

Introduction

We are often asked how income tax is calculated. The basic method is not too complicated if you understand the essential structure. What follows is a brief summary with several examples to help to make clear:

- The four different rates at which tax is calculated.
- The reliefs and allowances that are given as part of the calculation of tax.
- The two methods by which these tax reliefs are given.

All tax rates and tax band limits are stated as they apply to 2009/10. The tax band limits generally increase each year. Tax rates usually change less frequently.

Tax rates

The rate at which tax is charged depends on:

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

The starting rate limit

Savings income that falls within the starting rate band is taxed at the starting rate of 10%.

- The starting rate limit is currently £2,440.
- Non-savings income (eg 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 £2,440 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 £1,440 (£2,440 – £1,000) is taxed at 10%.

The basic rate limit

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 a rate that depends on the type of income.

- Dividends are taxed at the dividend ordinary rate, which is 10%. The dividend tax credit is equal to the ordinary tax rate on dividends, 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 HM Revenue and Customs (HMRC).

The basic rate limit is normally £37,400. For savings income this means that the next £34,960 (£37,400 – £2,440) of income above the starting rate band is taxed at the basic rate. The basic rate limit can be increased by certain payments, as explained with regard to personal pension payments below.

Income above the basic rate limit

There are two higher tax 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 2009 Budget announced an additional higher rate of 50% for taxable income above £150,000 from 6 April 2010. The corresponding rate for dividends will be 42.5%.

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.

The rules are:

- 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 savings starting rate and then the basic rate tax band in the same order. Only if savings income falls within the first £2,440 of income is it taxed at 10%.

See the examples on pages 6, 7 and 8.

Pension contributions with relief at source

Most contributions to registered personal pensions made by an individual are paid net of basic rate tax.

For example, a person paying £3,600 into a pension will actually pay the pension company £2,880 (£3,600 less basic rate tax of 20%).

- The pension company reclaims the 20% tax from HMRC.
- Deducting basic rate tax has the effect of automatically giving the payer basic rate tax relief. The payer does not have to claim this tax relief from HMRC.
- The basic rate tax relief is given even if the payer does not pay as much tax as 20% of the pension contribution.

An individual who pays higher rate tax on any of their income is entitled to higher rate tax relief on personal pension payments but has to claim it.

- This is done by adding the gross pension payment (before deduction of tax) to the basic rate limit before calculating income tax.
- For example, an individual who pays £3,600 gross into a personal pension plan will only pay tax at the higher rates on total income above £41,000 (£37,400 + £3,600) instead of on total income above £37,400.

- The result in terms of tax is that an individual whose non-savings income is equal to or more than the increased basic rate limit will pay tax at 20% instead of at 40% on income equal to the gross pension payment.
- This produces additional tax relief of 20% of the gross pension payment. When this is added to the 20% tax relief given by deduction from the payment, the total relief is 40%.
- The principle is the same in relation to the income tax on dividends, but the tax rates are different.
- For dividends, the total tax relief resulting from the payment of pension contributions is 42.5%, consisting of 20% tax deducted at source plus 22.5% because the addition to the basic rate limit results in dividends being taxed at 10% instead of 32.5%.

The 2009 Budget announced that higher rate tax relief on pension contributions would be restricted for people with taxable income of £150,000 or more from 6 April 2011. Above that level of income, the value of pension tax relief will be tapered down until it is 20% for people with income over £180,000.

Anti-forestalling provisions have been put in place to prevent people with 'relevant income' of £150,000 or more from significantly increasing their pension contributions on or after 22 April 2009 (Budget Day) in order to take advantage of higher rate tax relief before the restriction comes into effect.

- Broadly speaking, the interim rules apply to people whose normal pattern of regular (at least quarterly) pension contributions is changed, or the way in which their pension benefits are accrued is altered after 21 April 2009, and whose 'pension savings' (total pension contributions from all sources and/or value of additional benefits accrued) are more than their special annual allowance, calculated as the greater of:
 - £20,000 a year; and
 - The average over 2006/07, 2007/08 and 2008/09 of their 'irregular (less frequently than quarterly) money purchase contributions, subject to a maximum average of £30,000
- People who meet these criteria will suffer a special annual allowance charge (SAAC) on the excess contributions, defined as:
 - The excess over regular pension savings, where those savings exceed their special annual allowance.
 - The excess over their special annual allowance where regular pension savings are below their special annual allowance.
- The SAAC will have the effect of restricting tax relief on the excess pension savings to basic rate and will be collected through the self assessment tax return.

Donations to charity

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

Any donation to a charity established in the UK 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 and higher 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 rate tax in only some years, a choice of two years in which to claim higher 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.

Married couple's and civil partners' allowances

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 basic allowance is £2,670 in 2009/10.

- Higher allowances are available but they are subject to an income limit. The higher allowance for 2009/10 is £6,965. (Note that there is no longer a separate rate for people aged 65 to 75 because in the 2009/10 tax year all married couple's allowance claimants born before 6 April 1935 will become 75 at some point during the year).

This higher allowance is reduced by £1 for every £2 of total income over £22,900. Total income in this calculation is measured in the same way as for the personal age allowances.

- 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 from 5 December 2005 onwards, the reduction is by reference to the income of the higher earner.
- The reduction to the higher rate of 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.
- The couple's allowance is never reduced to less than £2,670 regardless of income.
- 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 on or after 5 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, ie the amount of the allowance x 10% (but not so that the allowance produces a tax repayment).

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.

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 £2,670. 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 is given at 20% on subscriptions to shares under the enterprise investment scheme (EIS) and at 30% on venture capital trust (VCT) investments in 2009/10.

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 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 rate limit.
- Calculate tax on the total income less reliefs and allowances at the appropriate tax rates:
 - Any savings income that falls within the first £2,440 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 £37,400 (or for savings income the next £34,960 above the starting rate limit) plus the amount of any addition to the basic rate limit is taxed at 20% or 10% (dividends).
 - Income above the basic rate limit is taxed at 40% or 32.5% (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 in section 2.8.

Examples

Joseph

For 2009/10, Joseph has a salary of £39,000, bank interest of £3,000 (gross), from which tax of £600 has been deducted at source, and gross UK dividends of £2,000, consisting of cash received of £1,800 and tax credits of £200. He is not entitled to any tax deductions other than the personal allowance.

- The personal allowance of £6,475 is deducted from his salary, leaving £32,525 taxable. This is taxed at 20%, giving tax of £6,505.
- This leaves £4,875 (£37,400 – £32,525) 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 £1,875 (£4,875 – £3,000) of the basic rate tax band left. This means that £1,875 of the gross dividends falls below the basic rate limit and £125 is above.
- The dividends below the basic rate limit are taxed at 10%, which is equal to the tax credits on these dividends.
- The remaining £125 is taxed at 32.5%, but 10% is covered by the tax credits. The additional tax on this income is therefore 22.5%.

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

	Salary	Savings	Dividends
	£39,000	£3,000	£2,000
Less personal allowance	£6,475		
Taxable	£32,525		
Taxed as follows			
Earnings			
£32,525 at 20%	£6,505		
Savings			
£3,000 at 20%		£600	
Dividends:			
£1,875 at 10%			£187.50
£125 at 32.5%			£40.62

In this example it is immediately apparent that none of the savings income is taxable at 10%, so the calculation could be shortcut by considering the salary and savings income together.

Daphne

Daphne, aged under 65, has the following income in 2009/10:

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

(She 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.

- 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 her salary.
- Then the personal allowance (£6,475) is deducted from her salary. This leaves taxable salary of £38,525 (£48,000 – £3,000 – £6,475).
- The gross personal pension payments increase the starting point for the higher rate of tax to £41,400 (£37,400 + £4,000).

- The taxable salary is only £38,525, leaving £2,875 (£41,400 – £38,525) of the basic rate band available for other income.
- Tax is calculated as:

	£
£38,525 (salary) at 20%	7,705
£2,875 (interest below basic rate limit) at 20%	575
£1,125 (interest above basic rate limit) at 40%	450
£1,000 (dividends) at 32.5%	325
Total	9,055

- The VCT investment of £1,000 qualifies for tax relief of £300 (30%). This reduces her tax liability still further.
- Part of this tax liability would be covered by the 10% tax credits on dividends (£100 on dividends received of £900), the 20% tax deducted from the building society interest (£800) and tax deducted from her salary under PAYE. She would also have received basic rate tax relief of £800 on the £4,000 pension payment by paying only £3,200 to the pension company.

Sven

Sven is self-employed. He always prepares his accounts up to 30 June. In the year ending on 30 June 2008, 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 2009, he made 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 2009/10 consisted 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 a VCT and made a donation to charity under gift aid of £1,600 (actual payment). His tax computation for 2009/10 can be set out as follows:

	Earned income	Savings income	Dividends	Total tax
	£	£	£	£
Trading income	65,000			
Less losses brought forward	(10,000)			
	55,000			
Savings income		2,800		
Add tax deducted at source (20/80ths)		700		
Taxable savings income		3,500		
Dividends			450	
Add tax credit (10/90ths)			50	
			500	
Deduct retirement annuity premium	(5,000)			
	50,000			
Deduct personal allowance	(6,475)			
	43,525			
Taxable as follows				
£39,400* at 20%	7,880			7,880.00
£4,125 at 40%	1,650			1,650.00
£3,500 at 40%		1,400		1,400.00
£500 at 32.5%			162.50	162.50
Total				11,092.50
Less 30% tax relief on VCT investment				(3,000.00)
Tax for the year				8,092.50
Less tax credits and tax deducted from interest				(750.00)
Tax payable				7,342.50

* Basic rate band of £37,400 is extended by £2,000. This is the net donation to charity of £1,600 plus basic rate tax of £400 together making a grossed up donation of £2,000 (£400 is 20% of £2,000).

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 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 2008/09 tax return must be filed by 31 January 2010 if filed online or by 31 October 2009 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 2010/11, but has to file the tax return by 30 December 2009 online or 31 October 2009 on paper.
 - Where a return is filed on paper by 31 October 2009 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 were needed for 2008/09 if the tax payable under self-assessment for the previous year was less than £500 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 £500 limit has been increased to £1,000 for payments on account for 2009/10 onwards. The first payments on account to be affected will be those due on 31 January 2010 and 31 July 2010.
 - The balance of tax due for the year has to be paid by 31 January following the tax year (so 31 January 2011 for 2009/10).
 - 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.

Basic tax planning

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, you are a director–shareholder, you should try to ensure that your personal allowances and basic rate 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 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 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. Registered same sex couples will be able to do likewise. 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 a fluctuating income so that in some years you are a higher rate taxpayer and in others you are a basic 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 £50,000 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 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.

This guide is for general information only and is not intended to be advice to any specific person. You are recommended to seek competent professional advice before taking or refraining from taking action on the basis of the contents of this publication. The guide represents our understanding of the law and HM Revenue & Customs practice as at September 2009, which are subject to change.