trusts is taxed.

By the end of this topic, you should have an understanding of:

- the concepts of residence, domicile and reciprocal tax treaties;
- income tax and how to work out taxable income;
- income tax bands and rates;
- the different ways in which employed and self-employed people pay tax;
- tax and allowances relating to savings and dividends;
- deduction of income tax at source;
- National Insurance contributions.

This topic covers Unit 1 syllabus learning outcomes U7.1, U7.2, U7.7 and U7.8.

THINK . . .

This is probably an aspect of financial services that is only too familiar to you! Everyone in the UK who has an income – whether from earnings, property, savings or investments – has to consider whether they are liable for income tax.

- If you are employed, have a look at your most recent pay slip to see the difference between your gross and net pay and what deductions were made for income tax and National Insurance.
- If you are currently self-employed, you might be familiar with the self-assessment system, under which you potentially pay income tax twice a year.

- You might have seen media coverage around the time of the Chancellor's annual Budget statement, discussing the likelihood of a rise in income tax rates.

3.1 Tax legislation

The main statute relating to taxation is the Income and Corporation Taxes Act 1988 but there are other sources of tax law. Some of these take the form of statutes (ie legislation passed by Parliament), while others are case law (ie law established by the decisions made by judges in court cases).

Each year, following delivery of the Budget, a Finance Bill is published containing the government's taxation proposals. When the Bill is approved by Parliament and becomes a Finance Act it becomes law, the new tax measures take effect at the dates set out in the legislation.

The new Act (a Bill that has gone through Parliament and has received Royal Assent) becomes a part of the substantial body of legislation that relates to income tax and other taxes. In the UK, a tax year (also known as a fiscal year) runs from 6 April in one calendar year to 5 April in the next.

3.2 What are residence and domicile?

Whether or not a person is liable to pay income tax, capital gains tax (CGT) and inheritance tax (IHT) will depend on their residence or domicile according to UK law.

3.2.1 Residence

Residence mainly affects income tax and CGT. Any person who is present in the UK for at least 183 days in a given tax year is regarded as automatically UK resident for tax purposes. Where someone is not resident for at least 183 days in a tax year, the statutory residence test is applied (unless they are regarded as automatically not UK resident). This determines whether they will be treated as resident for a particular tax year. The nature and conditions of the tests are complex.

A person who is resident and domiciled in the UK will be subject to UK income tax on their worldwide earned and unearned income, whether or not such income is brought into the UK. Similarly, CGT is charged on the realisation of gains anywhere in the world. (There are separate, more complicated rules for those who are UK resident but not UK domiciled.)

The UK, however, has reciprocal tax treaties (more commonly known as double taxation agreements) with many other countries, the purpose of which is to ensure that individuals are not taxed in full twice on the same income or gains. Some income will only be taxed in one of the two countries covered by the agreement. In other cases, income will be taxed in both countries but, for a

UK resident, any overseas tax that has been paid will be deducted from the UK tax liability. Such reciprocal tax treaties often contain agreements to exchange information in order to combat tax evasion.

KEY TERMS

CAPITAL GAINS TAX

Tax payable on the gain made when certain assets (eg personal property above a specific value, or business assets) are disposed of, usually by selling them.

EARNED INCOME

Income from employment or self-employment (profits, salary, tips, commission, bonuses and pension benefits).

UNEARNED INCOME

Income that is not derived from employment or self-employment (interest/dividends from investments, rental income, trust income, etc).

3.2.2 Domicile

Domicile is best described as the country that an individual treats as their home, even if they were to live for a time in another country. Everyone acquires a domicile of origin at birth. This is the domicile of their father on the date of their birth (or the domicile of the mother if the parents are not married).

A person can change to a different domicile (known as domicile of choice) by going to live in a different country, intending to stay there permanently and showing that intent by generally 'putting down roots' in the new country and severing connections with the former country. There is no specific process for this.

WHY IS DOMICILE IMPORTANT?

Domicile mainly affects liability to IHT.

If a person is domiciled in the UK, IHT is chargeable on assets anywhere in the world, whereas for persons not domiciled in the UK, tax is due only on assets in the UK.

People who are not UK-domiciled but have been resident in the UK for tax purposes in at least 15 of the previous 20 tax years are deemed to be UK-domiciled for IHT purposes.

We will look at IHT in more detail in Topic 4.

CHECK YOUR UNDERSTANDING 1

Which of the following people would be most likely to be a 'UK resident'?

a) Susan, who normally lives in Spain but spends three months a year working for the family business in England.

b) Antoine, a French surveyor, whose eight-month contract in Devon with a construction company started in May.

c) Max, who moved to London from Cologne on 6 January for a seven-month teaching contract.

d) Brenda, who spends 180 days a year in the UK and the remainder in the USA.

CHECK YOUR UNDERSTANDING 2

Which of the following will **not** be subject to UK inheritance tax upon death?

a) UK property owned by Paolo, who has lived in the UK for three years but is not UK domiciled.

b) Overseas property owned by Kavita, who was born in the US (to American parents) but has lived in the UK for the past 18 years.

c) Overseas property owned by Helena, who is UK resident but not UK domiciled nor deemed domiciled.

d) Overseas property owned by David, who is UK domiciled but resident in France.

3.3 Taxable income

Income tax is one of the main sources of government revenue. Liability for income tax is based on income received in a tax year.

Income tax is due from individuals on their income from employment (including benefits in kind, such as company cars), self-employment, pension income, rental income and also on interest and dividends they receive from investments. All UK residents, including children, may be subject to income tax, depending on the type and amount of income they receive.

The income of a child that arises from a settlement or arrangement made by the parents is normally treated as the parents' income for tax purposes. In this situation, the child's unused allowances cannot be set against this income.

Not all of the income that an individual receives is taxable. Examples of taxable and non-taxable types of income are given in the following table.

Income **assessable** to tax includes:	Income **not assessable** to tax includes:
▪ salary/wages from employment, including bonuses and commissions, and taxable benefits in kind; ▪ pensions and retirement annuities, including state pension benefits; ▪ profits from a trade or profession; ▪ inventor's income from a copyright or patent; ▪ tips; ▪ interest on bank and building society deposits; ▪ dividends from companies; ▪ income from government stocks, local authority stocks and corporate bonds; ▪ income from trusts; ▪ rents and other income from land and property; ▪ the value of benefits in kind, such as company cars or medical insurance.	▪ redundancy payments and other compensation for loss of office (if total receipts exceed the current threshold, then the excess is assessable. Any payment in lieu of notice is fully taxable); ▪ a certain amount of shares given to an employee in their employer's company as part of a Share Incentive Plan; ▪ interest on NS&I Savings Certificates; ▪ income from ISAs (in most circumstances); ▪ certain covenanted or Gift Aid payments; ▪ proceeds of a qualifying life assurance policy; ▪ casual gambling profits (eg football pools); ▪ lottery prizes; ▪ wedding presents and certain other gifts from an employer that are not given in return for service as an employee; ▪ certain retirement gratuities paid by an employer (within limits); ▪ any scholarship or other educational grant that is received if one is a full-time student at school, college, etc; ▪ certain grants received from an employer solely because an individual has passed an examination or obtained a degree or diploma (certain criteria need to be satisfied); ▪ war widows' pensions; ▪ certain state benefits; ▪ housing grants paid by local authorities; ▪ the capital part of a purchased life annuity (but not the interest portion); ▪ interest on a tax rebate.

CHECK YOUR UNDERSTANDING 3

For a child, which of the following would be subject to income tax?

a) All earned income.

b) An educational grant.

c) Any earned income that exceeds their personal allowance.

d) A settlement from their parents.

KEEPING UP TO DATE

The rules relating to tax change very frequently and it is essential that you, as a financial services professional, keep up to date.

The rates, allowances and other taxation arrangements can be found on the UK government's website at www.gov.uk/browse/tax.

3.3.1 Allowances

All UK residents, including children from the day of their birth, have a personal allowance, ie an amount of income that can be received each year before income tax begins to be charged.

- **Personal allowance** – the personal allowance threshold usually determines the rate above which income tax is charged. Individuals whose annual income exceeds an upper threshold have their personal allowance reduced, depending how much their earnings exceed the threshold.
- **Marriage allowance** – it is possible for an individual to transfer part of their basic personal allowance to their spouse or civil partner, providing the transferor is not liable to income tax at all and the recipient is not liable to income tax at the higher or additional rate.
- **Married couple's allowance** – this allowance is available if one partner in a marriage or civil partnership was born before 6 April 1935. The allowance is provided as tax relief and is limited to a percentage of the applicable allowance amount.
- **Blind person's allowance** – this allowance is available to those registered as blind with a local authority. If the allowance cannot be used by the individual, it can be transferred to their spouse or civil partner.

- **Personal savings allowance (PSA)** – this enables savers to receive a certain amount of savings interest tax-free. The tax-free amount decreases for higher-rate taxpayers and there is no tax-free savings interest allowance for additional-rate taxpayers.
- **Dividend allowance (DA)** – where an individual's aggregate dividend income in a tax year falls within the DA, no tax is payable.
- **Allowances for property and trading income** – so-called 'micro-entrepreneurs' who supplement their main income with property or trading income are entitled to an additional allowance. There are two separate allowances, one for trading income and one for property income. The allowances apply to those who, for example, make small amounts of money by selling on eBay or by renting a room in their house or a parking space. If trading/property income is less than the allowance, then no tax is payable on that income; if it is more than the allowance, then the individual has the choice to either deduct the allowance from trading/property income or calculate profit in the usual way and deduct allowable expenses.

FACTFIND

For the latest rates and allowances, check:

www.gov.uk/income-tax-rates

3.3.2 Deductions

In addition to these allowances, taxpayers are permitted to make certain deductions from their gross income before their tax liability is calculated.

These deductions include:

- **certain pension contributions** (within specified limits) – for example, a scheme set up by an employer;
- **certain charitable contributions**;
- **allowable expenses** – such as costs incurred in carrying out one's employment.

For self-employed people, allowable expenses can only be incurred "wholly and exclusively for the purpose of trade", while for employed persons they must be incurred "wholly, exclusively and necessarily" while doing the job.

When all the relevant deductions have been made from a person's gross income, what remains is their taxable income. This is the amount to which the appropriate tax rate(s) is applied in order to calculate the tax due.

3.3.3 Income bands and tax rates

Income tax rates and the bands of income to which they apply are reviewed by the government each year. Any changes are announced in the Budget and included in the subsequent Finance Act.

As an example, the rates and bands for most of the UK for until 2025/26 are as follows.

		Income band (£)
Basic rate	20%	0–37,700
Higher rate	40%	37,701–150,000
Additional rate	45%	150,001+

In addition, there is a starting-rate for savings income, including interest from bank and building society accounts; anything below the limit has a tax rate of nil. Section 3.4.4 explains how the starting-rate band works.

In Scotland, different rates and bands of income tax are applied.

If someone's income comes from different sources, there is a set order in which income tax is applied.

1) First, tax is calculated on non-savings income, such as earned income, self-employed net profits, pension income and rent received.
2) Second, it is applied to savings income, ie interest received.
3) Third, income tax is calculated on dividends.
4) Finally, any chargeable gains on non-qualifying life assurance policies are brought into the calculation.

3.4 Paying income tax

3.4.1 Income taxed at source

In some cases, HMRC collects income tax at source, ie from the person who makes the payment, not the recipient.

An example of where tax is deducted at source is PAYE (see section 3.4.2). Employers deduct tax weekly or monthly (as appropriate) from wages and salaries, which are then paid to the employee net of tax.

Some other types of income are taxed at source, such as income from certain trusts.

3.4.2 How do employees pay income tax?

Employees pay income tax under the pay-as-you-earn (PAYE) system. Employers use tables supplied by HM Revenue & Customs (HMRC) to calculate the tax due from each employee; they then deduct the appropriate amount from their wages or salary and pass it to HMRC. In order to deduct the right amount of tax, the employer is supplied with a tax code number for each employee: the tax code relates to the amount that the employee can earn without paying tax, taking account of allowances, exemptions, and adjustments for taxable employee benefits (commonly referred to as benefits in kind) and for amounts overpaid or underpaid from previous years.

A P60 is issued to each employee by the employer in May each year. This shows, for the previous tax year, total tax deducted, National Insurance contributions (NICs) and the final tax code.

On leaving an employer, an employee should be provided with a form P45 showing their name; district reference; code number; week or month of last entries on the employee's deductions working sheet; total gross pay to date and total tax due to date. A copy is sent to HMRC. The P45 provides the new employer with all the information they require to complete a new tax deductions working sheet for the employee.

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INCOME TAX LIABILITY – EMPLOYEE

Saira (24) is employed. She has a salary of £27,430. Her personal allowance is £12,570.

Income:	£27,430
Less personal allowance:	£12,570
Taxable income:	£14,860
	£14,860 x 20% = **£2,972**

Saira's employer will collect this tax monthly under the PAYE scheme.

3.4.3 How do self-employed people pay income tax?

People who are self-employed (including partners in a business partnership) pay income tax directly to HMRC on the basis of a declaration of net profits calculated from their accounts. For a self-employed person, net profits are broadly the equivalent of the gross income of an employee, ie they are the amount on which income tax is based. They are calculated by taking the total income of the business and deducting allowable business expenses and capital allowances.

Taxpayers are expected to calculate their own liability and submit their figures to the tax authority for approval (although taxpayers who submit their returns promptly can ask HMRC to do the calculation for them). This process is called self-assessment. Some self-employed people use an accountant to prepare their accounts and to deal with HMRC on their behalf.

Self-employed people pay their income tax and Class 4 NICs in two equal parts. The first payment is due on 31 January of the tax year in which their business year ends; the second is due on 31 July, six months later. Any under or overpayment is then rectified on the 31 January following the end of the tax year. Class 2 NICs are also due in one lump sum on this date.

Self-assessment may apply to (among others):

- the self-employed;
- those with investment income in excess of relevant allowances;
- those who receive rental income from land and property in the UK;
- trustees;
- personal representatives of deceased persons.

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INCOME TAX LIABILITY – SELF-EMPLOYED

Michael (36), who is based in Wales, is self-employed with gross profits of £240,000. His allowable business expenses are £40,000. His personal allowance would have been £12,570 but because his income is so high, the allowance is reduced by £1 for every £2 that his income exceeds the £100,000 threshold. As a result the personal allowance is reduced to nil.

Income	£240,000
Less allowable deductions	–£40,000 (business expenses)
Net profits	£200,000
Taxable income	£200,000
Taxable income broken into tax bands:	
	£37,700 x 20% = £7,540
	£112,300 x 40% = £44,920
	£50,000 x 45% = £22,500
Income tax due	**£74,960**

As Michael is self-employed, he will calculate his own tax and pay HMRC in instalments.

3.4.4 How do people pay tax on their savings and investment income?

As well as paying tax on their income from employment, people also have to pay tax on the income they get from their savings.

Since 6 April 2016, interest on deposits has been paid gross to all customers, and individuals have to advise HMRC to deduct tax via their tax code or pay via self-assessment.

For those on low incomes a starting rate of 0 per cent applies to the first £5,000 of savings income. The starting-rate band reduces as taxable non-savings income is received, and the starting rate does not apply at all where income received exceeds an individual's personal allowance plus the starting-rate band.

Additionally, there is a personal savings allowance (PSA) for basic-rate taxpayers and a lower allowance for higher-rate taxpayers: savings income falling within these limits is subject to 0 per cent tax. In calculating eligibility for the PSA, all of an individual's income is taken into account in assessing whether they are a basic- or higher-rate taxpayer.

This is probably best explained with an example of three individuals, who each have savings income of £2,500 but have different levels of earned (non-savings income).

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APPLYING THE STARTING-RATE BAND AND PSA

Jamie

Earned income	£12,720
Taxable earned income (£12,720 – £12,570 personal allowance)	£150
Savings income	£2,500
Savings income falls within starting-rate band and total income is less than £17,570 (£12,570 plus the available starting-rate band of £4,850)	
Tax due on savings income	Nil

Roisin

Earned income	£29,600
Taxable earned income (£29,600 – £12,570 personal allowance)	£17,030
Savings income	£2,500
No starting-rate band as total income is above £17,570	
Total earned and savings income is within the basic-rate tax band so Roisin is eligible for a PSA of £1,000	
Thus £1,000 of her savings income is subject to 0% tax and £1,500 of her savings income is taxable at 20%	
Tax due on savings income	£1,000 x 0% = £0
	£1,500 x 20% = £300
	Total = **£300**

Jodie

Earned income	£49,000
Taxable earned income (£49,000 – £12,570 personal allowance)	£36,430
Savings income	£2,500
There is no starting-rate band as total income is greater than £17,570	
Total income is £51,500 (£49,000 + £2,500) meaning Jodie pays higher-rate tax. She is eligible for a PSA of £500, so the first £500 of her savings income is subject to 0% tax	
Her taxable earned income is £36,430	
£500 of her savings income is subject to 0% tax. A further £770 falls within the remaining basic-rate tax band (£37,700 – £36,430 – £500 = £770)	
The balance of £1,230 is in the higher-rate tax band	
Tax due on savings income	£500 x 0% = £0
	£770 x 20% = £154
	£1,230 x 40% = £492
	Total = **£646**

In general, savings income will fall into one of two categories:

- **Tax-free** – including income from ISAs and some National Savings and Investments accounts.
- **Paid gross without deduction of tax but subject to tax in the hands of the individual** – including interest from bank and building society accounts – if in excess of the personal savings allowance.

People may also receive dividend income, from shares, investment trusts and equity-based unit trusts/open-ended investment companies. Dividends are paid without deduction of tax. If dividend income exceeds the dividend allowance, it is taxed at different rates depending on the tax band into which it falls.

FACTFIND

Find out more about the current dividend allowance and rates.

GOV.UK: www.gov.uk/tax-on-dividends

IN BRIEF

The calculation of personal liability to income tax is broadly a four-stage process.

1) Work out the total income.
2) Make appropriate deductions, eg allowable expenses or certain pension contributions.
3) Deduct the personal allowance and other reliefs (eg blind person's allowance) to arrive at the taxable income.
4) Apply tax at the current rates to the appropriate bands of income.

Remember:

If a person's income comes from several different sources, it is taxed according to a set order of priority:

1) Non-savings income.
2) Savings income.
3) Dividends.
4) Chargeable gains on a non-qualifying life assurance policy.

3.5 Charitable giving

Making gifts to charity can be beneficial for the charity and reduce an individual's income tax liability.

3.5.1 Gift Aid

When a gift is made using Gift Aid, the charity can recover the basic-rate tax (20 per cent) that is assumed to have been paid on the amount of the gift, increasing the value of the net gift. For example, a gift of £80 from an individual who pays income tax is treated as a gift of £100: the donor pays £80 and the charity reclaims £20 from HMRC. Effectively, this is an uplift of 25 per cent (as £20 is 25 per cent of £80).

In addition, the donor making the gift has their basic- and higher-rate tax thresholds extended by the value of the gross gift.

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The following example uses the income tax bands and rates in place until 2025/26.

Ruben is a higher-rate taxpayer who makes a gift of £800.

The gross value of the gift is £800 ÷ 0.8 = £1,000.

As a result of making the gift, Ruben's basic-rate income tax band is extended by £1,000 to £38,700.

3.5.2 Payroll giving

This enables employees to make tax-efficient gifts by having a charitable gift deducted from their salary before income tax is charged. By making a gift in this way, tax relief is granted on the value of the gift at the individual's highest rate of income tax.

3.6 National Insurance contributions

NICs are a form of taxation in everything but name. They are in effect a tax on earned income and are payable in different ways according to whether the earner is employed or self-employed.

They are classified as follows.

CLASS 1

- Paid by employees at a percentage on earnings between certain levels, known as the primary threshold and the upper earnings limit with a reduced percentage payable on earnings above the upper limit.
- They are also paid by employers on most employees' earnings above a lower limit called the secondary threshold – but with no upper limit.
- No employer NICs are paid in respect of employees and apprentices under a certain age on earnings between the primary threshold and the upper earnings limit.

CLASS 2

- Flat-rate contributions paid by the self-employed if their annual profits exceed the small profits threshold.
- They are quoted as a weekly amount.
- They are collected through self-assessment.

CLASS 3

- Voluntary contributions that can be paid by people who would not otherwise be entitled to the full state pension or sickness benefits.
- This can occur because a person has, for instance, taken a career break or spent some time working overseas.
- They are flat-rate contributions.

CLASS 4

- Additional contributions payable by self-employed people on their annual profits between specified minimum and maximum levels, with a reduced rate payable above the upper limit, as for Class 1.
- They are paid to HMRC in half-yearly instalments by self-assessment.

FACTFIND

For current National Insurance rates and thresholds, go to:

www.gov.uk/national-insurance/how-much-you-pay

THINK AGAIN . . .

Now that you have completed this topic, how has your knowledge and understanding improved?

For instance, can you:

- explain the difference between residence and domicile?
- name three sources of income that are assessable to tax and three that are not?
- explain who issues individuals with their tax code and how the tax code is used?
- describe how a self-employed person pays income tax?
- explain how the starting-rate band and personal savings allowance work?
- outline the different classes of National Insurance contributions?

Go back over any points you don't understand and make notes to help you revise.

Test your knowledge before moving on to the next topic.

Test your knowledge

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Use these questions to assess your learning for Topic 3. Review the text if necessary.

Answers can be found at the end of this book.

1) A person who is UK resident for tax purposes only pays income tax on earnings generated in the UK. True or false?
2) A person may become UK domiciled once they have been settled in the country for a number of years. True or false?
3) Which of the following is **not** assessable for income tax purposes?
   a) Tips.
   b) Interest from bank and building society deposits.
   c) Lottery prizes.
   d) Rents from land and property.
4) In what order of priority is income taxed?
5) Blind person's allowance can be transferred to a spouse or civil partner if the blind person does not use the allowance. True or false?
6) Emma worked abroad for five years but is now back working in the UK. What class of National Insurance contributions could she pay to improve her contribution record for the state pension?

For the following questions, use the current tax rates, bands and allowances, which you can find at www.gov.uk/income-tax-rates.

7) Mike earns £22,000. He also receives £500 interest on his savings from a building society deposit account. Calculate the income tax payable.
8) Roopa is a company director. In the current tax year, she draws a salary of £12,500. She has dividend income of £27,000. Calculate the income tax payable.
9) Jemma is self-employed and is in receipt of blind person's allowance. In the current tax year, her gross profit is £20,000 and she has allowable expenses of £2,500. She has to pay Class 4 NICs at 9 per cent on her taxable profit above £9,500. Calculate the income tax and Class 4 NICs payable.
10) Ashok's salary is £75,000 and he is paid savings interest of £650. He also has dividend income of £7,000. Calculate the income tax payable.