Income Tax—An introduction

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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 The tax was repealed a number of times in the early years but the foundations of Income Tax as we know it were laid by Pitt's successor, Henry Addington, who brought in the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, it set a precedent to tax individuals that 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

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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 2016 is £11,000. In previous years, there were higher age related allowances for older individuals but these allowances have been phased out.

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

The personal allowance is gradually reduced by £1 for every £2 of income over £100,000 irrespective of age.

New marriage allowance

The new marriage allowance came into force on 6 April 2015 and applies to married couples and those in a civil partnership where a spouse or civil partner doesn't pay tax or doesn't pay tax above the basic rate threshold for Income Tax (i.e. one of the couples must currently earn less than the £11,000 personal allowance for 2016-17).

The allowance permits the lower earning partner to transfer up to £1,100 of their unused personal tax-free allowance to a spouse or civil partner. This could result in a saving of up to £220 for the recipient (20% of £1,100) or £18.33 a month.

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 2016-17 and 2015-16 are as follows:

Income tax bands	2016—17	2015—16
Savings starting rate—0%*	£0—£5,000	£0—£2,880
Basic Rate—20%	£0—£32,000	£0—£31,785
Higher Rate—40%	£32,001—£150,000	£31,786—£150,000
Additional Rate—45%	Over £150,000	Over £150,000
Dividend Allowance	Over 5,000	—
Dividend Ordinary rate	7.5%	10%
Dividend upper rate	32.5%	32.5%
Dividend additional rate	38.1%	37.5%

Personal savings allowance

Basic rate taxpayers	£1,000	—
Higher rate taxpayers	£500	—

Anyone with taxable income of less than £16,000 (2015-16: £15,600) will have no interest to pay on their savings. For all other basic rate taxpayers the first £1,000 interest on savings income will be tax-free. For higher rate taxpayers the tax-free personal savings allowance will be £500. Anyone earning over £150,000 will not benefit from the personal savings allowance.

The High Income Child Benefit charge applies to taxpayers whose income exceeds £50,000 in a tax year and who are in receipt of Child Benefit. The charge either reduces or removes the financial benefit of receiving Child Benefit. Where both partners have an income that exceeds £50,000, the charge applies only to the partner with the highest income.

The Child Benefit charge is charged at the rate of 1% of the full Child Benefit award for each £100 of income between £50,000 and £60,000. For taxpayers with income above £60,000, the amount of the charge will equal the amount of Child Benefit received. Taxpayers affected by the change have the choice to keep receiving Child Benefit and pay the tax charge through Self Assessment, or elect to stop receiving Child Benefit and not pay the new charge.

Dividend taxation changes

As part of the Summer 2015 Budget measures, the government announced the introduction of a new dividend allowance from April 2016. The new allowance replaces the non-refundable dividend tax credit of 10%. The new dividend allowance means that no tax will be due on the first £5,000 of dividend income received, regardless of the amount of non-dividend income.

However, dividends in excess of the £5,000 allowance will be taxed at the following new rates based on the recipient's highest rate of Income Tax:

— 7.5% if dividends are taxed as part of the basic rate tax band
— 32.5% if dividends are taxed as part of the higher rate tax band, and
— 38.1% if dividends are taxed as part of the additional rate tax band.

Dividends received within the £5,000 allowance will still count towards the basic or higher rate bands and may therefore affect the rate of tax paid on dividends received in excess of the £5,000 allowance. Dividends received by pension funds and dividends received on shares held in an ISA continue to be tax-free.

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 HMRC.