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Chapter 2

INCOME TAX COMPUTATION

1 Introduction

One of the 15 mark questions in section B will always be an income tax question. It is likely to contain most sources of taxable income and require an income tax computation to be prepared. However, there may be also be marks available for dealing with trading losses, pensions, national insurance contributions, and the residence status of an individual. In addition any of the other 10 mark questions in section B may be based on any aspect of income tax and specific income tax issues will be tested in Section A of the exam.

There are two main parts to the computation, firstly the computation of Taxable Income and secondly the calculation of the Income Tax Liability and/or Income Tax Payable thereon.

The Taxable Income will also be divided into three possible analysis columns, Dividend income, Savings Income which is interest income and Non-Savings Income which will be made up of employment income, trading profits of the self-employed and property income. This analysis is required as different tax rates may apply to the different types of income.

In computing Taxable Income UK taxpayers may be entitled to a deduction of a Personal Allowance, a level of tax free income. The details of this are in Section 4 of this chapter, but the normal Personal Allowance available to those taxpayers born since 6 April 1948, is £10,000 for the 2014/15 tax year.

Computation of Taxable Income

An Income Tax Computation is prepared for each taxpayer and records the income to be taxed for that individual for a tax year. The tax year runs from April 6 to following April 5. The tax year 2014/15 runs from April 6, 2014 to April 5, 2015. Therefore each source of income requires its own basis of assessment to determine how much income is to be assessed to tax in each such tax year.

Proforma income tax computation for 2014/15

	Non-savings income	*Savings income*	*Dividends*	*Total*
	£	£	£	£
Trading Profit	X			X
Less Trading Loss relief – brought forward	(X)			(X)
	X			X
Employment Income	X			X
Property Income	X			X
Dividends from UK companies × 100/90			X	X
Building society interest × 100/80		X		X
Bank deposit interest × 100/80		X		X
Other interest - gross		X		X
TOTAL INCOME	X	X	X	X
Less				
Qualifying interest	(X)			(X)
Other Trading Loss reliefs	(X)			(X)
NET INCOME	X	X	X	X
Less: Personal Allowance	(X)			(X)
TAXABLE INCOME	X	X	X	X

1.1 Exempt Income

The following sources of income are exempt from income tax

(a) Interest or bonuses on National Savings & Investment Certificates

(b) Interest and dividends within an Individual Savings Account [ISA]

(c) Gaming, lottery and premium bond winnings

1.2 Tax liability and Tax Payable

Having calculated the taxable income, the examiner could ask for one of two things:

(a) Tax liability = income tax on taxable income

(b) Tax payable = tax liability
LESS
tax already deducted at source, for example, Pay As You Earn (PAYE) on employment income and tax credits on interest received net.

1.3 Taxation of non-savings income.

Non-savings income is taxed at the following rates:

£1 to £31,865	20%	(basic rate)
£31,866 – 150,000	40%	(higher rate)
£150,001 +	45%	(additional rate)

Non-savings income consists of:

(a) Trading Profit - see chapters 4-8

(b) Employment Income - see chapter 9

(c) Property Income - see chapter 3

Example 1

Mr Smith is a single man, born in 1960, who has been working for many years and earns a salary of £50,000 per annum (PAYE £9,627).

Calculate the income tax payable for Mr Smith in 2014/15?

2 Savings income and Dividend Income

Savings income is interest income and is received either gross or net of deduction of basic rate tax at source

2.1 Types of taxed savings income

(a) Building society interest

(b) Bank deposit interest

(c) Company loan stock interest

Most building society interest, bank deposit interest and company debenture interest is received by individuals net of 20% income tax deducted at source. This tax credit is refundable if the amount deducted at source exceeds the Tax Liability of the taxpayer.

2.2 Interest received Gross:

(a) National Savings & Investment (NSI) Bank Interest

(b) Government Stock Interest (Gilts, Treasury Stock, Exchequer stock)

2.3 Basis of assessment

Savings income is assessed in the tax year that it is **received**.

2.4 Dividend Income

Dividends are included on the computation on a basis of actual amounts **received** in the Tax Year. The figure is also grossed up but now at a rate of 100/90 for what is a notional tax credit of 10%. In this case no actual tax is deducted at source by the company paying the dividend nor then paid over to HMRC. As no tax has actually been paid no repayment can therefore arise if this credit exceeds the Tax Liability. For this reason the notional tax credit on dividends is always deducted first.

2.5 Calculation of tax on all savings income and all dividend income

(a) Interest received net and dividends must be grossed up for inclusion in the income tax computation

- interest received net is grossed up by 100/80
- dividends are grossed up by 100/90

(b) Interest received (including interest received gross) is included in the saving income column of the computation, dividends received are included in the dividend column

(c) Any deductions in the income tax computation (personal allowance and/or reliefs) are deducted first from non-savings income, then savings income, then dividend income hence the order in which the analysis columns are listed.

(d) Non-savings income is treated as the first slice of taxable income to be taxed followed by savings income then dividend income. The total of this tax is the Tax Liability of the taxpayer

(e) Tax suffered as source is deducted from the tax liability in order to arrive at tax payable.

(f) If there is no liability, the tax suffered on interest and PAYE may be repaid, but tax suffered on dividends is not repayable.

(g) The different types of income are taxed as follows and in this order:

Non Savings	£1 to £31,865	20%
	£31,866 – 150,000	40%
	£150,001 +	45%
Savings	• Savings income is taxed in the same way as non-savings income, however a starting rate of tax of 10% will apply to the first £2,880 of savings income in the following circumstance: • The 10% rate only applies where savings income falls within the first £2,880 of taxable income. • If the first £2,880 consists of non-savings income then the 10% rate will not apply.	
Dividends	• After considering non savings and savings income the dividend tax rates are: £1 – £31,865 @ 10% £31,866 – £150,000 @ 32.5% £150,001 + @ 37.5%	

Example 2

Billy had a trading profit of £25,000 and received bank deposit interest of £8,000 in 2014/15

Calculate Billy's income tax payable in 2014/15

Example 3

Recalculate Billy's income tax payable, assuming the bank deposit interest is £16,000

Example 4

Molly receives bank interest of £16,000 and no other income in 2014/15.

Calculate Molly's income tax payable in 2014/15

Example 5

Rework the example of Molly, assuming she makes a trading profit of £11,000 in addition to the bank interest.

Example 6

Daisy received a salary of £15,000 (PAYE £1,112), received £8,000 bank deposit interest and dividend income of £1,800 in 2014/15

Calculate Daisy's income tax payable for 2014/15

EXAMPLE 7

Recalculate Daisy's income tax payable, assuming Daisy received a salary of £35,000 (PAYE £5,705) and received bank deposit interest of £9,600. Dividend income received remains at £1,800.

3 Personal allowances

The Personal Allowance (PA) is a level of tax free income available to UK taxpayers and is deducted from Net Income to derive Taxable Income on the Income Tax Computation and as can be seen on the pro forma computation on page 5 is deducted from the analysis columns in the order of firstly non-savings income, followed if necessary by savings income and finally dividend income.

- The normal PA for 2014/15 is £10,000. However if an individuals Adjusted Net Income (ANI) exceeds £100,000 then the PA is reduced by:

  ½ × [ANI – £100,000]

- Once adjusted net income ≥ £120,000 the PA is reduced to nil.
- Net income is total income less qualifying interest payments and trading loss reliefs (see pro forma page 5)
- ANI is net income less gross personal pension contributions and less gross gift aid payments (see section 5)

EXAMPLE 8

Mike received gross employment income of £108,000 in 2014/15 of which £33,130 was deducted at source under PAYE in 2014/15.

Calculate Mike's income tax payable for 2014/15.

Example 9

Ken made trading income of £130,000, received bank interest of £32,000 and dividend income of £32,400 in 2014/15.

Calculate Ken's income tax payable for 2014/15.

- The normal PA for the tax year 2014/15 is £10,000 which is given to taxpayers who were born from 6 April 1948
- Taxpayers born between 6 April 1938 and 5 April 1948 enjoy a higher PA of £10,500 instead of the normal PA of £10,000
- Taxpayers born before 6 April 1938 receive a slightly higher PA of £10,660 instead of the normal PA of £10,000
- However where Adjusted Net Income (ANI) exceeds £27,000, the higher PA is restricted by ½ [ANI – 27,000] until it is reduced to a minimum of the normal PA of £10,000
- There will again be a further reduction if ANI exceeds £100,000 as detailed previously and therefore regardless of a persons age, no personal allowances will be available where adjusted net income ≥ £120,000

Example 10

Tony has adjusted net income of £27,800 in 2014/15. He was born in 1945.

Calculate the personal allowance to which Tony is entitled.

Example 11

Recalculate the personal allowance assuming Tony's adjusted net income is £31,100 in 2014/15

Example 12

James was born in 1940. He made a trading profit of £102,000 and receives bank interest of £3,200 in 2014/15.

Calculate James's income tax payable for 2014/15.

Example 13

Norman was born in 1935 and has net income in 2014/15 of £28,000 and had made gift aid payments of £400 during the tax year

Calculate the personal allowance available to Norman for 2014/15

4 Reliefs

4.1 Reliefs are tax deductible

The only reliefs examinable at Paper F6 are

(a) qualifying interest

(b) loss reliefs

4.2 Qualifying interest is:

(a) On a loan to purchase an interest in a partnership or a contribution to the partnership of capital or a loan

(b) On a loan to purchase plant or machinery used in the business, by a partner

(c) On a loan to purchase plant and machinery by an employee if used in the performance of duties

(d) On a loan to purchase an interest in a close company

4.3 Loss reliefs

These will be explained in chapter 7.

EXAMPLE 14

Kathy has trading profit of £50,000 in 2014/15 and paid £1,000 interest on a loan to purchase plant & machinery used in the business of her partnership.

Calculate Kathy's income tax liability for 2014/15

5 Payments to charity under the Gift Aid System

5.1 Basic rate taxpayers

Payments to charity under gift aid are treated as being paid net of the basic rate of tax (20%). For a basic rate taxpayer tax relief at the basic rate is automatically obtained as payments are made to the charity net of basic rate relief being given at source ie to give a charity £100 the taxpayer need only make a gift aid payment of £80 . The charity will then be able to claim back from HMRC the basic rate tax of £20 thereon collected by HMRC from the taxpayer's income. Therefore the donation is not deducted in the calculation of Taxable Income, but see note below on restriction of personal allowance.

5.2 Higher rate tax payer

For higher rate taxpayers, 40% tax relief is given as follows:

(a) 20% at source (as noted above), and

(b) 20% through the income tax computation, obtained by extending the basic rate band by the **gross donation** (so that more income is taxed at 20% and less at 40%)

The taxpayer can elect to treat gift aid payments made by 31 January to have been made in the previous year, ie a payment made by 31 January 2016 can be treated as if paid in tax year 2014/15. This would be advantageous if the taxpayer was likely to be a basic rate taxpayer in 2015/16 but was a higher rate taxpayer in 2014/15

5.3 Additional rate tax payer

For additional rate taxpayers, 45% tax relief is given as follows:

(a) 20% at source (as noted above) and

(b) 25% through the income tax computation by extending both the basic rate band and higher rate band by the gross donation (so that more income is taxed at 20% instead of 40% and 40% instead of 45%)

The same treatment as gift aid payments will also apply to payments made by individuals into their Personal Pension Scheme (see chapter 10)

See section 3 on page 10 that both the gross gift aid payments and personal pension contributions are deducted in arriving at the adjusted net income figure used to restrict the personal allowance of the taxpayer.

EXAMPLE 15

Elliot has trading profit of £48,000 in 2014/15. He paid £1,600 to charity under the gift aid system.

Calculate Elliot's income tax liability for 2014/15

EXAMPLE 16

Thomas earned £160,000 trading profit in 2014/15. In the tax year he paid £6,400 to charity under the gift aid scheme.

Calculate Thomas's income tax liability for 2014/15.

Example 17

Kerry made a trading profit of £102,000 in 2014/15. In addition she received bank interest of £3,200 and dividend income of £2,700. She paid interest of £3,000 on a loan to contribute capital into a partnership of which she is a partner. She made a payment of £4,800 to charity under the gift aid scheme.

Calculate Kerry's income tax payable for 2014/15.

6 Jointly owned assets of a married couple, or by a couple in a civil partnership

Spouses and civil partners are taxed as two separate people. Each spouse / civil partner has their own Income Tax Computation and includes within it their own taxable income and is entitled to a personal allowance or an age related personal allowance depending on his or her own age and income

6.1 Joint property

When spouses/civil partners own income generating assets jointly, it is assumed that they are entitled to equal shares of the income and it is split accordingly on a 50:50 basis between them.

However they may make a joint election to HMRC to split the income according to their actual ownership shares, (except in the case of jointly held bank or building society accounts).

The rules allow couples to rearrange joint income between them to better use their personal allowances and lower tax rates thereby reducing their overall tax liabilities

Note, for shares held in a husband and wife (or civil partner) company, dividends are always divided according to the exact proportion to which each is actually entitled, it is never assumed that it is in equal proportions.

The 50:50 rule may also be used to reduce income tax liabilities where a higher rate taxpayer currently owns outright an income producing asset while their spouse is not fully using either their personal allowance or basic rate band. A transfer of a nominal amount of the capital ownership eg 5% would allow 50% of the income to be assessed on the transferee spouse! Clearly if the taxpayer was happy to transfer the entire ownership of the asset to the spouse then an even greater amount of tax would be saved!

Example 18

Elton is a higher rate taxpayer (but with an adjusted net income of ≤ £100,000). This includes £20,000 of rental income on a property owned entirely by Elton on which he pays tax at 40%, a tax liability therefore of £8,000 thereon. David his civil partner has no income.

Discuss how Elton and David could reduce their income tax liabilities

7 Child Benefit Income Tax Charge

Child benefit is a tax free benefit payable to parents irrespective of what level of taxpayer they may be. It was decided therefore that from the tax year 2013/14 if a person's Adjusted Net Income (ANI) (or whose partner) exceeds £50,000 and they received child benefit, that a child benefit income tax charge would be raised to gradually remove the benefit from such higher income earners such that when the ANI reached £60,000 the benefit would be entirely removed.

If both partners have income over £50,000 the partner with the higher income is liable for the charge.

Where ANI falls between £50,000 and £60,000 the income tax charge would amount to 1% of the child benefit received for every £100 of income in excess of £50,000.

The following information will therefore be provided in the tax rates and allowances section of the examination paper:

Where income is between £50,000 and £60,000 the charge is 1% of the amount of child benefit received for every £100 of income over £50,000.

The income tax charge is added in deriving the income tax liability of the taxpayer.

Illustration 1
Catherine received child benefit of £1,056 in 2014/15 and has ANI for the year of £54,000.
As Catherine's ANI is between £50,000 and £60,000 the child benefit income tax charge is £422 (£1,056 x 40% (54,000 – 50,000 / 100))

Illustration 2
Victoria receives child benefit of £3,147 in respect of her 4 children and has ANI of £77,000.
As Victoria's ANI exceeds £60,000 the child benefit income tax charge is £3,147, being the full amount of the child benefit received.

8 Residence

Prior to 2013/14 the chargeability of an individual to income tax and capital gains tax in a tax year was based upon the taxpayer's residence and ordinary residence.

The new rules have abolished the term ordinary residence and created a new statutory test of residence.

These rules are detailed and the following table will therefore be given in the tax rates and allowances section of the examination paper.

Days in UK	Previously Resident (R)	Not Previously Resident (R)
<16	Automatically NOT R	Automatically NOT R
16 – 45	R if 4 UK ties	Automatically NOT R
46 – 90	R if 3 UK ties	R if 4 UK ties
91 – 120	R if 2 UK ties	R if 3 UK ties
121 – 182	R if 1 UK tie	R if 2 UK ties
>183	Automatically R	Automatically R

In the above table a taxpayer is Previously Resident if they have been resident in any of the previous 3 tax years.

The above table shows that the following persons will automatically be treated as NOT resident in the UK:

- Anyone in the UK for less than 16 days in tax year.
- A person in the UK for less than 46 days in tax year and who was not resident in previous 3 tax years

In addition a person who works full time overseas and who has not been in the UK for more than 90 days in the tax year is automatically not resident.

The above table also shows that any person in the UK for at least 183 days in the tax year is automatically RESIDENT. The following persons are also treated as automatically resident, unless they meet one of the automatic non-resident tests:

- A person whose only home is in the UK
- A person who carries out full time work in the UK

Where none of the automatic tests apply then based on the above table a person's status will be based on both how many days they are in the UK and how many ties they have with the UK in a tax year.

There are 5 UK ties as follows:

- Spouse/civil partner or minor child in the UK
- House in UK which is used during tax year
- In UK for more than 90 days in either of 2 previous tax years
- More time in UK than in any other country in tax year
- Doing substantive work in UK

A UK day is where the person is in the UK at midnight.

The detailed rules are far more complex but only the above rules are examinable.

Illustration 1
Sebastian was not previously resident in the UK but spent 35 days in the UK during 2014/15.

Sebastian is automatically not resident, as in UK for less than 46 days and not previously resident.

Illustration 2
Fernando was not previously resident in UK but bought a holiday home in the UK on 1 May, 2014 and lived in it for 140 days in the 2014/15 tax year. The remainder of the year he lived in his home in Spain.

Fernando was in the UK too long (>45 days) to be automatically treated as not resident, but not long enough to be treated as automatically resident (<183 days) nor did he have his only home in the UK.

Using the table therefore as he has been in UK for between 121 days and 182 days and has only one tie with the UK (made use of UK house), so as he was not previously UK resident he is therefore not UK resident in 2014/15.

Illustration 3
Lewis was in the UK for 80 days in 2014/15 when he lived in the only home that he owns.

Lewis has been in the UK too long to be treated as automatically not resident, irrespective of his previous residence. He will, however be treated as automatically UK resident as his only home is in the UK.

Illustration 4
Jensen has always been UK resident spending about 10 months of the year in the UK, but on 1 May, 2014 he purchased an apartment overseas where he lived for most of the tax year returning to the UK for a further 50 days in 2014/15 when he stayed at the family home with his wife and children.

Jensen has spent more than 15 days in UK in 2014/15 so will not be automatically not resident. He will also not be automatically resident in the UK as he has not spent 183 days in the UK nor does he have his only home in the UK.

As he was in the UK for between 46 and 90 days he will remain resident for 2014/15 as he has 3 UK ties:
- Spouse/children in UK
- A house in the UK that he uses
- In the UK for more than 90 days in previous 2 years

You should now work through the following part of the Finance Act 2014 technical article written by the F6 examining team - Income Tax section to example 7