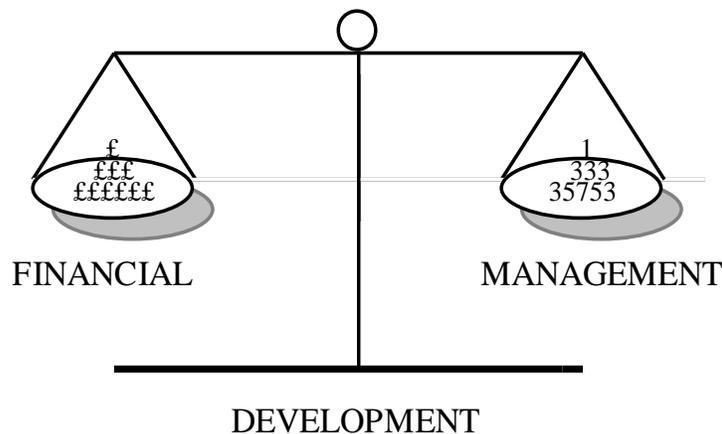


# FINANCIAL MANAGEMENT DEVELOPMENT

## Taxation

NO 412

### INCOME TAX



ONE OF A SERIES OF GUIDES FOR  
FINANCIAL MANAGEMENT DEVELOPMENT

FROM

[www.FinancialManagementDevelopment.com](http://www.FinancialManagementDevelopment.com)

This is one of a series of documents produced by David A Palmer as a guide for managers on specific financial topics to assist informed discussion. Readers should take appropriate advice before acting upon any of the issues raised.

## INCOME TAX

Introduced in 1799, and until 1909 at the penal rate of 5%, Income Tax has been as high as 98% (when anyone with any sense went abroad!).

Income tax is a tax on income due or paid to individuals and is payable for a Fiscal Year from 6 April to the following 5 April at rates which are set in the Finance Act of which the Chancellor's "Budget" is merely the opening speech.

Each year each taxpayer must complete a tax return (electronically or on paper) and submit it to HMRC. It covers

- Income from all sources
- Allowable outgoings paid
- Details of capital gains
- Details of the taxpayer's personal circumstances

Her Majesty's Revenue and Customs (HMRC) or if they wish, the taxpayer can calculate the tax payable and if this exceeds the tax paid, an assessment will be issued.

HMRC have six years from the end of a tax year to issue an assessment but can go back a further six years in cases of fraud, neglect etc.

When a tax payer receives an assessment they have 30 days to appeal against it. Interest can be charged on overdue tax.

In many cases tax is deducted at source from the payer of the income e.g.:

Earnings from Employment	PAYE
Dividends from Companies	10% Credit
Bank or Buildings Society Interest	20% deducted at source

It must be noted that although most income tax disputes are covered by legislation, there is a vast body of case law and numerous Extra-Statutory Concessions. In many instances it is possible to structure one's affairs so as to minimise the tax payable. In 1934 the following was part of the judgement in the House of Lords in a case involving the Duke of Westminster:

"Every man is entitled if he can to order his affairs so that the tax attaching under the appropriate Act is less than it otherwise would be. If he succeeds in ordering them so as to secure this result, then, however unappreciative the Commissioners of Inland Revenue or his fellow taxpayers may be of his ingenuity, he cannot be compelled to pay an increased tax".

HMRC can often be helpful in giving an indication of the effect of certain courses of action. They provide help lines for PAYE enquiries which is often useful to resolve a particular problem e.g. is it or isn't it taxable? They do not normally ask for names so effectively it is a confidential service. There are similar enquiry lines at the HMRC Districts dealing with Corporate or Sole Trader issues but these may wish to know the identity of the caller.

Income tax is payable under six schedules and nine cases. The most relevant are:

- Schedule DI Trading Profits (Self Employment)
- Schedule EI Income from UK Employment

Note that Schedule DI is taxed on the Current Year Basis i.e. Tax is payable on profits of the period ending in the tax year. This requires various adjustments when starting or ceasing to trade.

Although not shown in this format this is effectively what the return shows:

**INCOME TAX COMPUTATION FOR YEAR TO 6 APRIL .....**

	£	£
<b>EARNED INCOME (SELF)</b>	<b>X</b>	
<b>LESS ALLOWABLE DEDUCTIONS</b>	<b>(X)</b>	
	—	
<b>INVESTMENT INCOME</b>		<b>X</b>
<b>LESS ANNUAL PAYMENTS</b>		<b>(X)</b>
		—
<b>TOTAL INCOME</b>		<b>X</b>
<b>LESS PERSONAL ALLOWANCES AND RELIEFS</b>		<b>(X)</b>
		—
<b>TAXABLE INCOME</b>		<b>X</b>
		—
<b>TAX PAYABLE AT 20% UP TO £35,000 (2012)</b>		<b>X</b>
<b>TAX PAYABLE AT 40% £35,001 TO £150,000 (2012)</b>		<b>X</b>
<b>TAX PAYABLE AT 50% OVER £150,000 (2012)</b>		<b>X</b>
<b>LESS TAX PAID BY DEDUCTION AT SOURCE</b>		<b>(X)</b>
		—
<b>TAX DUE</b>		<b>X</b>
<b>LESS TAX SUFFERED, PAID AT SOURCE:</b>		
<b>Under PAYE</b>		<b>(X)</b>
<b>On Interest Dividends etc.</b>		<b>(X)</b>
		—
<b>TAX TO BE PAID OR (REPAID)</b>		<b>?</b>
		===

There may also be National Insurance or Student Loan Repayments to be added.

Earned Income includes:

Schedule DI	Profits from Trading
Schedule E	Income from office or employment including pensions

Allowable Deductions include:

- Capital Allowances or losses relating to a trade
- Allowable expenses incurred in employment
- Allowable retirement annuity premiums

Investment Income includes:

- All taxable income other than earned income
- Alimony and maintenance payments

(Note that there are various credits involved with most investment income due to the effective deduction of tax at source. These have deliberately been made extremely complicated and vary with income - one has to assume this is due to a) a drive to discourage investment; b) a desire to maximise the number of people employed at HMRC; or c) a complete failure by those who frame tax legislation to appreciate the mess to which constant tinkering with the tax system has made it incomprehensible and "unfit for purpose"; or d) all of the above.)

Annual payments include:

- Allowable interest paid
- Deeds of Covenant/ Gifts to Charities
- Alimony

State benefits are normally taxable under Schedule E. They include: Pensions, Unemployment Benefit, Statutory Sick Pay, and Maternity Pay

The following benefits are not taxed: Child Benefit, Attendance Allowance, Disability Living Allowance, Housing Benefit, Council Tax Benefit, Family Income Supplement, Maternity Grant and Allowance, Student Grants, Invalidity Allowance and Pension, etc.

## **TAX CREDITS**

Tax credits are payments from the government. If you're responsible for at least one child or young person, you may qualify for Child Tax Credit. If you work, but are on a low income, you may qualify for Working Tax Credit. You can often get both types of tax credits. They are not taxable.

## **ALLOWANCES**

Allowances are allowable deductions from taxable income. They vary with the circumstances of the individual.

Any taxpayer can claim the Single Person's Allowance. (2012 £7,475)

Allowances are higher for those over 65, or who are blind

Interest payments may also be allowable on specific loans.

If a taxpayer agrees to make voluntary payments they may be allowed as a deduction from taxable income. The gift must be made subject to deduction of tax at source.

The recipient must not be the taxpayer's own unmarried infant child (i.e. under 18).

Thus no giving your income to pay for nappies etc.

**EARNINGS (FROM EMPLOYMENT)**

Earnings can arise in two main ways:

From Employment

From Trading (as a self-employed person)

This section deals with earnings from employment, i.e. "all salaries, fees, wages, perquisites and profits whatsoever" of an office or employment.

An **office** or **employment** is where there is a **contract of employment**, written or implied, under which the employer obtains the services of the **employee**. This is distinguished from a self-employed sub-contractor who would be taxed under Schedule DI or II under a **contract of services**.

An employer can tell an employee how and when he is to perform services; a self-employed person merely contracts to product a specified result and is not under the direct control of an employer. However, there are other "badges" of self-employment and this test is by no means conclusive.

An **employee** is to be provided with and paid for a specified amount of work on a continuing basis and he is obliged to accept and perform the work. A **self-employed** person has no right generally to be provided with a specified amount of work and can refuse any work offered. Other factors indicating self-employed status are if the individual:

Provides his own tools and equipment.

Has more than one client and does not work more than 75% (approximately) in terms of pay or time for one client.

Is not paid on a time basis regardless of output.

Does not enjoy pension arrangements, non cash benefits or the right to holiday pay provided by a 'client'.

Can benefit from their own good management

Engages staff himself to fulfil their contractual arrangements with clients.

Stands to bear a loss if such an outcome occurs, or

Has the 'trappings' of a business name, business bank account, business address, VAT registration etc.

Often HMRC's view differs from that of the taxpayer, and HMRC have recently been seeking to re-categorise various sectors of the workforce: musicians, television technicians, builders, consultants etc.

The distinction between the two is of practical importance because the rules for measuring income under Schedule E are in general stricter than those for Schedule D and National Insurance Contributions are affected. HMRC may demand a schedule of names, addresses and amounts paid to non-employees.

## **EMOLUMENTS (BENEFITS IN KIND)**

Emoluments includes:

- Gifts (unless for personal qualities)
- Expenses unless "wholly, exclusively and necessarily" incurred in the performance of duties
- Provision of accommodation
- Non cash vouchers or credit tokens

The provision of such items (Benefits in Kind) is disclosed to HMRC by the employer on a P11D form which has to be submitted for all Directors and any employee earning more than £8,500 p.a. (Laughingly known as Higher Paid Employees since the Minimum Wage of £6.08 per hour at 48 weeks of 35 hours gives £10,214 p.a. !!!)

The value of a benefit is the cost to the employer and this includes the reimbursement of expenses. Normally expenses are then reclaimable as allowable deductions. In order to avoid unnecessary form filling etc. it is normal to negotiate a dispensation from the HMRC for certain items, and some e.g. car mileage reimbursement have set rates.

## **SELF EMPLOYMENT**

Profits from a trade or any "adventure in the nature of trade" are assessable to tax under Schedule DI (Schedule DII if it is a profession or vocation).

A UK resident is charged on all profits whether the trade is carried out in the UK or elsewhere. A non-UK resident is only charged if the trade is carried out in the UK.

**HMRC thereby do not seek to tax foreigners carrying on trades in foreign countries!**

Profits are computed under general accountancy rules except that:

- Capital Allowances replace depreciation
- Expenses must be wholly and exclusively for the trade
- Capital Expenditure is disallowed

Most of the rules relating to Corporation Tax are applicable for arriving at the taxable profits of a trade although the treatment of travel and subsistence costs varies.

## **TRAVEL AND SUBSISTENCE**

Travel expenses between home and work are not allowable. Normally the cost of meals while visiting customers is allowed as a subsistence expense although a 1975 case disallowed a self-employed carpenter's cost of meals. The claim was for the excess cost. Since it was for the excess only it was not "wholly" for the purposes of the trade.

**TAX IS PAYABLE ON THE CURRENT YEAR BASIS**

Payment of Tax on profits assessable under Schedule DI is in two equal amounts on 31 January within, and 31 July following, the year of assessment. Thus the tax payable on profits for the accounting period ended 30 June 2013 will be assessed to tax in the year ended 5 April 2014 and the tax will be payable half on 31 January 2014 and half on 31 July 2014.

**PAY AS YOU EARN**

PAYE is the method used to collect Income Tax.

Each employer is issued with Code Numbers for each employee. This number is set for a tax year although it may be amended during the year. The code is intended to reflect the anticipated personal allowances and reliefs for each individual less the value of any anticipated benefits.

The code is the total of these items with the last number omitted and a letter added.

The letters used are for HMRC's convenience and are:

L	(Lower) single person's allowance
H	(Higher) married allowance
P	Lower age allowance
V	Higher age allowance
T	Refer to Tax Office before changing code

In addition a code may be followed by WK1 or MTH1 signifying the code is temporary. The code is used to calculate the tax due by allowing a proportion of the code to be set against income (the proportion being fixed by the month/week of the year). Tax due on income to date is calculated, tax already paid is deducted and the balance is therefore the tax due.

When an employee changes jobs they receive a P45 showing income and tax paid to date and their current code. They are obliged to provide this to their new employer.

At the end of each year the employer provides each employee with a P60 showing income, tax deducted and the tax code at the year end.

Because estimates are used the tax code is frequently wrong. In cases where the error is in the HMRC's favour it is in the taxpayer's interest to write to them soon as possible because:

1. The correction of the code will result in an immediate repayment of tax (or reduction of the amount paid).
2. If the correction is not made until the next tax year the tax overpaid will be repaid by credit transfer rather than an adjustment to the Code.

This will normally be some months after the tax year end.

## SELF ASSESSMENT

Under the Self Assessment system Taxpayers are expected to complete their tax returns in great detail. If they wish to calculate the tax due they can submit their return by 31 January (for the tax year ended 5 April that year). If they want HMRC to calculate the tax they must submit the relevant details by 30 September of the previous year.

There are automatic penalties for late submissions and interest is due on tax paid late.

All taxpayers (or people who should be taxpayers) must keep records for 12 months after the filing date (5 years for business records).

For most people - the majority of employers paying tax under PAYE - the main need is to put their P11D data on their return (P11D's show all benefits paid to "Higher paid" employees i.e. those earning over £8,500 and the employer has a duty to send the relevant information to each employee.) and include any investment income.

Note: All payments are taxable; the question is only whether they are also allowable as deductions. Thus all expense reimbursements should be shown on the P11D (Some companies may have organised dispensations) and then the employee shows them as legitimate business expenses and deducts them from the "income". Failure to prove allowability e.g. "I've lost the receipt" will merely mean tax is paid on the reimbursement plus of course interest on late payment and possibly a fine.

There are various rules to convert benefits into cash values for -

Cars

Health Provision

"Free" Goods

The time limit for supplying the information to employees is 6 July each year.

For the self-employed there are similar needs to keep records and justify expenditure.

## "UNUSUAL" OCCUPATIONS

There are a number of occupations with special rules including Farmers, Ministers of Religion, Actors, Sports men and women, Builders, Barristers, Soldiers, Politicians and Members of Parliament. These mainly deal with the treatment of "lumpy profits" and what are allowable costs (and what are not).

**Rev. DAVID A. PALMER BA (Financial Control) FCA CTA MCIPD**

David is an experienced financial professional who has devoted his skills to management training in practical understanding and utilisation of financial information. A Graduate, Chartered Accountant, and Associate of the Institute of Taxation, he is also a Member of the Chartered Institute of Personnel and Development and has been an Ordained as a Deacon in the Catholic Church.

He has worked as a Financial Controller and Company Secretary in the Finance industry and as a Director of Finance and Administration in the Computer Services industry. Since 1990 he has conducted management development programmes for over forty major organisations including Arla Foods, Blue Circle, BP, CSC Computer Sciences, Conoco, Ernst & Young, Lloyds Bowmaker, Royal Mail, Unilever and Zeneca. He also runs programmes for the Leadership Foundation and the management teams at a number of Universities. International training experience includes work in Belgium and Holland for CSC, in Denmark, Kenya and the Czech Republic for Unilever, in Holland and the US for Zeneca, in Dubai for Al Atheer, in Bahrain and Saudi Arabia for Cable & Wireless.

He specialises in programmes in financial management for both tactical and strategic decision making. In addition he has run courses in acquisition evaluation (The Economist, Eversheds, Blue Circle and Hays Chemicals) and in post-acquisition management (Unilever). All training is specifically tailored to the needs of the organisation with the emphasis on practical applications to enhance profitability and cashflow. He has developed material for delivery by in-house personnel (Royal Mail, Lloyds Bowmaker and Conoco), computer based training packages (The Post Office, Unilever and BP), and post course reinforcement self-study workbooks (CSC and Zeneca). He has also produced a training video on Cashflow Management.

He is a prolific writer of case studies, role plays and course material. He has also published articles on the financial justification of training, financial evaluation of IT investment proposals, the use of Activity Based Costing and Customer Profitability statements, commercial considerations for consultants, the need for taxation awareness training for general managers, evangelisation and Christian business ethics.

Many of his generic documents are freely available on his website:

**FinancialManagementDevelopment.com** including papers on Charity Management.

In addition to his Diaconal work in the Church, he has held a number of voluntary positions including University, College and School Governor, Hospice Treasurer and Trustee of various charitable institutions. He continues to provide ad hoc commercial advice to several other charitable organisations. He has been married for over 35 years and has one daughter and three granddaughters.

This series of papers is designed to help managers by providing a basic understanding of key financial concepts to assist them in their work. It is provided at no cost since this knowledge is a Gift from God and thus to be shared (Matthew 10:8).

(I wonder how God copes with disallowance of this cost in his Tax Computation?)