

# PAYE INCOME

Income from a job, a company pension or a private pension is usually taxed under the pay as you earn (PAYE) system. Here's how it works

**T**he PAYE scheme applies mainly to income from a job, but the same system is used for taxing most company and private pensions. Under PAYE, deductions from your earnings or pension are used to pay tax due on all your income. The Revenue gives your employer (or pension company) a tax code that indicates how much tax-free pay you should get each pay-day. Tax is deducted from any amount above this.

Your tax code depends on your circumstances. If it is based on the wrong information or your circumstances change, the wrong amount of tax will be deducted. So it's important to check your tax code is correct and up to date.

Your tax code should be shown on the payslip accompanying your pay or pension, but you will normally get a coding notice from your tax office explaining how your code is worked out.

## TAX CODES

Most tax codes consist of a number and a letter. The number tells your employer how much tax-free pay you're allowed in each tax year. The letter gives your employer further information on the type of allowances you receive. The 'Glossary', p18, shows what the letters mean.

The number is arrived at by adding up all the allowances and reliefs to which you are entitled. But your tax code may also be used to collect tax on taxable benefits, such as a company car, or on income from other sources that is taxable but paid out before tax, such as a state pension. In this

case, these amounts are deducted from your allowances when your code is calculated.

The final result is the amount of tax-free income to which you are entitled in the tax year. This is converted to your tax code by removing the last digit and adding the relevant code letter.

To work back from your code to your tax-free

**Your tax code shows the tax-free income you're allowed**

## TAX REVIEW FORM

Changes in the Revenue's self-assessment criteria mean fewer people will be getting tax returns in the future. However, even if you've been removed from self assessment, the Revenue may send you a tax review form (P810) to check your tax code is correct. This might apply to higher-rate taxpayers who have additional investment income or to people who are making expense claims.

pay, just put a 9 on the end of the number (the knocked-off figure is always assumed to be 9). So, if, say, your code is 154L, like June Budd in the example opposite, you can earn one twelfth of £1,549 (£129) free of tax each month.

If your deductions, such as fringe benefits, exceed your allowances and reliefs, your code will begin with a K. The difference between your deductions and allowances (shown by the number part of your code) is added to your pay for tax purposes. If your deductions exceed your allowances by £1,350, say, your code is K134 (the last figure is rounded down).

## More than one job

People with more than one job will have a separate tax code for each. Personal allowances will be given against what you, or your tax office, regard as your main job. Your gross pay from your

second (and subsequent) job will probably all be taxed at the basic rate (or 40 per cent for higher-rate taxpayers). If this means you pay too much, or too little, tax over the year, an adjustment will be made at the end of the tax year.

However, you can ask your tax office to allocate your allowances differently to stop errors building up. For example, if you have two part-time jobs, and do not use all your allowances against the first, you can ask your tax office to split your allowances between your jobs so that you pay less tax on the second.

## YOUR CODING NOTICE

A coding notice gives details of how your tax code is worked out. Coding notices are normally sent out in January or February each year, so that any tax changes can be put into effect at the beginning of the next tax year, which starts in April. However, you may receive one at different times of year if the tax rules or your circumstances

change. But you won't necessarily get a coding notice at all. For instance, if the letter in your code is L, P, V or Y, your employer may be able to alter your code number automatically, to take account of the new allowances.

If you become entitled to a new allowance or tax relief during the year, tell your tax office and ask for a new code, otherwise you may pay too much tax, which will have to be refunded. Also, you should tell your tax office about any change that might reduce your code (a new source of untaxed income, for example). If you don't, you will have more tax to pay later on.

## Allowances

We show an example coding notice below. Entries on the left under 'Your tax allowances' increase your tax-free pay. The first entry is your personal allowance. If you are 65 or over, the 'Estimated income' that your tax office has used to work out any extra age-related allowance may also appear (see 'Tax in later years', p40

## CODING NOTICE

June Budd received her coding notice for the 2005-2006 tax year in February 2005.

The left-hand side shows June's personal allowance (the amount she can receive in income before paying tax) of £4,895. She doesn't qualify for any other allowances.

On the right-hand side are the amounts that must be deducted from June's allowances. These are: her company car (with a taxable value of £2,500); other taxable expenses payments (£400); and an adjustment for tax June underpaid last year.

June underpaid £99 tax. However, the

actual deduction needs to be the amount that, when multiplied by her top rate of tax, comes to £99. As June is a basic-rate taxpayer, the deduction is £450, since  $£450 \times 22\% = £99$ .

The deductions on the right-hand side of the coding notice are taken away from the allowances on the left-hand side and the result is the amount of income June is allowed to receive in the 2005-2006 tax year before she pays tax – £1,545. The first three numbers make up her tax code (154). June receives the basic personal allowance, so she gets an L code, 154L.

**HM Revenue and Customs**  
**PAYE Coding Notice**  
 Tax code for tax year: **2005/06**

Please keep all your coding notices. You may need to refer to them if you have to fill in a tax return. Please also quote your tax reference and National Insurance number if you contact us.

**MR J BUD**  
**100 ACACIA AVENUE**  
**NEW TOWN**  
**WILTSHIRE**  
**NP23 7AB**

**2005/06**

**200 BLAKE**  
**WILTSHIRE 1**  
**CROWN BUILDINGS**  
**NEW TOWN**  
**NP23 7DE**

HM Revenue and Customs phone: **01234 567 890** Date of issue: **05 FEB 2005**

Tax reference: **222/A960** National Insurance number: **AB 12 34 56 7**

Your tax code for the year shown above is **154L**

This tax code is used to deduct tax payments on your income from:

**ANY OLD BUSINESS LTD**

If you move to another job, your new employer will normally continue to use this tax code. The tax code is worked out as follows:

See note	Your tax allowances	£	See note	Amounts taken away from your total allowances	£
01	PERSONAL ALLOWANCE	4895	30	TAX BENEFIT	2500
			38	TAXABLE EXPENSES PAYMENTS	400
			39	TAX UNDERPAID	450
<b>A</b>	<b>Total allowances</b>	<b>4895</b>	<b>B</b>	<b>Total deductions</b>	<b>3350</b>
<b>C</b>	<b>Your tax-free amount for the year is £</b>	<b>1545</b>	<b>...making your tax code</b>		<b>154L</b>

see example overleaf

If necessary we will use this box to give you further information about your tax code

for details). You should tell your tax office if this figure is wrong.

Payments that qualify for tax relief may also be shown. The figure on the coding notice is the amount your tax office expects you to pay in the coming tax year (for example, if pension contributions are shown, it will assume that you're paying the same as last year). Possible entries include:

- payments for allowable expenses incurred in your job, and professional subscriptions that are essential for work
- payments to private pensions. With personal and stakeholder pensions, the pension company claims the basic-rate tax relief for you and adds it to your plan, so you will see an entry only if you are a higher-rate taxpayer.
- extra tax relief for higher-rate taxpayers on qualifying payments to charity (see p6).

### Restricted allowances

Married couple's allowance and maintenance relief give restricted tax relief of 10 per cent of the allowance (see p40). For example, if you receive married couple's allowance of £5,905 in 2005-2006, it is worth only £591 ( $£5,905 \times 10\%$ ).

If you receive a restricted allowance, the full amount of the allowance is shown on the left-hand side of your coding notice (£5,905, for example) and a deduction called 'Allowance restriction' is shown on the right-hand side of your coding notice (£3,220, say).

To check the relief you've been given, deduct the restriction from the full allowance (so  $£5,905 - £3,220 = £2,685$ ) and multiply that amount by your highest rate of tax. The result should be within a few pounds of the relief due (for example,  $£2,685 \times 22\% = £591$ ).

### Deductions

Entries in the right-hand column reduce your allowances so that you get less tax-free pay. Such entries include:

- most fringe benefits from your job, such as private medical insurance or a company car
- other income from working that is not taxed under PAYE, such as part-time freelance earnings, commission or tips
- taxable rental income
- taxable state pensions and benefits
- investment income received before tax (see p49).

Tax owed from a previous year which is not being collected in one payment will be shown as 'tax underpaid'. An adjustment reduces your code so that you pay what you owe over the course of the year (see our example coding notice on the previous page).

For higher-rate taxpayers, any additional tax owed on investment income is collected under the heading 'Higher-rate tax adjustment'.

## GLOSSARY

**Ever wondered what the letter in your tax code means? We reveal all**

**BR or DO** All your pay from this source is taxed at the basic (BR) or higher (DO) rate. Used if you have more than one source of PAYE income and all your tax allowances have been used up against another source of income

**K** Your total deductions, such as fringe benefits, exceed your allowances

**L** You get the basic personal allowance

**NT** You pay no tax on this income

**O** No tax-free pay, but tax at starting rate first then basic rate then higher rate as applicable

**P** You get the full age-related personal allowance for someone aged 65 to 74

**T** Used if your tax office needs to review your tax code. You can also ask your tax office to use it if you don't want your employer to know personal details. It does not mean that you have been given a temporary tax code.

**V** You get full age-related personal allowance for someone aged 65 to 74, plus full married couple's allowance for couples aged under 75, and you are likely to pay basic-rate tax

**Y** You get full age-related personal allowance for someone aged 75 or over

## GET THE RIGHT CODE

When you start or return to work, or change jobs, your income is likely to change – and you may find that, because of lack of information, you pay the wrong amount of tax.

### Your first job

Your first job brings money and responsibility – but it may also mean paying tax. Your employer should give you form P46 to complete when you start work. Anyone earning less than £94 a week in 2005-2006 will be a non-taxpayer and your employer will keep the P46; otherwise it will be sent to your tax office which will then work out your tax code.

Until you get your tax code, you will be given an emergency tax code if this is your first regular job since full-time education and you haven't been receiving jobseeker's allowance. This is 489L for the 2005-2006 tax year and it assumes that the only allowance you are entitled to is the personal allowance. You can therefore earn one twelfth of the personal allowance (£408) each month of the tax year before paying tax.

Tax won't be deducted until the tax-free pay you were entitled to in the months that you weren't working has been used up. So, if you are on code 489L during this tax year, and your first monthly pay-day is in the fourth month of the tax year, you are entitled to earn £1,632 (£408 for each of the four months) before any tax starts to become due.

## When you change jobs, your

## employer should give you a P45

If your total pay for the month is less than this amount, you'll pay no tax. The balance of the tax-free pay you can receive is given to you on subsequent pay-days until it's used up.

### Changing jobs

Changing jobs means upheaval, and that includes tax. When you change jobs, your previous employer should give you a P45 form. This shows your PAYE code and the tax deducted from your total pay for the year to date. Give it to your new employer so the correct amount of tax can be deducted from your pay.

If you don't have a P45, or can't give one to your new employer, you will be given a form P46 in the same way as for your first job. Until the Revenue sorts out your code, your employer will usually operate the emergency code on a 'week one' or 'month one' basis. This works as though each week or month is the first one of the tax year, and no account is taken of any free-of-tax pay due from the beginning of the tax year to the time you started working. You may pay too much tax

## IT PAYS TO TAKE NOTICE OF A CODING NOTICE

The Inland Revenue does make mistakes, but if you understand your tax position, you can sort things out quickly.

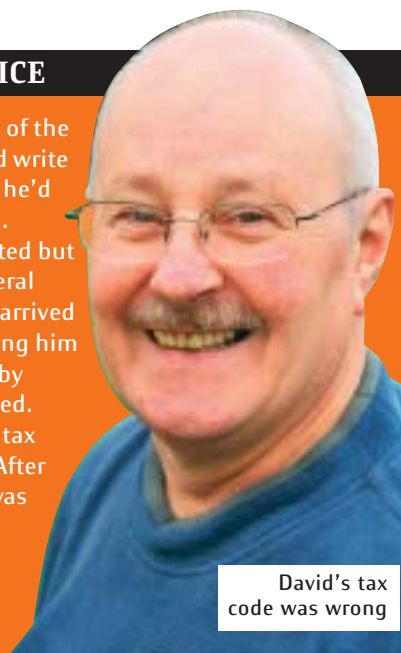
David Smith retired in January 2004 and received his coding notice for 2004–2005, based on his pre-retirement income, shortly after. As David's income had dropped, he was worried he would be paying too much tax.

David phoned his tax office and was told he would get a new coding notice for 2004–2005 that would be based on his new income. His existing code for 2003–2004 wouldn't change as

it was close to the end of the tax year, but he should write in and fill in a form as he'd be entitled to a refund.

David did as instructed but heard nothing for several months. Then a letter arrived from the Revenue telling him he had underpaid tax by £147. He was perturbed.

David contacted his tax office and explained. After some discussion, he was told he was owed a refund. In due course, he received a cheque for £195.



David's tax code was wrong

for a while but, when the Inland Revenue allocates your proper tax code, your employer will refund any overpayment of tax you have made.

### CHANGING INCOME

Because PAYE taxes anything above your tax-free pay, the right amount of tax will still be deducted if your income goes up. But if you earn less than your tax-free pay entitlement in the year to date (because of unemployment or sickness, for example), you will pay too much tax. Your employer or Jobcentre Plus will normally refund this automatically but contact your tax office if it doesn't happen.

### Off work

Sick pay from your employer (including statutory sick pay) is normally taxable, and the tax is collected through the PAYE system. However, if the amount you have received is less than the tax-free pay to which you are entitled, you will receive a refund of tax already paid. Any incapacity benefit you receive becomes taxable after 28 weeks – the Department for Work and Pensions will deduct tax.

Statutory maternity pay (and, since April 2003, statutory adoption and paternity pay), together with any maternity pay you received from your employer, are also taxable through the PAYE system. However, the state maternity allowance isn't taxable.

If you (rather than your employer) pay for insurance to cover periods of sickness or unemployment, benefits payable under these policies are free from tax.

### Unemployed

You may become unemployed before you have used up all of your tax-free pay. If so, any unused entitlement will be set against the taxable amount of any jobseeker's allowance or income support you receive. When you stop claiming benefit, or at the end of the tax year if this comes first, either the Jobcentre Plus or your new employer will give you a refund of any tax you have overpaid.

Your former employer should give you a P45 if you become unemployed. You need to give this to the Jobcentre Plus so that it can work out your tax position. However, don't be put off claiming just because you do not have a P45.

If you are still not working at the end of the year, you will get a P60U, which shows the taxable amount of benefit that you have received and the tax you have paid. When you eventually find a job, you should fill in the form in the back of booklet ES40 provided by your Jobcentre Plus. Return this to the Jobcentre, which will give you a P45 for you to hand to your new employer.

### Retiring

Make sure that your tax office knows in good time when you plan to retire or start drawing a pension, or when you or your husband or wife are nearing 65. This is because your PAYE code may need to change. Your tax office may send you a pension enquiry form P161 to collect the necessary information.

State pensions are usually paid out before tax – but they are taxable. As a result, tax due on them may be collected by adjusting your tax code for any other pension you get (or other income taxed under PAYE). ■

## MORE HELP

### Inland Revenue leaflets/helpsheets

- IR10 Paying the right tax on your earnings or pension
- IR121 Income tax and pensioners
- IR208 Payslips and coding notices
- P3 Understanding your tax code