R03 Income tax 2020/2021

This guide will cover the whole subject in five parts

- The basic calculation
- Pension and Gift Aid Contributions
- Adjusted Net income, the withdrawal of the Personal Allowance and Child Benefit Tax charge
- Marriage Allowance and Children's income
- Paying Income Tax

The basic calculation

Her Majesty's Revenue and Customs (HMRC) seek to tax an individual's income in the tax year which runs from April 6 to April 5.

Income includes:

- Earnings from employment (salary and benefits in kind)
- Profits from self-employment
- Pension income (including State Pension)
- Profits from rented property
- Interest from deposits, gilts/bonds
- Dividend Income
- Proceeds on non-qualifying life policies

The list is not exhaustive but will suffice for R03

Most individuals are classed as **UK resident and domicile** and are liable to tax on income wherever it arises.

Jim receives income from a buy to let property in Spain. He will be liable to pay UK tax on this.

HMRC splits income into four groups and taxes them in a set order

1. Non savings income
2. Savings income
3. Dividend income
4. Chargeable gains under non-qualifying policies

Chargeable gains under life policies will be dealt with later.

The tax bands

Most individuals pay no tax on the first £12,500 of income. This is known as the **Personal Allowance.**

The **next** £37,500 is the basic rate band so for 20/21 you won't pay higher rate tax until your income is more than £50,000
Income between £37,500 to £150,000 falls into the **higher rate** band
Income above £150,000 is classed as **additional rate.**

Non-savings income

The following is classed as NS income:

- Wages/salaries
- Taxable benefits in kind
- Profits from self-employment
- Pension income (including State Pension)
- Rental Profits

Once the Personal Allowance has been deducted any non-savings income is taxed as follows:

Basic rate	20%
Higher rate	40%
Additional rate	45%

The following examples show how different levels of earnings are taxed across the different tax bands.

Alan's sole income is a pension of £8,000. This is below the Personal Allowance (PA) so he pays no tax.

Belinda has a salary of £32,500. The first £12,500 is covered by her PA leaving £20,000 subject to tax. This is less than £37,500 so it is all taxed at 20% giving a liability of £4,000.

Charlie has a salary of £55,500. Again, the PA covers the first £12,500 and £43,000 is taxable. This uses up all the basic rate band of £37,500 so £5,500 is taxed at the higher rate

From this you should be able to deduce the process:

- Deduct the PA of £12,500 from the individual's non-savings income
- If the resulting figure is below £37,500 it is all taxed at 20%
- If the resulting figure is above £37,500 deduct £37,500, which is taxed at 20% and the excess is taxed at 40%.

Set out as a calculation the last example would be like this:

Non Savings	£55,500		
Less PA	12,500		
	43,000		
Less	37,500	@ 20%`	£7,500
	5,500	@ 40%	£2,200
Total			£9,700

If the non-savings income is less than £12,500 the unused balance can be carried forward to savings and even dividend income.

Benefits in kind

Many employees receive part of their remuneration in the form of benefits rather than cash. The most common examples are:

- A car that the employee can use for private as opposed to the employer's business.
- Private health Insurance.
- A subsidised loan

HMRC convert the benefit into a monetary amount which is then classed as non-savings income.

The taxation of these was standardised in the 1981 budget and only "higher paid employees and directors" were to have their benefits subject to tax. The definition of a higher paid employee was set at £8,500 and this has never been changed. In 2020/21 the personal allowance is higher than this so in practice anyone whose earnings are above the personal allowance will pay tax on any benefits in kind.

The £8,500 figure is still in the rules as employers must report to HMRC any BIK paid to an employee whose total income, including the BIK is more than this.

At the end of the tax year the employer will give the employee a P11D certificate which confirms the monetary amount of the benefit.

Savings income

Savings income is taxed after non-savings income and includes:

- Interest from banks and building societies
- Interest from Gilts and corporate bonds
- Interest from unit trusts and OEICS investing in gilts and corporate bonds

Interest from banks and building societies, gilt based unit trusts and OEICs is paid gross with no tax deducted.

Savings income is taxed at the same rates as non-savings income but there is also a 0% starting rate and a Personal Savings Allowance.

The 0% starting rate

To qualify for the 0% starting rate, savings income must fall in the first £5,000 above the personal allowance.

Claire has no earnings but receives gross interest of £15,000. She has a personal allowance of £12,500 so £2,500 of her interest is taxable. As all this is within the first £5,000 above the personal allowance it is all taxed at 0%

Judith has a salary of £20,000. This means that £7,500 of this is taxable so she cannot use the 0% savings rate.

TIP

If the question states that the subject's non-savings income is less than £17,500 be aware that the 0% savings rate is available.

Personal Savings Allowance

Tax on savings income changed radically from April 6 2016 with the introduction of the **Personal Savings Allowance** or **PSA**. The key features of this are:

- The PSA is £1,000 for a basic rate and £500 for a higher rate tax payer so the saving in tax is always £200.
- Additional rate tax-payers do not get a PSA.
- Unlike the Personal Allowance the PSA does not reduce the amount of income that is taxable. It is effectively a 0% rate

What is a higher rate tax payer?

HMRC will class individuals as higher rate tax payers if **any** of their income is taxed at higher rate. They will then have a PSA of £500. Similarly if any of an individual's income falls in the additional rate band they will have no PSA.

Put another way, if total income, taking into account the personal allowance is less than £50,000 you get the full PSA of £1,000, if it is between £50,000 and £150,000, you get £500 and if it's above £150,000 you get nothing.

In the current low interest rate climate, few individuals will probably pay tax on their savings income but the following examples illustrate how the PSA works in a calculation.

Eric has a salary of £27,500 and non ISA savings income of £600. He gets the full PSA of £1,000.

	Non Savings	Savings
Income	£27,500	600
PA	12,500	
	15,000	
£15,000 @ 20%	£3,000	
£600 @ 0% (PSA)	0	
Total	£3,000	

Fiona has a salary of £42,500 and non ISA savings income of £7,000. She gets the full PSA of £1,000.

……Non Savings		Savings
Income	£42,500	7,000
PA	12,500	
	30,000	7,000
£30,000 @ 20%	£6,000	
£1,000 @ 0% (PSA)	0	
£6,000 @ 20%	1,200	
	£7,200	

In this last example tax on her interest is due but as no tax was deducted at source this must be paid to HMRC. To avoid increasing the number of individuals having to make tax returns HMRC will collect data from banks and other institutions and when tax is due will adjust an employee's tax code.

George has a salary of £48,500 and savings income of £4,000. Since his total income is more than £50,000 his PSA is £500

	Non Savings	Savings
Income	£48,500	4,000
PA	12,500	
	36,000	4,000
Non Savings		
£36,000 @ 20%	£7,200	
Savings		
£500 @ 0%	0	
£1,000 @ 20%	200	
£2,500 @ 40%	1,000	
	£8,400	

Without the PSA, £1,500 of the savings income would be taxed at 20%.

There is no phasing in of the PSA. Someone with non-savings income of £49,150 and savings income of £1,000 would get a PSA of £500 even though they are only £150 above the higher rate threshold.

Combining the 0% rate and PSA

Ken earns £14,500 and gross interest of £5,000. His personal allowance of £12,500 means that £2,000 of non-savings income is taxed at 20%. There is still £3,000 of the first £5,000 band left so £3,000 is taxed at 0%. He then gets a PSA of £1,000 which means that only £1,000 of the interest is subject to tax.

This would be shown like this in a calculation:

Non savings Income less PA = £2,000

Starting rate savings band £5,000 less £2,000 = £3,000

Non-savings	
£2,000 @ 20% =	£400
Savings	
£3,000 @ 0% =	0
£1,000 (PSA) @0%	0
£1,000 @ 20%	£200
Total	£600

Where both the starting rate and PSA are available the starting rate is used first.

To summarise:

- Anyone with a non-savings income of less than £17,500 will have at least part of their savings income taxed at 0%
- Anyone whose non-savings income is less than £12,500 will always have the first £5,000 of savings income taxed at 0%
- Anyone whose non-savings income is higher than £17,500 will not get the 0% rate
- In all three situations, the PSA will also be available which is applied after the 0% rate

Dividend income

Dividend income is taxed after non-savings and savings income but to keep it simple we will assume that someone has just non-savings and dividend income.

The key points of dividend taxation are:

- Dividends are paid gross
- The first £2,000 of dividend income is tax free
- Dividend income above this that falls in the basic rate band is taxed at 7.5%
- Dividend income above this falling in the higher rate is taxed at 32.5%
- Dividend income above this falling in the additional rate is taxed at 38.1%

As with the PSA the £2,000 is effectively a 0% band. It does not decrease the amount of taxable income.

In practice many individuals will not have to pay tax on dividends since they will be less that £2,000 but exam questions will be more complicated!

Majinda has non-savings income of £30,000 and dividend income of £10,000
£2,000 of her dividends will be taxed at 0% and the remainder at 7.5% as it all falls in the basic rate band.

Norman has non-savings income of £60,000 and dividend income of £20,000.
£2,000 of his dividend income will be taxed at 0% and £18,000 taxed at 32.5% as it all falls into the higher rate band.

But consider this example

Olivia has non-savings income of £49,000 and dividend income of £12,000.

The obvious way to do this would be to deduct £2,000 from her dividend income to give £10,000. After her non-savings income has been taxed she has £1,000 of her basic rate band left so £1,000 of her dividends would be taxed at 7.5% and £9,000 at 32.5%. **This is incorrect!**

The remaining £1,000 of her basic rate band uses up £1,000 of the £2,000 tax free band and the remaining £1,000 takes her into the higher rate band. £10,000 is then taxed at 32.5%. Whilst it sounds illogical it does make sense if you think about it.

The key is that the £2,000 is a 0% band rather than an allowance. As all Olivia's non-savings income has been taxed and as there is no savings income then her dividends are next to be taxed. If the £2,000 zero percent band didn't exist, then the next £1,000 would be taxed at basic rate and £11,000 would be taxed at higher rate. The £2,000 band uses up the remaining basic rate band together with £1,000 of the higher rate band so all her dividend income over £2,000 is all taxed at the higher rate.

In any calculation if the total of non-savings and savings income is between £48,000 and £50,000 any dividend income in excess of the £2,000 zero rate band will be taxed at 32.5%.

Dividend Allowance and Personal Allowance

Many directors pay themselves primarily in dividends rather than salary as this is more tax efficient.

For example, Kate pays herself £9,500 in salary but takes £35,000 in dividends. She still has £3,000 of her PA left and it would seem logical that the first £2,000 of her DA would be used up by this. However, the DA is only applied when the PA is used up.

This means that all of Kate's salary and the first £3,000 of dividends will be within her PA. The remaining £32,000 will be taxable with £2,000 @0% and £30,000 being taxed at 7.5%

If Kate had £10,000 of savings income she would have a PSA of £500 because she would be a higher rate tax payer. She would also benefit from the £5,000 0% savings starting rate because savings income is taxed before dividend income. The calculation would be:

Salary	£9,500	£0
Interest	£2,500	£0 (balance of PA)
	£5,000	£0 (Starting rate)
	£500	£0 (PSA)
	£1,500 @20%	£300.00
Dividends	£2,000	£0 (Dividend Allowance)
	£28,500 @ 7.5%	£2,137.50 (remainder of basic rate)
	£4,500 @ 32.5%	£1,462.50 (higher rate)
Total		£3,900.00

Note that whilst all her savings income is in the basic rate band, she still only qualifies for a £500 PSA

A full income tax calculation

Finally we will look at how the liability of someone with all three types of income is calculated. Whilst you won't be asked to do this in R03 it will help put the whole process into context.

Dan has a salary of £41,500 with taxable benefits in kind of £2,000. He has £1,000 in interest from a cash ISA together with interest from a deposit account of £4,000. He also has dividend interest of £6,000 from a portfolio of UK shares

Step 1

Start with three columns, **"Non-Savings"**, **"Savings", "Dividends**"

Under **Non-Savings** you enter salary, pensions, rental income, bonuses and benefits in kind.

Under **Saving**s you enter all interest. This will include bank and building society interest and interest from Gilts and Corporate Bonds (including distributions from unit trusts investing in these).

Under **dividends** enter all dividends. From April 2016 dividends are paid without a tax credit so just input the figure given in the question.

Step 2

Add up all non-savings (£43,500) and deduct Personal Allowance. £12,500 to give £31,000

Add up Savings and Dividends in their respective columns to get a table like this:

	Non-Savings	Savings	Dividend
Salary Benefits in Kind	41,500 2,000		
	43,500	4,000	6,000
Less Personal Allowance	12,500		
Total	31,000	4,000	6,000

Note that in establishing whether he is a basic or higher rate tax payer we do not deduct the PSA or the dividend tax free allowance. His total taxable income is £31,000 + £4,000+ £6,000 = £41,000 and therefore a higher rate tax payer so his PSA is £500

Step 3

Apply tax rates to non-savings income which is all in the basic rate band so taxed at 20%. £31,000 @ 20% = £6,200

Dan's non-savings income hasn't taken him into higher rate tax so we next calculate how much is left. This is £37,500 less £31,000 which is £6,500

Step 4

Apply tax to savings income.

The PSA is a 0% rate band but Dan's total savings income of £4,000 will still be in basic rate. The correct calculation is:

£500 (PSA) @ 0% = £0
£3,500 @ 20% = £700

Step 5

Apply tax to dividend income

The remaining basic rate band should be calculated. This is £37,500 less £31,000 less £4,000 = £2,500. The DA will be applied first with £500 taxed at 7.5%.

The correct way to show this is

£2,000 @ 0% = £0
£500 @ 7.5% = £37.50
£3,500 @ 32.5% = £1,137.50

Step 6

- Total the tax due under all three elements

In Dan's case this is:

Non-savings	£6,200.00
Savings	700.00
Dividends	1,175.00
	£8,075.00

Pension and Gift Aid Contributions

Pension contributions

Pension contributions are an allowable expense against an individual's income tax. How that relief will be given will depend on the type of pension which will either be:

- Occupational schemes including any voluntary contributions
- Personal/Stakeholder Pensions

Occupational schemes

Gross contributions are deducted from a member's pay and they are taxed on the balance. When calculating an IT liability. you should deduct the gross contribution from the individual's basic pay and put the remaining figure in the non-savings column. This means you get tax relief at source at your highest rate.

Personal Pensions/Stakeholder Pensions

These are always paid net of basic rate tax but higher rate and additional rate tax payers can claim further relief.

In all cases you should gross up the net amount paid (Net x 100/80). The gross contribution is then used to extend the basic rate band from £37,500 and additional rate band from £150,000.

Fred makes a net contribution of £4,000 to a Personal Pension.
The Gross contribution is £4,000 x 100/80 = £5,000
Basic Rate band is extended by £5,000 to £42,500

Fred will pay tax at 20% on a further £5,000 of his income rather than 40% which would be the case if he hadn't had made the contribution. He has already received 20% relief through the net pay method so he gains the other 20% relief he is due.

Extending the basic rate band may also result in more savings or dividend income being taxed at basic rate. It can also mean that the PSA will be £1,000 rather than £500

Sam has £40,000 of non-savings income (after his personal allowance) and gross interest of £2,000. A gross pension contribution of £5,000 would extend the basic rate band to £42,500. This means that all his non-savings income and savings income will be in the basic rate band. His PSA will be £1,000 so £1,000 will be taxed at 0% and £1,000 taxed at 20%.

If his savings income was £3,500, £1,000 would be in the higher rate band and the PSA would be £500. His tax liability would be £500 @ 0%, £2,000@ 20%. £1,000 @40%

Charitable Contributions

The Government offers two incentives for individuals wishing to make a contribution to a charity. These are:

- Payroll Deduction Scheme
- Gift Aid.

Payroll giving allows donors, provided the employer is willing to set up a system, to make a donation directly from their salary. As with contributions to occupational schemes, payments are deducted from gross pay so no tax is paid on the donation.

Gift Aid allows the donor to make a contribution to a UK charity which can them reclaim tax at 20%. The charity must be registered in the UK and the individual must give consent for the charity to reclaim gift aid. This is usually done by a declaration on the form. The donor must also have a liability to income or capital gains tax of at least the amount of relief claimed.

The gift is grossed up by dividing by 0.8 and the individual's higher and additional rate threshold is extended by this amount.

Tina makes a donation of £1,200 claiming Gift Aid. This is grossed up to £1,500. The charity reclaims £300 and Tim's basic rate band is extended to £39,000.

Whilst the charity can always reclaim the difference between the grossed up and net amounts there is no **personal** benefit to a basic rate tax payer.

Adjusted net income

ANI is significant in three situations:

- If ANI is over £100,000 individuals will start to reduce an individual's PA
- Imposing a child benefit tax charge if ANI is more than £50,000

Calculating an individual's ANI

Most people would consider net income to be their income after tax but HMRC have a different definition!

The starting point is to total all the individual's taxable income. This will include all non-savings, savings and dividend income together with chargeable gains under non qualifying life policies. Tax free income such as from ISAs can be excluded.

From this can be deducted.

- Pension contributions which have been paid gross as in an occupational scheme
- Trading losses.

This figure is what HMRC classify as net income.

You then deduct

- Grossed up contributions to Personal Pensions (net contribution divided by 0.8)
- Grossed up Gift Aid contributions. (net gift divided by 0.8)

The resultant figure is the **adjusted net income**.

David has a gross income of £50,000 together with dividends totalling £20,000. He pays £10,000 into his Personal Pension and a Gift Aid contribution of £1,000.

His ANI is £70,000 less £12,500 (grossed up pension) and £1,250 (grossed up gift aid)= £56,250

Withdrawal of Personal Allowance

If an individual's Adjusted Net Income (ANI) exceeds £100,000 their personal allowance is reduced by £1 for each £2 of income in excess of this. Personal Allowance is lost completely once ANI exceeds £125,000. (£100,000 + £12,500 x2). The marginal rate of tax between £100,000 and this figure is effectively 60%.

EXAM HINT

Be alert where total income is around £100,000 as you will have to calculate the amount of PA

The following process should be followed:

1. Check if there are any Personal Pension or Gift Aid contributions
2. Gross these up and deduct from net taxable income
3. Using this figure calculate the PA and proceed as normal.

Mary has a total income of £115,000. She made a net PP contribution of £4,000 and a donation using Gift Aid of £800. These are grossed up to £5,000 and £1,000 respectively. Her adjusted net income is £109,000 so she loses £4,500 of her PA bringing it down to £8,000

If she hadn't made these contributions her PA would have reduced by £7,500 to £5,000.

Another trap!

Even if someone has lost all their personal allowance, as long as they aren't an additional rate tax payer they will still get a PSA of £500.

Child Benefit tax charge

When it was first introduced Child Benefit was universal and tax free. Since 2013-14 it has been restricted if one parent has an adjusted net income of greater than £50,000. Note the parents don't need to be married.

The basic rules are:

- If one parent has an ANI greater than £60,000 child benefit is withdrawn. The family can choose whether to give this up completely or to still collect it and suffer an income tax charge.
- If ANI is between £50,000 and £60,000 the benefit is still paid but there is a tapered tax charge

Child Benefit is paid at a rate of £21.05 a week for the first child and £13.95 for subsequent children. (These figures are in the exam tax tables)

If one income is over £50,000 then there is a tax charge of 1% of the family's child benefit for every complete £100 or income exceeds £50,000

William and Kate have two children and their Child Benefit is £35 a week which gives a total income of £1,855 a year (weekly benefit x 53)

Kate has an adjusted net income of £52,340 so she has to pay a tax charge of 23% of the total Child Benefit which would be £426. (The tax charge is rounded down and pence are ignored)

Once income is £60,000 the charge will equal the amount of child benefit. Some families still choose to take child benefit and pay the charge because if one of the couple has no income, receiving child benefit gives them a credit for the State Pension

Marriage Allowance

The income tax system is based on individual rather than family income. This treats two earner couples more favourably than a single earner one.

John and Sandra are married but only John is employed. His gross salary is £42,000 so £29,500 of his income is subject to tax and Sandra's PA is wasted. His income after tax is £36,100

Peter and Julia are both employed and each earns £21,000. Each can use their personal allowance so the total taxable income for both is £8,500. Each would receive £19,300 after tax, a total of £38,600

Even though both couples have the same gross income, Peter and Julia have a higher net income.

It is now possible to have up to 10% of the personal allowance (£1,250 for 2020/2021) transferred from one partner to the other. The conditions are:

- The couple must be married or in a civil partnership
- The partner transferring the PA must have some unused PA and the one receiving it must not be a higher rate tax payer
- Both must have been born on or after April 6 1935.
- The maximum saving is £250 (£1,250 @ 20%)

Sue has a salary of £30,500 and her husband, Ben, has an income of £5,000

Before using marriage allowance Sue's tax liability is £3,600

By transferring £1,250 to Sue, her PA is increased to £13,750 and her liability is reduced to £3,350

To be 100% accurate whilst Sue's PA is increased by £1,250, Ben's is reduced by the same amount. This is significant if the person transferring the PA has less than £1,250 of unused allowance. This restricts the maximum saving to 20% of the donor's unused allowance.

Jack and Kath are married. Jack's income is £20,500. Kath has an income of £12,000. Their joint liability is £1,600.

Her unused PA is £500 but by applying for marriage allowance the maximum £1,250 is transferred to Jack giving him a PA of £13,750 and Kath's is reduced to £11,250.

Jack's income tax liability is £20,500 less £13,750 = £6,750 @ 20% = £1,350. Kath's income tax liability is £12,000 less £11,250 = £750 @ 20% = £150

Joint liability is £1,500, a saving of £100 which is the equivalent of her unused allowance: £500 @ 20%

Marriage Allowance can be claimed for both the current year and the previous four tax years.

Paying income tax

Income tax is a retrospective tax in that no one can be absolutely sure of their income until the tax year ends on April 5. HMRC requires all income to be declared and all tax paid by January 31st in the following year. For example, all tax for year 18/19 that ended on April 5 2019 must be paid by January 31st 2020.

In practice, there are two methods of collecting tax:

- Pay as You Earn (PAYE)
- Self-Assessment.

In general employed individuals pay their tax through PAYE whilst the self employed pay through self-assessment.

Employed or Self-Employed?

An employee has a contract **of** service whereas the self-employed have a contract **for** service. The difference will often be apparent but at other times it is not so clear cut.

The Revenue uses a "badges of trade" test to determines an individual's status.

They would consider a person to be self-employed if the individual:

- exercises a high degree of control over their work. In other words they can choose what work to take and when to do it.
- carries the business risk. They are responsible for unpaid bills or other debts. They are also financially responsible for any losses, breakages or cost overruns in carrying out their work
- has to provide own tools and equipment
- can subcontract work to another person.
- works for more than one client
- does not get employee benefits such as holiday or sick pay

If you reverse these tests, i.e. if someone must work set hours and doesn't carry the business risk, it is a reasonable test of employment.

A director is always an employee and never self-employed.

Pay As You Earn

Employees, including directors, and pensioners pay income tax under the PAYE system. The employer or pension scheme administrators deduct tax from the gross income or pension and pay this directly to HMRC.

The employer knows what tax to deduct by use of the employee's tax code. This consists of a letter and a number. The letter indicates the type of personal allowance to which the employee is entitled to and the number indicates how much tax-free income the employee is entitled to. Someone with no taxable benefits in kind and whose total income is within the basic rate band will normally get a code 1250L. (£12,500/10 = £1,250)

Although everyone with an adjusted net income of less than £100K has a Personal Allowance of £12,500 HMRC adjusts the code to take account of another untaxed income or benefits in kind

If an employee gets a company car with a tax value of £3,500 the tax code will be reduced by £3,500 so instead of being 1250L it is 900L.

It is possible to wipe out all the personal allowance and then the individual has a K code. This means that the employee has a notional additional income and no tax-free pay.

Employers and pension providers are legally obliged to deduct tax before paying the employee or pensioner. It is not unusual for retired individuals to have more than one pension. In general, the main provider will hold the pensioner's main code including their personal allowance. Other pensions will have a code that will instruct the to deduct 20% or 40%. A similar situation will arise if someone has more than two jobs.

For many employees the tax code will deduct the correct amount of tax and they need have no further dealings with the HMRC. However, the code may be incorrect or there may be other sources of untaxed income so too much or too little tax may have been deducted which will have to be adjusted. If the amount owing is less than £3,000 this can be repaid over the next tax year by an amendment to their tax code.

Self-Assessment

Self-assessment can be a misleading term. It does not mean that individuals have to calculate their own tax but rather refers to the way in which the self-employed pay their income tax.

The key principle of being taxed as a self-employed person is that HMRC does not differentiate between individuals and their business. This is in contrast to the director of a limited company where HMRC taxes the profits made by the company under Corporation Tax and the director's income as income tax.

- The self-employed pay tax on the annual profits made by their business. Broadly profits are the annual income less allowable expenses. Once profit has been calculated it is entered in the non-savings column.
- The self-employed pay tax using **payments on accounts** with tax being paid in two instalments on January 31 and July 31.

Payments on Account, the basics

The two key skills needed to answer any question on this subject are:

- How to match the business's trading year to the tax year
- Identifying what payments the individual has to make and when these must be made, assuming that you are given the total tax liability

Matching trading year to assessment year

The method is simple.

1. Look at the date of the final day of the individual's trading year
2. Identify which tax year this is in
3. That becomes the year of assessment.

John Smith's trading year runs from October 1 to September 30
The last day of his 2018/2019 trading year was September 30 2019
This is in tax year 2019/20
So profits for trading year 18/19 will be assessed in tax year 19/20

In terms of his tax return.

John would be sent a tax return or reminded to submit on-line after April 6 2020
He must complete this showing the profits earned for trading year 2018/19
The tax due will be calculated and John must pay all this by January 31 2021

What payments must be made and when must these be paid

For any tax year the process is always the same.

January 31 in the current tax year	First payment on account
July 31 in the following tax year	Second payment on account
January 31 in the following tax year	Balancing Payment

So for tax year 2019/20 the payment dates are:

January 31 2020	First payment on account
July 31 2020	Second payment on account
January 31 2021	Balancing payment

The first and second payments on account are each for 50% of the previous year's tax liability. The balancing payment is for the difference between the current and previous year's tax liability.

An example will illustrate this.

Tax due for 17/18 £20,000 (assume all paid)
Tax due for 18/19 £30,000
Tax due for 19/20 £36,000

Tax payment for 18/19

31/1/18	First payment on account	£10,000 (50% of 17/18)
31/7/18	Second payment on account	£10,000 (50% of 17/18)
31/1/19	Balance payment	£10,000 (£30K less payments on account)

Tax payment for 19/20

31/1/19	First payment on account	£15,000 (50% of 18/19)
31/7/19	Second payment on account	£15,000 (50% of 18/19)
31/1/20	Balancing payment	£6,000

Two payments must be made on January 31: The first payment on account for the current year plus the balancing payment for the previous year.

On January 31 2019, he paid £25,000 (£15,000 + £10,000)
On January 31 2020, the liability is £6,000 balancing payment plus 50% of the 16/17 bill, (£18,000) giving a total of £24,000.