



Overview

Income tax is **paid** by individuals, trusts, personal representatives and members of partnerships on their income and some benefits. It is not paid on capital gains which may be subject to capital gains tax. Income tax is also not paid by companies, associations and some other collective bodies, who pay corporation tax.

Thus, income tax, capital gains tax and corporation tax are mutually exclusive. If an income, profit or gain falls to be taxed under one of these taxes, it is automatically excluded from the other two. The distinctions are not always clear. Sometimes, such as for a lease premium, one payment has to be split between capital and income.

There are some circumstances where a company can have income tax deducted from a payment, and where it may be required to account for income tax.

Each **individual** is liable for his or her own tax. The incomes of husbands and wives ceased to be aggregated in 1990. An individual can be liable for income they have earned which is paid to someone else, such as when part of a salary is paid to a husband or wife.

Income must first be assessed according to its **source**, such as whether it arises from employment, trading, investment, property etc. There are different rules for expenses and some allowances that are specific to particular sources.

The net figures for each source are added, and the tax is charged on the total. A taxpayer is usually entitled to a **personal allowance** which may be deducted from that total. Income tax is then charged at increasing percentages on slices of income.

Income tax is charged for **tax years** which run from 6 April to the following 5 April. There are some schemes which collect the tax at source, of which pay as you earn (PAYE) on employment income is the most important.

Otherwise taxpayers are required to report their own income, calculate the tax payable, and ensure it is paid to HMRC. Penalties and interest may be imposed for misdeclarations and lateness. Although HMRC does remind taxpayers, the onus of compliance is with the taxpayer. Such taxpayers usually declare their income under **self-assessment**, which means completing a

return online. A source of income must be disclosed to HMRC by 5 October following the end of the tax year in which that income arose.

From September 2017, there is a new procedure known as **simple assessments**. This allows HMRC to issue an assessment to a taxpayer where it has sufficient information to do so. The taxpayer may either pay the assessment, or contest the amount.

UK **resident** taxpayers are liable to pay income tax on earnings from anywhere in the world. This may be subject to double taxation relief if it would otherwise be taxed in two countries. Non-residents are generally liable to UK tax on earnings in the UK or remitted to the UK. There are some exceptions for those who are not domiciled in the UK.

Scotland has set different rates from 6 April 2017. Wales will be setting different rates from 6 April 2019.

There are no age limits, so **children** can be liable if they have sufficient income. Their returns may be submitted by parents or guardians on their behalf.

Law

Income tax is, at least in theory, a temporary tax that requires a new **Act of Parliament** each year. It has been charged every year since 1842. The main laws are:

- Income Tax Act 2007
- Income Tax (Trading and Other Income) Act 2005
- Income Tax (Earnings and Pensions) Act 2003
- Taxation (International and Other Provisions) Act 2010

Administration procedures are contained in Taxes Management Act 1970. Capital allowances are contained in Capital Allowances Act 2001. Each year a Finance Act is passed, some of which amends other Acts and some of which stands as new provisions. Some provisions are contained in statutory instruments.

Income tax is administered by HM Revenue and Customs (HMRC). HMRC provides much guidance, such as helpsheets, toolkits and manuals. These are available from HMRC's website.

HMRC also issues statements of practice and Briefs, explaining its position on particular tax matters. While these are binding on HMRC officers, they are not binding on taxpayers. A taxpayer may challenge such statements before a tribunal or court.

Generally, the amount of income tax payable under assessment must either be agreed by the taxpayer or confirmed by a tribunal or court. Their decisions are now published and provide further direction on tax matters.

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
- pension payments, including state retirement pension
- profits from trading
- income from property (such as rent)
- income from investments (such as dividends on shares, and bank interest)
- interest on savings accounts and from investments.

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
- lump sums from pension funds (to a limit)
- social security benefits that do not replace income
- winnings from gambling
- maintenance payments
- scholarship income
- insurance proceeds
- housing grants and similar
- compensation for loss of office up to £30,000 (subject to conditions)
- payments of compensation.

There are also tax-advantaged schemes where income tax is not charged.

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

If a donation is made to a charity under **Gift Aid**, the charity may claim back the income tax paid by the taxpayer at the basic rate, provided the taxpayer paid sufficient income 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.

Amount of tax

Most taxpayers are entitled to a **personal allowance**. This is revised each year with effect from 6 April. The personal allowance for 2018/19 is £11,850. A married person may transfer 10% of his or her personal allowance to their partner.

There are separate additional allowances for blind people, and for married people where either of them was born before 6 April 1935. Otherwise, there are no longer additional allowances for older taxpayers, nor are there allowances for children, housekeepers or dependent relatives.

The personal allowance means that someone with income below that figure pays no income tax at all. If someone has income above the allowance, they pay tax on slices of income above that allowance. Except in Scotland, there are three rates:

- basic rate of 20%
- higher rate of 40%
- additional rate of 45%.

There is a provision that anyone with taxable income above £100,000 has their personal allowance reduced by £1 for every £2 above £100,000 until the figure is zero. Zero is reached for income of £100,000 plus twice the personal allowance. For 2018/19, this is £123,700. It means that on the slice of income between £100,000 and £123,700, the taxpayer is paying tax at an effective rate of 60%.

From 6 April 2016, there is also a personal savings allowance of £1,000 a year for basic rate taxpayers, £500 for higher rate taxpayers, and nil for additional rate taxpayers. This is additional to the personal allowance.

Low earners whose income is solely from saving may also claim £5,000 **savings income rate** of 0%. With the personal allowance and personal savings allowance, this means that an individual may receive up to £17,850 a year in savings tax-free, provided they have no other income.

Special rates apply for **dividends**. There is a dividend allowance of £2,000 for 2018/19 (£5,000 for 2017/18) on which no additional tax is paid. For dividends above this allowance, dividends are (from April 2016) taxed at special rates of 10%, 32.5% and 38.1%. As the dividend income has already been subject to corporation tax, this means that the total tax on dividends is about 5 percentage points higher than other forms of investment income.

From 6 April 2017, there is a £1,000 a year allowance for property income and £1,000 a year for trading income. This figures may be claimed instead of claiming actual expenses.

A simple tax computation for 2018/19 for a single person with taxable income of £50,000 in England is:

£11,850 taxed at 0%	£0
£34,500 taxed at 20%	£6,900
<u>£3,650</u> taxed at 40%	<u>£1,460</u>
<u>£50,000</u> taxed at	<u>£8,360</u>

Where there are different sources of income and claims for reliefs, the tax computation can be more difficult.

Income tax is also used for some other purposes. If a person uses a **pre-owned asset**, such as living in a house donated to a child, there can be an income tax charge unless the donation counts as a gift with reservation for inheritance tax. If a taxpayer earns more than £50,000 and either the taxpayer or their partner receives child benefit, all or some of that benefit may be clawed back as income tax under **high income child benefit charge**.

Administration

Income tax is collected in one of these ways:

- at source by someone else, such as under PAYE or construction industry scheme
- by HMRC issuing a simple assessment
- by the taxpayer completing an annual self-assessment return
- by an assessment issued by HMRC.

The annual self-assessment return procedure will change in 2020 when **Making Tax Digital** is widely adopted.

A self-assessment return must be completed:

- on a paper return by 31 October following the end of the tax year
- online by 31 December if the taxpayer has outstanding tax that he or she wants collected by adjusting their tax code for the following tax year, or
- online by 31 January otherwise.

There is an automatic £100 fine for being late with a tax return, followed by further penalties if the return continues to be outstanding.

From filing, there is a 12-month period in which the taxpayer can amend the return, or HMRC can query anything on it. HMRC may make a determination within four years. For fraud, HMRC can go back 20 years. HMRC may issue a **discovery assessment**, at any time, provided it has something to discover. The bar is set very low, so, for example, a tax inspector changing his or her mind can be a discovery. However, an inspector cannot “discover” something that is clearly stated on the face of a tax return.

Online filing requires the taxpayer to be **registered** with HMRC. The taxpayer is given a Unique Taxpayer’s Reference (UTR) which identifies him or her (in addition to the national insurance number) and a Gateway code to access the online facilities. From 2017, there is another level of protection in that another number is phoned through to the taxpayer to make a return.

One of the benefits of Making Tax Digital is that HMRC accesses data from other sources, so that online returns are now prepopulated with some data such as income from employment and pensions.

HMRC is also introducing **personal tax accounts**. This allows the taxpayer to manage their tax affairs online, such as notifying a change of address. It also allows the taxpayer to see how

much tax is owed and how much has been paid. It can also be used for other purposes, such as recording national insurance and entitlement to certain benefits.

In general, income tax returns simply require the figures. A taxpayer must keep proper **records** to substantiate those figures, but does not have to send copies to HMRC unless, exceptionally, HMRC requests sight of them.

Taxpayers must **keep records**. Those who are trading or otherwise in business must keep them for five years and ten months after the end of the tax year. Other taxpayers must keep them for 22 months. The records may be kept on paper or computer. If HMRC starts an enquiry, the records must be kept for any further period until the enquiry ends.

A **partnership** itself is not subject to income tax — the partners are. One partner must be designated to submit a partnership return (form SA 800) disclosing partnership income and how it has been apportioned to each partner. Each partner then includes that income with any other taxable income on his or her own tax return.

A similar procedure can apply for **trusts**, using form SA 900. This establishes any liability for the settlor or beneficiaries.

Where income tax is collected under self-assessment, **payments** are generally due in two instalments:

- on 31 January in the tax year
- on 31 July after the tax year (ie six months later).

As the January figure may not be known, it is usual to use the same figure as for the year before. If this results in too much tax being paid, a refund is now automatically given. If it results in too little, a further payment is required. A taxpayer who believes his or her tax will be less than for the previous year may apply by 31 January to pay a lower sum. The reason must be given, either on form SA 303 or in a letter.

Payment may be made online using Internet banking, by cheque or by debit card. HMRC no longer accepts payment by credit card or by paying-in at a Post Office. If paying by a cheque, sufficient time should be allowed for the post to avoid a penalty for lateness.

An individual who has difficulty in paying his or her tax is advised to contact HMRC who may be able to agree a longer period to pay. The Business Payment Support Service can be contacted on 0300 200 3835. It has a good record in quickly agreeing terms, usually allowing an extra period of between three and six months.

Interest and **penalties** are imposed for late filing, late payment and errors that are either deliberate or careless. A penalty may be appealed on grounds of reasonable excuse. There is no appeal against interest. There are particularly steep penalties for deliberate evasion involving

overseas territories. These can be as much as 200% of the tax involved. Very serious cases of tax evasion are criminal offences for which a person can be imprisoned.

Scotland

The Scottish Parliament has had the power to set its own income tax rates or vary the UK rates since 1999, but has only used that power from 2017.

For 2017/18, the only change was to keep the higher rate threshold at £43,000 instead of increasing it to £45,000. This meant that a higher rate taxpayer could pay up to £400 (20% of £2,000) more tax in Scotland than England.

For 2018/19, the changes were more significant. The personal allowance was kept the same at £11,850, but two additional rates were added. There is a starting rate of 19% for the first £2,000 of taxable income. This means that low earners can pay up to £20 a year (68p a week) less tax than in England. An intermediate rate of 21% was added, and the higher and additional rates were all increased by 1 percentage point to 41% and 46%.

The marginal rate of income tax payable on incomes between £100,000 and £123,700 is 61.5%.

In 2018/19, someone in England earnings £200,000 pays £73,230 income tax. In Scotland, they pay £78,042.

The Scottish rates are paid by Scottish residents only on *earned* income. This includes income from employment and self-employment, and pensions. It does not include income from investments, dividends and similar. These are still subject to what is known as rest of UK (rUK) rates. It can mean that a Scottish taxpayer has to prepare two tax computations.

A Scottish taxpayer is basically anyone who is:

- an MP, MEP or MSP for Scotland
- resident in Scotland for at least half the tax year, or
- resident in Scotland for more days than anywhere else for the tax year.

It should be noted that it is the residence of the taxpayer that determines whether a taxpayer pays Scottish rates. So an English employer with a Scottish representative could have to operate Scottish rates for that employee.

From 6 April 2019, different rates of income tax will be introduced for Wales.

Some reliefs

Historically, a taxpayer could claim many reliefs. These included 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. A taxpayer 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 scheme** usually do qualify for tax relief, up to a limit, which has been reducing.

A taxpayer with a lodger may claim **rent-a-room**. This means that up to £7,500 a year may be received 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 a taxpayer donates £80, the charity receives another 25% or £20. The taxpayer earned £100 to receive £80 after tax. For a higher rate taxpayer, the additional tax relief is refunded to the taxpayer.

Expenses

A taxpayer who is trading may claim expenses that are **wholly and exclusively** incurred. This can include wages, employer's national insurance, insurance, stock, materials, stationery, audit, and rent.

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

If money was borrowed for the business, the interest on the loan may be claimed.

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.

Capital expenditure and depreciation are not allowed. For these purposes, expenditure is capital if the item is expected to last for at least *two years*, and regardless of how small the amount is. Note that this definition differs from that of a fixed asset in normal accounting. Buying a new coffee mug, hammer or stapler is capital. If the expenditure relates to plant and machinery, it may be possible to claim a capital allowance.

A business that makes a loss may be able to claim **loss relief** against another source of income or against income of another year. There are limits and rules on how loss relief may be claimed.

For income from **employment**, expenses may be claimed only if they are **wholly, exclusively and necessarily** incurred in the duties of the employment. In addition to the "necessarily" condition, an expenses must be incurred "in the duties" of the employment. This means that

expenses such as commuting, childcare and examinations are not usually allowable (though there are some limited exceptions).

In practice, the only expenses an employee is likely to be able to claim are professional subscriptions, business use of own car when not fully reimbursed, and necessary tools that the employer does not provide.

Basis periods

For trades and some other sources, income is taxed for the tax year in which the taxpayer expects to receive the money.

For a trade in all tax years except the first and last, income is taxed according to the profit for the accounting period ending in that year. A trade may choose any date it wishes as its accounting date. If it choose 30 September, tax for 2018/19 is taxed according to the profit for the year to 30 September 2018. The period whose income is taxed is known as the basis period.

For the first tax year, tax is calculated on actual profits earned in the tax year, regardless of accounting date. This means that some profit is taxed twice, once each in two consecutive years. The amount of profit thus taxed twice qualifies for **overlap relief**. In the final tax year, the trade is taxed on profits from the end of the previous accounting period to cessation of trade, minus overlap relief. No allowance is given for the loss of value between commencement and cessation.

Before 1994, a different system was used to determine basis periods. This did not have overlap relief. Such businesses will have generated overlap relief in respect of profits for 1996/97 tax year. Under the previous system, trades often used a date early in the tax year, such as 30 April, as this created the longest period between earning income and paying tax on it. Under the system since then, it is more common to choose a later date, such as 31 March or 5 April, as this minimises the overlap relief.

In practice, overlap relief is often not much of an issue as profits will often be low or even zero as the trade is starting. If overlap relief is significant it can be crystallised, and thus relieved earlier by moving to a later accounting date, for which there are special tax procedures.