

TAXATION

Policy and Practice

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FISCAL

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* Page xi shows how to access the Additional Contents on our website where purchasers of the book can access these chapters in full.

P Preface to the 30th Edition

Philosophy and history of the book

This book was initially created at a time when there was a significant gap in the market for tax textbooks. Excellent material already existed which covered a legal approach to tax, an economic/public sector approach and very detailed technical materials. What was missing, however, was an introductory level text that took a combined, interdisciplinary view on the subject, written in a readable style. Dr Hancock produced the first six editions of the text until Andy Lymer (Aston University) took over producing the text. Since the eleventh edition, authorship has rested entirely with Andy and Lynne Oats (University of Exeter).

Our aim is to provide a complete, but readable, general UK tax textbook that also covers the requirements of professional level introductory UK tax courses. This book is therefore suitable as a supplement to the UK accounting and business professional examinations, particularly in providing greater depth to the courses you may be undertaking towards professional exams to enhance your understanding of this topic.

A number of key changes were made in this edition including:

1. Updating the book fully for the various changes brought about this year in the March 2023 Spring Statement and the various Finance and other Acts in the last year including:
 - Reduction to the levels of income at which the additional rate of income tax starts to apply (to £125,140 from £150,000 previously);
 - Changes related to moves from the current to the tax year basis for trading income computations;
 - Reduction in dividend allowance from £2,000 to £1,000 (on the way to being £500 next year);
 - Reversal of previous changes to the National Insurance Contribution rates and the removal of the planned Health and Social Care Levy due to have commenced in April 2023;

- Amendments to the pension rules related to annual allowance increase (to £60,000 per annum from £40,000) and suspension of the lifetime allowance cap charge;
- Confirmation of the Annual Investment Allowance cap of £1 million to remain at that level indefinitely from April 2023;
- Re-introduction of a higher main rate of corporation tax for larger businesses (25%) and marginal relief for companies with profits between the small profits threshold (£50,000) and the new main rate threshold (£250,000);
- Introduction of the Multinational top-up tax from 31 December 2023 for large UK headquartered business groups, or overseas headquartered groups that have UK members, that have operations in foreign tax jurisdictions taxed at rates below 15%;
- Changes to the Research and Development tax relief scheme;
- Increase in the Diverted Profit tax rate to 31% (from 25%) from 1 April 2023;
- Reduction of the Capital Gains Tax annual exemption allowance to £6,000 (from £12,300 – on the way to being £3,000 next year);
- New developments in environmental taxes including energy levies; and
- Outline details of important changes that were announced in the March 2023 Spring Statement but will not apply until at least April 2024.

2. Updating and widening of the range of Fiscal Facts added throughout the text to contextualise further the material being discussed.
3. Updating of the tax glossary.

Other well liked features of the book have been updated and developed where necessary, based on user feedback received and reviews of how tax is taught in the UK at present.

How to use this text

This textbook is not written as a reference text, although the detailed indices and glossary it contains will help direct you to specific areas of material when you need this help. It is instead written to be read. To gain the most from this text we would advise you to read chapters in their entirety, preferably starting at the beginning of the chapter!

Regular activities are included in the text to illustrate the important points you will need to understand and to give you a chance to practice what you are learning as you go through the book. Although there may be a significant 'urge' to jump straight from the activity to the feedback provided, you will miss much of the benefit of the activities if you do not first attempt them yourself.

You will also find a number of quick quizzes, longer self-test and full exam style questions at the end of each chapter that cover the material explained in the chapter. Some of these have answers provided in the back of the book but for others you will have to obtain the answers from your lecturer or teacher, as they will only be provided to them via their section of the website. You will find signposts throughout the text to show which questions you should be ready to attempt.

As you read the text you will regularly meet new tax terms. You will find all the terms you will need to be familiar with in the glossary at the back of the book. Use this resource as you come across the terms so you can gradually build up your tax vocabulary as you learn new tax ideas and techniques. To help you in the process we put words in italics when we introduce new terms that so you can easily spot you need to take special note and make sure you are aware of the meaning.

Website

A comprehensive website is available to all purchasers of this book to support your use of this text (<http://www.fiscalpublications.com/lymerandoats/2023>). The site is enhanced and updated each year and you should consider it as a direct extension to the book. It contains a range of materials and resources that will help you gain the most from your studying of the UK's taxation system. The site includes:

- several extra chapters for this book (for the print version - these are included in the e-text version of the book) providing discussion of environmental taxation (Chapter 13) and of the impacts of the UK tax system (Chapter 14),

- two additional chapters online providing greater details on UK tax system history and inheritance tax,
- extensive multiple choice based self-test questions for each chapter,
- extensions to many areas of the text to allow you to go deeper into particular topics if you need to (watch out for the pointers to this as you work through the text - these are marked with the computer symbol in the left hand margin), and
- a range of links and other resources to help with your wider reading for this subject and any assignments/dissertations you may need to undertake associated with a course you may be taking.

The website is frequently updated throughout the year so check it from time to time for changes.

Acknowledgements

We acknowledge the permission granted us by CIMA, ICAS and ACCA to use past examination questions in this text, and on the website.

CIMA, the Chartered Institute of Management Accountants, part of the Association of International Certified Professional Accountants (AICPA), is the world's leading and largest professional body of management accountants, with 206,000 members and students operating in 168 countries, working at the heart of business.

The Institute of Chartered Accountants of Scotland (ICAS) is the world's first professional accountancy body. It was the first to adopt the designation 'Chartered Accountant', and the letters 'CA' can only be used in the UK by ICAS members. ICAS has been training CAs for over 150 years and is highly regarded throughout the world for the high calibre of its members.

ACCA (the Association of Chartered Certified Accountants) is the global body for professional accountants. They aim to offer business-relevant, first-choice qualifications to people of application, ability and ambition around the world who seek a rewarding career in accountancy, finance and management.

You can find out more about these bodies at the following links:

- AICPA-CIMA at www.aicpa-cima.com or www.aicpa-cima.com/membership/landing/students
- ICAS at www.icas.com or www.icas.com/become-a-ca and
- ACCA at www.accaglobal.com or www.accaglobal.com/gb/en/qualifications.html

The Fiscal Facts notes added throughout the text were sourced from various public online resources including the Institute for Fiscal Studies, HM Treasury and HMRC websites.

We would particularly like to thank Nicky Thomas (Senior Lecturer in Tax and Accounting, University of Exeter) for her continued technical assistance in the development of this year's text, Felix Wilson (PhD student, University of Exeter) for his assistance with the environmental tax chapter, and various others. In particular, we would like to thank our students and adopting lecturers, who have provided helpful suggestions and new ideas included in this edition as they do every year and for which we are most grateful.

Please note, however, that whilst every attempt has been made in writing this text to be accurate and true to the current UK tax system, it should not be solely relied upon as a definitive source of information on current tax rules. Readers are advised to seek specific professional advice in their tax affairs. Neither the authors nor the publishers accept any legal responsibility for any loss related to actions taken based on material contained in this book.

This book is improved year on year in part on the basis of feedback people provide to us as the authors. We are most grateful for this and very much welcome comments you wish to make about the book or suggestions for future development of the book, or the associated website. The authors can be contacted for this purpose at:

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Andrew Lymer and Lynne Oats
July 2023



Taxation: Policy & Practice – website

<https://www.fiscalpublications.com/lymerandoats/2023>

Fiscal Publications, and the authors of this text, have created a website to be used in conjunction with this textbook.

Visit the above address to find:

- 1 Answers to questions at the end of each chapter (note – some are reserved for lecturer use only as teaching aids – if you want copies of these, please ask your lecturer).
- 2 Extension materials for many parts of the text allowing you to go deeper into these topics than are covered in the book.
- 3 An extensive tax term glossary (included in the ebook version of the book).
- 4 Extra chapters to the book (for all versions) on UK tax system history and inheritance taxation, and (included in the ebook version), environmental taxation and impacts of the UK tax system.
- 5 Multiple choice questions – self test questions for each chapter.
- 6 A large extra question and answer bank for self or classroom managed extra practice and illustration of tax computations.
- 7 A large list of tax related links for further reading, dissertation etc.
- 8 Easy to print rates and allowance pages.

Whilst the lecturer area of the website is only available to bona fide teachers, the student area is open to all purchasers of this book. Basic registration will be required for this access.

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Project areas

There are many interesting questions which are inspired by the material dealt with in this chapter. For example,

- the potential role for hypothecated taxes;
- the impact on the UK economy of avoidance activity and corresponding anti-avoidance strategies;
- is progressivity always desirable in a tax?
- what is the appropriate mix of tax bases for the UK's tax system?
- how might the UK look to repay the economic costs incurred related to the Covid-19 pandemic and its related huge levels of government support to the economy and workers - while maintaining Smith's principles?

You may consider for a project the extent to which a particular tax, or tax system more generally, achieves one or more of Adam Smith's desirable characteristics, or how some countries can operate without a balance of income, wealth and expenditure taxes.

The question of the funding of higher education is topical. An interesting question is 'Should a graduate tax be used to fund higher education?' Would it comply with the characteristics of a good tax system?

Using the tax system as a way of influencing transport policy has been a major focus of the current UK Government. For example:

- congestion charges have been introduced for vehicle traffic in London (and proposed for other UK cities),
- a number of new roads have been built in a way that allows for them to pay for themselves using tolls,
- the Government is considering replacing the Vehicle Excise Duty (VED) with a charge based on road use (and the 2006 Budget introduced a graduation to the levels of this duty in favour of low emissions production vehicles and in 2008 increased Vehicle Excise Duty on higher polluting cars).

Why do you think taxes, and related charges, have become some popular way of influencing transport policy?

Discussion questions

- 1 Road fund licences were originally introduced to pay for road building and maintenance. This is a tax based not on an ability to pay but according to use. In practice much of the road fund licence is now used for other purposes. Is this a good way to raise taxes?
- 2 Would increased hypothecation be a better way to organise the Government's revenue and expenditure systems?
- 3 What corrective taxes, if any, might you introduce in the UK at present?
- 4 Do you think parents should pay more or less tax than childless individuals?
- 5 If a government wished to provide funding to increase the level of fitness of the population would it be better to provide subsidised facilities such as leisure centres or to give tax relief on the cost of getting and keeping fit, such as health club memberships?
- 6 Has the sugar tax led to a reduction in sugary drink consumption?
- 7 To what degree does the current UK tax system fulfil the characteristics of a desirable tax system?
- 8 Is an expenditure, income or wealth tax inherently fairer than the others?
- 9 Not all countries use all tax bases. Why might this be the case and what features of a country allow different mixes of tax bases to operate?
- 10 Have the Mirrlees Review or the Taxpayers' Alliance Single Income Tax proposals provided useful and practical suggestions for improving the UK's tax system?

Further reading

- ACCA, (2008), Discussion Paper: *Perspectives on Fair Tax*, available at <http://www.accaglobal.com/uk/en/technical-activities/technical-resources-search/2008/june/perspectives-on-fair-tax.html>.
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- Smith, A., (1776), *An Inquiry in the Nature and Causes of the Wealth of Nations*, Ward, Lock & Co. Ltd: London, UK. (The World Library 1812 reprint)
- Taxpayers' Alliance, (2012), *The Single Income Tax*, Final report of the 2020 Tax Commission, see https://www.taxpayersalliance.com/the_single_income_tax.

For detailed discussions of alternative tax bases and their application see:

Evans, C., Hasseldine, J., Lymer, A., Ricketts, R. and Sandford, C., (2012) *Comparative Taxation: Why Tax Systems Differ*, Fiscal Publications: Malvern, UK.

For a review of the potential for an annual wealth tax to be used in the UK, see:

A wealth tax for the UK, the Wealth Tax Commission (2020) led by A. Adair, E. Chamberlain and A. Summers - <http://www.ukwealth.tax>

For the Mirrlees Review publications, see:

<http://www.ifs.org.uk/mirrleesReview>

Details on the work of the Office of Tax Simplification can be found at:

<https://www.gov.uk/government/organisations/office-of-tax-simplification>

4

Personal income taxation

Introduction

4.1 In Section 1 of this book we examined the history of the UK tax system, outlined its administration and looked at the principles of tax system design. This foundation provides us with the background we need to now begin to examine the current UK tax system in detail.

This chapter introduces you to the personal income tax computation and explains the various elements that go into its make-up. Chapters 5, 6 and 7 review the sources of taxable income in more detail and show you how to calculate the correct values to enter into the respective parts of the income tax computation. Chapter 8 then introduces you to capital taxes particularly focusing on capital gains tax, a different tax to income tax, but one that is also paid by individuals. Throughout the chapters in this section the focus is on income taxation of the individual, either as an employed person, or as a self-employed person (as a sole trader). We will examine how the direct tax system operates for companies in Chapter 9.

Fiscal Fact



In 1938/39 there were only 3.8 million taxpayers liable for income tax (with married couples counting as one taxpayer, as that was how income taxpayers were assessed then) of 47.4 million people in the UK at that point i.e. only approx. 15% of the population were income taxpayers (on the basis that around 50% of the total population were married then). By 2022/23 the number is expected to reach 34 million (of approximately 66.5 million people, i.e. 48%). Of these, 26.3 million are expected to be aged 65 or less, with 7.7 million therefore aged over 65; 19.2 million are male and 14.7 million are female. (Source: HMRC Income tax statistics and distributions - Table 2.1 ONS Historical UK Population Estimates)

In the UK, individuals pay tax on their income for a tax year. The tax year runs from 6 April to the following 5 April (the reason for these odd dates was described in Chapter 1).

A tax system rarely remains the same for long and over the years there have been a number of major changes to the way in which individuals are taxed in the UK. For example, key changes in the last 35 years have included the introduction of independent taxation in the 1990/91 tax year (separate taxation of men and women whether they are married or not) and self-assessment for personal taxation was introduced from 6 April, 1996. With all of the additional pressure on public finances as a result of Covid-19 we can expect more changes to the UK individual tax system in the next few years as the huge sums borrowed begin to be repaid.

In this chapter you will learn how to calculate the amount of an individual's income that is subject to income tax and learn about the reliefs and allowances that are available to reduce the tax due. Once you have deducted the allowances and reliefs from the taxable income you will learn how to compute a taxpayer's tax liability.

At the end of this chapter you will be able to:

- differentiate between income that is taxable and that which is exempt;
- describe the tax rules for the different categories under which individuals pay income tax;
- calculate the allowances and reliefs available to an individual;
- describe the system of national insurance and calculate any national insurance contributions payable by both employers and employees;
- prepare a personal tax computation for an individual;
- outline the system of self-assessment for individuals; and
- offer basic income tax planning advice to individuals and members of their family unit.

The tax computation

4.2 A tax computation for an individual can be set out in the following way. This structure is identical to the one used by HMRC when calculating income tax due and follows the computation steps of the Income Tax Act 2007. Laying out your computation this way therefore helps with real tax filing processes. It will also help ensure you include all the necessary stages in your computation and put things in the correct order. You are strongly advised to follow this proforma each time you do a personal tax computation.

We will outline the seven steps in this computation briefly for you first in this section before providing further details on each step of the calculation.

Thomas Lester's income tax computation for 2023/24:

	Non-savings £	Savings £	Dividends £	Total £
Income:				
Property Income	1,500			1,500
Trading Income	21,000			21,000
Employment Income	28,850			28,850
Savings Income:				
Bank interest received		3,500		3,500
Building Society interest		3,000		3,000
Dividend Income			1,500	1,500
Total Income	51,350	6,500	1,500	59,350
Less reliefs	(500)			(500)
Net Income	50,850	6,500	1,500	58,850
Less Personal Allowance	(12,570)			(12,570)
Total Taxable Income	38,280	6,500	1,500	46,280

Tax Due:				
Non savings income	37,700	@ 20%		7,540.00
	580	@ 40%		232.00
Savings income	500	@ 0%		
	6,000 (6,500 - 500)	@ 40%		2,400.00
Dividend income	1,000	@ 0%		-
	500	@ 33.75%		168.75
	<u>46,280</u>			<u>10,340.75</u>
Tax Borne				10,340.75
Less:				
Tax reductions	(none apply for Thomas this year)			(0.00)
Add:				
Additional tax	(none applies for Thomas this year)			0.00
Tax Liability				10,340.75
Less tax already paid:				
PAYE				(3,400.00)
Tax Payable				<u>6,940.75</u>

In this section of the book you will find out how to produce a tax computation like this one, given basic facts about a taxpayer's situation.

You can see that Thomas receives his income from a number of sources. This includes income from owning property in the UK, income from being partly self-employed, income from employment and some interest and dividends. It is not uncommon to see multiple income sources like this in a tax computation. It is becoming more common than it was in the past to see both income from

employment and from self-employment (trading income) in the same tax year as people's working lives become less traditionally structured and portfolio careers and working structures become more common.

The income tax computation is split into eight 'steps'. The first three aggregate a taxpayer's taxable income from all sources and then deducts any reliefs and allowances that are applicable to produce "taxable income". The remaining five steps then calculate the tax due on this taxable income, and how much of that tax still needs to be paid (as often some tax is paid during the tax year). The way in which a component of income is taxed depends on the tax rules under which it is assessed.

The income tax system contains a number of tax reliefs which are special rules that reduce the amount of tax otherwise payable. These tax reliefs serve a number of purposes. They can be used by the government to help specific categories of individuals, products or services and can encourage particular activities by reducing the comparable post income tax cost of the activity. When used in this way they are effectively a replacement for direct public expenditure and therefore can be called *tax expenditures*. We will look at the concept of tax expenditures more closely in Chapter 14.

In this chapter you will meet several types of tax relief as we work through the steps of the income tax computation. There are a number of ways of providing tax reliefs and you will see that they can take the form of exemptions from tax (step 1), deductions from the calculation of taxable income (steps 1 and 2), allowances which operate in a similar way to deductions (steps 1 and 2), adjustments to the rates of tax (step 4) and reductions in tax liability (step 6).

In the next section we summarise the seven steps of the tax computation before looking more closely at step 4, how the tax rates are applied. We then come back to the remaining steps in more detail.

Computing taxable income

Step 1 – Aggregating the categories of income

4.3 All the taxable income Thomas has received or earned in the year, from all sources, is listed in his tax computation, grouped into various categories (what the tax legislation calls 'components' of income). A few sources of income are exempt from income tax, as we will see later, but most have to be taxed and so must be listed here. For most categories of income we include what is due to Thomas, even though he may not have actually received it all yet (i.e. we use an *accruals basis* – we will explain further how this works later).

Note that we split up Thomas' income sources into different categories by using different rows and into different types by using four columns. This is important to help us calculate the correct rate of tax at step 4 of the tax computation; note how each of the three (non-total) columns in the first part of the computation becomes a row when computing tax borne – the fourth step.

Property, trading and employment income

4.4 Income from owning and renting out property, from being self-employed (trading) or from employment is listed in Thomas's tax computation first. Usually property and trading income have not had tax deducted by the payer (i.e. what we call 'taxed at source') so can just be listed here at the value the tax rules set out for each category (we'll show you how these rules work in Chapter 5, 6 and 7).

Income from employment, however, usually has some income tax deducted by the taxpayer's employer before it is paid via a system called 'Pay as You Earn' (PAYE) and so the taxpayer only receives the net amount after the tax is deducted. The employer then pays this tax to the Government on the employee's behalf. You will see that in Thomas' case his computation shows the total (gross) he has earned from employment during this year (£28,850) in step 1, but he is able to later deduct the PAYE already paid via his employer (£3,400 in this case) at the end of the computation when determining what tax may still be payable.

Savings and investment income

4.5 Bank deposit interest and the building society interest is usually received 'gross', which means that no tax is withheld by the payer of the interest. In Thomas' case you can see he received £3,500 of bank interest and £3,000 of building society interest.

Exempt income


4.6 Most income is potentially subject to income tax under the UK's tax system and therefore needs to be included in one or other of the categories of income calculations. There are, however, various exempted sources of income that can be received without any income tax becoming due. You should be aware of the most common of these, including:

- the increase in the value of National Savings & Investments savings certificates,
- premium bond prizes, betting and lottery winnings and other competition prizes,
- gifts,
- interest from Individual Savings Accounts (ISAs) or Junior ISAs,
- interest from Child Trust funds,

- some social security benefits, including child benefit and universal credit. Universal credit is increasingly replacing other separate benefits, some of which were taxable, in the interest of efficiency.
- shares allotted to employees under approved schemes such as share option plans,
- educational grants and scholarships (for the recipient),
- statutory redundancy pay, pay in lieu of notice and some other payments up to a maximum of £30,000 made when an employment is terminated.
- payments made by employers to employees for death in service or in respect of disability sustained at work (e.g. personal injury payments),
- lump sums received from approved pension schemes,
- qualifying care relief (fostering and shared lives carer income) – qualifying income up to an annual sum is exempt from tax (the excess is taxable). Currently this sum is £18,140 per residence, plus £375 per week (for a child under 11 years of age) and £450 per week (for a child/adult older than 11). These figures were significantly increased in the Spring Budget 2023 for the tax year (and will increase by CPI inflation going forward from 2024/25).

Whether or not tax has to be paid on specific categories of income, and how much, is detailed in the tax legislation. We will review the rules for calculating these amounts throughout the remaining chapters of the book.

Fiscal Fact



Exempting income from tax, of course, costs the UK Government foregone tax revenue (this is called 'tax expenditure'). For example, for 2021/22, the forecasted cost of exempting ISAs from income tax was £4.3 billion. For the same year the cost of allowing redundancy pay up to £30,000 to be tax free is estimated to be £610 million, exempting value increases of National Savings and Investments saving certificates £190 million and exempting premium bond winnings could cost £110 million. Exempting Universal Credit is expected to reduce tax receipts by approximately £30m per annum, but will be offset by savings in other parts of the tax and benefits system. (See the table 'Non-structural cost estimates' on the HMRC website for further examples.)

Step 2 – Dealing with deductible reliefs

4.7 After you have computed the total income received by aggregating categories of taxable income, any reliefs that are applicable can be deducted at step 2. In our example, Thomas made payments of £500 that can be treated as reliefs. An example of a relief is a trading loss, which we will cover in Chapter

Tax deductions available for any pension contributions paid *gross* are another example dealt with at this step (see further details in Chapter 5.3).

Total income minus reliefs produces *net income*.

Step 3 – Personal allowances

4.8 Most individuals are entitled to a certain amount of income each year free from income tax. This is called a *personal allowance* and is deducted from the net income figure to arrive at total taxable income. If a blind person's allowance is applicable, it is also deducted at this stage. Thomas does not appear to qualify for a blind person's allowance so no deduction is made in his case.

Net income minus personal allowances produces *taxable income*.

Having completed steps 1-3 and determined the taxable income of the taxpayer, you are now ready for the computation of tax liability using steps 4-7.

Computing tax liability

Step 4 – Income tax rates

4.9 The next stage of the tax computation is to calculate what rates of tax apply to the total taxable income. As part of step 1, the income categories were classified into one of three *types* – non-savings, savings income, and dividend income. This is necessary as each of these income types has its own tax rates. Later in the chapter we will examine exactly how these different rates are applied to a taxpayer's total income.

Step 5 – Tax borne

4.10 Tax borne is the outcome from applying the tax rates to the taxable income, and represents the amount of tax that the taxpayer is liable for on his or her taxable income before any tax reductions (which can reduce the tax borne) or additional tax on their income (that may increase it).

Step 6 – Tax reductions

4.11 At this step there is a deduction from the tax borne for any entitlements the taxpayer has for *tax reductions*. There is a limited range of special reductions that includes married couples' and civil partners' reduction for elderly taxpayers, qualifying maintenance payments and some special schemes for tax deductible investments. Tax relief for any foreign taxes paid at source (double tax relief) is given at this point in the computation – see Chapter 12 for more on this topic.

Step 7 – Additional tax

4.12 The final step in computing the tax liability for the taxpayer is to add any extra tax that may be due. These are fairly rare but include, for example, extra tax where gift aid is claimed on donations to charities but insufficient tax has been paid to cover the claim.

We will discuss charitable donations, and where this situation may arise, later in this chapter at 4.38. Pension related surcharges are also applied here. We will talk about these in Chapter 5.

Tax payable- Step 8

4.13 The result of completing all seven steps is the computation of the taxpayer's tax liability for the tax year. This is the sum that the taxpayer needs to pay to HMRC to settle their income tax bill for the year. In Chapter 2 we explained that some of this tax may have already been deducted at source, i.e. paid via the taxpayer's employer, or otherwise credited to the taxpayer directly, before this computation is done. So we can say the final (eighth) step in the tax computation therefore is to deduct from the overall tax liability for the year any sums that form part of this total liability but have already been paid (or deemed paid) to HMRC during the tax year. This most commonly will include PAYE tax withheld by the taxpayer's employer but occasionally may include other things such as tax paid at source on patent royalties.

If the taxpayer still owes any tax after deducting these sums already paid or deemed paid it must then be paid to HMRC directly. As outlined in Chapter 2, this is likely to be due by 31 January following the end of the tax year (this is also the latest date by which the tax return for the current year should be received by HMRC). However, in some cases sums may be due earlier in the tax year, as we will see in Chapter 6.

If the taxpayer has paid more tax during the year than the final tax liability, the taxpayer will receive a refund (repayment) from HMRC of the tax overpaid. This can happen from time to time, often associated with situations where the taxpayer's circumstances have changed during the year (e.g. they lost their job, retired perhaps) and so the tax their employer deducted was too much once the whole year is taken into account. The taxpayer can request a refund of the overpayment.

Important: Note that the taxable income part of the calculation (steps 1 to 3) is always rounded down to the nearest pound (i.e. you can effectively chop off the pence at each step in your computation). For the tax due part of the calculation (steps 4 to 7), you should always round down your figures to the whole penny. This is important to ensure you do not get rounding errors in your tax computation.

Basis of assessment

4.14 It is important when undertaking a tax computation to know at what point any income needs to be included in an income tax computation. The basis of assessment is the way in which income is allocated to the correct tax years for income tax payment purposes. The different categories of income each have different ways of working out what amount has to be included in any particular tax year although there are several common general bases of assessment that are used across the different income categories as follows:

Cash or Accruals basis – a cash basis is sometimes called a receipts basis, and is where the amount included in the tax computation for a particular tax year is the amount actually received during the year. An accruals basis on the other hand, includes the amount accrued during the tax year, regardless of whether it is actually received by the taxpayer or not i.e. it will include income owed to the taxpayer even if they haven't actually received it yet. The cash basis is most commonly used for employment income. The accruals basis has historically been mainly used for trading (business) income, in line with the method used for accounting purposes. From April 2013, however, small businesses have had the option to use the cash basis for this source of income too, as we will see in Chapters 5 and 6.

Whether the basis of assessment is cash or accruals can make a difference to the taxpayer. For example, employees are normally taxed on a cash basis. It would be theoretically possible, however, to tax employment income using an accruals basis. For most employees this would make little or no difference to their tax bills each year, but for those who receive performance-related bonuses, which are often paid in the tax year after the one in which they were earned, the tax on the bonus would then be payable before the bonus was actually received. Most people would not like this idea!

Arising or remittance basis – where UK taxpayers have income or profit from other countries, we need to decide when it will be taxed in the UK. An arising basis means that the overseas income or profit is taxed when it accrues, even if the money is not brought into the UK. The remittance basis means that it is not subject to UK tax until it is actually brought in (or 'remitted') to the UK. We will look at this more closely in Chapter 12.

Current year or preceding year basis – this difference relates to trading income computation. For many years in the past, businesses were taxed on the profit they earned during the previous tax year. Now, however, business profits are taxed on a current year basis i.e. what is accrued in the current tax year. For self-employed people this is linked to their business year (i.e. the period for which they produce accounts). We will see how this operates in practice in Chapter 6.

The system of income tax rules

4.15 There are four primary Acts that contain the main rules for income tax: the Income and Corporation Taxes Act (ICTA) 1988, the Income Tax (Earnings and Pensions) Act (ITEPA) 2003, the Income Tax (Trading and Other Income) Act (ITTOIA) 2005 and the Income Tax Act (ITA) 2007. The Finance Acts produced each year from the annual UK Budget amend these Acts. In this book we will look at the combined rules of the various tax Acts and any changes that have occurred to them as a result of any subsequent Finance Acts.

It is important to identify which set of tax rules any particular income stream is taxed under because each has its own specific rules for:

- the income to be taxed;
- allowable deductions, if any, from the income;
- the basis of assessment; and
- how the tax is collected.

We saw in Chapter 1.3, that ever since we started collecting income tax in the UK, the rules used a series of discrete categories to classify different income sources. There were referred to as 'Schedules', sometimes divided into subsections called 'Cases'. We no longer refer to these Schedules and Cases although you may come across references to them when reading older case law.

The current system for determining UK income tax liability is structured as follows:

Employment income	Income from employment or office holding – Part 9 ITEPA 2003 (was Schedule E ICTA 1988);
Pension income	Income received from a pension – Part 9 ITEPA 2003;
Property income	Income, such as rent, from UK property – Part 4 ITTOIA 2005 (was Schedule A ICTA 1988);
Trading income	Income from a trade or profession – Part 2 ITTOIA 2005 (was Schedule D Cases I & II ICTA 1988);
Savings income	Interest income for example from banks and building societies – Part 4 ITTOIA 2005 (was Schedule D Case III ICTA 1988);
Dividend income	Income from UK dividends and other distributions from UK companies – Part 3 & 4 ITTOIA 2005 (was Schedule F ICTA 1988);
Miscellaneous income	Income not dealt with under any of the above categories – Part 5 ITTOIA 2005 (was Schedule case VI ICTA 1988).

As we go through this section of the book we will look in detail at the most important tax rules for calculating what income is taxable. In this chapter we will determine the aggregated income which is subject to tax, the allowances and reliefs which can be set against the income for tax purposes and the date on which tax must be paid. Chapter 5 will look at income from employment and pensions. In Chapter 6 and Chapter 7 we will examine trading income and deductions for taxpayers who are carrying on business as sole traders, as well as property income.

Throughout this chapter we only discuss income from UK sources. The general rules for income tax change when the source of the income comes from outside the UK. We will examine these differences in Chapter 12.

Rates of tax

4.16 Having looked in outline at how we aggregate the categories of income in the top part of the individual taxpayer's tax computation (steps 1 – 3), let us jump ahead and examine the *tax due* part of the computation before we return to the top part for a more detailed examination in the following section.

Income tax bands

4.17 As we noted in the previous section, to determine the rate of tax to be paid on the taxable income (i.e. step 4 of the computation), we need to classify the taxable income into three broad types i.e. non-savings, savings and dividend income. This classification is important as each type of income has a different set of rates that will apply to it. Which rate is used will vary from person to person based on the band into which the income type falls. Someone receiving an additional £1 could therefore be taxed on it at different rates depending on the income type it is, and how much other income of that type, and other types, the taxpayer receives. Remember as we discussed in Chapter 3.5, this is called the *marginal tax rate*.

While this might sound confusing initially, it is fairly simple to apply in practice once understood – particularly if you follow the proforma we illustrated in Thomas Lester's income tax computation.

There are three bands (sometimes called *brackets*) that currently apply across the various income types: the basic rate band, the higher rate band, and the additional rate band. There is also a special starting rate for savings, but first we will deal with the three bands that apply to all income categories.

The size of these bands is fixed each year. For 2023/24 this is set as:

	Tax Band
Basic rate	0 - 37,700
Higher rate	37,701 - 125,140
Additional rate	>125,140

All taxable income must be allocated to these bands to determine which tax rate to use to calculate the tax payable. The following sections show how this is done.

Fiscal Fact

HMRC believe there will be approximately 629,000 UK taxpayers who will have earned £150,000 (the level at which additional rate taxes started to apply in that year) or more in 2022/23 and 18,000 of these are expected to earn £1m or more. (Source: HMRC Statistics - Table 2.5: Income tax liabilities by income range)



Non-savings income

4.18 Let's look at how these tax bands apply to non-savings income first. This includes any employment, property, trading, foreign and miscellaneous income. For most people this will be their main income type.

For the current tax year rates of tax for non-savings income are:

	Tax Band	Rate	Maximum amount payable in band
Basic rate	0 - 37,700	20%	£ 7,540.00
Higher rate	37,701 - 125,140	40%	£ 34,976.00
Additional rate	>125,140	45%	

Activity

Calculate the income tax due on taxable incomes of:

- £2,500
- £10,000
- £45,000
- £150,000

(Assume all income is non-savings income. Don't forget that 'taxable income' means the amount remaining after the correct personal allowance has been deducted)

Feedback

(a)	2,500 @ 20%	£ 500.00
(b)	10,000 @ 20%	2,000.00
(c)	37,700 @ 20%	7,540.00
	(45,000 - 37,700) @ 40%	2,920.00
		<u>10,460.00</u>
(d)	37,700 @ 20%	7,540.00
	(125,140 - 37,700) @ 40%	34,976.00
	(150,000 - 125,140) @ 45%	11,187.00
		<u>53,703.00</u>

Note what happened in (c). Initially the basic rate band (first £37,700 of taxable income) was 'filled up' and taxed at 20%. Any amount falling into the higher rate band (taxable income between £37,700 and £125,140) is then taxed at 40%. In (d) the 45% rate applied to taxable income over £125,140 as the 40% band (between £37,700 and £125,140) was also filled up.

Fiscal Fact

In 2022/23 income tax of £109 billion is expected to be paid by taxpayers on non-savings income taxable within the basic rate band. A further £74.8 billion will be collected from those who have non-savings earnings falling into the higher rate band and £49.4 billion from those with these earnings falling in the additional rate band (a total from non-savings income of £233.2 billion). (Source: HMRC Table 2.6).

Savings income

4.19 Since 1996/97 a distinction has been drawn between savings and non-savings income for calculating tax due and a lower rate of tax used for some savings income to encourage people to save more. Savings income is treated as being the middle part of taxable income for the purposes of determining rates of tax to be applied, so you allocate this income to the tax bands only after you have allocated all the non-savings income to the bands as part of your computation.

Savings income includes:

- interest from a bank account (including from National Savings & Investments accounts);
- interest from a building society;
- interest from gilt edged securities (i.e. British Government stock);

- interest from debentures; and
- income from an annuity.

Under Islamic law, receipt or payment of interest is prohibited. Alternative finance arrangements have developed to accommodate this. For tax purposes, the profit element of purchase and resale arrangements, and profit share arrangements, is treated the same as if it were interest.

For savings income only, there is an initial tax band that may apply - called the starting rate for savings band. Savings income in this band is taxed at 0% in the current tax year. The rates of tax for savings income are:

	Tax Band £	Rate	Maximum amount payable in band £
Starting rate	0 - 5,000	0%	-
Basic rate	5,001 - 37,700	20%	6,539.80
Higher rate	37,701 - 125,140	40%	34,976.00
Additional rate	>125,140	45%	

* only if all of the taxpayer's income is from savings.

Note that the starting rate for savings of 0% only applies if the non-savings income is less than £5,000. Savings income falling into the starting rate savings band in this way is tax free.

Since 6 April 2016, a personal savings allowance (PSA) is available to taxpayers in addition to the starting rate for savings band and gives an additional zero rate sum of £1,000 to basic rate taxpayers and £500 to higher rate taxpayers. This means, irrespective of their non-savings income, they can receive the first £1,000 (if basic rate taxpayers) or £500 (if higher rate taxpayers) of any savings income without incurring any tax. Additional rate taxpayers are not entitled to a personal savings allowance.

Once the starting rate for savings band is full, and the personal savings allowance (if applicable) has been taken into account, any further savings income which falls within the basic rate band is then taxed at 20%, as for non-savings income. Also, like non-savings income, any savings income falling into the higher rate band is taxed at 40%, and that falling into the additional rate band is taxed at 45%. Note that, although the personal savings allowance carries a zero rate of tax, it is still taken into account to work out how much of each rate band has been used up. In this way it is different to the personal allowance we saw earlier.

Try the following activity to see how the bands, and this time two income types, interact. Note the order in which the taxable income is applied to the bands. Getting the order right is essential (i.e. non-savings income is always considered first before savings income when filling up the bands).

Activity

Calculate the income tax liability for an individual with total taxable income consisting of savings income of £2,500 and employment income of:

- £3,800
- £20,000
- £50,000
- £150,000

(Remember 'taxable income' means the correct personal allowance has already been applied)

Feedback

(a) Non-savings income		£
3,800 @ 20%		<u>760.00</u>
Savings income		
(5,000 - 3,800) @ 0%		-
1,000 PSA @ 0%		-
300 - (£2,500 - 1,200 - 1,000) @ 20%		<u>60.00</u>
		<u>820.00</u>

(b) Non-savings income		
20,000 @ 20%		4,000.00
Savings income		
1,000 PSA @ 0%		-
1,500 @ 20%		<u>300.00</u>
		<u>4,300.00</u>

(c) Non-savings income		
37,700 @ 20%		7,540.00
(50,000 - 37,700) @ 40%		4,920.00
Savings income		
500 PSA @ 0%		-
2,000 @ 40%		<u>800.00</u>
		<u>13,260.00</u>

(d) Non-savings income		
37,700 @ 20%		7,540.00
(125,140 - 37,700) @ 40%		34,976.00
(150,000 - 125,140) @ 45%		11,187.00
Savings income		
2,500 @ 45%		<u>1,125.00</u>
		<u>54,828.00</u>