

## **Property Appraisal & Valuation Coursework – The Tax System**

The Tax System is a way for Government to raise funds to cover its expenditure by taxing individuals and businesses. Taxation is needed to pay for national expenditure on defence, government administration and interest on government borrowings. It is also needed for local expenditure such as health, education, welfare and interest on loans.

Taxation is also necessary to help enforce government financial policy, through inflation control and encouraged investment in industry.

Taxes are typically described as either 'direct' or 'indirect' – direct taxes are those charged on individuals, partnerships, trusts and corporate bodies and indirect taxes are of more general application. Below is a summary of both 'direct' and 'indirect' taxes:

### **DIRECT TAXES**

- 1) INCOME TAX
- 2) CORPORATION TAX
- 3) CAPITAL GAINS TAX
- 4) INHERITANCE TAX
- 5) RATES & COUNCIL TAX
- 6) NATIONAL INSURANCE CONTRIBUTIONS

### **INDIRECT TAXES**

- 1) CUSTOMS & EXCISE DUTIES
- 2) V.A.T. (VALUE ADDED TAX)

In addition to the general regulations governing liability to income tax, there is a set of more detailed rules (applying to each of the taxpayer's different sources of income), covering such matters as the basis of calculating the taxable income, and the method of assessment and payment.

The rules are set out in 3 'schedules' – A, D and F (found in the Taxes Act 1988).

**SCHEDULE A** – covers income from property, i.e. rents

**SCHEDULE D** – incorporates six sub-divisions of income, or 'cases':

- 1) Deals with the profits of a trade or business
- 2) Applies to income from professions, e.g. lawyers/doctors/accountants
- 3) Taxes interest from a loan; from government securities, cooperative society dividends; and other untaxed income.
- 4) Covers income from foreign securities
- 5) Covers income from foreign possessions – business profits, dividends and rents from abroad
- 6) Covers all income not falling within the other schedules – such as dealings in futures, revision of 'venture capital' relief and development gains

**SCHEDULE F** – covers income tax payable by a limited company or other corporate body and embodies the tax credit on the dividend.

## **DIRECT TAXES**

### **INCOME TAX**

Taxpayers are obliged to complete income tax returns every year to ensure that the correct declarations are made. The tax payer has the facility of submitting the tax return by the end of September and in turn the tax inspector (Inland Revenue) can work out the liability or the refund that the taxpayer may owe or be owed respectively.

The tax payer may submit the return between September and January; however, he is responsible for working out the liabilities/computations himself. Unless the taxpayer is versed with the computations, he is responsible for any errors committed/discrepancies found (which are subject to penalties and interest charges).

Failure to submit tax returns by the end of January carries an automatic penalty of £100. This penalty is increased if the tax return is not submitted by July and interest is charged on tax that is not paid on time.

In addition to the personal allowances, the taxpayer can also apply for working tax credit which entitles them to additional income from the government.

### **WORKING/CHILD TAX CREDIT**

This benefit is subject to a person's earnings and is geared towards helping those earning an average income.

### **CORPORATION TAX**

Tax payable on the profits generated by limited companies after deducting allowable expenses, capital allowances and other allowances.

Special provisions are given for 1<sup>st</sup> year allowances (1<sup>st</sup> year of incorporation):

- 1) 50% for small companies
- 2) 40% for medium sized companies.

A small company in this instance is determined by the following:

- a) annual turnover is less than £2.8m
- b) total assets are under £1.4m
- c) not employing more than 50 employees.

The standard 'writing down' allowance on plant/machinery is 25% . 'writing down' allowances is the accepted system, although expenditure on electronics (computers) can be written off in four years (using the straight down system).

There are various rates of corporation tax – starting at 0% on net profits of £10,000 or under and increasing on a sliding scale to a maximum of 30% on profits of £1.5m or above.

## **CAPITAL GAINS TAX**

Tax chargeable on profits made on disposal of assets, including:

- 1) land & buildings (excluding principal residence of an individual)
- 2) shares and securities

(Individuals do not pay tax on the 1<sup>st</sup> £8,200 for 2004/5)

Most Trusts are exempt to half the usual rate. Full exemption will however, apply to Trusts for the mentally handicapped, persons receiving attendance allowance and the middle or higher range of disability allowance.

Capital Gains Tax is charged at 40%, but there are other exemptions applicable:

- 1) transfers between husband and wife
- 2) gifts to charities/capital gains of charities.

## **INHERITANCE TAX**

This tax is charged when someone dies and is chargeable on all of the assets of the deceased (although transfers between husband and wife are exempt). Inheritance tax may arise on the amount of a taxpayer's wealth passing on death, on certain lifetime transfers and on certain transfers into and out of trusts.

The tax applies when the total value of the estate and chargeable transfers exceed £263,000 (rate charged is 40%).

N.B. the amount chargeable to tax includes the value of property both inside and outside of the UK.

There are certain exemptions:

- 1) all property passing on death and 7 years prior to death (up to a value of £263,000)
- 2) transfers or 'gifts' between husband and wife made on death or at any time previously
- 3) gifts which represent normal expenditure out of income
- 4) lifetime gifts in consideration of marriage, gifts to charities, and gifts to political parties.

Gifts given before seven years of death are exempt, while those which are made within 3-7 years of death carry tax at a reduced rate (tapered according to a prescribed scale).

## **RATES AND COUNCIL TAX**

This tax is levied by local councils on occupiers of property. There are 8 bands in which a property falls into, depending on its value: (different bands exist for properties in Scotland & Wales)

Band A – property valued at up to £40,000 (1<sup>st</sup> band)  
Band H – property valued above £320,000 (8<sup>th</sup> band)

The level of the rates charged varies from council to council. The council levies rates every March and the occupier can choose to pay the rates (averaging £1500 per annum) either outright or by 10 monthly instalments (commencing in March). People living on their own normally get a 25% reduction.

Dwellings exempt from tax are those exclusively occupied by students and certain empty properties (e.g. a property which has been empty and unfurnished for 6 months).

Businesses are also charged business rates which fall more or less under the same regulations, although business rates are higher than those chargeable on residential properties.

### **NATIONAL INSURANCE CONTRIBUTION**

This tax is normally referred to as employment tax. Contributions are divided into 4 classes:

- 1) employed persons – an employee normally pays 11% of his earnings subject to a threshold of £79/week (an additional 1% is payable on earnings of over £610/week).

In addition to that, the employer pays 12.8% (above £91/week) and whereas the employee pays (NIC) up to a prescribed limit of £610/week, an employer has no limit on payment of his share.

- 2) self-employed persons – pay (class2) national insurance contributions at a rate of £2.05/week with an earnings exception of £4215/annum.

In addition, self-employed persons pay (class4) national insurance contributions at a rate of 8% of the net income earned for £4,745 - £31,720 (an additional 1% is payable on earnings above £31,720).

- 3) voluntary contribution – this tax is normally paid by widows/widowers and the current weekly rate is £7.15 on annual earnings of over £4,745.
- 4) Earnings-related contribution (payable by the self-employed), as mentioned above, the current rate of tax is 8% of net income between £4,745 and £31,720 p/a (with an additional 1% payable on all income above £31,720)

### **INDIRECT TAXES**

#### **CUSTOMS & EXCISE DUTIES**

Customs and excise duties are chargeable on certain dutiable goods imported and those produced in the UK, such as liquors and tobacco.

Customs collect this tax directly from the manufacturers and is payable upon release from the bonded warehouse/ place of storage.

#### **VALUE ADDED TAX (VAT)**

'value added tax' is referred to as consumer tax because it is ultimately payable by the consumer. The current standard rate of tax is 17.5% and it is chargeable to

businesses that have an annual turnover of £58,000. these businesses are required to register for VAT. They pay the VAT on purchases which they are then able to claim back on a quarterly basis when they submit their quarterly VAT return.

These companies are required to charge VAT on their sales. Once a quarter, they take the tax charged on sales and deduct the tax paid on purchases (with the difference being payable to or claimed from customs and excise).

There is also VAT at 0% which normally applies to food, and there is also an exempt rate of VAT which normally applies to banks and insurance companies. This means however, that banks do not charge VAT on their banking services and are not allowed to claim VAT on their purchases.

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### **PERSONAL TAXATION EXAMPLE (BASIC RATE TAXPAYER)**

(A) INCOME	£20,000
(B) INTEREST FROM BANK	£200
(C) SHARES	
PURCHASE PRICE	£1,000
SALE PRICE	£1,500
(D) NET INCOME FROM PROPERTY	£500
(A) INCOME (Y/E 05/04/04)	£20,000
LESS: PERSONAL ALLOWANCE	£4,615
TAXABLE INCOME	<b>£15,385</b>
TAX PAYABLE	
£1960 @ 10%	£196
£13425 @ 22%	£2,954
<b>TOTAL TAX PAYABLE</b>	<b>£3,150</b>

The above table shows the breakdown of earnings and the relevant taxation for:

(a) income - If I were an employee, this tax would have been deducted via the PAYE (pay as you earn) system. Otherwise I would owe the £3150 tax by 31/01/05.

b) interest from bank – as a basic tax payer (earning less than £35,115) the tax at basic rate would have been deducted by the bank. Therefore, no further tax is payable. However, if my savings were held in a National Savings Account, then interest would have been paid gross and I would have to add the interest receivable to my £20,000 income.

(c) the profit from sale of the shares held is £500 (£1500 - £1000). As this is within the annual exempt limit of £7900, then no tax is due under the 'Capital Gains Tax' banner.

(d) net income from property represents the gross rent receivable (less maintenance costs), 10% depreciation on rent receivable and interest payable on the mortgage. Therefore, I would have to pay tax on £500 @ 22% which = £110.

## **BUSINESS COSTS**

Companies are allowed to claim (or write down) motor vehicles @ 25%/per annum, (reducing matters) on purchasing motor vehicles. The companies are also entitled to claim repairs and running expenses, insurance and road tax.

However, if vehicles are used by employees (earning more than £8,500 per annum) and there is an element of 'private use', then the employee has to pay a certain amount of tax as a 'taxable benefit'.

The taxable benefits for cars are based on a percentage of their list price, graduated according to their levels of CO<sub>2</sub> emissions.

Benefits range from 15% of list price to a maximum of 35% of list price. Diesel cars will be subject to a 3% supplement.

In addition to the car benefit, an employee may also be liable to pay tax on the use of fuel.

Self-employed people are also allowed to claim capital allowances of up to £3000p/a, but these allowances will be reduced by the proportionate private mileage of the vehicle. The same applies cost of fuel, maintenance and insurance.

## **BUSINESS EXPENSES**

A company is entitled to treat the expenses it incurs in running the business as an expense against its income. There are, nonetheless, a number of exceptions – i.e. the company cannot claim entertaining expenses as an expense for tax purposes. When a company leases motor vehicles, it can only claim up to a maximum prescribed limit.

Capital expenses can only be written down under the capital allowance regulations, rather than being written down against the income of the relevant year.

Certain legal expenses are also not an allowable expense for tax purposes.

## **LIABILITY INSURANCE**

Since 6 April 1995 – liability insurance on work-related risks is tax free for employees and gives tax relief when paid for by employers. The tax-free relief applies for 6 years after the end of the employment. Payments for uninsured work-related charges which could have been insured (including legal costs in defending an action) are also tax-free.

## **BUSINESS LOANS**

Interest paid is an allowable expense where the loan is used for business purposes – (including the interest on higher purchase transactions).

## **LOANS FOR LET PROPERTY**

Let property – interest on the mortgage acquired on a let property is an allowable expense against the rent receivable as long as the property is let for at least 26 weeks in a year at a commercial rent.

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