MODULE 10 Taxation

Learning objectives

By the end of the session you will…

Know the main kinds of taxation.

Understand how income tax is calculated.

Know what the taxes listed below are and how they are calculated.
- Inheritance tax
- Value Added Tax (VAT)
- Capital Gains Tax
- Council Tax

Be able to calculate income tax on a straightforward example.

Activity

10.1 Try the quiz, then check out the answers.

10.2 How to calculate Income Tax.

Taxation – Introduction

Taxation is the means by which government raises money to fund public expenditure including Education, Health, Social Security and other public services. It is a 'necessary evil' and, over the years, tax rules have changed considerably. They are always subject to controversy. We all complain that we pay too much tax and rarely view tax rises favourably! On the other hand we would (and do) complain if the public services fall below acceptable standards. So a balance has to be struck – this balance is crucial and is reviewed each year by the Chancellor and his team in their Budget. Both companies and individuals pay tax but in this module we will only be considering individual taxation.

So how do we as individuals pay tax?

Well, we are taxed on:

What we spend	VAT
What we earn	Income Tax
What we make a profit on	Capital Gains
When we die	Inheritance tax
On where we live	Local tax/ council tax (also stamp duty on house purchase)

If we live or work abroad we may be subject to further local taxes.

So it seems that tax is very difficult for us to avoid and therefore some understanding and a little planning can make a significant difference.

Income Tax

Once our earnings from any source rise above a threshold known as the Personal Tax Allowance we start to pay Income Tax. The more we earn, the more tax we pay. The maximum level of Income Tax is currently 40%, or 50% for those with very high incomes.

For most of us our main income is either pay or a pension. These incomes are relatively fixed and so the tax levied on them is relatively straightforward and cannot be influenced unless the income level changes.

Some things to watch out for:

Change of job / gaps in employment – excess tax may have been levied and may be reclaimed.

Savings or capital – it is important to ensure that money is invested carefully and in the right person's name. It is also important that tax deducted at source is recovered if you are a non-tax payer – many people fail to do this.

Self-employed – if you are in this category you generally need more specialist advice particularly on what can or cannot be offset against your tax bill.

Pension contributions – these attract tax relief and can be a very tax effective way of building up capital for retirement.

Claiming allowances – it is important to ensure that all tax allowances are claimed.

Capital Gains Tax

This is a tax on the profits that you may make, but not all profits are taxed. An example of a profit that is not taxed is the one you make on the sale of your house – that is if you make any! However, if the house is not your main residence e.g. a second house, then any profit on the sale of the property is taxable. Tax is only levied when the profit is realised.

Here again you have an annual allowance and tax is only levied if your gains in the year exceed this allowance. For most employees Capital Gains Tax becomes a potential reality if you have a system at work which enables you to acquire company shares. The profit on those shares (and any others you hold) may be liable to Capital Gains Tax and careful tax planning is required.

Making a profit can be a lot more tax efficient than taking an income. A profit can often be totally tax-free whereas income, once it rises above your personal tax allowance, will be taxable. However, you must bear in mind that share prices can go down as well as up.

Some things to watch out for:

Being a little more adventurous with part of your savings for the longer term to take advantage of these Capital Gains allowances. This is particularly true if you are a 40% tax payer.

If you are married then make sure that you both take full advantage of both allowances if you have the scope to do so.

Inheritance Tax

When someone dies, everything they own is given a value and this is added up. The total is called the estate. Inheritance tax is levied on the estate of a deceased person. If the estate passes to a surviving husband / wife or registered civil partner or to charity there is no tax levied on the estate. However, if the deceased's assets are to pass to anyone else, e.g. children, and the value exceeds a limit set each year by HM Revenue & Customs then the estate is potentially liable to tax on anything over that limit.

With rising property values, more and more people are finding that their assets are closing in on, or exceeding, the HM Revenue & Customs limits. For some, potential Inheritance Tax planning should be considered.

Some things to watch out for:

Wills – ensuring that your will is in order and tax efficient

Making gifts

Setting up Trusts

Considering insurance

Enjoying life and spending some money before you die!

Value Added Tax / Excise Duties

VAT is added to most goods and services. For the majority of us buying and using these goods and services, the tax must be paid, and is included in the prices we pay.

Some goods such as cigarettes or tobacco attract a very high duty and other goods such as food and clothes are exempt. VAT is levied on many services which would include building work, vehicle repairs and many types of fees and the current rate is 20%.

Some things to watch out for:
Check the bill / services at the outset to ensure that VAT is included.

Council Tax

This is a tax levied by the local authority on its residents to subsidise local services. It is normally levied in bands and reviewed by the local authority each year.

Some things to watch out for:
Those on low incomes may receive help in the form of subsidies.

Reductions may be available for single occupancy.

The more expensive the property the more tax is likely to be levied.

Different areas have different tax rates and of course have different levels of services.

Further help

This module gives a general outline of taxation and it is very important that if you have any issues or concerns on taxation you seek specialist help. A good starting point is your local tax office or, for Council Tax enquiries, your local authority's offices. You may require extra help with some of the things listed in the 'something to watch out for' boxes.

Try to answer the questions in the tax quiz. Then check your answers.

1. Steven is a basic rate taxpayer and has accumulated £200 gross profit within his ISA. If he draws the money is it:-
   - ☐ a) Totally tax free
   - ☐ b) Partially taxable
   - ☐ c) Fully taxable

2. What are the three rates of income tax?
   - ☐ a) 25%, 45%, 50%
   - ☐ b) 20%, 40%, 50%
   - ☐ c) 22%, 40%, 50%

3. Which taxes generally go with each scenario?

TAX	SCENARIO
a) Income tax	i) Fees for building work
b) Capital gains tax	ii) Wages / salary
c) VAT	iii) Profit on shares
d) Inheritance	iv) Value of one's estate on death

4. If a building society account is held in joint names (between husband and wife) who pays tax on the interest?
   - ☐ a) Husband
   - ☐ b) Wife
   - ☐ c) They can elect who pays the tax
   - ☐ d) Half interest is taxed individually
   - ☐ e) There is no tax to pay

5. a) A non-taxpayer with a building society account can receive the income gross?
   - ☐ True
   - ☐ False

   b) A non-taxpayer can recover tax paid on building society interest?
   - ☐ True
   - ☐ False

6. If John makes a gift of £1,000 to his grandchild Lucy and has made no other gifts in the year, is it taxable?
   - ☐ Yes
   - ☐ No

7. Joe makes a profit of £2,000 on some shares he bought some years ago.
   Does he pay tax on the profit?
   - ☐ Yes
   - ☐ No

8. Shirley is under 65 and working. What is her personal tax allowance (amount she can earn before paying any tax?) (Figures are approximate).
   - ☐ a) £2,500
   - ☐ b) £3,500
   - ☐ c) £6,000
   - ☐ d) £6,500

9. John is married to Jane, and is a 40% taxpayer while Jane does not work. From a tax point of view, in whose name should any building society account monies be placed to save the most tax?
   - ☐ a) John
   - ☐ b) Jane
   - ☐ c) Joint names

10. Is the State Pension taxable?
    - ☐ Yes
    - ☐ No

11. Your Endowment Policy matures at the end of its 15 year term – do you pay tax on the proceeds?
    - ☐ Yes
    - ☐ No

12. If you make a pension contribution, at what rate to you get tax relief?
    - ☐ a) Basic relief
    - ☐ b) No tax relief
    - ☐ c) At whatever rate of tax you pay

13. When you come to draw your pension, what rate of tax do you pay?
    - [ ] a) Basic rate
    - [ ] b) Higher rate
    - [ ] c) No tax
    - [ ] d) Whatever tax rate your income justifies

14. Frank who was a very wealthy builder left all of his assets worth a total of £400,000 to his wife Susanne. Is the estate subject to tax?
    - [ ] Yes
    - [ ] No

15. Joe put £5,000 into an Individual Savings Account (or ISA) some years ago and it is now worth £8,000. Can he take this:
    - [ ] a) All tax free?
    - [ ] b) £5,000 tax free and the balance taxed?
    - [ ] c) With tax to pay on all of it?

16. Which one of the following National Savings & Investments products provide a tax-free return on an investment of £10,000?
    - [ ] a) Saving Certificates
    - [ ] b) Capital Bonds
    - [ ] c) Investment Accounts
    - [ ] d) Ordinary Accounts

17. How are the children's Bonus Bonds taxed?
    - [ ] a) They are totally tax free
    - [ ] b) The person given the Bond is subject to higher rate tax only
    - [ ] c) The person given the Bond is subject to capital gains tax on any gain
    - [ ] d) The person given the Bond is subject to basic and higher rate tax

18. Is a lump sum payable at retirement from a pension taxable or not?
    - [ ] Yes
    - [ ] No

19. Is tax relief available on a mortgage?
    - [ ] Yes
    - [ ] No

20. If you sell the house that you live in, do you pay tax on any profit that you have made?
    - [ ] a) Yes – fully taxable
    - [ ] b) Yes – partially taxable
    - [ ] c) No – tax free

Answers to the Taxation Quiz

1) (a) Totally tax free – Any profits resulting from an investment within an ISA are tax free irrespective of how long the investment has been held.

2) (b) 20%, 40%, 50%. These are the current rates of tax (2011/12) and are subject to review by the Chancellor and the Treasury in the Budget each year. They can of course go up or down – and do!

3) (a) Income tax – (ii) Wages and Salary. Any pay, tips, bonus, pensions, overtime or interest received are generally subject to income tax.

(b) Capital gains tax – (iii) Profits on shares. A profit realised when shares are sold is potentially liable to Capital Gains Tax.

(c) VAT – (i) Fees for building work.
VAT is levied on many goods and services – always check the VAT position before agreeing a job or a purchase!

(d) Inheritance tax – (iv) Value of one's estate on death.
Over a certain limit (the nil rate band) inheritance tax is levied at the rate of 40% (2011/12).

4) (d) Half of the interest is taxed individually. Each of the joint holders is liable for tax on their share of the total, i.e. A husband and wife who have £1,000 in a joint account earning interest of £50 per annum gross will each have to declare interest of £25 to HM Revenue & Customs. For most people however, the tax deducted at source means that no further tax is due. Those on very low incomes should reclaim tax deducted at source and higher rate taxpayers will have to pay more tax.

5) (a) True. If income from all sources when added up is less than the personal tax allowance then a non-taxpayer can go along to the Building Society and ask for the interest to be paid gross.

(b) True. As an alternative to (a) above, the non-taxpayer can receive a refund of tax via HM Revenue & Customs.

6) No. Each one of us can give up to £3,000 in any tax year without any inheritance liability – either immediately or on early death.

7) No. Provided that this was the only profit he had made in a complete tax year then there would be no liability to Capital Gains Tax, as the profit is less than the allowance provided by the Revenue.

8) (d) The allowance is currently £7,475 (2011/12). It is important to remember that this allowance changes each year in the Budget. Any income received below this figure is tax free.

9) (b) Jane. This is extremely important. If the money is held in John's name or indeed in joint names then half or all of the income will be taxed at John's penal 40% rate.

Whereas if the money is held in Jane's name, the interest will be tax free at least until her allowance has been used up. Even then the tax rate will be lower at 20%.

10) Yes. It is a commonly and wrongly held belief that the State pension is tax free. The State pension income is added to any other income and tax is levied if the total income exceeds the personal allowance.

11) No. The money received from a maturing Endowment with a term of ten years or more is tax free. Despite the bad press many of these policies have provided good returns for investors. Beware – do not surrender policies early if it can be helped. The returns will be low and also may be subject to tax.

12) (c) Except for those with very high earnings (£130,000 + per annum) you get tax relief at whatever rate of tax you pay. The Government is very keen for us to save for our retirements by encouraging us to make pension contributions. As an incentive they give valuable concessions in the form of tax reliefs and exemptions on pension premiums and pension funds. In fact pensions are one of the most tax effective ways of saving for retirement.

13) (d) Whatever tax rate your income justifies. Having received valuable tax reliefs and exemptions whilst saving for retirement, the income you receive from your pension provider is taxable as income.

14) No. Irrespective of the size of your estate, if you have willed it all to your surviving spouse then it will pass to her / him tax free.

15) (a) All tax free. The value contained within an Individual Savings Account is available at any time and is free from tax.

16) (a) Savings Certificates. It is a commonly held belief that all National Savings & Investments products are tax free – this is not true. National Savings & Investments have a range of products both taxable and non-taxable catering for those over retirement age to products for young children. They also cater for higher rate taxpayers and non-taxpayers alike.

17) (a) They are totally tax free. Subject to a maximum level, any interest credited will not be subject to tax.

18) No. At retirement, in the majority of cases, a lump sum can be taken from the Pension Scheme which reduces the regular pension income in the future. In other words some of the pension can be given up for a lump sum. This lump sum, if taken, is generally tax free. Care must be taken in deciding which option should be taken.

19) No, tax relief was available on mortgages but the Government stopped this several years ago.

20) (c) No – Tax Free. Any profit you make on the sale of your principle residence i.e. your own home, is tax free. However, if you have a second house and sell it, then you may be liable to Capital Gains Tax on any profit you make less your annual Capital Gains Tax limit.

Calculating Income tax

It is very useful to be able to calculate your own Income Tax, if only to be able to check that HM Revenue & Customs has got it right!

This is how it is done

1. Add up all your income

2. Deduct the relevant allowance – see below.

TAX ALLOWANCE (2011/12)	
PERSONAL ALLOWANCE (to age 65)	£7,475.00
Age Allowance (65 - 74) *(but reduces if total income exceeds £24,000)*	£9,990.00
Age Allowance (75 or over)	£10,090.00

3. Apply the tax bands to your net income, after allowances

TAX BANDS (2011/12)	
For the first £35,000 after allowances, deduct	20%
For any amount over £35,000 to £150,000, deduct	40%

Example		**£**
Let's look at an example. Patricia has a salary of £25,000.00 which at the moment is her only income	Total income =	25,000.00
She has a personal allowance (which is the tax free part of her income) of £7,475.00	Allowances =	7,475.00
So her taxable income is calculated as £25,000 (income) – £7,475.00 (allowance)	Taxable Income =	17,525.00

Let's now look at the tax:

Patricia's taxable earnings will all be taxed at the rate of 20%.

So, 20% of £17,525.00 is £3,505.00 — Total tax = 3,505.00

Question

What would Patricia's tax bill be if she got a new much better paid job and earned £45,000? Using the Allowance and Tax Band tables, try and calculate her tax yourself while covering the answer below:

Total income = £ ________

Personal Allowance = £ ________

Total income - Allowance = Taxable Income

Taxable Income = £ ________

First band of tax @ 20% = £ ________

Second band of tax @ 40% = £ ________

First band + Second band = Total tax

Total tax = £ ________

Answer

Total income =	£ 45,000.00
Personal Allowance =	£ 7,475.00
Total income - Allowance = Taxable Income	
Taxable Income =	**£ 37,525.00**
The first £35,000.00 of taxable income First band of tax @ 20% =	£ 7,000.00
The rest above £35,000.00 of taxable income is £2,525.00 Second band of tax @ 40% =	£ 1,010.00
First band + Second band = Total tax	
Total tax =	**£ 8,010.00**

If Patricia had had an interest-paying bank or building society account, or some taxable investments, she would pay some tax on these. This tax would effectively be at her higher rate (40%), but she would be allowed to offset against this the basic rate tax deducted by the bank or building society. Some investments like Occupational Pensions or ISAs are largely tax-free, so she would not have to declare these to HM Revenue & Customs. If she had a Personal Pension, she could reclaim higher-rate tax relief and offset it against her tax bill.