AF1 Income Tax 2023/24
Part 1: Basic principles

AF1 will test your knowledge of income tax in two ways. It will ask you to calculate an individual's liability and explain some of the main technical aspects of the tax.

It is not an accountancy exam but even at this level income tax is complicated, so these notes will go back to first principles to enable you to build up your knowledge bit by bit.

It is 99% certain that the exam will contain at least one income tax calculation, so the overall objective is to ensure that you can answer any question and get full marks,

In this first part, the milestones are to understand:

- The key principles of income tax
- How the band system works
- The four types of income
- The taxation of non-savings, savings and dividend income.

The key principles of income tax

Income tax is a retrospective tax

His Majesty's Revenue and Customs (HMRC) tax an individual's income in each tax year which runs from April 6 to April 5. In practice HMRC collect tax throughout the year. This is based on an estimated liability but the accurate figure can only be calculated once the tax year has ended.

Why April 6? It's not the start of a month; it tends to be round about Easter so why pick such an odd date? The tax year used to start on March 25. This was on the old Julian calendar which wasn't totally accurate as it calculated a year lasted exactly 365 days whereas it is slightly longer. In 1582, Pope Gregory XIII reformed the calendar and to correct the inaccuracy that had built up the new calendar missed out 10 days by jumping from October 4 to October 14. England didn't want anything do with this new stuff coming from Europe (no change there then) and kept to the old calendar. By 1752 our calendar was 11 days behind Europe so it was decided to reform it by going straight from September 2 to September 14. The year was shorter by 11 days which was obviously unfair since you'd be paying 365 days of tax or rent for an actual period of 354 days. To solve this problem, the tax year was extended to April 5 with the new one starting on April 6

Income tax in Scotland is different

From 18/19 the rates and income tax bands in Scotland are slightly different to the rest of the UK. It is assumed that the CII will only test the non-Scottish rates.

Income tax works on a tiered system

Income tax works on a "banding" system. An analogy might be to think of a cylinder into which an individual's income is poured. As more income is poured in, it goes through different bands as follows:

- Most individuals pay no tax on the first £12,570 of income. This is known as the **Personal Allowance**.
- The next £37,700 is taxed at **basic rate** so for 23/24 you won't pay higher rate tax until your income is more than £50,270. (£37,700 is known as the **higher rate threshold**.)
- Any income from £37,700 (£50,270 with PA) to £125,140 is charged at **higher rate**
- Income above £125,140 is charged at the **additional rate**

These bands aren't rigid. The Personal Allowance is reduced if income is higher than £100,000 and both the higher and additional rate thresholds can be increased by Personal Pension and Gift Aid contributions. This will be looked at in Parts 3 & 4.

Income is split into four types and taxed in a set order

HMRC splits income into four types and taxes them in this order

1. Non-savings income, primarily income from employment, self-employment profits, pension income and rental profits
2. Savings income, primarily interest payments
3. Dividend income
4. Chargeable events under non-qualifying policies

The tax treatment of chargeable events from life policies will be dealt with under **Taxation of Investments.**

Not all income is taxable

Certain types of income are exempt from tax. This means that they can be ignored and will not form part of a calculation. The main ones are:

- Income from an ISA
- Income from National Savings Certificates
- The Trading Allowance of £1,000
- Income using Rent a Room Relief
- Property Allowance of £1,000

The trading allowance will be covered in more detail in Part 2.
Rent a Room Relief and Property Allowance will be covered in Part 6

The four types of income

Non-savings Income

This includes:

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

Any benefits in kind may be given as a figure, *"she receives a company car with a P11D value of £5,400"* Sometimes you may have to work this out particularly if it's a company car. How to do this will be covered in Part 5.

Taxable profits for a self-employed individual may be given to you but you might also get a statement like this: *"He had a turnover of £100,000 and allowable expenses of £45,000".* This means his taxable profits were £55,000. More details on allowable expenses will be covered in Part 2.

Profits from renting out property are gross rental income less allowable expenses. This will be covered in more detail in Part 6.

Pension income needs special care. This may come from a pension that the subject has built up themselves **(a member's pension)** or they could be receiving a pension from a deceased spouse/partner/parent's scheme. This is **a beneficiary's or nominee's pension**. The taxation of these will vary as follows:

A member's pension, whether private or state, is **always taxable** and should be entered under non-savings.

A beneficiary's or dependent's pension will be tax free if:

- The member (that is the original recipient of the pension) died before their 75th birthday **AND** the income is paid either from a joint life annuity or Drawdown and the **first** payment to the dependant was made on after April 6 2015

The income will be taxable if:

- It is paid from a final salary scheme whenever death occurred.
- For annuity and drawdown payments the first payment was made before April 6 2015
- The deceased member was over 75 on the date of their death regardless of the year death occurred.

Non-savings tax rates

These are:

Basic	20%
Higher	40%
Additional	45%

For the moment we will just consider cases were total income is below £100,000. Here are some examples of how this works:

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 £32,570. The first £12,570 is covered by her PA leaving £20,000 subject to tax. This is all within the basic rate band so it is taxed at 20% giving her a liability of £4,000

Charlie has a salary of £52,570. The PA covers the first £12,570 and £40,000 is taxable. This uses up all the basic rate band of £37,700 so £2,300 is taxed at the higher rate

The calculation is:

£37,700 @ 20% =	£7,540
£2,300 @ 40% =	£920
Total	£8,460

From this you should be able to deduce the process:

- Deduct the PA of £12,570 from the individual's non-savings income
- If the resulting figure is below £37,700 it is all taxed at 20%
- If the resulting figure is above £37,700 deduct £37,700, which is taxed at 20% and the excess is taxed at 40%.

In a full calculation the last example would be like this:

Non Savings	£52,570	
Less PA	12,570	
	40,000	
Less	37,700 @ 20%`	£7,540
	2,300 @ 40%	£920
Total		£8,460

Having taxed non-savings income, we now move to savings income.

Savings Income

All non-ISA interest received by an individual is classed as savings income. This 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, building societies unit trusts and OEICS is paid gross with no tax deducted.

It is possible to avoid tax on savings income by using an ISA. When this happens, the income is totally tax exempt and can be ignored in the calculation.

Since savings income is taxed after non-savings income, if non-savings income is less than £12,700 the unused balance can be carried forward to savings income.

Alan has a pension income of £7,570 so he has £5,000 of his PA left. If he has £3,000 of non-ISA savings income no tax will be payable on this.

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

The 0% starting rate

Consider this situation.

Ken has non-savings income of £13,570 and savings income of £2,000. It would appear that £1,000 of non-savings income and £2,000 of savings income is taxed at 20%. This is incorrect.

Ken qualifies for **the starting rate of 0%** because he has **savings income** falling in a band of £5,000 above the personal allowance, that is between £12,570 and £17,570.

The clue to spotting this situation in an exam question is when non-savings income is below £17,570. Here are some examples.

Clare has no earnings but receives gross interest of £16,570. She has a personal allowance of £12,570 so £4,000 of her interest is taxable but as this is within the first £5,000 above the personal allowance and therefore taxed at 0%

Ken earns £14,570 and gross interest of £2,000. His personal allowance of £12,570 means that £2,000 of non-savings income is taxed at 20%. There is still £3,000 of the £5,000 band of the 0% band left so he pays no tax on this interest

Jean earns £20,000 and has savings income of £1,000. As non-savings income is above £17,570 she cannot use the 0% starting rate and all the interest is liable to tax.

KEY POINT: There a difference between a 0% rate and income being exempt

- If income is exempt, e.g. income from an ISA, it is not included in the tax calculation.
- If it is subject to a 0% rate, it will use up some of the basic or higher rate or additional rate band, even though no tax is payable.

This is also important for the Personal Savings and Dividend Allowances

Personal Savings Allowance

The key features of this are:

- The PSA is taxed is a 0% rate band, it is not a tax exemption. `
- It does not reduce the amount of income that is taxable.
- 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.

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 a zero PSA.

In the following table the PA has been deducted.

	Non Savings	Savings	Total	PSA
Tom	£20,000	£500	£20,500	£1,000
Dick	£37,000	£800	£37,800	£500
Harry	£50,000	£1,000	£51,000	£500
Sally	£200,000	£5,000	£205,000	Nil

Note that Dick's case only £100 of his savings income is in the higher rate band but as his total income breaches the higher rate threshold his PSA is £500.

In practice, you also have to add any non-ISA dividend income so there could be a situation where all the savings income is in the basic rate band but some of the dividend income is in the higher rate therefore the PSA is £500.

Put another way, if **total income**, including the personal allowance is less than £50,270 the PSA is £1,000, if it is between £50,270 and £125,140, it is £500 and if it's above £125,140 it is nil.

To be strictly accurate you need to calculate an individual's ***Adjusted Net Income (ANI)****. This will be looked at in part 4.*

Here are a couple of examples

Eric has a salary of £26,570 and non ISA savings income of £600. He gets the full PSA of £1,000.

Income type	Non Savings	Savings
Income	£26,570	600
PA	12,570	
	14,000	
£14,000 @ 20%	£2,800	
£600 @ 0% (PSA)	0	
Total	£2,800	

Fiona has a salary of £35,570 and non ISA savings income of £7,000. She gets the full PSA of £1,000.

	Non Savings	Savings
Income	£35,570	7,000
PA	12,570	
	23,000	7,000
£23,000 @ 20%	£4,600	
£1,000 @ 0% (PSA)	0	
£6,000 @ 20%	1,200	
	£5,800	

In Fiona's case 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 the employee's tax code will be adjusted.

As interest rates are rising, savings income is now more likely to be higher than the PSA. If the rate is 2.5%, a lump sum of £40,000 produces £1,000 income. This means that if the capital is higher some of the income will be subject to tax

A higher rate tax payer would only need £20,000 at 2.5% to exceed the PSA

George has a salary of £45,570 and savings income of £5,000. Since his total income is more than £50,270 his PSA is £500

	Non Savings	Savings
Income	£45,570	5,000
PA	12,570	
	33,000	5,000

Non Savings

£33,000 @ 20% £6,000 (£4,700 of the basic rate band remains.)

Savings

£500 @ 0%	0
£4,200 @ 20%	840
£300 @ 40%	120
£7,000	£960

There is no phasing in of the PSA. Someone with non-savings income of £49,270 and savings income of £1,000 would get a PSA of £500 even though their total income is only £100 above the higher rate threshold.

The PSA can also be combined with the 0% starting rate.

Ken earns £14,570 and gross interest of £5,000. His personal allowance of £12,570 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.

The last case 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

To summarise:

- Anyone whose non-savings income is less than £12,700 will have the full £5,000 0% starting rate band
- Anyone with a non-savings income between £12,570 and £17,570 will have at least part of their savings income taxed at the 0% starting rate band
- Anyone whose non-savings income is higher than £17,570 will not get the 0% rate starting rate.
- The order of calculation is starting rate first (if available), then PSA

Dividend Income

Dividend income is, not surprisingly, dividends received from directly held shares and equity based unit trusts and OEICs. The key points are:

- Dividends are paid gross with no tax deduction.
- The first £1,000 of dividend income is taxed at 0% (the Dividend Allowance)
- Dividend income above the DA falling in the basic rate band is taxed at 8.75%
- Dividend income above the DA falling in the higher rate is taxed at 33.75%
- Dividend income above the DA falling in the additional rate is taxed at 39.35%

As with savings income if the shares or unit trusts are placed in an ISA, then all income is tax free and does not need to be included in the calculation.

The £1,000 is effectively a 0% band. It does not reduce the amount of taxable income.

Majinda has non-savings income of £30,000 and dividend income of £10,000
£1,000 of her dividends will be taxed at 0% and £9,000 at 8.75% as it all falls in the basic rate band.

Norman has non-savings income of £60,000 and dividend income of £20,000.
£1,000 will be taxed at 0% and £19,000 of his dividend income will be taxed at 33.75% as it all falls into the higher rate band.

But consider this example

Olivia has non-savings income of £49,270 and dividend income of £12,000.

The obvious way to do this would be to deduct £1,000 from her dividend income to give £11,000. 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 8.25% and £10,000 at 33.75%. This is incorrect!

Her DA of £1,000 uses up the remaining £1,000 of her basic rate band **but is taxed at 0%** so the remaining £11,000 dividends are all in the higher rate and taxed at 33.75%.

Whilst it sounds illogical it does make sense if you think about it.

The key is that the £1,000 is a 0% band rather than an allowance. As all Olivia's non-savings income has been taxed and she has no savings income then her dividends are next to be taxed. If the £1,000 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 £1,000 DA uses up the remaining basic rate band so the remaining £11,000 is all taxed at the higher rate.

In any calculation if the total of non-savings and savings income is between £49,270 and £50,270 any dividend higher than the £1,000 DA will be taxed at 33.75%.

Dividend Allowance and the Personal Allowance.

An individual's personal allowance can be offset against all three types of income.

Often a director will elect to pay themselves mainly in dividends as they are taxed at a lower rate than non-savings and no National Insurance liability is payable on dividends,

Jack is a director and pays himself £10,570 salary but takes £40,000 in dividends.

Jack still has £2,000 of his PA left which is used up by his dividend income. He can then use the Dividend Allowance so £2,000 will be at 0% using the PA, £1000 at 0% using the DA, £36,700 at 8.75% and £300 @33.75%

This would be shown in a calculation as follows:

Non-savings	£10,570
Less PA	£12,570
Remaining PA	(£2,000)
Dividend Income	
£2,000 of remaining PA	0.00
£1,000 DA @ 0%	0.00
£36,700 @ 8.75%	£3,211.25
£300 @ 33.75%	101.25
	£3,312.50

Finally let's put all this information together in a some worked examples.

Gemma is employed and gets a salary of £38,000 together with a company car that has a P11D value of £6,700. She gets non-Isa interest of £6,500 and dividends of £6,000 from a non-ISA shareholding. Calculate her income tax liability for 2023/24.

Salary	38,000
BIK	6,700
Savings	6,500
Dividend	6,000
Total	£57,200

She is a higher rate tax payer therefore her PSA is £500

Non savings

£44,700
£12,570 (PA)
£32,130 @ 20% £6,426

£5,570 of basic rate band left

Savings	£500 @ 0%	
	£5,070 @ 20%	£1,014
	£930 @ 40%	£372
Dividends	£1,000 @ 0%	
	£5,000 @ 33.75%	£1,687.50
Total		**£9,499.50**

Marie is a director and pays herself £9,570 in salary and £40,000 in dividends. In addition she receives £2,000 in non ISA interest. Calculate her income tax liability for 2023/24.

Non Savings

£9,570 less £12,570 = (£3,000 PA left)
£9,570 @0%

Savings
£2,000 @ 0%

Dividends

£1,000 @ 0% (remainder of PA)	
£1,000 @ 0% (Dividend Allowance)	
£35,700 @ 8.75%	£3,123.75
£2,300 @ 33.75%	£776.25
Total	£3,900.00

Ken has a total pension income of £13,570. He has non-ISA interest of £6,000 and dividend income of £2,000. Calculate his income tax liability for 2023/24

Non Savings	£13,570
Savings	£6,000
Dividend	£2,000
Total	£21,570

He is a basic rate tax payer therefore his PSA is £1,000

Non Savings £13,570 less £12,570 = £1,000

	£1,000 @20%	£200
Savings	£4,000 @ 0%	
PSA	£1,000 @ 0%	
	£1,000 @ 20%	£200
Dividends	£1,000 @ 0%	0
	£1,000 @ 8.5%	£85
Total		**£485**

That concludes this part so you should now understand:

- The key principles of income tax
- How the band system works
- The four types of income
- The taxation of non-savings, savings and dividend income.

Sources and further reading

https://www.gov.uk/income-tax