AF1 Income Tax 2021/22
Part 8: Paying Income Tax

This final part will cover how individuals pay income tax.

The milestones are:

- To understand the differences between Pay as You Earn and Self-Assessment.
- To be able to establish accurately when payments are due under self-assessment and how much is payable
- Know the fines HMRC impose for non-filing and non-payment

HMRC have two ways of collecting tax:

- **Pay as You Earn (PAYE)**. Used to collect tax from employees and pensioners.
- **Self-assessment**. Used to collect tax from the self-employed.

They are not mutually exclusive and a salaried employee who also runs a consultancy on a self- employed basis will pay tax under both PAYE and Self-Assessment.

Pay As You Earn

Employers and pension providers operate the PAYE system and are legally obliged deduct tax from gross pay or pension sending this directly to HMRC.

PAYE aims to collect the right amount of tax and does this by giving each employee a tax code which consists of a letter and a number. The most common one is 1257L. This is used when the employee has no other taxable income or Benefits in Kind. It is derived by taking the last digit off the PA. Therefore £12,570 becomes 1257L

The suffix letter gives information about the individual’s personal allowance. L is used when the full PA is available, N when 10% of the PA has been transferred.

Apart from individuals whose ANI is above £100,000 everyone can use the full PA of £12,570 in calculating their income tax liability. Some income, such as the State Pension will be paid gross and to avoid individuals having a tax liability at the end of the year, HMRC will adjust their tax code.

> Jack has retired and gets a company pension of £20,000 and a State Pension of £9,000. Whilst he is entitled to the full PA HMRC give him a code of 357L (£12,570 - £9,000/10) His company pension scheme will use this code to calculate his tax and at the end of the year Jack should have paid the right amount of tax

This approach is also used when an employee gets taxable Benefits in Kind.

Kate gets a company car with a P11D value of £5,000. Her tax code will be reduced by £5,000 so instead of being 1257L it is 757L.

If Kate's BIK were £13,570 her code would be K100. This is because the BIK are more than the standard PA. Assuming her total income is less than £100,000 she still has the standard PA of £12,500. The code ensures that the employer deducts the correct amount of tax and Kate isn't faced with a large tax bill at the end of the year.

If the PA has been lost because ANI is more than £125,140 an OT code is used so tax is payable on all income.

Retired individuals may have more than one pension and normally the scheme with the highest pension will hold the pensioner's main code including their personal allowance. Any other pensions will usually have a code that will instruct them to deduct 20% (BR) or 40% (DR) from the gross payment. A similar situation will arise if someone has more than two jobs.

PAYE works extremely well for anyone who receives a regular income. The tax code will deduct the correct amount of tax. They don't need to have any further dealings with HMRC nor complete a tax return. 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. It is unusual for anyone with a regular salary to have to make a lump sum payment for any underpayment.

Do you need to complete a tax return?

Most individuals do not have to complete a tax return although there is a legal obligation to declare any untaxed income to HMRC.

HMRC require a form to be completed by the following:

- The self-employed.
- Company directors
- Individuals who have a gross savings or investment income is more than £10,000 gross
- You have a CGT liability.
- You or your partner's income was over £50,000 and are claiming child benefit
- Individuals who have taxable income from abroad.
- Individuals with gross income over £100,000

They can ask anyone outside these categories to submit a return. The return can be made on paper but HMRC encourage people to complete it on line. Confusingly HMRC refer to this as a **self-assessment form** even if the individual is an employee and pays tax under PAYE.

The tax return calendar

The key dates for completing a tax return using tax year 20/21 as an example are as follows:

October 31 2021	Final date to submit a paper return Only on-line filing is available after that date
December 30 2021	Final date for an employed person to file if they want any unpaid tax to be collected through PAYE
January 31 2022	Last day to file on-line. All outstanding tax for20/21 must be paid by this date

Individuals who fail to complete a form and/or pay any tax due will start to incur fines.

HMRC fines

HMRC have a scale of fines for both failing to file a tax return by the due date and failing to pay the amount due

Late Return

Taking the 19/20 tax year

Return outstanding	**Fine**
January 31 2021	£100
April 30 2021	£10 per day, maximum £900
July 31 2021	£500
January 31 2022	£500

Failure to pay on time

There is a standard penalty of **5% of the tax owing** which kicks in at 30 days , 6 months and 12 months after the tax was due. Since the deadline for paying income tax is January 31 someone who didn't pay a balancing payment of £10,000 for tax year 19/20 on January 31 2021 would be liable for the following fines

2 March 2021	£500
1 August 2021	£500
1 February 2022	£500

Interest is payable on top of this. The maximum penalty for both failure to return or to pay on time cannot be more than 100% of the tax due.

Self-Assessment

The self-employed pay income tax on their profits. PAYE would not be an appropriate method of collecting tax because profits will not be known until the end of the trading period.

HMRC could wait until the end of the tax year and demand a single payment but self-assessment requires the self-employed to make three payments. These are known as **Payments on Account**.

The payments on account process

The tax year runs from April 6 to April 5 and all tax for any one tax year must be finalised and paid by the following January 31. Therefore:

April 6 2016 to April 5 2017	All tax paid by January 31 2018
April 6 2017 to April 5 2018	All tax paid by January 31 2019
April 6 2018 to April 5 2019	All tax paid by January 31 2020
April 6 2019 to April 5 2020	All tax paid by January 31 2021

The easiest way to understand the process is to give an example.

Tom has been self-employed for a number of years.

On **January 31 2020** he finalised his tax for 2018/19 and his liability was £20,000.

On that date he must pay 50% of the 18/19 bill which is £10,000. This is the **first payment on account for 19/20** Note that tax year 2019/20 hasn't ended at this point.

On **July 31 2020** he makes the **second payment on account of £10,000**. He has now paid £20,000 which is exactly the same as his 2018/19 liability

Before January 31 2021 he completes his self-assessment form and his liability is £30,000. As he has already paid £20,000 he must pay a further £10,000. This is the **balancing payment** and must be paid by **31 January 2021.**

By the same date he must also make the **first payment on account for 2020/21**. This is 50% of the 2019/20 liability which is £15,000 so he has to pay a total of £25,000

If Tom's profits had fallen in 2019/20 and his tax liability was £15,000, he would be owed £5,000 as he had already paid £20,000. He would still have to pay £7,500 as the first payment on account but could offset the overpayment of £5,000 to make this £2,500. The second payment on account due on 31 July would still be £7,500.

Should Tom feel that his profits would be lower in the following year, perhaps because he has decided to take on less work, he could ask HMRC to accept lower payments on account.

However, if it turns out that he was too pessimistic, HMRC will charge interest on the "underpayment".

Let's summarise the process:

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

Therefore 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

In table form Tom's liability would be shown like this.

Tax payment for 19/20 (£30,000 liability)

31/1/20	First payment on account	£10,000 (50% of 18/19)
31/7/20	Second payment on account	£10,000 (50% of 18/19)
31/1/21	Balancing payment	£10,000 (£30K less payments on account)

Taking this one stage further into **2020/21**, if his liability was £36,000 the payments would be as follows.

31/1/21	First payment on account	£15,000 (50% of 19/20)
31/7/21	Second payment on account	£15,000 (50% of 19/20)
31/1/22	Balancing payment	£6,000

This would then be followed by the first payment on account for 2021/22 of £18,000.

There amount due on 31st January will consist of the balancing payment for the previous tax year and the first payment on account for the current tax year,. On 31st January 2021 the total bill would be £25,000 and on 31st January 2022 £24,000.

Trading year v Tax year

Self-employed individuals running a trading business can elect to have a trading year that is different to the tax year, for example January 1 to December 31. Profits will be calculated for this period but rather than splitting it between two tax years, it is allocated to a single one using this method.

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 2019/2020 trading year was September 30 2020 This is in tax year 2020/21. Profits for trading year 19/20 will be assessed in tax year 20/21

This is known as **Current Year Basis (CYB).**

In terms of his tax return.

- John would be sent a tax return after April 6 2021
- He must complete this showing the profits earned for trading year 2019/20
- The tax due will be calculated and John must pay all this by January 31 2022

First year of trading

Most businesses will probably start to trade at some other date than the 6th April, the start of the tax year so the first year's profits will straddle two tax years.

Max starts to trade on July 1 2017 and his first trading year ends on June 30 2018

In his first year his profits are £9,000

For tax year 17/18 his apportioned profits are £6,750 (9/12 of £9,000)

He is also taxed on £9,000 profits from July 2017 to 30th June 2018

His profits from July 1 2018 to June 30 2019 the profits are £30,000

In table form it would be shown like this.

Tax Year	Relevant accounts	Taxable Profit	Tax finalised
2017-18	July 1 2017 – March 31 2018	£6,750	January 31 2019
2017-18	July 1 2017 – June 30 2018	£9,000	January 31 2020
2018-19	July 1 2018 to June 30 2019	£30,000	January 31 2021

You will note that he pays tax effectively twice on his first year's profits. This will be refunded when the business is wound up.

The first year's trading period can be longer than 12 months.

Bill starts to trade on July 1 2016 but his trading year will be October 1 to September 30

His profits for July 1 2016 to September 30 2017 are £18,000

His taxable profits for July 1 2016 to March 31 2017 are 9/15 of £18,000 or £10,800

His taxable profits for October 1 2016 to September 30 2017 are £14,400. (12/15 of £18,00)

That concludes this part so you should now know:

- Understand the differences between Pay as You Earn and Self-Assessment.
- Establish accurately when payments are due under self-assessment and how much is payable

Sources and Further reading

https://www.gov.uk/self-assessment-tax-returns

https://www.wellersaccountants.co.uk/blog/payments-on-account

https://www.rossmartin.co.uk/penalties-a-compliance/721-tax-penalties-self-assessment-late-filing-a-payment-from-201011