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Direct taxes: rates & allowances 2001-02

This paper sets out the main changes to direct tax rates and allowances announced in the Budget of 7 March 2001. It lists the principal personal allowances which will be available against income tax in the tax year 2001-02, and it outlines the conditions necessary for eligibility for these allowances.

This paper provides a summary of the general tax position in straightforward cases only. It should be stressed that this paper deals only with tax allowances. No reference is made to cash benefits provided under the social security system, or to the Working Families Tax Credit.

Antony Seely

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Summary of main points

- Income tax on earned income is charged at three rates. For 2001-02 all three rates are unchanged: the starting rate is set at 10%, the basic rate at 22%, and the higher rate at 40%. The starting rate is charged on the first £1,880 of taxable income. The basic rate is charged on income in excess of this limit, up to the basic rate threshold of £29,400. The starting rate band has been increased by £300 in excess of statutory indexation.

- The personal allowance is increased in line with inflation to £4,535 for 2001-02. The two age-related personal allowances for older people are also increased in line with inflation: to £5,990 and £6,260 for people aged 65-74 years and 75 years and over respectively. The income limit for the age-related allowances is increased to £17,600 in line with statutory indexation.

- A new children's tax credit is introduced from April 2001. Families who have one or more children under 16 living with them are eligible to claim this credit, which takes the form of an allowance – set at £5,200 for 2001-02 – for which relief is given at 10 per cent: in effect those families eligible to claim the CTC will be able to cut their annual income tax bill by up to £520. The CTC is tapered for claimants who are higher rate taxpayers. It is reduced by £1 for every £15 of income above the point at which they start to pay higher rate tax until their entitlement to the credit is exhausted (typically at an income of £41,735 for 2001-02).

- It is proposed that from April 2002 the children's tax credit increased by an extra £10 a week for families in the year of a child's birth. A short appendix to this paper gives details.

- Elderly taxpayers may be entitled to the married couple's allowance which was withdrawn from all couples aged under 65 on 6 April 2000. Only couples in which one partner was born on or before 5 April 1935 are entitled to receive an allowance; for 2001-02 this allowance is set at £5,365, or £5,435 if one partner is 75 or over. Both allowances are restricted to 10 per cent.

- This paper does not provide details of the cash benefits provided under the social security system. In addition, it only deals with tax allowances and 'wasteable' tax credits: those which are limited to the amount of the tax liability and therefore cannot give rise to a payment by the authorities to the taxpayer. The CTC is one example of a wasteable tax credit. 'Non-wasteable' tax credits are not so limited, so that the excess of the credit over the tax liability can be paid to the taxpayer. The Working Families Tax Credit (WFTC) and Disabled Person's Tax Credit, which replaced the in-work benefits Family Credit and Disability Working Allowance from October 1999, are non-wasteable credits. It is intended that a separate Library Research paper will deal with the treatment of families by the tax system, including the introduction of the WFTC.

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I Rates and thresholds

A. Income tax

Income tax on earned income is charged at three rates: the starting rate, the basic rate, and the higher rate. All three rates are unchanged for 2001-02: the starting rate of 10%, the basic rate of 22%, and the higher rate of 40%.

The 10% starting rate applies to taxable income up to £1,880. Taxable income excludes personal allowances, which represent the amount of money someone may receive free of tax. Taxable income in excess of the starting rate threshold is charged at the basic rate of 22%. The upper limit of the basic rate band is £29,400. Taxable income in excess of this second threshold is charged the higher rate of 40%. The higher rate threshold is increased in line with inflation, whereas the basic rate threshold is increased by £300 above indexation. The three tax rates and thresholds for 2001-02 are:

Taxable income	**Tax rate**
First £1,880	**10%**
£1,881 - £29,400	**22%**
Over £29,400	**40%**

The rates of income tax on savings income - other than dividend income - are unchanged for 2001-02: 10% for income in the starting rate band; 20% for income in the basic rate band; 40% for income above that. Generally savings income is taxed at source at 20%. Those only paying the starting rate can claim a repayment of tax from the Inland Revenue.[1] The rates of tax on dividend income are 10% for income below the basic rate limit, and 32.5% above that. In calculating tax liability, dividend and savings income is regarded as the 'top slice' of income, with dividends the highest.

B. National Insurance contributions

Employees are charged National Insurance contributions (NICs) on their earnings if their earnings exceed the lower earnings limit (LEL), which is set at £72 per week for 2001-02. A zero rate of NICs is charged on earnings between the LEL and the primary threshold (PT), which is set at £87.[2] Earnings above the PT are charged NICs at 10%, subject to a cap at the upper earnings limit (UEL), which is set at £575 per week. Employees contracted out of the state earnings related pension scheme (SERPS) pay a reduced rate of NICs. Employers pay NICs on employee earnings at a rate of 11.9%, on earnings above

1 An Inland Revenue helpline is available to give advice to those in this situation: 0845 307 5555. Calls are charged at local rates. Further information is on the Revenue's internet site at: www.inlandrevenue.gov.uk/taxback/index.htm

2 No NICs are actually payable but a notional primary Class 1 NIC will be deemed to have been paid in respect of earnings between LEL and PT to protect benefit entitlement.

the secondary threshold (ST), also set at £87 a week for 2001-02.[3] The rates of NICs for 2001-02 are set out below:[4]

Total weekly earnings[1]	**Employee (primary) NICs rate**[2]	**Employer (secondary) NICs rate**[3]
£0 to £72 (LEL)	0%	0%
£72 to £87 (PT/ST)	0%	0%
£87 to £575 (UEL)	10%	11.9%
Above £575	0%	11.9%

[1] *The limits are defined as LEL - lower earnings limit; PT - primary threshold; ST - secondary threshold; and UEL - upper earnings limit.*
[2] *The contracted-out rebate for primary contributions in 2001-02 is 1.6 per cent of earnings between the LEL and UEL for all forms of contracting out: contracted-out salary-related schemes (COSRS), contracted-out money purchase schemes (COMPS) and appropriate personal pensions (APPs).*
[3] *The contracted-out rebate for secondary contributions is 3 per cent of earnings between the LEL and UEL for contracted-out salary-related schemes. For contracted-out money purchase schemes, the employer's contracted-out rebate varies according to the age of the employee. For appropriate personal pensions, the total rebate (primary and secondary combined) applicable to earnings is, like the rebate for COMPS, related to the age of the employee.*

II Personal allowances

All individuals receive a personal allowance which they can set against income tax, irrespective of sex or marital status. Two age-related additions are made to the allowance: the first, if someone is 65 or over, the second if they are 75 or over. Those born before 6 April 1935 may be eligible for two other allowances: the married couple's allowance; and, tax relief on maintenance payments. An allowance is also given to individuals who are blind. From April 2001 a new allowance – the children's tax credit – is introduced, given to families with one or more children under 16.

Income tax legislation requires the main allowances and thresholds to be increased in line with the Retail Prices Index (RPI) unless Parliament determines otherwise. This statutory requirement - the so-called "Rooker-Wise" amendment - was introduced under section 22 of the *Finance Act 1977*.[5] The amendment was successfully made through the cross-party co-operation of Jeff Rooker and Audrey Wise with Nigel Lawson. All three argued that without indexation, inflation acted as an unauthorised, unintended and an unknown increase

[3] Both the PT and ST are now aligned with the personal tax allowance.
[4] HM Treasury, *Budget 2001*, HC 279 March 2001 p 136
[5] Consolidated in section 257C of the *Income and Corporation Taxes Act (ICTA) 1988*. The statutory requirement to uprate the starting rate and basic rate thresholds in line with inflation unless Parliament determines otherwise is provided under section 1 of *ICTA 1988*.

in taxation. By ensuring that any real changes in allowances would have to be voted on, the amendment ensured changes in the income tax structure would be 'out in the open'.

Personal allowances should be increased by a percentage equivalent to the rise in the RPI rounded up to the nearest £10; the income limit for age allowances should be increased by a similar proportion but rounded up to the nearest £100. In the case of thresholds, changes must be rounded up to the nearest multiple of £10 (starting rate threshold) or £100 (basic rate threshold). When uprating the main allowances and thresholds, the relevant inflation rate taken is the increase in the RPI in the year to September. For the year to September 2000 the rate of inflation was 3.3%.[6]

A. Personal allowance

Every taxpayer resident in the United Kingdom is entitled to a personal allowance that can be set against any type of income for tax purposes. Two additional levels of the allowance are provided for the elderly. The allowance is not transferable between spouses.

These three allowances for 2001-02 are:

Under 65	**£4,535**
65 – 74	**£5,990**
75 and over	**£6,260**

All three allowances have been increased in line with statutory indexation: the personal allowance by £150, and the two age-related allowances by £200 and £210 respectively.

The extra age allowances are reduced above a certain income limit by £1 for every £2 by which income exceeds the limit (this is explained below, in the part II.B of this paper). In such cases only the extra allowance is withdrawn. No-one over the age of 65 receives less than the basic personal allowance.

B. Income limit for age-related allowances

Taxpayers claiming an age-related allowance whose income exceeds £17,600 for 2001-02 will have their allowance reduced by £1 for every £2 that their income exceeds this limit. This progressive reduction continues until the allowance is equal in value to that of the ordinary personal allowance, or, in the case of those taxpayers still entitled to the married couple's allowance (MCA), a 'minimum' allowance.[7] The income limit is increased by

[6] Office for National Statistics, *Consumer Price Indices*, September 2000 p 5. The legislation is framed in terms of the consumer price index itself, rather than the RPI figure, and this may make a difference: notably, allowances which end in a 5 may continue to do so. For details see, HM Treasury, *Tax Benefit Reference Manual*, 2000-01 edition para 1.21

[7] The continued provision of this allowance to people born before 6 April 1935 is examined in part II.E of this paper.

£600 in line with statutory indexation. For individual taxpayers qualifying for an age-related personal allowance, the benefit of the additional allowance will not be completely withdrawn until their total income reaches the following limits:[8]

65 – 74	**£20,510**
75 and over	**£21,050**

C. The children's tax credit

A new tax credit – the children's tax credit (CTC) – is introduced from April 2001. Families who have one or more children under 16 living with them are eligible to claim this credit, which takes the form of an allowance – set at £5,200 for 2001-02 – for which relief is given at 10 per cent:[9] in effect those families eligible to claim the CTC will be able to cut their annual income tax bill by up to £520.

The Government's purpose in introducing the new credit is, in the words of the Chancellor Gordon Brown, to "substantially increase support for families with children", and to do so, "in the fairest way" – two principles governing its approach to the taxation of families.[10] As a consequence eligibility for the CTC will be based on whether someone is caring for a child – rather than their marital status, as was the case with the married couple's allowance, which was withdrawn from April 2000.

In addition the CTC is tapered, so that it is gradually withdrawn where the person claiming it is liable to tax at the higher rate. These people will lose £1 of tax credit for every £15 of income above the point at which they start to pay higher rate tax until their entitlement to the credit is exhausted (typically at an income of £41,735).[11] To ensure that the taper operates in the way intended, should one partner in a couple be a higher rate taxpayer, they are *obliged* to claim the CTC for their household, and cannot transfer it to their lower earning partner. In contrast to the CTC, the married couple's allowance was worth the same cash amount to all taxpayers, irrespective of their income.[12] As the Chancellor went on to say in his 1999 Budget speech, "it is in fulfilment of [these] two principles that the children's tax credit will be tapered away for the higher-earning family where there is a top-rate taxpayer."[13]

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8 Only the 'minimum' MCA is transferable between husband and wife. As a consequence, for the MCA the figures will depend on the income of the husband and the age of the older spouse.

9 When the introduction of the CTC was first announced in the March 1999 Budget, it was anticipated that the credit would be set at £4,160 restricted to 10%.

10 HC Deb 9 March 1999 c 183

11 For 2001-02 the basic rate limit and the personal allowance are £29,400 and £4,535 respectively. The credit will start to be withdrawn from those earning above £33,935. It would be exhausted once income rose above £33,935 + [15 x £520] = £41,735.

12 For 1999-2000, the basic MCA for all couples under 65 was set at £1,970 reduced to 10%: ie, a tax credit of £197.

13 HC Deb 9 March 1999 c 183

D. Blind person's allowance

Any person registered as blind is entitled to the blind person's allowance (BPA). The allowance is increased in line with inflation by £50 to £1,450 for 2001-02. The allowance is not restricted in value. If someone has insufficient income to make use of the allowance it can be transferred to a spouse.

E. Two transitional allowances for the elderly

Four allowances were withdrawn from April 2000: the married couple's allowance (MCA) for couples born after 5 April 1935; the additional personal allowance; the maintenance allowance for separated or divorced couples under 65; and the widow's bereavement allowance.[14] However, both the MCA and tax relief on maintenance payments were retained for individuals receiving these allowances, where either they, or their spouse/one-time spouse, had reached the age of 65 by the start of the tax year 2000-01; ie, they were born on or before 5 April 1935.

1. Married couple's allowance

A **married couple's allowance** is given to married couples in which at least one partner has reached 65 by 6 April 2000.[15] In line with the personal allowance, a higher allowance is given to couples in which at least one partner is 75 or over. For 2001-02 the two age-related allowances are:

One or both aged 66 – 74	**£5,365**
One or both aged 75 or over	**£5,435**

Both allowances have been increased by £180, in line with statutory indexation. Tax relief for these allowances is 'restricted' to 10 per cent. In effect taxpayers receive a credit worth 10% of the MCA to set against their final tax bill: ie, £537 in the case of the MCA for couples between 66 and 74.

The value of the MCA is gradually reduced for taxpayers earning above the income limit, in the same way as the age-related personal allowances (see Part II.B of this paper). The withdrawal of the MCA from elderly couples is subject to a minimum allowance set at £2,070 restricted to 10 per cent for 2001-02.[16] No couple entitled to the allowance will receive less than this. In the first instance the MCA is given to the husband, though if couples elect, the minimum MCA can be transferred to the wife or split equally between

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[14] The abolition of these allowances was announced in the March 1999 Budget. For further details see, *Direct taxes: rates & allowances 2000-01*, Library Research paper 00/38, 29 March 2000 pp 11-12

[15] When a person born on or before 5 April 1935 newly gets married, that person or their spouse is entitled to claim the MCA.

[16] The minimum amount of the MCA is also increased in line with statutory indexation for 2001-02.

spouses. The allowance is reduced by one twelfth for each complete tax month pre-marriage.

2. Tax relief for maintenance payments

Generally maintenance payments are made outside the tax system: those who make payments cannot claim them against tax, and those who receive them are not taxed on them. Separated or divorced individuals who pay maintenance direct to their ex-spouse under a legally binding agreement qualify for a limited form of tax relief – often referred to as a '**maintenance allowance**' – provided that one or more of the parties reached 65 prior to 6 April 2000. This relief is set equal to the 'minimum' MCA that couples over 65 can receive (which is £2,070 restricted to 10 per cent for 2001-02). Individuals who make maintenance payments to a child, or to someone to whom they have not been married do not qualify for this relief. Tax relief is withdrawn if the ex-spouse who receives maintenance remarries.[17]

F. Summary table of the allowances

£

	1996-97	1997-98	1998-99	1999-00	2000-01	2001-02
Personal allowance	3,765	4,045	4,195	4,335	4,385	4,535
" (65 - 74)	4,910	5,220	5,410	5,720	5,790	5,990
" (75 & +)	5,090	5,400	5,600	5,980	6,050	6,260
CTC	-	-	-	-	-	5,200†
MCA (basic)	1,790*	1,830*	1,900*	1,970*	Withdrawn	Withdrawn
MCA (65 - 74)††	3,115*	3,185*	3,305*	5,125*	5,185*	5,365*
MCA (75 & +)	3,155*	3,225*	3,345*	5,195*	5,255*	5,435*
Income limit	15,200	15,600	16,200	16,800	17,000	17,600
BPA	1,250	1,280	1,300	1,380	1,400	1,450

† Relief restricted to 10 per cent for 2001-02

†† For 2000-01 and 2001-02, the MCA is only given to couples in which at least one partner was born before 6 April 1935.

* Relief restricted to 15 per cent for the tax years 1996-97 to 1998-99, and to 10 per cent for 1999-2000 to 2001-02.

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17 This relief is also given to those paying maintenance under arrangements set up before 15 March 1988, who benefited from transitional relief withdrawn in April 2000. Again, relief is only given if one or more of the parties reached 65 prior to 6 April 2000.

III Fringe benefits: company cars & free fuel

Generally individuals are taxed on the cash value of any fringe benefit they enjoy by virtue of their employment.[18] Special rules apply in evaluating the cash value of a company car, and free fuel provided for private motoring in a company car. Tax is charged on 35% of the list price of a company car, with discounts for business mileage and older cars. A new system for taxing the benefit of a company car will come into operation from *April 2002*. It will charge tax on a percentage of the car's price, graduated according to the level of the vehicle's carbon dioxide emissions.

For free fuel, individuals pay a fixed charge dependent on the engine size of the car they use. In the March 1998 Budget it was announced that this charge would be increased by 20 per cent over and above the usual increases in line with pump prices each year for the following five years. The scale charges for free fuel for 2001-02 are given below:[19]

PETROL CARS		DIESEL CARS	
Engine size cc	**Scale charge**	**Engine size cc**	**Scale charge**
0 – 1,400	**£1,930**	**0 – 2,000**	**£2,460**
1,400 – 2,000	**£2,460**	**2,001 +**	**£3,620**
2,001 +	**£3,620**		

IV Pensions

The pension scheme earnings cap is increased in line with inflation by £3,600 to £95,400 for 2001-02. This is the maximum earnings from which contributions to a personal or occupational pension scheme can attract tax relief. The earnings cap generally applies to people who contribute to a personal pension scheme, joined an occupational scheme set up since 14 March 1989, or joined any occupational scheme from 1 June 1989 which was set up before 14 March 1989. From 6 April 2001 the cap will apply to people who contribute to stakeholder pension schemes.

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18 The cash value is added to their taxable income, and taxed accordingly; ie, taxed at the same rate as the rest of their income (ie 22% or 40% depending on their circumstances). Benefits in kind are taxed if the person receiving them is a director, or an employee who earns £8,500 or more per year.

19 As fuel prices have recently fallen, the actual increase of these charges is 14%. The scale charge for cars without a cylinder capacity is £3,620 for 2001-02.

V Charities

There is no general tax exemption or relief granted to taxpayers who make gifts to charities. Tax relief is provided through two schemes which cover regular donations made out of one's salary (Payroll Giving), and one-off cash gifts (Gift Aid).

Under the Payroll Giving scheme charitable donations are wholly deductible for income tax purposes, the relief being given through the PAYE system. The employer deducts the appropriate sum from a participating employee's pay, and passes it to an agency who distributes it to the charity or charities of the employee's choice. There are no minimum or maximum limits for donations under the scheme (a maximum limit of £1,200 a year applied prior to 6 April 2000).[20]

Gift Aid allows income tax relief for single donations by individuals. When this relief was introduced in 1990, a minimum limit on donations was set at £600. Tax relief applies to a donation of any size, following the abolition of the minimum limit of £250 from 6 April 2000.[21] Tax relief for donations under a deed of covenant is no longer given, as the abolition of the Gift Aid minimum limit made this method of tax-privileged donation redundant.

VI Capital gains tax

Capital gains tax (CGT) is charged on gains in excess of the annual exempt amount, which is increased in line with statutory indexation to £7,500 for 2001-02. Individuals may realise gains up to this threshold free of tax. For tax purposes, capital gains are treated as the top slice of income. The rates of CGT are the same as the rates of tax on savings income. For 2001-02 gains below the starting rate threshold of £1,880 are taxed at 10%. Gains between the starting rate threshold and basic rate threshold of £29,400 are taxed at 20%, and gains above this are taxed at 40%. Chargeable gains are tapered according to the length of time an asset has been held; the taper is more generous for business assets than non-business assets.[22]

VII Inheritance tax

Inheritance tax is levied on the value of a person's estate at the time of their death. Most large gifts made out of someone's estate within seven years of their death are treated as part of their estate for tax. The tax is charged at 40% above the tax-free threshold. The threshold is increased in line with inflation by £8,000 to £242,000 for 2001-02.

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[20] Further information is on the Revenue's site at: www.inlandrevenue.gov.uk/payrollgiving/index.htm

[21] Details are given in the Inland Revenue leaflet, *Giving to charity by individuals IR65*, September 2000 The leaflet is published on the Revenue's site at: www.inlandrevenue.gov.uk/pdfs/ir65.pdf

[22] The operation of the tax is relatively complex. A introductory guide is published by the Revenue: *Capital Gains Tax CGT1*, February 2001, available at: www.inlandrevenue.gov.uk/pdfs/cgt1.pdf

Appendix: The children's tax credit from April 2002 ("the baby credit")

In his Budget speech on 7 March 2001 the Chancellor Gordon Brown confirmed that the new children's tax credit to be introduced from 6 April 2001 would be set at £5,200 restricted to 10%.[23] He also proposed that an extra credit would be added in April 2002, to cover just the first year of a child's life:

> For the first year of a child's life, I propose a further innovation. From April next year, for families with new-born children, the children's tax credit will be set at an even higher level and paid up the income scale to all households where the main earner earns up to £50,000 a year. I propose to set this children's credit at over £1,000 a year, worth £20 a week, and I will ensure that this £1,000 baby credit will be continued, and it will be paid to the mother when the new integrated child credit comes in, in 2003.[24]

The credit would be set at £1,040 from April 2002.[25] On the assumption this one year credit was tapered in a similar fashion to the CTC, and that both the personal tax allowance and the higher rate threshold were increased in line with inflation for 2002-03, entitlement to the credit would be exhausted for claimants on an income above £50,220.[26]

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[23] Initially, it was envisaged the credit would be £4,160, restricted to 10% (ie, a credit of £416), though in the March 2000 Budget it was proposed the CTC would be £442, and in his Pre-Budget Statement on 8 November 2000, the Chancellor announced that it was his aim to increase the credit to £520.

[24] HC Deb 7 March 2001 c 305 The Government issued a consultation paper on the introduction of a single new tax credit for families with children from 2003 in March 2000, and intends publishing further details in summer 2001 (*Budget 2001* HC 279, March 2001 p 84).

[25] ie, £10,400 restricted to 10%

[26] RPI to September 2001 is estimated to be 1.75% (HC 279 p 186). On these assumptions, individuals would become liable to pay tax at the higher rate on income above £34,620 (£4,620 + £30,000). The credit would be exhausted at (15 x 1,040) + 34,620.