

AF1 Income Tax 2023/24

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 on whether the pension is either:

- An occupational scheme, that is one set up by an employer for its employees (both final salary and money purchase) including any voluntary contributions
- A Personal/Stakeholder Pension including SIPP and 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** (ignore bonuses and things like Large Town Allowance) 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 gives 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 she does not pay tax.

Personal Pensions/Stakeholder Pensions/SIPP/GPP

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. It also gives tax relief to a non-tax payer. Further 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/ 0.8). The gross contribution is then used to increase the basic rate band from £37,700 and increase the additional rate threshold from £125,140.

Fred is a higher rate tax payer and makes a net contribution of £4,000 to a Personal Pension. The Gross contribution is $£4,000 / 0.8 = £5,000$
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 made the contribution. He has already received 20% relief through RAS 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%.

Gross pension contributions also increase the additional rate threshold of £125,140 but this is complicated by the fact that when your total income is higher than £100K your personal allowance is reduced. This will be looked at in more detail in the next part.

There is an old pension product called a **Retirement Annuity Contract (RAC)**. These were withdrawn in 1988 but existing ones can continue. Payments are made gross and tax relief is claimed through self-assessment. If it comes up in a calculation simply deduct the gross contribution from the person's gross income

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 2023 (2023/2024). If he hasn't submitted his tax return for 2022/23, he can make his carry back election and get the relief in 22/23

If he had already submitted his tax return for 2022/23 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	<u>3,600</u>		
	56,400		
Less PA	<u>12,570</u>		
	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	£1,000 @ 0%		
	£4500 @ 33.75%	<u>£1,518.75</u>	
Total		£10,324.75	

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.moneyadvice.service.org.uk/en/articles/tax-relief-and-your-workplace-pension>

<https://www.gov.uk/donating-to-charity/gift-aid>