Topic 8

Pay and tax

Learning outcomes

After studying this topic, you will be able to:

- describe the main types of income for tax purposes;
- explain how employed and self-employed workers are taxed;
- describe the components of a payslip;
- explain the importance of P45 and P60 forms;
- calculate a simple income tax example.

Introduction

Income tax is used to support government spending on all sorts of things, such as running important public services, providing state benefits, running the armed forces and all the other services that the public expects a government to provide. It is payable by anybody who receives what is termed 'taxable income', which includes income from working, savings, investments, renting out property, pensions and some state benefits. The amount of tax payable depends on the individual's total income.

Did you know?

Income tax has been around for a long time. It was first introduced in Britain in 1799 as a temporary tax to raise money for the war against Napoleon's France, because the government had borrowed huge sums of money to fight the war but still needed more.

Napoleon Bonaparte

In 1816, a year after the war was over, the government abolished income tax. However, in 1842 the government brought back income tax to help provide money to spend on running the country, and it has been with us ever since.

Technically, it is still a temporary tax, and Parliament has to renew it every year through the Chancellor of the Exchequer's annual Budget.

National Insurance (NI) pays for the National Health Service, the state pension and a number of other state benefits for those who are unemployed, those who are unable to work through illness and those who don't earn enough to support their families. It is paid by employees, employers and self-employed people. Although it is not meant to be used for other purposes, the government can borrow from the fund to cover the cost of providing other public services and government spending.

NI is payable by all those aged 16 to state pension age who are working, and the amount depends on their income. Those who are not working, such as unemployed people and those who are retired, do not have to pay NI.

Did you know?

The system of National Insurance (NI) in the UK was introduced in 1911, mainly to provide a fund to help workers who needed medical treatment or fell into financial difficulties. Workers paid a subscription into the scheme from their wages, and could claim payments from the fund if their circumstances met certain requirements. As with income tax, NI has developed over the years and now has a much wider scope.

As you can see, both income tax and NI are taxes based on a person's income. They are collected by Her Majesty's Revenue & Customs (HMRC) via Pay As You Earn (PAYE) if you are working for an employer, or by completing a self-assessment tax return form if you are self-employed. Tax return forms are gradually being replaced by digital tax accounts for individuals and businesses.

The tax and NI years run from 6 April to 5 April, and until now the government has confirmed the rates for the following tax year in the March Budget. However, the government has announced that after 2017, the Budget will take place in the autumn.

Budget

The rates for the tax year 2017/18 are confirmed in the 2017 Budget, the rates for 2018/19 are confirmed in the 2018 Budget, and so on.

In recent years, many of the main changes to income tax and other personal taxes have been announced a few months before the Budget. Changes to other taxes and other matters are then revealed in the Budget, and the changes already announced are confirmed.

Note to students

To keep things simple, we have used the rates for 2017/18 throughout this topic as examples to illustrate how tax works. This will not affect your study or your assessment, so don't worry. You can see the current rates by using the links below:

- www.hmrc.gov.uk/rates/it.htm
- www.hmrc.gov.uk/rates/nic.htm

8.1 What is income?

Before we look at the taxes in more detail, we need to know what types of income there are. Income comes in three broad categories.

- **Earned income** – money received for doing a job or carrying out a trade or profession. It covers both employees and self-employed people and includes pensions.
- **Savings and investment income** – income received from a wide range of savings and investment products. Examples include interest from bank and building society accounts, and dividends from shares and unit trusts.
- **Rental income** – income received by renting out property.

In addition, some benefits provided by employers for employees are also treated as income.

When an employer provides certain benefits to an employee – such as a company car, private medical insurance or subsidised accommodation – the value of the benefit may be treated as a form of income.

For example, if the employer pays for medical insurance and the premiums are £200 a year, the employee will be treated as receiving £200 extra income for tax calculations.

Company cars are taxed under the same principle, but the cash value is worked out using a formula that assesses how much use of the car is worth each year, rather than taking the total value of the car itself. These are known as 'benefits in kind' and apply to all employees.

8.2 How taxes are calculated

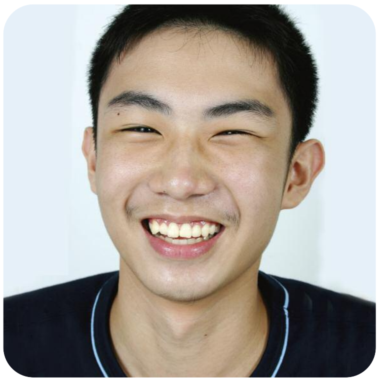
Although we don't need to know lots of details about tax calculations, we do need to know some basics to help us put it all into context.

8.2.1 Personal allowance

Everybody is allowed to earn a certain amount of income before they start to pay tax. This is known as the 'personal allowance', and the standard personal allowance for 2017/18 is £11,500.

This means that anyone with income up to £11,500 will not pay tax, and anyone with income above £11,500 will only pay tax on income above £11,500. Some people may have a lower personal allowance because of their particular circumstances.

The amount of the personal allowance is set in each year's Budget.



Kristian

I've started working part-time at the local swimming pool. If I do this for a year I will earn about £6,000, which falls within my personal allowance, so I don't pay any tax.

8.2.2 Income tax rates

There are three rates of income tax, and they are applied to total income from all sources after the personal allowance has been taken off.

- Basic-rate income tax is charged at 20% on the first £33,500 after the personal allowance (ie up to £45,000).
- Higher-rate income tax is charged at 40% on the next £105,000 (which is the band between £45,000 and £150,000).
- Additional-rate income tax is charged at 45% on income above £150,000.

People who should pay higher-rate or additional-rate income tax usually have to complete a self-assessment tax return each year. This is a form issued by HMRC consisting of a series of pages requesting information about their income from all sources and their expenses, so that their tax bill can be calculated. The form can be completed on paper or online. People who have savings and investment income may also be required to complete a self-assessment tax return.

8.2.3 What income do we use in order to budget?

We've talked a lot about budgeting in Topics 3, 4 and 5 and how important it is to be able to live within our means and make financial plans. In order to achieve this, we need to know what our 'net' income is. Net income is what we have left after income tax and NI have been deducted – what we have available to spend.

Michelle

I am employed and earn £30,000 a year. I have gross income of £2,500 a month, which sounds great. However, after taking off income tax and NI, I'm left with £1,973 a month net income.

Danny

I'm employed and earn £20,000 a year, which gives me gross income of £1,667 a month. Once tax and NI are taken off I have £1,407 net income.

For both Michelle and Danny, their actual income is a lot less than you might think! In the next section we will consider both tax and NI, and look at how to work out some simple examples.

8.3 How employees pay their taxes

Employed and self-employed people are taxed differently. Employed people are taxed under a system called Pay As You Earn, shortened to PAYE. Under this system, the employer must deduct the right amount of income tax from the employee's pay and send it to HMRC each time the employee is paid. Pensions are taxed using a similar system.

Did you know?

PAYE was introduced in 1944 as the Second World War saw an increased reliance on taxation. The system was designed for better efficiency in processing a growing number of taxpayers.

(Source: HMRC)

8.3.1 Income tax

To help the employer to deduct the right amount of tax, HMRC provides a tax code for each employee. This tells the employer how much the employee can earn before they must start to pay tax. The tax code is usually three numbers and a letter, with the numbers being the employee's personal allowance divided by 10. The most common tax code in the tax year 2017/18 is 1150L, which is £11,500 divided by 10, so it means that the employee can earn £11,500 before the employer must deduct tax.

The letter in the tax code is HMRC's own code for the type of allowance the employee has been given. The 'L' in the standard tax code tells HMRC that the employee is just allowed the basic personal allowance. Some people have a different letter after the numbers because they have different allowances, but we don't need to go into detail about them here.

Some people have a tax code that just says BR. The tax code BR is an instruction to the employer to deduct basic-rate tax on all the employee's earnings without taking off the personal allowance. This often happens when someone starts work for the first time or starts a new job, and it is a temporary measure until HMRC can sort out the correct tax code. There's no need to panic, though, as once the correct tax code is sorted out, any overpaid tax is refunded. BR is also used when someone has two jobs or other sources of income that use up their personal allowance.

Jenny

I earn £18,000 a year in my main job, and also have an evening job that pays £4,000 a year. All my personal allowance is set against the income from my main job, which means I only pay tax on £6,500 of that income. My main job has used up all my personal allowance, so I pay tax on all the income from the second job. My second employer was given a BR tax code for me, to tell them to tax all that income.

Each time the employee is paid, a proportion of the tax code is set against the income for that period. For example, if the employee is paid monthly and has a tax code of 1150L, the first £958.33 of their pay would not be taxed. £958.33 is $^1/_{12}$ of £11,500.

If the employee receives benefits in kind, such as a company car, the value of the benefit is usually taken off their personal allowance. This means that they would have a lower tax code than normal. For example, a company car with a benefit value of £2,500 would reduce the employee's personal allowance to £9,000, giving a tax code of 900L.

PAYE means that the employee does not have a big bill to pay at the end of the tax year, and HMRC gets its money on a regular basis. Sometimes an employee's earnings vary during the year and they may pay too much or not enough tax as they go along. At the end of the tax year, HMRC checks the employee's total income and the tax paid. HMRC will pay a refund if too much tax was paid, or arrange for any underpaid tax to be collected in the next tax year; either way the difference will not usually be very much.

8.3.2 National Insurance (NI)

Employers are also responsible for collecting and paying NI for their employees. Employees pay NI Class 1, which is calculated on a sliding scale as shown in the Table 8.1.

Table 8.1 How National Insurance is calculated

Weekly pay	National Insurance
First £157	Nil
£158 to £866	12% of £158 to £866 (or their income if lower than £866)
Over £866	12% of £158 to £866 plus 2% above £866

eg

Someone earning £150 a week would not pay NI.

Someone earning £650 a week would pay £59.16 NI (£650 – £157 x 12%).

Someone earning £870 a week would pay £85.16 NI. (£866 – £157 x 12%) + (£870 – £866 x 2%).

If an employee is paid monthly, you can calculate their weekly equivalent wage and NI, and multiply by 52 weeks to get a yearly total. Then divide by 12 to get the monthly equivalent.

Employers also pay Class 1 NI based on the employee's income, but the rate is slightly different.

8.3.3 What does a payslip look like?

Employers must give employees a payslip every time they are paid. A payslip tells them how much they were paid, how much income and NI were deducted, and whether there were any other deductions, such as pension contributions. It will also show how much they have been paid so far in the tax year and the total deductions for tax, NI, and so on for the year so far.

We can see an example of a payslip in Figure 8.1. You will notice that each of the important headings in the payslip has a small number next to it. This would not appear on a normal payslip but is to help us identify and explain each part.

Figure 8.1 Jenny's payslip

The Big Company Ltd			
Date: 31. 07. 201X	**Payroll number:** 12345678	**Name:** Jenny Brown	**Month number:**[1] 4
Pay method:[2] Bacs	**Tax code:**[3] 1150L	**NI number:**[4] AB 123456A	**NI code:**[5] A
Payments:[6]		**Deductions:**[7]	
Basic pay	£1,500	Income tax:	£108.33
		National Insurance:	£98.36
Total payments:	£1,500	Total deductions:	£206.69
Cumulatives:[8]			
Pay to date	£6,000		
Tax to date	£433.32		
NI to date	£393.44		
Bank details Jenny's account: Sort code: 12-34-56 Account number: 87654321		**Net payment this month:**[9]	£1,293.31

Let's look at what each part of the payslip tells us. Jenny Brown earns £18,000 a year as an employee of The Big Company Ltd, and the company identifies her on its computer by giving her the payroll number 12345678.

1 – The month number tells us which month in the tax year the payslip covers. In this case it is July, which is Month 4.

2 – The pay method states that Jenny has been paid through a Bacs bank transfer.

3 – Jenny's tax code is the full 1150L, which means that the first £11,500 of her earnings is not taxed.

4 – This is Jenny's National Insurance number, which is how she is identified and recorded on the NI and other government systems. Every UK citizen is given an NI number when they reach the age of 16 and it stays with them throughout their life.

5 – This tells us the type of NI that Jenny pays.

6 – This shows how much Jenny was paid in July. Overtime, bonuses or other pay would be shown as separate items in this section.

7 – This tells us how much was deducted from Jenny's wages for the month. Income tax and NI are the obvious deductions, but pension contributions would also be shown if they were taken.

8 – Cumulatives shows the totals for pay, income tax and NI for the tax year to 31 July 201X.

9 – This shows the total payment made to Jenny this month after all deductions.

8.3.4 Important documents

There are two important tax documents that employees may receive. It is very important to keep them safe.

8.3.4.1 Form P60

A form P60 is given to each employee by their employer at the end of the tax year. It is an official document that shows the final tax code, the total amount that they earned from that job during the tax year, and how much income tax and NI the employer deducted. These are the figures that the employee must use when they complete any HMRC forms or have to report their income.

8.3.4.2 Form P45

A form P45 is given to an employee when they leave an employer. It reports their tax code and their total pay, income tax and NI from the start of the tax year to the date they leave. When the employee starts a new job, they must give the P45 to their new employer so that they are taxed properly in their new job. If the new employer does not have the P45, they will have to tax all the employee's wages, using the code BR, until they receive a new tax code from HMRC.

8.4 How self-employed people pay their taxes

If a person is self-employed, it means that they don't work for an employer. They run their own business and decide what to do and when to do it. Very often plumbers, painters and decorators and other tradespeople are self-employed, as are many professionals.

Self-employed people are taxed under a different system, because their income can vary and they won't know their total income and expenses until the end of the tax year. There are strict rules on what counts as being self-employed – such as the ability to decide what work to do, when to do it, how to do it, who to work for, and so on.

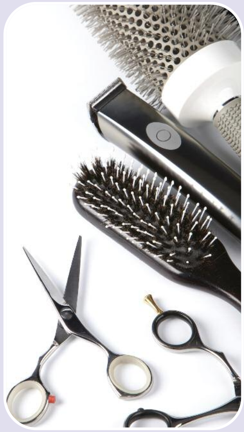
8.4.1 Income tax

Self-employed people are taxed on their profits from carrying out their job. Profit is calculated as their income from self-employment less any deductible business expenses. To be deductible, a business expense must be wholly and exclusively for the purpose of carrying out the business. Examples would include materials for carrying out jobs, tools essential for doing the work, running an office, and travel expenses.

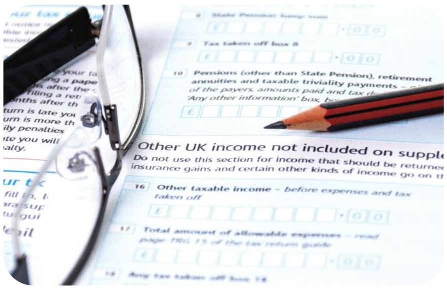
Self-employed people are required to keep a record of payments received and the expenses they incur for doing the work, and at the end of the tax year they must complete an income tax self-assessment form to declare their profit to HMRC. Self-employed people with turnover below a certain amount can submit simple accounts to show their income, while those with turnover above that figure must submit detailed accounts.

Kyle

I'm a self-employed mobile hairdresser. My total income for the tax year was £30,000 – in business terms this is known as my 'turnover'. In order to run my business I had a number of deductible expenses, such as hair products, equipment and travel costs. These expenses totalled £5,000. That means I have a profit of £25,000 for the year, and my tax will be based on that figure.



8.4.2 Completing a self-assessment tax return



Kyle pays income tax in a different way from Jenny. He won't have to deduct tax monthly, but at the end of the tax year he must complete a self-assessment tax return, either on paper or online. The tax return must be completed at the latest by 31 January after the end of the tax year, so for the tax year 2017/18 he would have to complete it by 31 January 2019.

The tax return consists of a series of pages covering questions about:

- his income;
- his expenses;
- other income he receives;
- pension contributions he makes;
- other tax-related matters.

8.4.3 Calculating and paying tax

Once the tax return is complete, HMRC will calculate how much tax Kyle must pay, using the same principles as for an employee. So they will deduct any personal allowance from Kyle's profit and then apply the same tax rates of 20%, 40% or 45%, depending on his profit.

The payment of tax for a self-employed person is quite complex and we don't need to go into too much detail here. HMRC will estimate Kyle's tax bill at the start of each tax year, and he will have to make two payments – one by 31 January in the tax year and one by 31 July just after the end of the tax year – each one covering 50% of the estimate. He may have to make another payment in January after the tax year ends to make up the difference between the estimate and the real figures.

It is very important that Kyle makes sure that he puts money away regularly in a savings account so that he can pay the bills when they are due. If he doesn't, he will be in trouble and will be charged a penalty for late payment.

eg

Self-employed tax payments for the tax year 2017/18

Date	Payment
31.1.2018	50% of estimated bill for 2017/18
31.7.2018	50% of estimated bill for 2017/18
31.1.2019	The balance of the actual bill for 2017/18 Plus 50% of the estimated bill for 2018/19

8.4.4 National Insurance

Self-employed people also pay NI but in a slightly different way. Once their profits are more than a certain amount, they must pay Class 2 NI, which is charged at a weekly flat rate and is collected through their tax return. Once their profits are above a certain higher threshold, they must also pay Class 4 NI, which is calculated as a percentage of their profits above this higher threshold. The rates are shown in Table 8.2.

Table 8.2 National Insurance rates for self-employed people

Annual profit	National Insurance
Up to £6,025	Nil
Above £6,025	Class 2 NI @ £2.85 per week
Between £8,164 and £45,000	Class 2 plus Class 4 NI @ 9% between £8,164 and £45,000
Above £45,000	Class 2 plus Class 4 NI @ 9% between £8,164 and £45,000 plus 2% above £45,000

Class 2 NI and Class 4 NI are paid with the person's income tax by the January after the end of the tax year. However, Class 2 NI is due to be scrapped in April 2018.

8.5 Savings interest

If you have money in a bank or building society account, any interest earned over an amount called the personal savings allowance is taxable, as we saw in Topic 3.

Remember that:

- for basic-rate taxpayers, the first £1,000 of interest received each tax year is tax-free; and
- for higher-rate taxpayers, the first £500 of interest received each tax year is tax-free.

Kyle

I've got £5,000 in a building society savings account, which pays 2.5% interest each year. The total interest, known as the 'gross' interest, is £125. I receive that without any tax taken off. As I'm a basic-rate taxpayer, it's within my £1,000 personal savings allowance and I don't have to pay tax on it.

Anna

I earn £50,000 a year as a manager. That means I am a higher-rate taxpayer and pay 40% tax on the top part of my income. I have £30,000 in a building society account, which pays £600 a year interest. Like Kyle, I receive the interest without tax taken off, so I receive £600 in my account. I have a personal savings allowance of £500 because I'm a higher-rate taxpayer, so £100 of my interest is taxable and I will have to pay 40% (£40) tax on it.

Summary

Finally, we can recap what we learned in this topic.

We learned:

- how income tax and National Insurance developed and why we pay the taxes;
- the meaning of income for tax purposes;
- how income tax is charged and collected;
- how National Insurance is charged and collected.

Key terms

Benefits in kind – certain benefits, given to an employee by an employer, which are treated as income.

HMRC – Her Majesty's Revenue & Customs.

Income – refers to all income received from working, saving, investing, renting property, and any other source. Gross income is total income before tax, and net income is income after tax and NI have been deducted.

Income tax – a form of tax on all income received by an individual. It helps to fund general government spending, and is charged at the rates of 20%, 40% or 45% of income above a certain amount, known as the personal allowance.

National Insurance (NI) – a form of tax on earned income paid by employees, employers and self-employed people. The money raised pays for the National Health Service, the state pension and a number of other state benefits.

Net income – what we have left after income tax and NI have been deducted; what we have available to spend.

P45 – the form that employees receive when they change jobs. It states how much they earned and how much tax they paid in their last job.

P60 – the form all employees receive at the end of the tax year, telling them how much they were paid and how much tax was deducted.

PAYE – Pay As You Earn is the way that income tax is collected from employees. Their employer deducts tax each time they are paid, which means they don't have a big tax bill to pay at the end of the tax year.

Personal allowance – every individual is allowed to receive a certain amount of income before they have to pay tax. There is a standard allowance that applies to most people, but some people have a different personal allowance because of their circumstances.

Self-assessment – the system by which self-employed people, higher-rate and additional-rate taxpayers and those with unusual circumstances declare their income for tax purposes.

Self-employment – someone who is self-employed doesn't work for an employer but has set up their own business. This means that they have to find their own work and sort out their own tax.

Taxable income – income that is subject to tax deductions.

Turnover – in business terms, total income for the tax year.

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Napoleon portrait engraved by D.J. Pound circa 1800s