



Income Tax – An introduction

A brief history

Income tax has a long history. It was first announced in 1798 and introduced in 1799 by the then Prime Minister, William Pitt the Younger to help pay for the war against France under Napoleon. The tax raised almost £6 million in its first year. The tax was repealed a number of times in the early years but the foundations of income tax as we know it were laid by Pitt's successor, Henry Addington who brought in the Addington Act which introduced two major innovations:

- Taxation at source – for example, the Bank of England deducting income tax when paying interest to holders of gilts.
- The division of income taxes into five 'Schedules' - A (income from land and buildings), B (farming profits), C (public annuities), D (self-employment and other items not covered by A, B, C or E) and E (salaries, annuities and pensions).

Although there have been many changes since the Addington Act of 1803, a precedent to tax individuals had been set which, as we all know, continues to this day!

What is Income tax?

Income tax is a tax paid on taxable income received by individuals including:

- Earnings from employment
- Earnings from self-employment
- Pensions income
- Interest on most savings
- Dividend income
- Rental income
- Trust income

There are certain types of income which are not taxable such as:

- Income from Individual Savings Accounts (ISA's)
- Interest from tax exempt savings accounts
- Premium Bond wins
- Working tax credit

These income sources are ignored when calculating the amount of income tax payable.

Individuals can be liable to income tax at any age and there are special rules to stop parents avoiding tax by putting assets into their children's names.

Personal allowances

Most individuals in the UK have a personal allowance threshold which is the amount of taxable income they are allowed to earn annually without being taxed.

The basic personal allowance for the tax year commencing 6 April 2011 is £7,475. There are higher allowances for individuals over the age of 65, although these allowances can



be reduced to the level of the basic personal allowance where income exceeds certain levels.

There is also a blind person's allowance and a married couple's allowance where one of the spouses was born before 6 April 1935.

From 6 April 2010 the personal allowance is gradually reduced by £1 for every £2 of income over £100,000.

Income tax rates

After personal allowances are calculated the amount of income tax payable depends on the level of income, the type of income and the income tax rates. The income tax rates for 2009-10 and 2010-11 are as follows:

<u>Income tax bands</u>	<u>2010-11</u>	<u>2011-12</u>
Basic Rate - 20%*	£0-£37,400	£0 - £35,000
Higher Rate - 40%	£37,401-£150,000	£35,001-£150,000
Additional Rate - 50%	Over £150,000	Over £150,000

*Dividend and savings income is taxed at 10% up to £2,560 (2010-11 £2,440). The 10% rate does not apply if taxable non-savings income exceeds £2,560 (2010-11 £2,440).

Dividends are deemed to be the top slice of total income in computing tax liability at 10%, 32.5% or 42.5% respectively.

Employment matters

Income tax is also due on certain non-cash benefits received from an employer including:

- Company cars or vans
- Fuel
- Medical insurance
- Living accommodation
- Low interest loans

The rules for obtaining tax relief for business related expenditure incurred by employees are notoriously restrictive.

Paying income tax

Taxpayers who are employed usually have most, if not all, of their tax collected using the Pay as You Earn (PAYE) system. The employer will deduct tax using a tax code determined by HMRC to calculate how much tax should be paid.

In most cases, basic rate tax is also deducted on interest received from banks and building societies.



Taxpayers who are company directors, self-employed or who have complex tax affairs will need to file self assessment tax returns and pay their tax through the self assessment tax system. This is a special process with its own rules that can be found in one of our other guides.

National Insurance

National insurance is a separate tax (or contribution) payable in addition to income tax. National insurance contributions are meant to fund social security benefits such as an entitlement to the state pension. The amount of national insurance payable by taxpayers depends on the level of income and their employment status.

Claiming Tax Relief

There are a number of tax reliefs which can reduce the amount of income tax due. These reliefs mainly relate to gifts to charities using Gift Aid, pension contributions and employees using their own car for business mileage.

How we can help

We would welcome the opportunity to assist you in completing your annual tax returns or resolving any disagreements you may have with the taxman (HMRC).