CHAPTER 1

INTRODUCTION TO THE UK TAX SYSTEM

1.1 Taxes in the UK

The UK government raises in the region of 400 billion pounds in taxation each year.

Income tax is the single largest earner for the government making up **33%** of total revenue. Income tax is charged on salaries from employment, on rental income from properties let out, on interest from banks and building societies, on dividends from companies and on the profits of the self employed.

National Insurance contributions (**NIC**) are the second largest earner and make up **22%** of total government income. National Insurance contributions are generally paid by both employers and employees on earnings from employment, although NIC is also levied on self employed persons on the profits of their trade.

Value Added Tax (**VAT**) makes up about **18%** of the total government revenue and is charged by businesses to customers on supplies of goods or services in the UK.

Income tax, VAT and NIC are the three most important taxes as far as raising money is concerned, making up about 75% or so of total government revenue.

A large part of the remainder (**14%**), is made up of **duties**, being taxes on alcohol, petrol and tobacco, as well as certain levies on goods coming into the UK.

Corporation tax makes up about **10%** of total government revenue, being the tax paid by UK companies on their taxable profits.

The remaining slice consists of the **"capital taxes"** being capital gains tax (CGT), inheritance tax (IHT), stamp duty (SD) and stamp duty land tax (SDLT). Capital gains tax is the tax levied when individuals sell assets and make a profit.

1.2 The tax year

Individuals pay income tax by reference to the "tax year". The UK tax year runs from **6 April to the following 5 April**. For example, the tax year that begins on 6 April 2010 and ends on 5 April 2011 is known as the tax year 2010/11.

The tax rates and tax allowances for the 2010/11 tax year have remained at 2009/10 levels, although generally they are raised each year in the Finance Act.

There are two stages in calculating an individual's tax liability. First we compute the individual's taxable income from all sources in the relevant tax year. Having arrived at **taxable income** we then apply the 2010/11 **tax rates and allowances** to that income, to arrive at the **tax liability** for the year. This tax will be collected by the HM Revenue & Customs ("HMRC" or "the Revenue") under the "self-assessment" system. This will be dealt with in a later chapter.

1.3 Sources of income

The tax legislation categorises various sources of income. Each type of income has its own special rules. This is why we need to decide what type of income an individual has received.

The first type of income that we will think about is **trading income**. This covers profits from a trade. For instance, a **self employed** person in business as a taxi driver, market trader, builder or plumber, would be taxed on his **trading income.**

Trading income also covers profits from a profession or vocation. For instance, a **self employed** professional, such as a solicitor or barrister, would also **have trading income**.

The second type of income to consider is **property income**. This is income from **land and buildings**, such as **renta**l income. We need to keep property income from **UK** land and buildings separate from property income from **non-UK** land and buildings.

Next, there is a very important type of income called income from **earnings and pensions**. **Earnings** covers **salaries, bonuses** and **non-cash benefits**. We will look at these in detail in later sessions.

There are various types of **savings and investment** income. A very common one is interest arising from **UK banks** and **building societies**. We call this **interest income**.

Another type of investment income is **dividends received from companies**. As we will see later, **dividend income** needs to be kept separate from other types of investment income because it has different rates of tax applied to it.

These are the two **main types** of savings and investment income, but there **are some others** which we will explain more about later in this course.

An individual may have income from **outside the UK**. We have already seen that he may have **property income** from **non-UK land and buildings**. He may also have **investment income** from outside the UK such as **non-UK bank interest** or **non-UK dividends**. All income arising outside the UK is now called **foreign income**.

It is important to note here that income can still be **taxable** in the UK, even if it arises from a source **outside** the UK. As a general principle, individuals who **live** in the UK and who were **born** in the UK will pay UK income tax on their **worldwide** income wherever it comes from. So, a **UK resident** will generally pay income tax on foreign income.

Finally, there is income which is chargeable to income tax which does not fall within any of the categories that we have just looked at. This is called **miscellaneous income**. It is the HMRC's way of covering itself and making sure that taxable income doesn't fall through the net. We will consider miscellaneous income in more detail later in the course.

1.4 Exempt income

There are a few sources of income which are specifically exempt from income tax. Income from **National Savings Certificates** is exempt from tax, as are any winnings on **Premium Bonds**. Any income from **betting, gaming** or **lotteries** is exempt from income tax. ITTOIA 2005, s. 692

Many **social security benefits** are also exempt from income tax. The notable exceptions to this are the state pension and any job-seekers allowances. These are taxable income. ITEPA 2003, s.677

Scholarship awards are exempt, as is any income from **ISAs** (individual savings accounts). ITTOIA 2005, s. 776 SI 1998/1870

Dividends paid on the **first £200,000** of **Venture Capital Trust** shares acquired in any tax year are exempt from income tax. ITTOIA 2005, s. 709

Example 1

Which of the following sources of income are exempt from income tax:

	Taxable	*Exempt*
a) Interest on a National Savings Account		
b) Dividend from a foreign company		
c) Child's wages from a newspaper round		
d) Income from National Savings Certificates		
e) Housing benefit		
f) State retirement pension		

Answer 1

	Taxable	*Exempt*
Interest on a National Savings Account	✓	
Dividend from a foreign company	✓	
Child's wages from a newspaper round (note)	✓	
Income from National Savings Certificates		✓
Housing benefit		✓
State retirement pension	✓	

Note:
Wages are taxable as employment income. The fact they are paid to a child is irrelevant. However, in most instances, the child's income will be covered by Personal Allowances so no tax will be due.

Income from National Savings Certificates is exempt, whereas income from a National Savings Account is not.