Personal, Employment and Owner-Managed Taxes

Interview preparation summary · AU track

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INT.TP.1.a · Income tax and employment

Work out income tax on employment income using bands and a personal allowance, and say what the marginal rate on the next pound of pay is.

Income tax is charged on a person's taxable income after a personal allowance, in slices called bands. Income within the allowance is not taxed. The next slice is taxed at the basic rate, the next at a higher rate and, for very high income, an additional rate. Each slice is taxed at its own rate, so crossing a threshold raises the tax only on the income above it, and never makes the whole pay packet taxable at the higher rate. In the UK the allowance is also withdrawn gradually once income passes a high threshold, which creates an unusually high marginal rate in that range. Employees also pay national insurance on earnings, which is a separate calculation with its own thresholds, so the marginal rate on the next pound is the income tax rate plus the employee national insurance rate. Pension contributions can reduce taxable income. Interviewers want a clear calculation, an awareness of the marginal rate and a reminder that all rates and thresholds change, so use illustrative figures and say to check current ones.

WORKED EXAMPLE: TAX ON A 62,000 SALARY

An employee in an invented firm earns 62,000 and has no other income. Use illustrative figures: personal allowance 12,000, basic rate 20 percent on the next 38,000 of taxable income, higher rate 40 percent above that, employee national insurance of 8 percent on earnings between 12,000 and 50,000 and 2 percent above 50,000. Find income tax, national insurance, take-home pay and the marginal rate. Then find the saving from a 5,000 contribution into a pension taken from gross pay under a net pay arrangement. Check current rates.

Answer: Income tax is 12,400, national insurance 3,280 and take-home pay 46,320. The marginal rate is 42 percent, and a 5,000 pension contribution saves 2,000 of tax.

> **Interview tip:** Work band by band, give the marginal rate and not just the average, and say that the figures are illustrative and must be checked against current rates.

INT.TP.1.b · Income tax and employment

Explain how PAYE, national insurance and benefits in kind work for an employee and the employer, and outline how employee share schemes are taxed.

Under PAYE the employer deducts income tax and employee national insurance from each payment of pay and sends it to the tax authority, so most employees never file a return. The employer also pays its own national insurance on earnings above a threshold, a cost on top of salary. A benefit in kind is a non-cash benefit such as a company car, private medical insurance or a cheap loan. The employee is taxed on a value set by the rules, often reported after the year end, and the employer typically pays a separate charge, in the UK called Class 1A national insurance, on the value of most benefits. Some items are exempt, for example certain pension contributions and work-related training. Employee share schemes in outline: shares given or sold cheaply to an employee are usually taxed as employment income on the value received, but tax-advantaged schemes can reduce income tax and national insurance, with gains taxed under capital gains rules if conditions are met. Describe both sides: what the employee pays and what the employer pays. Use illustrative figures and say to check current rules.

WORKED EXAMPLE: THE COST OF A BENEFITS PACKAGE

An employee in an invented company earns a salary of 45,000 and receives a company car with a taxable value of 6,000 and private medical insurance with a taxable value of 1,200. Use the same illustrative figures as before, with employer national insurance of 15 percent above 5,000 and Class 1A national insurance of 15 percent of benefits. Find the extra income tax caused by the benefits, the employer's Class 1A charge and its national insurance on salary. Check current rules.

Answer: The benefits add 1,880 to the employee's income tax and cost the employer 1,080 of Class 1A. The employer's cost of salary and charges is 52,080 before the benefits themselves.

> **Interview tip:** Always say who pays what: the employee pays income tax on the benefit and the employer pays its own national insurance. Mention that a share award is usually taxed as pay on its value.

INT.TP.1.c · Income tax and employment

Judge whether a worker is employed or self-employed from the facts, and size the exposure for a business that gets the status wrong.

Whether a worker is an employee or self-employed decides which taxes apply and who accounts for them. An employee is paid through PAYE with deductions at source and employer national insurance, and has employment rights. A self-employed person is taxed on profits through a return, pays a different form of national insurance and carries more risk. The label in a contract does not decide it; the facts do. The factors usually weighed are control over how, when and where the work is done, whether the worker must do the work personally or can send a substitute, mutuality of obligation (an obligation to offer and accept work), who provides equipment, who bears the financial risk, whether the worker is part and parcel of the business, and how long and exclusive the relationship is. No single factor is conclusive. Where a worker supplies services through their own company, special rules in the UK can treat the arrangement as employment-like. Getting it wrong can mean a liability for unpaid tax and national insurance, interest and penalties. Describe the factors, a view, and the risk.

WORKED EXAMPLE: A CONTRACTOR WHO MAY BE AN EMPLOYEE

An invented firm paid a contractor fees of 60,000 in a year, with no tax or national insurance deducted. The contractor works only for the firm, on its premises, at times set by the firm, using its equipment, and cannot send a substitute. If the contractor is in fact an employee, find the possible exposure, treating the fees as gross pay and using the illustrative figures: income tax with allowance 12,000, a 20 percent basic band of 38,000 and a 40 percent higher rate; employee national insurance of 8 percent between 12,000 and 50,000 and 2 percent above; employer national insurance of 15 percent above 5,000. Check current rules.

Answer: On these facts the contractor looks like an employee, and the exposure for one year is about 23,090 before interest and penalties: 11,600 of income tax, 3,240 of employee national insurance and 8,250 of employer national insurance.

> **Interview tip:** Give your view from the facts, name the two or three factors that drive it, then size the cost of being wrong. Say that status depends on the whole picture and needs careful assessment.

INT.TP.2.a · Owner-managed businesses, gains and estates

Compare salary and dividends as ways of taking money from a company the owner controls, and say what limits the choice.

An owner-manager has two main ways to take profit from their own company: salary and dividends. Salary is a deductible cost for the company and is taxed on the owner as employment income, with national insurance for both the employee and the company. A dividend is paid from profits that have already borne corporation tax, is not deductible, carries no national insurance, and is taxed in the owner's hands at dividend rates, which are lower than the rates on salary. Because of this, a common pattern is a modest salary, often set near the level where the owner still builds up state pension entitlement without paying much tax or national insurance, with the remainder paid as dividends. The limits are real: a dividend can be paid only from distributable profits, a loan from the company to the owner can trigger a tax charge, anti-avoidance rules affect arrangements such as splitting shares with a spouse, and personal pensions and retained profit may be better uses of cash. Always compare total tax to the owner and the company. Use illustrative figures and check current rates.

WORKED EXAMPLE: SALARY OR DIVIDENDS FOR A 100,000 PROFIT POT

An owner-manager's invented company has 100,000 of profit before paying the owner and before the company's employer national insurance. Compare (A) taking everything as salary, with the company's cost of salary plus employer national insurance equal to 100,000, with (B) a salary of 12,000 and the remaining profit after corporation tax paid as a dividend. Use illustrative figures: allowance 12,000, basic rate 20 percent on 38,000 and 40 percent above; employee national insurance 8 percent between 12,000 and 50,000 and 2 percent above; employer national insurance 15 percent above 5,000; corporation tax 25 percent; dividend allowance 500, dividend rates 8 percent in the basic band and 33 percent above. Check current rates.

Answer: Option A leaves the owner about 61,173 and option B about 65,232, a difference of about 4,059 in favour of salary plus dividends, on these illustrative rates. Dividends need distributable profits and the comparison changes with current rates.

Interview tip: State the assumptions, compare what the owner keeps from the same pot, then add the limits: distributable profits, loans to the owner, anti-avoidance and pension use. Say that the numbers are illustrative.

INT.TP.2.b · Owner-managed businesses, gains and estates

Compute a capital gain, apply the annual exemption and rates, and outline the main reliefs and exemptions for a private disposal and a business sale.

Capital gains tax is charged on the gain when an individual disposes of a capital asset such as shares, a second property or a business. The gain is the proceeds less the original cost and the allowable costs of buying, improving and selling. An annual exempt amount covers the first slice of gains. The rate depends on the individual's other income: gains are taxed at a lower rate to the extent the person has unused basic rate band and at a higher rate otherwise, and rates can be higher for residential property in some regimes. Transfers between spouses are normally made on a no gain, no loss basis, so planning can use both spouses' exemptions and bands. Reliefs in outline: the main home is typically exempt, certain business disposals by owners qualify for a reduced rate on gains up to a lifetime limit if conditions on shareholding, role and trading status are met, and some gains can be deferred by reinvesting. Losses can usually be set against gains. Use illustrative figures, and tell the reader to check current rates and conditions.

WORKED EXAMPLE: A FOUNDER SELLS THE COMPANY

A founder of an invented company sells all her shares for 340,000. The shares cost 100,000 and selling costs are 5,000. She is a higher rate taxpayer and has not used the annual exempt amount. Use illustrative figures: annual exempt amount 3,000, a standard higher rate of 24 percent and a reduced rate of 14 percent for qualifying business disposals if conditions are met. Compute the gain and the tax each way. Check current rates and conditions.

Answer: The gain is 235,000, the taxable gain after the exemption is 232,000, and tax is 55,680 at the standard rate or 32,480 if the reduced rate applies, a saving of 23,200 that depends on the conditions being met.

Interview tip: Compute the gain step by step, then name the relief and its conditions. Say that a relief is something you check, not assume, and that rates are illustrative.

INT.TP.2.c · Owner-managed businesses, gains and estates

Outline inheritance tax on an estate and on lifetime gifts, and explain in broad terms how residence and domicile affect what a person is taxed on.

Inheritance tax is charged on a person's estate at death and on some lifetime gifts. Each person has a nil-rate band, with an extra band in the UK when the main home passes to direct descendants, and the excess is taxed at a flat rate. Transfers between spouses are usually exempt. A gift to an individual is typically exempt if the giver survives seven years, and if death occurs within seven years the gift is counted and uses up the nil-rate band first, with a sliding reduction in tax on the part above it. There are small annual exemptions and some reliefs, for example for certain business and agricultural property, which are being reformed, so check current rules. Residence and domicile decide what is taxed. A UK tax resident is generally taxed on worldwide income and gains, while a non-resident is taxed mainly on UK-source income. Residence is decided by tests that count days spent in the country and personal ties. Domicile, a person's permanent home under general law, has historically affected the taxation of foreign income and inheritance tax, and UK rules in this area have been reformed recently towards residence-based tests, so any answer here should be hedged and checked.

WORKED EXAMPLE: AN ESTATE AND A GIFT MADE LONG AGO

A widowed client dies with an estate of 1,150,000, including a home passing to her children. More than seven years earlier she gave 200,000 to her child. Use illustrative figures: nil-rate band 325,000, an additional band of 175,000 for a home passed to descendants (assume the conditions are met and it is not tapered), and a tax rate of 40 percent on the excess. Find the tax on her estate and how much the early gift saved compared with keeping the money until death. Check current rules.

Answer: Tax on the estate is 260,000. Because the 200,000 gift was made more than seven years before death, tax is 80,000 lower than if she had kept the money (which would have given 340,000).

> **Interview tip:** Give the bands, the excess and the rate, then the seven-year point. For residence and domicile say what each means in one sentence and that the rules have recently changed and need checking.

Summary of the Charta interview-preparation topic. Companies and figures in the examples are invented. Draft content, not yet expert reviewed.