

How to calculate personal taxes correctly

Personal tax has now become so complicated that HMRC has been unable to incorporate all of the complexities of the personal tax computation within the HMRC self-assessment online filing system.

As a result, there are a number of income combinations (referred to as exclusions) where the tax calculated by the HMRC system differs from the correct tax calculation. Exclusion case taxpayers must not file online: instead a paper return must be filed by the 31 October 2017 deadline (albeit that paper filing instead by 31 January 2018 will be covered by the reasonable excuse provisions).

The various commercial software houses are dealing with the challenges presented by this unprecedented circumstance in various ways (some more successfully so than others, thus far).

Allocation of income to different tax rate bands

The tax legislation requires that different types of income are allocated to the various rate bands in a prescribed order:

- 1 Non-savings income (employment, self-employment, pension, rent etc); then
- 2 Interest; then
- 3 Dividends.

The allocation to rate bands does not give rise to any particular difficulties.

The savings rate band (SRB) and personal savings allowance (PSA)

The calculation becomes slightly more complicated when the taxpayer has interest income. The SRB replaces the 20% basic rate of tax with a 0% rate on up to £5,000 of interest income. However first we have to identify whether the taxpayer is entitled to either the £1,000 or the £500 PSA.

In simple terms a basic rate taxpayer qualifies for a PSA of £1,000 and a higher rate taxpayer for a PSA of £500. Additional rate taxpayers (adjusted net income exceeding £150,000) do not qualify for a PSA. Any interest covered by the PSA has an effective tax rate of 0% but uses up an equivalent amount of the appropriate rate band.

The SRB works in a very different way. The SRB must first be allocated to non-savings income (employment, self-employment, pension, rent etc.) before being allocated to interest. It is never allocated to dividend income.

Unless the non-savings income is less than the sum of any personal allowance and other general reliefs plus the SRB there will be no SRB available to the interest.

For example, an individual with 2016-17 earnings of £14,000 and interest income of £7,000 will have to set £3,000 of the SRB against the earnings that exceed the personal allowance of £11,000 and so £2,000 of the interest will be covered by the remaining SRB and another £1,000 by the PSA leaving a tax liability of £1,400.

If an individual had earnings of £11,000, interest of £6,000 and dividends of £5,000 there would be no tax liability since the earnings would be covered by the personal allowance, the SRB and the basic rate PSA would cover the interest and the dividends would be covered by the dividend tax allowance (of which more below).

If an individual had interest of £5,000 and dividends of £200,000, there would be no tax on the interest as it is covered by the SRB which we do not allocate to dividends.

The dividend tax allowance (DTA)

Although like the SRB the DTA applies a 0% tax rate on the first £5,000 of income, it differs by being applied only to dividend income and being unaffected by the level or existence of any other income. But like interest covered by the SRB or the PSA, dividends covered by the DTA use up an equivalent amount of the appropriate rate band.

The example above has already demonstrated how the DTA is allocated and used.

Personal allowances and other reliefs (PAs etc.)

The real computational difficulties arise when we consider the allocation of PAs etc. These include the usual personal allowance of £11,000 for 2016-17, but also any reliefs that are available against general (rather than specific sources of) income such as qualifying loan interest, sideways loss relief and share loss relief.

PAs etc do not have to be allocated in the same prescribed order as the types of income. Instead (under s25(2) ITA 2007) the PAs etc may be deducted “in the way which will result in the greatest reduction in the taxpayer's liability to income tax”.

Until the introduction of the DTA this flexibility did not create any practical difficulty. And in relatively simple cases it is easy enough to identify the optimal allocation of PAs etc. For example, if an individual had earnings of £40,000 and dividends of £9,000 in 2016-17, allocating the full £11,000 PA to the earnings would give effective relief on £8,000 (the excess of the earnings over the basic rate band of £32,000) at 40% and the other £3,000 at 20%. This would leave £3,000 of dividends within the basic rate band but at 0%, then £2,000 of dividends in the higher rate band (HRB) but at 0%. The top £4,000 of dividends would be at the 32.5% dividend higher rate. But the £3,000 of PA set against earnings at 20% could be better used against higher rate dividends at 32.5%. So the optimal allocation of the PA is to set £8,000 against the earnings and the other £3,000 against the dividends.

This example is the same as in Example 6 in HMRC's dividend allowance factsheet (<https://www.gov.uk/government/publications/dividend-allowancefactsheet/dividend-allowance-factsheet>). As of May 2017 the HMRC guidance is still wrong and, if followed, would give rise to excess tax of £375 (despite HMRC having been alerted to this error over a year ago).

The basic allocation rule

Other things being equal we would simply identify income allocated to the different rate bands and then apply to PAs etc to the highest tax rate income first and so on down the rates. This could be expressed as allocating in this order:

- 1 Non-savings income taxed at additional rate (45%); then
- 2 Interest taxed at additional rate (45%); then
- 3 Non-savings income taxed at higher rate (40%); then
- 4 Interest taxed at higher rate (40%); then
- 5 Dividend income taxed at additional rate (38.1%); then
- 6 Dividend income taxed at higher rate (32.5%); then
- 7 Non-dividend income taxed at basic rate (20%); then
- 8 Dividend income taxed at basic rate (7.5%).

In the example above this allocation of the £11,000 PA is thus:

1 £0

2 £0

3 £8,000

4 £0

5 £0

6 £3,000

7 £0

8 £0.

The advanced allocation rule

Unfortunately, there is an added complication introduced by the operation of the 0% DTA. In some scenarios it turns out (counter-intuitively) to be better to allocate PAs etc to non-dividend income taxed at 20% rather than to dividends taxed at 32.5% (i.e. to allocate in the order 1, 2, 3, 4, 5, 7, 6, 8 rather than 1, 2, 3, 4, 5, 6, 7, 8!).

This advanced allocation rule is only relevant if the non-dividend income exceeds the basic rate band but does not exceed the higher rate threshold (basic rate band plus allowances) – so check first! The rationale for this is that using some of the PAs etc against non-dividend income taxed at 20% rather than against dividends taxed at higher rate (but not covered by the DTA) initially moves the PA from the higher rate band to the basic rate band at a cost of 12.5% (32.5% less 20%). But thereafter further such use moves the dividends from 32.5% to 7.5% giving a net saving of 25%.

So such a re-allocation of PAs etc is only advantageous if you can move at least double the DTA from higher rate to basic rate. To put it another way: If the excess of the dividend income over the DTA (ie dividends less £5,000) is more than double the excess of total income over the higher rate threshold (ie total income less BRB less PAs etc) then allocate excess PAs etc to BRB non-dividend income rather than to higher rate dividends. Simple!

Example 1:

Earnings £34,000

Dividends £14,000

Total income £48,000

Dividend excess of £9,000 is less than double the HR income of £5,000, so allocate in the order 1, 2, 3, 4, 5, 6, 7, 8.

Example 2:

Earnings £34,000
Dividends £12,000
Total income £46,000

Dividend excess of £7,000 is more than double the HR income of £3,000, so allocate in the order 1, 2, 3, 4, 5, 7, 6, 8.

The taxpayer in Example 2 is a higher rate taxpayer with a liability of £5,875. But with an extra £2,000 of dividend income (Example 1) the tax only increases to £6,400. That gives a marginal rate of 26.25% (rather than the expected 32.5%) on the extra dividends.

Higher levels of income

What about income combinations well into higher rate tax? Mathematicians could work out that the formula for applying the advanced allocation rule could be expressed as “Dividends + twice non-dividend income < £81,000” which would normally restrict the problem to total incomes in the range of £43,000 to £49,000.

However we have to factor in the possible extension of the basic rate band by gift aid and pension contributions and the inclusion in PAs etc of reliefs against total income such as qualifying loan interest, sideways loss relief and share loss relief.

Example 3:

Earnings £46,000
Dividends £14,000
Reliefs £12,000
Total income £55,000

Dividend excess of £9,000 is less than double the higher rate income of £5,000, so allocate in the order 1, 2, 3, 4, 5, 6, 7, 8.

Example 4:

Earnings £46,000
Dividends £12,000
Reliefs £12,000
Total income £46,000

Dividend excess of £7,000 is more than double the higher rate income of £3,000, so allocate in the order 1, 2, 3, 4, 5, 7, 6, 8.

Summary

- Step 1 Identify extended basic rate band
- Step 2 Identify total PAs etc
- Step 3 Calculate total non-dividend income
- Step 4 If amount at Step 3 does not exceed amount at Step 1, allocate PAs etc in the standard order
- Step 5 If amount at Step 3 does exceed Step 1 plus Step 2, allocate PAs etc in the standard order
- Step 6 Otherwise calculate $(2 \times (\text{Step 1} + \text{Step 2} - \text{Step 3}) - £5,000)$
- Step 6 If total dividends are greater than Step 5, allocate PAs in the order 1, 2, 3, 4, 5, 6, 7, 8.
- Step 7 Otherwise, allocate PAs in the order 1, 2, 3, 4, 5, 7, 6, 8.

Example 5:

Earnings £134,000
Dividends £12,000/£14,000
Relief £15,000
Gross gift aid £96,000
Total income £146,000

Step 1 Extended basic rate band is $£32,000 + £96,000 = £128,000$

Step 2 Total PAs etc are £15,000

- Step 3 Total non-dividend income is £134,000
- Step 4 £134,000 exceeds £128,000
- Step 5 £134,000 does not exceed £128,000 +£15,000 = £143,000
- Step 6 $(2 \times (\text{Step 1} + \text{Step 2} - \text{Step 3}) - £5,000) = 2(128,000 + 15,000 - 134,000) - 5,000 = £13,000$
- Step 7 If dividends greater than £13,000 allocate PAs in the order 1, 2, 3, 4, 5, 6, 7, 8.
- Step 8 If dividends are less than £13,000 allocate PAs in the order 1, 2, 3, 4, 5, 7, 6, 8.

This paper has been written with assistance from tax expert Tim Good of Absolute Accounting Software. If you are concerned that your tax may be calculated incorrectly please contact Guilford Accounting by emailing noel@guilfordaccounting.co.uk.