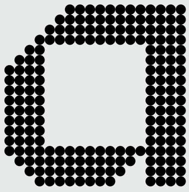


Understanding income tax and capital gains tax

Income Tax

What is income tax?

Income tax is a progressive tax system, which means that the more you earn, the higher the rate of income tax you will pay. There are three different tax rates applying to bands of income and the slice of income which falls within each tax band is taxed at the rate for that band.

The bands for 2022/23 are:

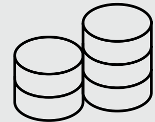
- **basic rate** – taxable income up to £37,700
- **higher rate** – taxable income between £37,701 and £150,000
- **additional rate** – taxable income over £150,000

Scotland has a seven band system for the taxation of earned income but these additional bands do not apply to income from savings and investments, which will follow the same three bands as the rest of the UK (see appendix for details for Scottish Taxpayers).

Income tax is charged on your total income from all sources in the tax year. This includes:

- **employment income** – salary, P11D benefits, self- employed profits and pension income
- **rental income** – rent from buy to lets or commercial property
- **savings income** – interest from banks, building societies and certain investments
- **dividend income** – dividends received from shares and investments
- **life assurance policy gains** – chargeable gains made on investment bonds

The personal allowance



There is an amount of income which can be received each year before tax is payable. The Personal Allowance is currently £12,570 (2022/23). However, it may be reduced if income is greater than £100,000. The allowance is reduced by £1 for every £2 of income over £100,000 so that those with income greater than £125,140 will lose their entire allowance.

Eligibility to the personal allowance is tested using 'adjusted net income'. This is broadly total income before the application of various reliefs such as top slicing relief, but there are allowable deductions for individual pension contributions and gift aid.

Marriage allowance

It's possible for some married couples (and civil partners) to transfer some of their unused personal allowance to their spouse. Up to £1,260 of unused allowance can be transferred from a non-taxpaying spouse (income below £12,570), provided the spouse receiving the additional allowance does not pay income tax at higher than basic rate. This allows a maximum tax saving of £252 (£1,260 x 20%).

The order of taxing income

The order in which income is taxed is significant. Different sources of income may be taxed at different rates and the order in which they are taxed may determine the availability of certain tax free allowances.

The order in which income is taxed is non-saving income, then savings income followed by dividend income and finally, onshore bond gains.

Non-savings income

Non-savings income is first to be taxed through the bands in the order of taxation. This includes income employment, self-employed profits, pension income, rental income and trust income.

The rates of tax for non-savings income in excess of the personal allowance are:

- **basic rate** – 20%
- **higher rate** – 40%
- **additional rate** – 45%

Savings income

Savings income uses the same rates of tax as non-savings income (20%, 40% & 45%). However, there are additional tax free allowances for savings income.

The first £5,000 of savings income may be taxed at zero percent. This is known as the starting rate for savings and is in addition to the personal allowance. So someone with just savings income could receive £17,570 (£12,570 + £5,000) without paying any tax. But this additional tax free amount only applies if taxable non-savings income (i.e. income above the personal allowance) is less than £5,000.

The personal savings allowance is a further tax free allowance for basic and higher rate taxpayers. Basic rate taxpayers can receive £1,000 while higher rate taxpayers can receive £500. There is no allowance available to additional rate taxpayers.

Adjusted net income is used to determine whether the allowance is given at £1,000 or £500 and therefore individual pension contributions will reduce income for this purpose.

Dividend income

Dividend income has its own set of tax rates which are different from all other income. These are:

- 8.75% basic rate
- 33.75% higher rate
- 39.35% additional rate

There is also a Dividend Allowance of £2,000. Unlike other income allowances everyone is entitled to the full allowance regardless of their income levels. The first £2,000 of dividend income is taxed at zero percent and the allowance uses part of whichever tax band the income falls in.

The illustration below shows the rates and tax bands for each of the income types in 2022/23.

Taxable income	Non-savings income	Savings income	Dividend income
Over £150,000	45%	45%	39.35.1%
£37,701 – £149,999	40%	40%	33.75%
£0 – £37,700	20%	20%	8.75%
		0% £0 – £5,000	0% £0 – £2,000

Life assurance policy gains

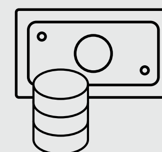
Investment bonds and other life assurance policies are subject to chargeable events legislation. Gains arising on these policies are subject to income tax. Where they sit on the order of income will depend upon whether it is an onshore or offshore policy.

UK onshore policy gains are the top slice of all income and are taxed after dividend income. Proceeds are paid with a 20% non-reclaimable tax credit to account for the tax paid within the fund. This will satisfy the liability for basic and non-taxpayers. Higher rate tax payers may have an additional 20% to pay and additional rate taxpayers have a further 25% to pay.

Offshore policy gains are taxed as savings income. As a result, gains which fall within the personal allowance, starting rate for savings or personal savings allowance will be free of tax. These investments pay no tax within the fund on income or gains and therefore policyholders do not receive a tax credit. So gains in excess of the available allowances will be taxed at the savings rates of 20%, 40% or 45%.

Both onshore and offshore policies may benefit from top slicing relief. This can reduce higher rate or additional rate tax on chargeable gains by allowing the policyholder to spread the investment gains over the number of years the bond has been held. Top slicing cannot be used to keep income within the tax free personal allowance and starting rate band.

Allocating the personal allowance



The personal allowance can be set against whichever income gives the best tax outcome. It doesn't have to be applied in the natural order of taxation but in most cases it would be the tax efficient option to do that as dividend income is taxed last but at the lowest rate. However, there may be some circumstances where allocating the personal allowance to dividends can give a better result. This may be the case where the starting rate for savings and the personal savings allowance are going unused as savings income is utilising the personal allowance.

Tax reliefs

Tax reliefs are Government incentives to encourage certain investing and gifting.

Pension tax relief

Tax relief is given at the individual's highest marginal rate on their pension contributions. There are two ways in which pension tax relief may be given. These are often referred to as:

- net pay arrangements
- relief at source

Net pay arrangements are offered by certain workplace pensions, such as DB schemes. The pension contribution is deducted directly from payroll and before the deduction of tax. The amount of income subject to tax is therefore reduced and full tax relief is given directly into the pension at the highest marginal rate.

Relief at source is the method of relief used by personal pensions, including SIPPs and GPPs, as well as many occupational DC pensions. All contributions are paid net of basic rate tax (20%) and the pension provider adds the tax relief to the pension fund.

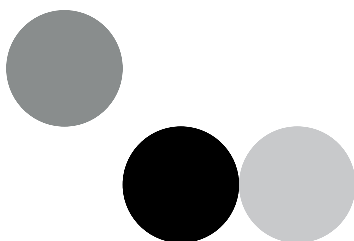
Higher rate and additional rate taxpayer can claim an additional 20% or 25% tax relief via their self-assessment. The additional tax relief is not paid directly into the pension but instead it reduces the tax paid on other income. This is achieved by extending the basic rate tax band by the amount of the gross pension contribution.

Gift aid

Tax relief can be claimed on gifts to charity. This works in a similar way to pension contributions which get relief at source. If a gift aid declaration is completed the charity is able to claim basic rate relief on the amount they receive. Higher and additional rate taxpayers get their extra tax relief via self-assessment and the basic rate tax band is extended by the contribution.

EIS & VCT income tax relief

There is tax relief available to investors in Enterprise Investment Schemes (EIS) & Venture Capital Trusts (VCTs) to encourage investment in start-up companies. Relief acts as a tax reducer - the relief is knocked off the eventual tax bill rather than by adjustment of the tax bands.



Standalone tax charges

There are some tax charges which are subject to income tax but do not form part of the tax computation.

High income child benefit charge

Child benefit may be lost if either parent earns more than £50,000. For incomes between £50,000 and £60,000 the tax charge is 1% for every full £100 of income over the £50,000 threshold. Child benefit is lost completely when adjusted net income exceeds £60,000. The child benefit is reclaimed by imposing an income tax charge, the High Income Child Benefit Charge on the highest earner.

Pensions tax charges

Exceeding the Lifetime Allowance (LTA) and Annual Allowance (AA) may result in a tax charge. Although the charges are subject to income tax they do not form part of the tax computation and therefore do not have a knock on effect for other income.

The LTA tax charge may arise where benefits are taken in excess of the Lifetime Allowance. The tax is deducted by the pension scheme before benefits are paid.

If you pay more into your pension than your available annual allowance will be subject to the AA tax charge. The excess funding is added on top of all other income to determine the amount of tax which is payable. In some circumstances it may be possible for the charge to be paid from pension benefits.

Paying income tax

Some income will be paid with the appropriate amount of tax already deducted under the Pay As You Earn (PAYE) system. This will be the case for employees and anyone receiving pension income. Self-assessment may be required for other sources of income where either no tax has been deducted or where additional tax may be due.

Dividend income and most savings income are now paid gross. Banks, Building Societies and Non-Equity Mutual Funds no longer pay interest with basic rate tax already deducted and dividends no longer have a notional 10% tax credit. This means if income is covered by the available allowances there may be no need to make a reclaim. However, if savings income is greater than £10,000 in the tax year self-assessment still needs to be completed even if no tax is due.

The following will also trigger the need to complete a self-assessment tax return:

- rental income
- taxable income of more than £100,000
- claiming child benefit with income over £50,000
- overseas income
- pension contributions exceed the available annual allowance

The timescales for HMRC Self-Assessment and payment of tax are:

5 October	register for self-assessment (following the tax year end 5th April)
31 October	paper returns
31 January	online return
31 January	first payment on account plus last year's balancing payment
31 July	second payment on account

Each payment on account is half of last year's tax bill, with the difference between the payments on account and the actual tax bill for the year made as balancing payment on the 31 January.

Scottish rate of income tax (SRIT)

Scottish resident taxpayers may pay a different amount of tax from the rest of the UK. Savings and dividend income continue to be taxed at the UK rates and bands.

The impact for Scottish taxpayers is:

- some Scottish taxpayers may pay more tax on their non-savings income than taxpayers with the same income in UK
- Scottish taxpayers may need to use the Scottish bands and the UK bands to calculate their tax, for example if they have earned income and/or savings interest, dividends and capital gains

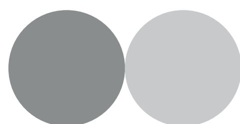
HMRC continue to be responsible for collecting and administering the SRIT, so any queries about an individual taxpayer should be directed to them, rather than Revenue Scotland.

Scottish taxpayers have a personal allowance of £12,570 (assuming income in below £100,000) then non-savings & non-dividend income is taxed in the following tax bands.

Bands for SRIT 2022/23

Non-savings & non-dividend income		
Band name	**Taxable income (£)**	**Tax rate**
Starter	1 - 2,162	19%
Basic	2,163 - 13,118	20%
Intermediate	13,119 - 31,092	21%
Higher	31,093 - 150,000	41%
Top	Over 150,000	46%

Personal savings allowance basic rate band £37,700.



What is SRIT payable on?

Individuals will pay the Scottish rate of income tax on:

- salary and self-employed earnings
- pensions
- rental income and income from Real Estate Investment Trusts and Property Authorised Investment Funds
- income received from discretionary trusts

The UK-wide threshold of £37,700 will apply for savings income, dividend income and capital gains received by Scottish taxpayers.

Pensions and the SRIT

- Relief at source

The Scottish basic rate band will be extended by the gross amount of any pension contribution, where the taxpayer pays tax at a higher Scottish rate.

- Annual allowance charge

Whether this is payable by the individual or the scheme, it will be calculated using the Scottish rates and bands if the individual is a Scottish taxpayer.

Gift Aid and the SRIT

Charities will continue to receive payments at the basic rate (20%) with Scottish taxpayers able to claim the correct amount of additional relief on top of this.

What is CGT?

Capital gains tax (CGT) may be payable on profits made from the disposal of certain assets. This is the increase in value between the original purchase cost and the disposal proceeds. If this investment profit, the 'gain', is greater than the annual CGT exemption of £12,300 there will be tax to pay.

What is a disposal?

A disposal for CGT purposes typically happens when ownership comes to an end. This is often when assets are sold, but also when assets are gifted outright or into trust.

Certain disposals are exempt from CGT:

- There's no CGT on gifts between spouses. The recipient of the gift simply takes over their spouse's acquisition cost of the asset and any gain is deferred until the second spouse disposes of the asset
- Gifts to charity are free of CGT
- There is no CGT payable on death

Gifts made to other family members are treated as a disposal at the market value on date of transfer. Where no consideration is received, the deemed proceeds are taken to be the market value on date of transfer.

Which assets are liable to CGT?

CGT is payable on the profit you make on the disposal of most assets such as:

- stocks and shares, including mutual funds
- property that isn't your main residence
- business assets

However, not all assets are liable to CGT. Some of the more common types of asset that are free of CGT are:

- someone's main residence
- cash and foreign currency for personal use
- government issued gilts
- EIS and VCT shares which have benefited from income tax relief
- wasting assets, such as cars

Investors with onshore and offshore investment bonds are not subject to CGT on the investment gains they make. Gains on these investments are subject to income tax under the chargeable event rules.

What rates of tax apply to CGT?

Individuals don't pay any CGT on total gains in a tax year up to £12,300. Any unused annual CGT exemption cannot be carried forward to future years. Total gains over the £12,300 exempt amount are added on top of all other income to determine the rate of tax which will apply.

Any part of the gain which is below the higher rate threshold is taxed at 10% and everything above it is taxed at 20%.

Capital gains made on the disposal of second properties are taxed at the higher rates of 18% and 28%.

2022/23 Tax Year		
Asset disposed of	**Below higher rate**	**Above higher rate**
Shares	10%	20%
OEICs/Unit trusts	10%	20%
Second properties	18%	28%
Entrepreneurs' relief	10%	10%

CGT is payable at a flat rate of 20% (28% on gains from residential property) where a trust makes a disposal and CGT is assessable upon the trustees. The annual CGT exemption for trustees is £6,150, which is half of the personal exemption. This amount is shared between any other trusts created by the same settlor, subject to a minimum per trust of £1,230.

Deferring the gain

It's possible in some circumstances for the gain on disposal to be deferred. This is possible where:

- holdover relief is claimed, or
- shares in an Enterprise Investment Scheme (EIS) are purchased

Calculating gains

A capital gain made on a disposal of an asset is, broadly, the difference between its value at the time of disposal and the cost of acquiring the asset. Certain costs directly incurred in acquisition and disposal can be deducted. This includes legal fees, estate agent fees, stockbroker fees and accountant fees. It doesn't include any fees payable for financial advice.

Share matching rules

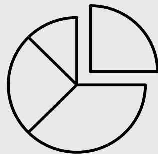
There are special rules which apply when there's a disposal of shares (including shares or units in collective investments such as OEICs and unit trusts). These help to determine the acquisition cost of shares which may have been purchased on different dates. The rules also prevent the sale and an immediate buy back of the same shares in order to crystallise gains within someone CGT annual exemption.

When a disposal is made, the shares sold are matched with shares held in the following order:

- shares acquired on the same day as disposal (same day rule)
- shares acquired in the 30 days following the day of disposal (bed and breakfast rules)
- all other shares on an average cost basis (these are sometimes referred to as the 'Section 104 holding')

Where there have been shares purchased on different dates at different shares prices, all purchase costs are added together and then divided by the total holding to arrive at an average cost per unit. The same cost is then applied to each unit.

Losses



Where an asset falls in value, this may create a capital loss. Capital gains and losses incurred in the same tax year are offset against each other. This includes reducing gains down to zero even though some of the gain would otherwise have been covered by the annual exemption. Therefore, some or all of the current year's annual exemption could be wasted if there are losses in that year.

Any excess loss can be carried forward indefinitely and carried forward losses may be offset against gains in future years. It's only necessary to offset sufficient carried forward losses against gains in excess of the annual exemption.

CGT and death

Capital gains tax is not payable upon the death of an individual. Any gain or loss on assets held at death is ignored. If the assets are transferred to the beneficiaries of the deceased's estate, they're deemed to acquire the assets at the market value immediately before death.

On jointly owned assets, the survivor acquires the deceased's share at the market value before death. On any future disposals there will be two acquisition costs used to calculate capital gains tax, their own share being half of the original amount invested and the value of the share immediately before death, they inherited.

If assets are sold during the administration period, any gains made on disposal of assets by the legal personal representatives are subject to CGT at 20% or 28%. The personal representatives will receive a full annual allowance for the tax year of death and up to two subsequent tax years.

Reporting & paying CGT

Whether gains need to be reported depends on the size of the gain, and your tax return status.

Individuals must report capital gains where the gain is greater than the annual CGT exemption of £12,300 or if the total proceeds of sale exceed four times the annual exemption, currently £49,200. This is regardless of whether there's an overall taxable gain or not.

Trustees must report capital gains where the sale proceeds exceed £49,200. The same reporting amount is used even though Trustees only have up to half of the annual exemption. Trustees must also report gains that exceed their annual CGT exemption.

Gains are reported on the self-assessment tax return and payment is usually due by 31st January following the end of the tax year where the disposal occurred.

The exception to this is residential property. If you are UK resident and sell a residential property in the UK on or after 27 October 2021 you now must report and pay any capital gains tax to HMRC within 60 days of completion of the disposal. If the completion was between 6 April 2020 and 26 October 2021 you must report and pay any capital gains within 30 days from the date of completion. CGT on disposals of residential property will be through an online service, rather than self-assessment.

Trustees disposing of a UK residential property must also ensure any CGT is reported and paid within the above timescales, exactly the same as a UK resident individual.

HMRC have introduced a real time reporting service for CGT. This can only be used if you don't normally complete a tax return. It allows those with one-off capital gains to avoid the need to complete a full self-assessment.

Losses may be carried forward indefinitely but need to be reported to HMRC within four years from the end of the tax year in which they arise.

For more information visit abrdn.com

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