CHAPTER 2

CALCULATING THE INCOME TAX LIABILITY

2.1 Introduction

The first step in calculating an individual's tax liability for the tax year 2010/11, is to arrive at taxable income for the year. Having arrived at taxable income, we then apply 2010/11 tax rates to that income to give a tax liability for the year.

The proforma for calculating an individual's tax liability is very important. A full income tax proforma is included at the end of the chapter and will be useful as we go through the next few chapters.

The income tax proforma differentiates between **three different types** of income. The first type of income is **non-savings income**. Non-savings income essentially means income from employment, income from self employment and rental income.

The second form of income is bank or building society **interest** and the third and final form of income received by individuals is **dividend income**.

We separate these three forms of income within the computation because they are taxed in different ways and at different rates.

2.2 Proforma income tax calculation

	Non savings	*Interest*	*Dividends*
Earnings	X		
Trading income	X		
Property income	X		
Interest		X	
Dividends			X
Foreign income	X	X	X
Total income	T	T	T
Less: Deductible payments	(DP)	___	___
Net income	NI	NI	NI

Foreign income could be non-savings income if it arose from rents in a villa in Spain. It could also be interest income if it was bank interest on a Jersey bank account. It could also be dividend income if it was dividends on shares in an American company. Entries could therefore be made in the non-savings column, the interest column or in the dividend column.

Income from all sources is then added together to give total income. Certain expenses incurred by individuals can be deducted in order to arrive at taxable income. These expenses are called deductible payments.

Deductible payments are deducted from **non-savings income first**, although if there is insufficient non-savings income, such payments can be deducted from interest and then from dividends as appropriate. **Total income** less **deductible payments** gives us **net income**.

From net income we **deduct the available personal allowance** for the year in order to arrive at taxable income.

	Non Savings	*Interest*	*Dividends*
Net Income	X	X	X
Less: Personal Allowance	(PA)	__	__
Taxable Income	X	X	X

As with deductible payments, the personal allowance is deducted from non-savings income in priority to interest and in priority to dividend income. Having deducted the personal allowance from net income, this gives us taxable income from all sources.

The **personal allowance** for the tax year **2010/11** is **£6,475**. ITA 2007, s. 35

The personal allowance is available to all individuals, including children, who are resident in the UK, and certain individuals who are resident abroad.

However, where an individual's adjusted net income exceeds £100,000 in 2010/11, the personal allowance will be reduced by £1 for every £2 of income above £100,000. Adjusted net income is simply net income reduced by the gross amount of any gift aid payments or personal pension contributions eligible for relief in the tax year. We will look at these payments in detail in later chapters. ITA 2007, s. 35

Illustration 1

Mr Brown has the following income and expenditure for 2010/11:

	£
Salary from his job	30,000
Benefits from his employment	8,000
Rents from flat in Brighton	7,000
Rents from chateau in France	4,500
Deductible payments	(1,000)

Mr Brown's taxable income is calculated as follows:

	Non Savings
	£
Income from earnings (30,000 + 8,000)	38,000
Property income	7,000
Foreign income	4,500
	49,500
Less: Deductible payments	(1,000)
Net Income	48,500
Less: Personal Allowance	(6,475)
Taxable Income	**£42,025**

Illustration 2

Mrs Smith has adjusted net income of £105,200 in 2010/11.

As her adjusted net income exceeds £100,000, Mrs Smith's personal allowance will be calculated as follows:

	£
PA	6,475
Less: $\frac{1}{2}$(105,200 – 100,000)	(2,600)
PA given	£3,875

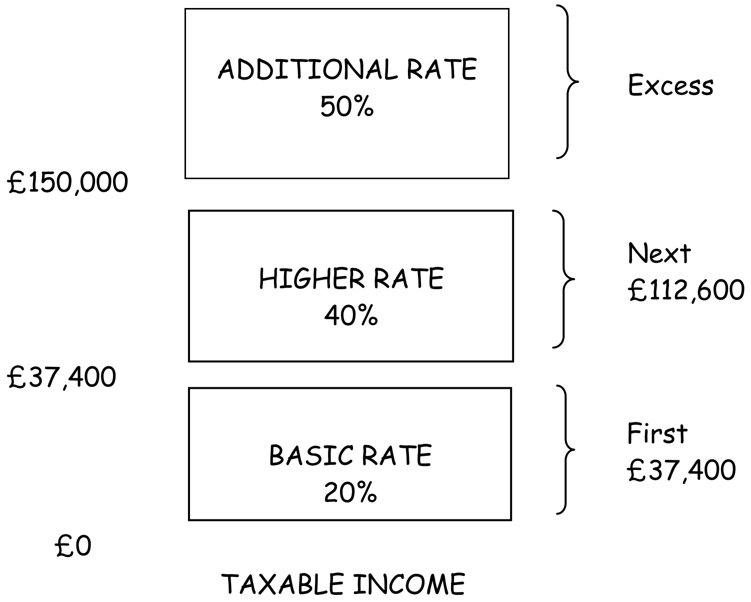
Individuals with adjusted net income of £112,950 or more will have the personal allowance reduced to nil.

2.3 Calculating the tax liability

To calculate an individual's tax liability, we start by looking at how non-savings income is taxed for the tax year.

Three rates of tax apply to non-savings income in 2010/11.

We have a basic rate of 20%, a higher rate of 40% and an additional rate of 50%. ITA 2007, s.6



The first £37,400 of an individual's income is charged at the basic rate of tax, which is 20%.

For individuals with taxable income in excess of £37,400, the higher rate of tax applies. This is currently 40%. This applies to taxable income in excess of the basic rate limit up to the higher rate limit of £150,000. Income in excess of £150,000 will be taxed at the additional rate of 50%.

Remember that the **20%, 40% and 50% rates** apply to **non-savings income** only. Different rates apply to dividends, (and sometimes to interest) as we shall see later.

Illustration 3

Continuing illustration 1, Mr Brown's tax liability is calculated as follows:

Taxable Income	£42,025
Tax	£
37,400 @ 20%	7,480
4,625 @ 40%	1,850
42,025	
Tax liability	**£9,330**

Any income tax which the individual has already paid during the course of the year can be deducted from tax liability to give a final figure of tax due and payable to HMRC. The tax due will be collected by HMRC under the self assessment regime.

If the tax paid at source in the tax year exceeds the tax liability, the taxpayer will be due an income tax repayment from HMRC.

Illustration 4

Assume that Mr Brown from Illustration 3 had paid tax on his employment income under the Pay As You Earn (PAYE) system of £8,000. This £8,000 can be deducted from the tax liability of £9,330 to give a figure of tax due as follows:

	£
Tax liability	9,330
Less: PAYE	(8,000)
Tax due	**£1,330**

Illustration 5

Let us now consider the position of Miss West, whose only source of income in 2010/11 is her salary of £200,000. She did not make any payments eligible for tax relief.

	£
Salary	200,000
Less: Personal Allowance	-
Taxable income	£200,000
Tax	
37,400 @ 20%	7,480
112,600 @ 40%	45,040
50,000 @ 50%	25,000
Tax liability	**£77,520**

Remember that Miss West will not receive a personal allowance as her adjusted net income exceeds the £100,000 threshold to such an extent that the personal allowance is reduced to nil.

As well as considering the tax bands which apply in 2010/11 we also need to consider the marginal tax rates which will apply to an individual's taxable income. In other words the rate of tax paid on each additional £1 of income.

For an individual with net income between £37,400 and £100,000 the marginal rate of tax is 40%. However, if an individual has taxable income of between £100,000 and £112,950 their marginal rate of tax is actually 60% due to the impact of the reduction in their personal allowance. Once income has exceeded £112,950 the marginal rate drops back to 40%, rising to 50% once income exceeds £150,000.

Illustration 6

Mr Martin is employed with a taxable salary and benefits package of £100,000. He is offered an alternative employment in 2010/11, with a total taxable salary and benefits package of £110,000. He has no other income.

Tax liability of current employment package:

	£
Net income	100,000
Less: Personal Allowance	(6,475)
Taxable income	£93,525

	£
37,400 @ 20%	7,480
56,125 @ 40%	22,450
93,525	
Tax liability	**£29,930**

Tax liability of alternative employment package

	£	£
Net income		110,000
Less: Personal Allowance	6,475	
Less: reduction		
110,000 – 100,000/2	(5,000)	
		(1,475)
		£108,525

	£
37,400 @ 20%	7,480
71,125 @ 40%	28,450
108,525	
Tax liability	**£35,930**

The additional £10,000 of income has resulted in an additional £6,000 of tax – a marginal tax rate of 60%! Net income between £100,000 and £112,950 may not be desirable and individuals may wish to avoid this, for example by making pension contributions which we will look at in later chapters.

Example 1

Mrs White has the following income/expenses in 2010/11:

	£
Earnings from employment (gross)	40,000
(PAYE deducted £7,000)	
Rent from apartment in New York	9,500
Deductible payment	(1,200)

Calculate her Income Tax due.

Example 2

Mr Green has the following income in 2010/11:

	£
Salary (PAYE £3,000)	12,000
UK rental income	3,500
Premium bond winnings	2,000

Calculate his income tax due/repayable.

Example 3

Mrs Yellow has the following income in 2010/11:

	£
Earnings from employment (gross)	100,000
(PAYE deducted £30,250)	
Rental income	8,000

Calculate her income tax due.

Example 4

Mr Blue has the following income in 2010/11:

	£
Earnings from employment (gross)	180,000
(PAYE deducted £63,500)	
Lottery winnings	20,000

Calculate his income tax due.

Answer 1

	Non Savings
	£
Earnings	40,000
Foreign income	9,500
Less: deductible payment	(1,200)
Net Income	48,300
Less: Personal allowance	(6,475)
Taxable Income	£41,825

Tax	£
37,400 @ 20%	7,480
4,425 @ 40%	1,770
Tax liability	9,250
Less: tax paid under PAYE	(7,000)
Tax due	**£2,250**

Answer 2

	Non savings
	£
Earnings	12,000
Property Income	3,500
Premium bond winnings	Exempt
Net Income	15,500
Less: Personal allowance	(6,475)
Taxable Income	£9,025

Tax	£
9,025 @ 20%	1,805
Less: PAYE deducted	(3,000)
Tax repayable to Mr Green	**£(1,195)**

Answer 3

	£	Non savings £
Earnings		100,000
Property Income		8,000
Net Income		108,000
Less: Personal allowance	6,475	
Less: reduction: 108,000 – 100,000/2	(4,000)	
		(2,475)
Taxable Income		£105,525

Tax	£
37,400 @ 20%	7,480
68,125 @ 40%	27,250
Tax liability	34,730
Less: tax paid under PAYE	(30,250)
Tax due	**£4,480**

Answer 4

	Non savings £
Earnings	180,000
Lottery winnings	Exempt
Net Income	180,000
Less: Personal allowance (reduced to nil)	-
Taxable Income	£180,000

Tax	£
37,400 @ 20%	7,480
112,600 @ 40%	45,040
30,000 @ 50%	15,000
Tax liability	67,520
Less: tax paid under PAYE	(63,500)
Tax due	**£4,020**