CHAPTER 7

DEDUCTIBLE PAYMENTS

7.1 Introduction

Below is a typical income tax proforma that differentiates between employment income, bank interest (grossed up) and dividend income (again grossed up). From total income and before arriving at net income, we can take a deduction for any deductible payments.

	Non Savings	*Interest*	*Dividends*
Earnings	X		
Interest (x 100/80)		X	
Dividends (x 100/90)			X
	X	X	X
Less: **Deductible payments**	**1st**	**2nd**	**Last**
Net Income	X	X	X
Less: PA	1st	2nd	Last
Taxable income	X	X	X

Deductible payments are expenditure incurred by a taxpayer for which he or she will receive tax relief. Deductible payments are deducted primarily from non-savings income. If such payments wipe out that non-savings income, they will be deducted from bank interest and then, if we have extinguished bank interest, deductible payments will be set against any dividend income.

Total income, less deductible payments, gives us Net Income. From net income we deduct any available personal allowance to give us taxable income.

The effect of deductible payments within the tax computation is to reduce net income and in turn, reduce taxable income. If that leads to a reduction in the overall tax liability, the amount saved on account of making the payment is called the "tax relief". If a taxpayer pays tax at a marginal rate of 40%, he will effectively have saved 40p for every £1 of the payment he pays in the year.

Deductible payments essentially fall into two categories; either types of **royalties** or **interest** paid on **"qualifying loans"**.

7.2 Royalties

Royalties will either be **copyright** royalties or they will be **patent** royalties.

A **copyright** royalty is typically a royalty paid to an author or a writer or a musician for the use or reproduction of his work. Copyright royalties are **paid gross**. This means that the amount of the copyright royalty paid in the year is the amount that we deduct as a deductible payment in the income tax computation. **No grossing up** is required.

A **patent** royalty is a payment made to an inventor for the use of a particular invention or a particular process. Patent royalties are typically paid by self employed traders. Patent royalties are always paid **net** of **basic rate** (20%) tax so we need to **gross up** the net figure by 100/80 for inclusion in the tax computation. ITA 2007, s. 900

Therefore, if a taxpayer pays a patent royalty of £8,000, what is deducted in the tax computation is the gross amount of £10,000.

$$£8,000 \times \frac{100}{80} = £10,000$$

Because the royalty is paid net of basic rate tax, what is actually paid to the inventor is the net amount of £8,000. This way the trader will obtain basic rate tax relief at source.

To deal with the patent royalty in the trader's tax computation, we do two things.

First the gross amount of the patent royalty is deducted from non-savings income to arrive at net income. The effect of deducting £10,000 from taxable income is to save the trader tax on the £10,000 at his marginal rate. If the marginal rate is 40% he will therefore save an additional £4,000 in tax.

However, do not forget that the amount the trader paid in the first place was not £10,000 - he only paid £8,000 as he received £2,000 worth of tax relief at source. This means that if we leave the tax computation unaltered, the trader would have saved £6,000 in tax, thereby obtaining tax relief at the very generous rate of 60%.

Hence**, secondly,** in order to make sure that excessive relief is not given, HMRC insist that **the basic rate tax relief obtained at source** - here being £2,000 - **is added to his tax liability at the bottom of his income tax computation**.

Illustration 1

Walter has trading income of £50,000 in 2010/11.

He pays a patent royalty of £4,000 every year for the use of a registered invention.

Walter's tax liability is calculated as follows:

	Non Savings
	£
Trading Income	50,000
Less: Patent royalty	
$(4{,}000 \times \frac{100}{80})$	(5,000)
Net Income	45,000
Less: Personal allowance	(6,475)
Taxable income	38,525
Tax	£
37,400 @ 20%	7,480
1,125 @ 40%	450
	7,930
Add: tax deducted at source on patent royalty	
(£5,000 x 20%)	1,000
Tax due	£8,930

7.3 Qualifying interest

ITA 2007, s.383

Interest paid on **"qualifying loans"** is also deducted as a deductible payment in the tax computation. Interest here is always paid gross - tax is never deducted at source for payments of qualifying interest. Therefore as with copyright royalties, the amount of interest actually paid in the tax year can be deducted as a deductible payment.

The types of loan that qualify for tax relief are easy to find in the tax legislation and you will find them between Sections 388 and 403 of the Income Tax Act 2007.

S.390

Loans taken out by an employee to purchase plant and machinery for use in his employment qualify for tax relief and interest paid on those loans can be a deductible payment. ITA 2007, s.390

A common example of this in practice is a loan taken out to buy **IT equipment** such as desktop or lap top computers, or printers etc as more and more employees choose to do some of their work from home. However, the relief does not apply to loans to purchase cars.

If an employee takes out a loan to purchase a computer and that computer is used wholly or partly for business purposes, the interest on the loan qualifies as a deductible payment. However, only interest paid in the **year of the loan** and the next **three** years will qualify for tax relief.

S.392

A loan taken out by an individual to purchase shares in a "close" company is also a qualifying loan. A "close" company is a UK company controlled by five or fewer shareholders. The individual claiming tax relief must either work for the company (and own some of the shares) or hold more than 5% of the shares. ITA 2007, s.392

Relief is also given where an individual takes out a loan to provide funds for a close company to use in its business. Once again the lender must either work for the company (and own some of the shares) or hold at least 5% of the share capital.

Ss.396 and 401 ITA 2007, s.396 ITA 2007, s.401

A loan taken out by an individual to purchase shares in an employee owned company or a cooperative qualifies for relief.

S.398

A loan taken out by an individual to buy into a partnership also qualifies for tax relief. This is common in practice where an employee is invited to become a member of a partnership. The partnership will often require a capital contribution from this employee. The employee may take out a bank loan to fund this. ITA 2007, s.398

Interest on all qualifying loans is paid gross so it is the amount of interest that is actually paid in the year that is a deductible payment. There is no limit on the amount of the loan that qualifies for tax relief.

7.4 Recovery of Capital

ITA 2007, s. 406

If the taxpayer is receiving interest relief in respect of a loan to buy shares and then sells those shares or otherwise recovers some or all of his capital outlay, he is **deemed to have repaid the loan** with the proceeds of sale, whether or not he actually does so. This means that he will **not** continue to receive interest relief in respect of the part of the loan he has been deemed to have repaid.

This is one example of "recovery of capital" that leads to denial of interest relief. Another example would be where a partner in a business sells his partnership interest. Again the sale proceeds are deemed to have repaid the loan and interest relief is denied.

If the shares or partnership interest are **given away** to a connected person rather than being sold, interest relief will again be denied. The taxpayer is deemed to have made a **sale** with proceeds being treated as equal to the **market value of the shares** at the date of the gift. This will be the case for all gifts, even gifts to the taxpayer's spouse.

Illustration 2

Marcus took out a loan a few years ago of £50,000 to buy shares in a close company and he qualifies for interest relief in respect of this loan. During 2010/11 he paid interest of £3,600 in respect of the loan. On 6 November 2010 he sold half of the shares for £40,000. He used the money to invest on the stock market.

Marcus will qualify for full interest relief from 6 April to 5 November 2010. On 6 November 2010 he is deemed to have repaid £40,000 worth of the loan and hence from then on only interest on £10,000 of the loan will attract relief.

His deductible expense for 2010/11 will therefore be:

	£
6 April 2010 – 5 November 2010	
7/12 x £3,600	2,100
6 November 2010 – 5 April 2011	
5/12 x £3,600 x $\frac{10,000}{50,000}$	300
Deductible payment	£2,400

Effectively we have pretended that Marcus used the proceeds from the sale of the shares to repay part of the loan. Notice that we do not restrict according to the proportion of shares sold – half of them in this illustration – but instead it is the **proceeds of sale** that restrict the relief.

Example 1

Trevor, aged 59, has the following income for 2010/11

	£
Salary from part-time job (PAYE £400)	8,000
National Savings Interest	1,500
Building Society interest	12,000
Dividends from unit trust	4,000

In the year he paid interest of £2,500 on a loan taken out to buy shares (> 5% holding) in a close company.

Calculate his tax repayment for the year.

Answer 1

	Non Savings	Interest	Dividends
	£	£	£
Employment income	8,000		
Interest – NS&I (gross)		1,500	
Interest – B.S. (x $\frac{100}{80}$)		15,000	
Dividends (x $\frac{100}{90}$)			4,444
	8,000	16,500	4,444
Less: Deductible payment	(2,500)		
	5,500		
Less: personal allowance	(5,500)	(975)	
Taxable income	Nil	£15,525	£4,444

Tax	£
2,440 @ 10%	244
13,085 @ 20%	2,617
4,444 @ 10%	444
Tax liability	3,305
Less: PAYE	(400)
Tax on interest (at 20%)	(3,000)
Tax on dividends (at 10%)	(444)
Tax repayable	**£(539)**

All repayable as can relate to tax deducted from interest/PAYE