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# How to Save Tax 2010/2011

By Carl Bayley BSc ACA

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Kirkcaldy  
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KY1 1TL  
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## Introduction

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Welcome to Taxcafe's *How to Save Tax 2010/2011*, our comprehensive guide to tax planning for the 2010/11 tax year, as updated for the changes announced in the new Coalition Government's Emergency Budget on 22<sup>nd</sup> June 2010.

This publication provides an overview of most of the major tax-planning measures available to help the reader save tax in three main areas: Income Tax, Capital Gains Tax and Inheritance Tax. More detailed advice is available from our specialist tax guides, available on the Taxcafe.co.uk website.

Many of the tax planning strategies outlined in this guide require action by the end of the tax year on 5<sup>th</sup> April 2011. Some of the resulting tax savings will be immediate, other measures will bear fruit later. The common factor in most cases is the need to take action by a specific deadline, which will often be 5<sup>th</sup> April 2011.

If you decide to follow some of the advice in this guide, remember that you will need to allow time for professional advisers, banks and other institutions to process your instructions. We recommend that you take action sooner rather than later, where possible.

Remember also that each person's own situation is unique. Whilst this guide is intended to be as helpful as possible, it is no substitute for professional advice and we cannot take any responsibility for any action which readers may take, or may choose not to take, as a result of reading this guide.

### **The Current Tax Year**

The current tax year runs from 6<sup>th</sup> April 2010 to 5<sup>th</sup> April 2011. I will generally refer to it as '2010/11'.

## Chapter 1

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# Just How Much Tax Do We Pay?

Before we get into the tax planning, it is perhaps worth stopping to think just how much tax we are all paying.

The tax rates and allowances applying for 2010/11 are set out in Appendix A. But what do all of these various rates, reliefs, tax bands, etc. mean for the individual taxpayer?

The exact amount of tax which each individual will pay for the tax year 2010/11 depends not only on the level of your income, but also on the type of income. Each of us will have a different mix of income types, giving us all a unique tax profile.

In this chapter, however, I will look at the simplistic situation where we assume that the individual receives only one type of income.

We will start by looking at the position for taxpayers under state retirement age and then look at older taxpayers later.

### **Income Tax Rates**

Most types of income are now subject to Income Tax at three rates: 20%, 40% and 50%. Interest and other savings income is also subject to a 'starting rate' of 10%. Different rates apply to dividends.

Where total income exceeds £100,000, the individual's personal allowance is withdrawn at the rate of £1 for every £2 of income above this threshold. This generally creates an effective marginal Income Tax rate of 60% on income between £100,000 and £112,950.

The £100,000 threshold is based on 'adjusted net income': that is taxable income less 'grossed up' gift aid and personal pension contributions. This means that these reliefs are now worth a lot more to people in this marginal tax bracket and we will return to this point in later chapters.

## Employment Income

In addition to Income Tax, employment income is also currently subject to Class 1 National Insurance at a rate of 11% on earnings between £5,715 and £43,875 and 1% on any further earnings above £43,875.

The combination of Income Tax and National Insurance produces effective total combined tax rates on employment income, as follows:

First £5,715:	Nil
£5,715 to £6,475:	11%
£6,475 to £43,875:	31%
£43,875 to £100,000:	41%
£100,000 to £112,950:	61%
£112,950 to £150,000:	41%
Over £150,000:	51%

In addition to these sums, the employer must also pay secondary National Insurance Contributions at a rate of 12.8% on all payments to employees in excess of £5,715 per annum.

Whilst this further charge is paid by the employer, it naturally adds to the cost of employment. This in turn limits the level of salary which the employer is able or willing to pay. Hence, although only suffered indirectly, this further National Insurance cost is, in truth, effectively borne by employees themselves.

Taking all of this into account, we see that the total tax suffered on different levels of employment income for 2010/11 is as follows:

Income	Income Tax	Employee's NI	Total paid by Employee	Employer's NI	Total Tax Suffered
£10,000	£705	£471	£1,176	£548	£1,725
£20,000	£2,705	£1,571	£4,276	£1,828	£6,105
£30,000	£4,705	£2,671	£7,376	£3,108	£10,485
£40,000	£6,705	£3,771	£10,476	£4,388	£14,865
£50,000	£9,930	£4,259	£14,189	£5,668	£19,857
£100,000	£29,930	£4,759	£34,689	£12,068	£46,757
£150,000	£52,520	£5,259	£57,779	£18,468	£76,247
£200,000	£77,520	£5,759	£83,279	£24,868	£108,147

## Self-Employment

The self-employed pay Income Tax at exactly the same rates as employees.

The National Insurance situation is, however, completely different.

Instead of Class 1 National Insurance at 11%, the self-employed pay Class 4 National Insurance at the lower rate of 8%.

There is no employer's secondary National Insurance but, for all self-employed taxpayers with annual earnings over the 'small earnings exception' limit of £5,075, there is also Class 2 National Insurance of £2.40 per week.

This time, the combination of Income Tax and National Insurance produces effective total combined tax rates on self-employment income, as follows:

First £5,075:	Nil
£5,075 to £5,715:	£124.80 (fixed cost)
£5,715 to £6,475:	8%
£6,475 to £43,875:	28%
£43,875 to £100,000:	41%
£100,000 to £112,950:	61%
£112,950 to £150,000:	41%
Over £150,000:	51%

Partnership trading income is also subject to exactly the same tax regime. The total tax suffered on different levels of self-employment or partnership trading income for 2010/11 is as follows:

Income	Income Tax	Class 2 NI	Class 4 NI	Total Tax Suffered
£10,000	£705	£125	£343	£1,173
£20,000	£2,705	£125	£1,143	£3,973
£30,000	£4,705	£125	£1,943	£6,773
£40,000	£6,705	£125	£2,743	£9,573
£50,000	£9,930	£125	£3,114	£13,169
£100,000	£29,930	£125	£3,614	£33,669
£150,000	£52,520	£125	£4,114	£56,759
£200,000	£77,520	£125	£4,614	£82,259

## **Landlords**

If there is one great virtue which can be attributed to property rental income, it surely must be the fact that it is generally exempt from all classes of National Insurance.

Landlords receiving rental income only will pay Income Tax at the same rates as detailed above for employment or self-employment income, but have no National Insurance liabilities.

## **Investment Income**

Investment income is also exempt from all classes of National Insurance but is subject to a slightly different Income Tax regime from earned income or property income.

For tax purposes, we must divide investment income into two categories:

- Interest and other savings income not classed as dividends
- Dividends

## **Interest and Other Savings Income**

The 10% starting rate of Income Tax was abolished for all other types of income in April 2008, but continues to apply to interest and other savings income not classed as dividends. This income is therefore currently subject to Income Tax at four rates: 10%, 20%, 40% and 50%.

It is important to note that the 10% starting rate can only apply where the taxpayer's other income (excluding dividends) is low enough to enable their interest and other savings income to fall into the starting rate band.

Hence, individuals aged under 65 on 5<sup>th</sup> April 2011 will generally only be able to benefit from the starting rate band in 2010/11 if their other income for the year (excluding dividends) is less than £8,915 in total.

Subject to this point, the effective tax rates on interest and other savings income for 2010/11 are as follows:

First £6,475:	Nil
£6,475 to £8,915:	10%
£8,915 to £43,875:	20%
£43,875 to £100,000:	40%
£100,000 to £112,950:	60%
£112,950 to £150,000:	40%
Over £150,000:	50%

### **Dividend Income**

For all dividend income, UK or foreign, the actual Income Tax rates applying are as follows:

First £6,475:	Nil
£6,475 to £43,875:	10%
£43,875 to £150,000:	32.5%
Over £150,000:	42.5%

However, in practice, the position is considerably more complicated. For each 90 pence of dividend actually paid by a company, a tax credit of one ninth, or 10 pence, is added. This produces a 'gross' dividend of £1.

The recipient is then treated as having received a dividend of £1. When calculating their tax liability, however, the taxpayer may then deduct the 10 pence credit.

The practical upshot of all this is that when one looks at the tax payable on the actual amount of dividends received, the effective Income Tax rates on most dividends are actually 0%, 25% or 36.1%.

For dividends falling into the marginal tax bracket where the individual's personal allowance is being withdrawn, the effective Income Tax rate depends on what other income they have in the same year and ranges from 37.5% to 48.6%. For those with dividend income only, the marginal tax rate in this bracket will be 37.5%.

The 'grossing up' under the tax credit system also has another effect – it reduces the size of the tax bands by one tenth. This produces the following effective tax rates for individuals receiving dividend income only in 2010/11:

First £39,487.50:	Nil
£39,487.50 to £90,000:	25%
£90,000 to £101,655:	37.5%
£101,655 to £135,000:	25%
Over £135,000:	36.1%

## Foreign Dividends

Before April 2008, the one ninth tax credit described above did not apply to any dividends received from foreign companies (i.e. companies not resident in the UK).

Today, however, the tax credit also applies to all foreign dividends except where the recipient individual owns 10% or more of the share capital in the paying company and that company is resident in a 'tax haven'.

## Investment Income: Summary

To summarise the position, the Income Tax suffered for 2010/11 on investment income is as follows:

Income	Income Tax Suffered On:			
	Property Income	Interest Income	Dividends	Tax Haven Dividends*
£10,000	£705	£461	£0	£353
£20,000	£2,705	£2,461	£0	£1,353
£30,000	£4,705	£4,461	£0	£2,353
£40,000	£6,705	£6,461	£128	£3,353
£50,000	£9,930	£9,686	£2,628	£5,731
£100,000	£29,930	£29,686	£16,378	£21,981
£150,000	£52,520	£52,276	£30,752	£40,335
£200,000	£77,520	£77,276	£48,807	£61,585

\* - Dividends from a shareholding of 10% or more in a company resident in a 'tax haven'

The tax applying to any foreign dividends is also subject to any Double Tax Relief which may be available.