Hello and welcome to this short video entitled “The Seven Steps Required to calculate a client’s income tax liability.”

I’ll explain these Seven Steps and in particular focus on Step 4 where you calculate tax at differing rates as determined by the particular income components.

The video is based on our understanding as at the date you can see in the important information section on the screen.

I’m Graeme Robb, and I’m a Senior Technical Manager. I’ll take you through this short video.

As you may be aware, the procedure for calculating an income tax liability is set out in a series of Steps.

I’ll run through these, but in simple terms what do these Steps tell us to do?

They tell us to add up the different components of income, before deducting any reliefs and allowances. We then calculate the tax due on each component and total these up. Sometimes that is all that’s required but in more complex cases you then need to deduct any tax reducers and add in any further amounts of tax due.

Hopefully all will become clear as we run through the video.

We identify the components of income and add them up to arrive at total income.

Common components are

- Employment income
- Pension income
- Taxable social security payments
- Trading income
- Property income
- Savings income, and
- Dividend income

Tax law establishes that the order is as shown on the slide. Note in particular that offshore Bond gains are taxed before dividends but onshore bond gains are taxed after dividends.

When you then come to calculate Top Slicing Relief, bond gains and slices are treated as the ‘highest part’ and therefore both onshore and offshore gains and slices come after dividends in the Top Slicing Relief calculation. The mechanics of Top Slicing Relief are covered in detail elsewhere in Pru Adviser. Speak to your account manager.

I'm not going to overly dwell on this, but Step Two is where reliefs can be deducted from the components to arrive at net income. Certain Reliefs can be deducted from any component but others are restricted to a particular component. For example, if the client is a trader and sustains a trading loss in the tax year then the loss can be deducted against general income of the same tax year. For losses arising in the 2020/21 and 2021/22 tax years only, you can carry the loss back to the previous three tax years and offset it against all of your other income in the earlier tax years. Any unrelieved loss can then carried forward and set off only against future income from that same trade. There are also loss relief provisions for new businesses.

Step three is where the personal allowance (and blind person's allowance) is deducted. Remember that the basic personal allowance is restricted for those where adjusted net income exceeds £100,000.

Step Four is where it begins to get a bit tricky. You need to calculate tax at each applicable rate on the amounts of the components left after Step 3. So, what are these different tax rates?

Remember our first component is Earnings, Pensions, Taxable Benefits, Trading profits and income from property.

We need to remember that…

1. The Personal Allowance & Blind Person's Allowances are set by the UK Government and are not devolved.
2. Also, reliefs and allowances are deductible in the way that will result in the least tax. Therefore, regarding the Personal Allowance, the general rule of thumb is to deduct the maximum personal allowance from non-savings, non-dividend income as this component suffers tax at the highest rates and enjoys no 0% bands which may apply to savings and dividend income. In other words, we're maximising taxable savings and taxable dividend income. Also as we will see shortly, dividends are taxed at a maximum rate of just 38.1%
3. Other than Scotland, there are three main tax bands – Basic 20%, Higher 40% and Additional 45%.
4. Scottish taxpayers have five tax bands. Starter Rate 19% / Basic Rate 20% / Intermediate Rate 21% / Higher Rate 41% and Additional Rate 46%.
5. The Scottish & Welsh Governments can only set income tax rates and limits applicable to non-savings and non-dividend income. Therefore, Scottish taxpayers still pay the same tax as the rest of the UK on savings and dividends income.

1. Saving income includes interest from savings accounts held with banks, building societies etc. as well as interest distributions from OEICs. Other types of savings income includes the non capital element of a purchased life annuity, and insurance bond gains (remembering though that onshore bond gains are taxed after dividends).
2. Where any of the first £5,000 of taxable income is savings income it will be taxed at 0%. To put this another way, take me as an example. My first £5,000 of taxable income is earned income meaning that I don’t qualify for this starting rate.
3. The amount of Personal Savings ‘Allowance’ depends on adjusted net income (up to £50,270, the PSA is £1,000 then £500 up to £150,000 then zero. How do you calculate Adjusted Net Income? It’s basically, total taxable income before personal allowances and less certain tax reliefs such as gross gift aid donations and gross pension contributions.
4. The use of the word ‘allowance’ is misleading as it is, in fact, a zero rate tax band. What this means is that income within the PSA still counts as taxable income in your tax calcs, but it’s just taxed at 0%.
5. As taxable savings income is taxed after earned income, the tax rates that apply to savings income depend on how much earned or other non-savings, non-dividend income the client has, for example, rental income.

1. Just like the Personal Savings Allowance, the Dividend Allowance is a misnomer. It's actually a nil rate which is currently £2,000.
2. Dividends within the nil rate still count towards your client's basic or higher rate band and may therefore affect the rate of tax paid on dividends in excess of £2,000.
3. The rates of tax on dividend income above the nil rate are

7.5% for dividends in the basic rate band

32.5% for dividends in the higher rate band

38.1% for dividends in the additional rate band

4. Dividend income includes dividends from UK resident and non UK resident companies.
5. For the avoidance of doubt, VCT dividends are exempt from tax

I’m repeating myself here but Onshore Bond gains are taxed after dividends while offshore bond gains are taxed before dividends.

When you calculate top slicing relief, note that both onshore and offshore gains and slices come after dividends in the top slicing relief calculation.

Chargeable event gains on UK bonds aren’t liable to basic rate tax. This means that your client is treated as having paid tax at the basic rate on the amount of the gain. In other words there will be a basic rate credit deductible when calculating the overall tax liability.

As far as we’re aware, it hasn’t been definitively settled whether or not the notional tax credit is repayable. Tax law tells us that it can’t be repaid. That indicates it isn’t available to set against other income resulting in an income tax repayment, but instead it should be possible to reduce that tax down to zero. Nevertheless, we are aware that HMRC have previously taken the view that the notional tax credit can be set against other income, creating a refund of other income tax if appropriate.

So…we know how to calculate tax on each component. What must we remember when doing so?

We must extend the Basic and Higher Rate Tax Bands for gross gift aid payments and gross relief at source pension contributions. This is the mechanism for delivering higher and additional rate tax relief.

STEPS SIX AND SEVEN

In Steps Six and Seven we can now adjust the tax liability that we have calculated where appropriate.

Tax reducers reduce the tax liability and the most common are

EIS, VCT & SEIS tax reliefs

Top Slicing Relief

Deficiency Relief on Bonds,

And Marriage Allowance

It is also here that additional 'relief at source' tax relief is available for Scottish taxpayers subject to 21% , 41% or 46% tax rates. This can be claimed via a tax return.

Step Seven is the final step in calculating a client's income tax liability where it's necessary to add any further amounts of tax due. Common examples include

- The High income child benefit charge
- The lifetime allowance charge, and
- The annual allowance charge.

And finally, remember that a client's income tax liability is not necessarily the same as tax payable because there may be tax already paid (e.g. PAYE) or tax deducted at source.

That’s us at the end of this short video and I hope its been of use.

If you wish to discuss matters further then please contact your Prudential Account Manager. You can also access our Knowledge Library within Pru Adviser for further information. In particular, these articles may be useful.

Thanks very much for your time.