AF1 Income Tax 2021/22
Part 3: Pension and Charitable contributions

In a typical AF1 income tax calculation, the subject will have made either a pension or Gift Aid contribution and possibly both.

The milestones for this part are to:

- Be able to identify how pension and gift aid contributions are dealt with.
- Be able to incorporate these into a tax calculation

Pension contributions

Pension contributions are an allowable expense against an individual's income. How that relief is given depends whether the pension is either:

- An occupational scheme (both final salary and money purchase) including any voluntary contributions
- A Personal/Stakeholder Pension including Group Personal Pensions.

Occupational schemes

These use the **Net Pay** system. 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.

On the other hand it give no benefit to a non taxpayer.

Brenda works part time for a bank and earns £12,000. She has been auto-enrolled into her employer's scheme and pays 5% (£600 a year) into this.

Her gross pay is reduced to £11,400 but she gets no tax benefit as does not pay tax.

Personal Pensions/Stakeholder Pensions

These use the **Relief at Source (RAS)** system. Contributions are always paid net of basic rate tax regardless of an individual's tax or employment status. This gives the correct relief for basic rate tax payers and additional relief for higher or additional rate tax payers is given in the following way.

In all cases you should gross up the net amount paid (Net x 100/80). The gross contribution is then used to <u>increase the basic rate band</u> from £37,700 and <u>additional rate band</u> from £150,000.

Fred is a higher rate tax payer and 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 £42,700

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 and now gets the other 20% relief that 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 £38,000 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 £42,700. 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 were £5,000, the total of his non-savings and savings income would be £43,000. This is £300 above his extended HRT so his PSA is £500. His tax liability would be £500 @ 0%.(PSA), £4,500 @ 20%.

Nigel has a total income of £160,000. As a result he has no PSA but if he had made an individual pension contribution of £10,000 net, (£12,500 gross) this would increase the additional rate threshold to £162,500 so he would get a PSA of £500

Comparison with occupational schemes

Take care in any calculation to distinguish between contributions to an occupational scheme and a PP/SIPP. The tax relief given to an individual is the same but it is delivered in a different way. This has an impact on answering a calculation question particularly in showing how higher rate relief is give.

William and Harry both have an annual income of £30,000 and both contribute 5% of total pay into a pension. Williams is an occupational scheme, Harry pays into a PP.

	William	Harry
Pay	£30,000	£30,000
Less OPS contribution	£1,500	
Taxable Pay	£28,500	£30,000
Less PA	12,570	12,570
	15,930	17,430
Tax all at 20%	3,186	3,486
Net Pay after tax	£26,814	£26,514
Payment to PP		1,200
Pay after tax and pension	£25,314	£25,314

Harry will pay £1,200 as a net payment since the provider will reclaim £300 from HMRC.

If they were higher rate tax payers, William's contributions would reduce his taxable pay and therefore reduce the amount that was in the higher rate band. Harry's gross contribution would increase the higher rate threshold and reduce the amount of his income that was taxed at 40%.

Charitable Contributions

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

- Payroll Giving
- Gift Aid.

Payroll giving allows employees, provided the employer has signed up to the scheme, to donate 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 a UK charity to reclaim 25p for every £1 donation.

Fred donates £100 to the NSPCC claiming Gift Aid. The gift is grossed up by 20% to £125 (£100/0.8) and the charity reclaims £25. (£125 less £100)

It must be a UK registered charity and the individual must give permission for the charity to reclaim the tax. This is usually done by a declaration on a form, but it can also be done verbally as in donating over the phone. The donor must have a liability to income or capital gains tax of at least the amount of relief claimed. A non-taxpayer cannot claim gift aid and if they do, they will face an HMRC fine. If the donation comes from a joint account, the gift aid is split 50/50 between the account holders.

It can be backdated to the previous tax year provided the donor has not submitted their tax return for the previous year.

Jed makes a gift aid donation of £2,000 on 1 September 2021 (2021/2022). If he hasn't submitted his tax return for 2020/21, he can make his carry back election and get the relief in 19/20 If he had already submitted his tax return for 2020/21 carry back would not be possible.

There is no personal benefit to a basic rate tax payer, but a higher or an additional rate tax payer gets a further relief.

Tina donates £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 £39,200.

In specie gifts, that is donations of property rather than cash, will also attract tax relief. Allowable assets are:

- Shares and securities listed on a recognised stock exchange
- Unit Trusts/OEICS
- Overseas collective investment schemes
- Freehold or leasehold property provided whole interest is given.

Transferring allowable assets to a charity does not qualify for Gift Aid but the donor can deduct the gift from their income.

Julie is a basic rate tax payer and has a salary of £35,000. She transfers shares with a market value of £10,000 to a registered charity. This would reduce her taxable salary to £25,000. The charity cannot claim any additional tax benefit.

If she sold the shares and then donated £10,000 claiming Gift Aid, the charity could reclaim £2,500 but Julie would get no personal benefit as she is a basic rate tax payer.

The next page shows a calculation that includes both pension and Gift Aid contributions.

Stephen is employed and a member of his employer's occupational money purchase scheme. He pays 6% of his basic salary of £60,000 and his employer pays in 10%. He also pays £5,000 pa into a SIPP. He also pays £200 a year to a charity on which he claims gift aid.

Stephen has non-ISA interest of £600 and dividend income of £5,500

Stephen's contribution of £3,600 (6% of £60,000) to his occupational pension will be deducted from his salary.
The employer contribution is a "red herring" as this is not taxable.
His SIPP contribution of £5,000 is grossed up to £6,250
The Gift Aid contribution of £200 is grossed up to £250
The SIPP and the Gift Aid contributions increase his higher rate threshold to £44,200

	Non-savings	Savings	Dividend
Salary	60,000	600	5,500
Less OPS	3,600		
	56,400		
Less PA	12,570		
	43,830	600	5,500

The increased basic rate band means that all his non-savings income is within the basic rate band but when we add on the savings and dividend income he is a higher rate taxpayer so his PSA is £500

We can now complete the calculation

Non savings	£43,830 @20%	£8,766.00	(£370 of the basic rate band left)
Savings	£500 @ 0% (PSA)		(The PSA takes him into higher rate)
	£100 @ 40%	£40.00	
Dividends	£2,000 @ 0%		
	£3500 @ 32.5%	£1,137.50	
Total		**£9,943.50**	

That concludes this part, so you should now understand

- how pension and gift aid contributions are dealt with.
- how to incorporate these into a tax calculation

Sources and Further reading

https://www.moneyadviceservice.org.uk/en/articles/tax-relief-and-your-workplace-pension
https://www.gov.uk/donating-to-charity/gift-aid