ROYAL LONDON

DECODING YOUR TAX CODE

Are you paying the right amount of tax?

INTRODUCTION

If you receive a wage or a pension, your employer or pension provider is required to deduct any income tax due before the payment is made. They do this on the basis of a 'tax code' issued to them by HM Revenue and Customs (HMRC). But how do you know if your tax code is correct?

If your tax code is incorrect, you could be paying the wrong amount of tax. And there is reason to believe that many people who are being over-taxed are unaware of this because they do not understand what their tax code is or how it is worked out.

The purpose of this guide is to 'de-code' the mysteries of your tax code. We aim to explain what your tax code means so that you can check if it is correct and, if not, get things sorted out.

We start by explaining the basic features of the income tax system before going into more detail about what tax codes mean. We then give a real-life example of someone who has recently started drawing a company pension and is currently being overtaxed by HMRC because she has the wrong tax code. Finally, we explain what you can do if you think your tax code is wrong.

We would stress that, for those with higher incomes and more complex tax affairs, a short guide cannot do justice to the hundreds of pages of legislation around income tax. The focus of this guide is on those on more modest incomes who may not have access to accountants or tax advisers but who may nonetheless need help to ensure that they are paying the right amount of tax.

1. THE BASICS OF INCOME TAX

Tax years run from 6th April one year to 5th April the next. The basic idea of income tax is that HMRC looks at your different sources of taxable income over the course of a tax year and, if your total taxable income is above a minimum level, seeks to collect income tax from you. If you are an employed earner or receiving a pension payment, tax is usually deducted 'at source' – that is, before you get your pay or pension. Taxable income includes things like wages, pensions and income from property, savings and investments.

For people with simple financial affairs – for example a single job and no other taxable income – the system will generally ensure that you pay the right amount of tax with no further form-filling on your part. But if you are self-employed, a higher earner or have more complex financial affairs, you will often have to fill in a 'self-assessment' tax return. This gathers information about your income from different sources, looks at the tax you have actually paid and compares this with the tax you should have paid, and makes an appropriate adjustment.

In 2020-21, each individual is allowed £12,500 of taxable income before they have to pay any income tax[1]. So, if you have less than £12,500 of income from wages, pensions, savings, property and so on, you should be a non-taxpayer. If you are in this position but have a payslip or pension statement which shows that tax has been deducted, then this guide will show you how to check if this is correct or not.

For tax purposes people are generally treated as separate individuals. In previous decades, married couples were taxed together on the basis of their joint income. But since 1990 people have been taxed on the basis of their individual income. The main exception to this is that there are certain tax-free allowances available to some married couples and civil partners. See page 6 for a description of which couples qualify for such allowances.

For those with taxable income in excess of the tax-free personal allowance, income tax is levied on each slice of your income according to the following schedule:

Table 1 - Income tax rates and bands 2020-21 in England, Wales and Northern Ireland[2]

Band of taxable income (£ pa)	Income tax rate
£0 - £12,500	Nil
£12,501 - £50,000	20% (the 'basic rate')
£50,001-£150,000	40% (the 'higher rate')
£150,001 and above	45% (the 'additional rate')

[1]Note that for individuals with income of £100,000 per year or more, this tax-free personal allowance is progressively reduced so that by the time you earn £125,000 you'll pay income tax on everything you earn and get no tax-free personal allowance.

[2]Different bands of taxable income apply in Scotland. For details of Scottish income tax see https://www.gov.scot/publications/scottish-income-tax-2020-2021.

To give an example, if someone has an income of £71,500 per year, the first £12,500 attracts no tax. The next £37,500 is taxed at 20% and the remaining £21,500 is taxed at 40%. The total tax bill would therefore be:

£12,500 @ 0%	=Nil
Plus £37,500 @ 20%	= £7,500
Plus £21,500 @ 40%	= £8,600
Total Tax Bill	£16,100

Tax allowances for married couples and members of civil partnerships

There are two groups of married couples who may qualify for additional tax-free allowances:

a) The 'Married Couples Allowance' (for older couples)

A general tax allowance for married couples was abolished from 6th April 2000. However, those who were already aged 65 or over at that point (i.e. born before 6th April 1935) continued to receive this allowance. In 2020/21 recipients are entitled to a reduction in their tax bill of up to 10% of £9,075 or £907.50. However, if your income is above a certain limit, married couple's allowance is reduced by £1 for every £2 of additional income[3]. More details can be found at: https://www.gov.uk/married-couples-allowance

b) The 'Marriage Allowance'

A new tax allowance for certain married couples was introduced on 6th April 2015. This is known as the 'Marriage Allowance' and is designed for married couples and civil partners where one partner is on a low income and is not using up all of their personal tax-free allowance. Under the terms of the 'Marriage Allowance', the lower earning partner can transfer £1,250 of unused personal allowance to the other partner, provided that the other partner is a basic rate taxpayer[4]. The recipient thereby saves 20% of £1,250 or £250 per year. More information can be found here: https://www.gov.uk/marriage-allowance/how-it-works. Take-up of this allowance has been lower than expected and there may be many couples who are entitled to benefit from it but who do not claim it. Note that you cannot claim both of these allowances. If you are entitled to the Married Couple's Allowance, then you cannot claim the Marriage Allowance.

[3]Source: https://www.which.co.uk/money/tax/income-tax/income-tax-on-your-pension/married-couples-allowance-aq4kl8t76p7r#headline_2

[4]In Scotland, your partner must pay tax at the starter, basic or intermediate rate.

2. HOW DO TAX CODES WORK?

The aim of HMRC is to collect the right amount of tax for the majority of people over the course of the year. It does this using the 'Pay-as-you-earn' or PAYE system. The basic idea is that when wages or pensions are paid, the employer or pension provider deducts tax at the levels set by Parliament using a tax code calculated by HMRC. Provided that HMRC has all the information it needs when it sends the employer a tax code, this should result in the right amount of tax being deducted over the course of the year.

How do I find out my tax code?

There are various places in which you may see your tax code. One is on any payslip you receive from an employer or pension provider. Note that you may have different tax codes for each employment / pension. Another place to look is on an annual 'notice of coding' from HMRC. This is a statement which sets out your tax code for the coming year (or any changes in your tax code) and provides an explanation of how it was worked out. If you have registered with HMRC for an online tax account, you should be able to see your tax coding notices online.

For more information about checking your tax code see: https://www.litrg.org.uk/tax-guides/employment/how-do-i-check-my-coding-notice

In the simplest case, an individual will have a tax code based around the full tax-free personal allowance of £12,500 per year. HMRC knocks off the final digit and adds a letter code to give information to employers about how much tax to deduct. The most common tax code in 2020/21 will be 1250L. The letter L tells the employer to charge tax at the basic, higher or additional rate depending on an individual's income.

If everyone's tax affairs were straightforward, everyone would have a tax code of 1250L and everyone would pay the right amount of tax each year without the need for end-year adjustments, filling in tax returns etc. However, as we see in the next section, life is rarely that simple.

2. HOW DO TAX CODES WORK?

Why is my tax code not 1250L?

There are many reasons why you may have a different tax code. The following are the main reasons:

a) You have multiple sources of taxable income

If you have more than one source of taxable income – for example, two wages or a wage and a company pension – you will have a tax code for each income source. HMRC will generally set your tax-free allowance against your main source of income. If that source of income exhausts your tax-free allowance then you have to pay tax on the whole of your other source of income.
To give an example, suppose you have a job paying £20,000 per year and a company pension paying £5,000 per year. For your job, your employer would probably be issued with a tax code of 1250L, thereby allocating your personal allowance to your main taxable income source. Because your wage is over £12,500, you have used up all of your tax-free allowance. This means that you have to pay income tax on the whole of your occupational pension income. HMRC would therefore issue a tax code of BR to your pension scheme, telling them to apply income tax at a rate of 20% on the whole of your pension payment.

Another common example would be someone who is drawing a state pension and a company pension, both of which are subject to income tax. Let us suppose you are entitled to a state pension of £8,000 per year and a company pension of £5,000 per year. In this situation, you have £13,000 of taxable income and a tax-free personal allowance of £12,500. You should therefore be paying tax on £500 per year at 20%, or £100 in tax. The question is, how does HMRC collect that £100? In general, state pensions are paid gross – that is, without the deduction of tax. So the £100 has to be collected via your company pension. If your company pension provider applied a basic tax code of 1250L, then it would deduct no tax from your company pension (because it is under £12,500 per year). But this means that you would end up paying no tax. So instead, HMRC deducts the value of your state pension - £8,000 – from the tax code that is sent to your company pension provider. Your tax code in this case would therefore not be 1250L but 450L – effectively you have £4,500 per year remaining of your tax-free personal allowance, and the company pension provider should tax you at the basic rate on anything above that.

b) You live in Scotland

Tax bands in Scotland are different to those in the rest of the UK. A letter 'S' before your tax code reminds your employer to apply the tax bands for Scotland to your taxable income for example S1250L.

c) You have under-paid tax from a previous year

In some cases, an individual may find that they have not paid the correct amount of tax in any given tax year. This sometimes becomes apparent if they fill in an annual tax return or perhaps a new source of income has kicked in without HMRC being aware of it. Where they have paid too much tax, most people will ask for an immediate refund, but where they have paid too little tax, HMRC will sometimes collect the under-paid tax gradually over the course of a year. They do this by reducing your tax code. This means that more of your income is taxed in the current year than would normally be the case and this makes up for the fact that you under-paid tax in a previous year.

To give an example, suppose that you are a basic rate taxpayer and you have underpaid income tax by £200 in a given year. Rather than write HMRC a cheque, you ask it to collect the money through your tax code the following year. HMRC works out that if it reduces your tax-free personal allowance by £1,000 for the following year this means an extra £1,000 will be taxed at 20%, increasing your tax bill by £200. So instead of giving you a tax code of 1250L (reflecting a tax-free allowance of £12,500) it gives you a tax code of 1150L (effectively giving you a tax-free allowance of only £11,500). This will enable it to claw back your underpayment over the course of the year.

d) You need to take account of other items which increase or reduce your tax bill

There are various things that mean you have to pay additional income tax and others which reduce your tax bill.

Very often these adjustments are made through your tax code so that you end up paying the right amount of tax.

i) Items which increase your tax bill

If you receive a taxable benefit-in-kind from your employer such as a company car or medical insurance, HMRC will make a tax charge. It can do this through your tax code. Remember that a large tax code is a good thing – because it means more of your income is exempt from tax. So if you have a taxable benefit in kind, HMRC will make a deduction from your tax code so that more tax can be collected each month. This means your tax code will no longer be the basic 1250L. Another example of something which can increase your tax bill is something called the 'High Income Child Benefit Charge'. In brief, if you are receiving Child Benefit and you or your partner has an income in excess of £50,000 per year, you will incur a tax charge which will offset some or all of the Child Benefit that you receive. The tax charge is levied on the higher earner of the couple, regardless of who actually receives the Child Benefit.

Those who are subject to the High Income Child Benefit Charge tax charge can ask for this 'clawback' of Child Benefit to be collected through their tax code. In this case, HMRC will reduce your tax code so that more tax is collected.

ii) Items which reduce your tax bill

The government seeks to encourage certain forms of activity by making them 'tax-deductible'. This means that the money you spend on them is taken off your income before your tax is worked out, thereby reducing your tax bill.

One good example of this is charitable giving. In general, donations made to registered charities are fully tax-deductible. For people who pay tax at the basic rate what happens is that you make your donation to the charity and then the charity claims back the tax relief from HMRC. So, for example, if you want a charity to receive £100, you can pay them £80 and they claim £20 in tax relief from the government. This is equal to the basic rate tax you would have paid if you had earned £100.

However, for higher rate taxpayers this does not deliver the full amount of tax relief. Someone paying higher rate tax who earns an extra £100 would normally pay £40 in income tax. If they pay the money to charity instead, then their tax bill should go down by £40. The charity can claim the basic rate of tax relief, £20, on the donation, but the extra tax relief to which you are entitled as a higher rate taxpayer, the further £20, has to be claimed by the donor from HMRC, usually through an annual tax return. Assuming that the giving is on a regular basis, HMRC will then make an addition to your tax code to reflect the fact that you are entitled to extra tax relief.

e) You have more than used up your personal allowance with other deductions

As noted above, although everyone starts with a tax-free personal allowance of £12,500 per year, various adjustments can be made which can raise or lower that starting figure. In some cases, the total of those adjustments is so large that it more than wipes out the £12,500 and people have – in effect – a negative personal allowance.

To give an example, suppose that your starting personal allowance is £12,500 but that you owe underpaid tax from a previous year, you have taxable benefits such as a company car, you are subject to the High Income Child Benefit Charge tax charge and so forth, and that the combined effect of this would be to reduce your tax free amount by £13,500. In this case, HMRC would issue your employer with a tax code which starts with the letter 'K'. That code tells your employer not only that you aren't entitled to any tax-free income, but that it should notionally*add* £1,000 per year to your taxable income before it works out your income tax. With K codes, a higher code is bad news, unlike the other ones we've been talking about.

Why does my tax code have W1 or M1 after it?

There are two ways in which HMRC collects tax over the course of the year – 'cumulatively' and 'non-cumulatively'.

For most people, their tax is worked out 'cumulatively'. This means that, for example, in month 2 of a financial year, your employer will not look just at your income and tax code in that month, it will look at your cumulative income and cumulative tax paid for the year to date. The advantage of this is that if you have unused personal allowances in any given week or month, they are rolled over to future weeks. This could happen if, for example, your pay level fluctuates and in some periods you earn below the tax threshold.

However, if your tax code has the letters W1 (week 1) or M1 (month 1) in it, this means that you are being taxed 'non-cumulatively' or on an 'emergency' basis. In simple terms, this means that your employer is looking at the current pay period only, and not taking account of any tax you may have paid earlier in the year. The disadvantage of this is that if you have *unused* tax

2. HOW DO TAX CODES WORK?

allowances in the current period these cannot be carried over into a future pay period. This may mean that you have paid the wrong amount of tax for the year as a whole and this may need to be adjusted at year-end.

When you start a new job your new employer may tax you on an 'emergency' basis while they obtain details of your earnings and tax from a previous job. Once it has this information it will usually be possible to move you on to a more normal tax code and any under- or over-deduction of tax will be adjusted by your employer in the next pay period.

Tax codes decoded – a summary

What does my tax code mean?[5]

HMRC takes your annual tax-free personal allowance (£12,500 in 2019-20), knock off the final digit, and adds a letter code.

The main letter codes used are:

BR [basic rate] – tells your employer to deduct 20% tax on all income

D0 – tells your employer to deduct 40% tax on all income

D1 – tells your employer to deduct 45% tax on all income

K at the start of your tax code – tells your employer to add this amount to your taxable pay as you have no remaining tax-free personal allowance

L – tells you employer to deduct tax at the basic, higher and additional rate on the amount of taxable income once your tax-free allowance has been deducted

M – means you have received a transfer of 10% of your partner's personal allowance

N – means you have transferred 10% of your personal allowance to your partner

NT – means you are not paying any tax on this income

S at the start of your tax code – tells your employer to deduct tax based on the tax bands applicable in Scotland

T – your tax code includes other calculations to work out your personal allowance; for example, this could be because your estimated annual income is more than £100,000

0T – your personal allowance has been used up, or you've started a new job and your new employer didn't have the details to give you a tax code

[5]Source: https://www.gov.uk/tax-codes

3. AN EXAMPLE – SOMEONE WHO IS BEING OVER-TAXED

The following example is based on a real case of someone who was over-taxed by HMRC. The payslips are for the financial year 2016/17 when the annual tax-free allowance was £11,000 per year.

Mary works part-time and earns £7,800 per year. As this is under the tax-free personal allowance of £11,000 she pays no tax. The following is her payslip from her employment (with personal details removed) which shows that she is correctly paying no tax on her wages.

RE-ORDER CODE SE 95 © N.C. 07/97

Company

Pay Advice

Department -

Description	Hours	Rate	Amount
Basic	1.00	650.0000	650.00

Payment Method - BACS

Description	Amount
PAYE Tax	0.00
National Insurance	0.00

Payment Period - Monthly

Description	Amount
Total Gross Pay TD	7800.00
Gross for Tax TD	7800.00
Tax paid TD	0.00
Earnings For NI TD	7800.00
National Insurance TD	0.00
Earnings for NI	650.00
Gross for Tax	650.00
Total Gross Pay	650.00
Nat. Insurance No	

Wk./Mth.	Date	Dept.	P/Method	Tax Code	Employee No.	Employee Name	Nett Pay
12	25/03/2017			1077L	2		650.00

3. AN EXAMPLE – SOMEONE WHO IS BEING OVER-TAXED

Mary had started drawing a small occupational pension of £1,137 per year or £94.79 per month. As her total income from both sources was under £11,000 she should not pay any tax. But this is the payslip that she received:

Payment Date	28/02/2017
Tax Period	11
Tax Code	0T
NI Number	

Pensioner Payroll

Payroll Ref

Payments		Deductions		Totals to Date	
Pension	94.79	Tax	18.80	Earnings to date	94.79
				Taxable Pay to date	94.79
				Tax to date	18.80
Total Payments	94.79	Total Deductions	18.80	**Net Payment**	**75.99**

HMRC incorrectly issued the pension provider with a tax code of 0T which means no allowances were given and tax was applied to the whole of Mary's occupational pension. This meant that she would lose a fifth of her pension, or over £225 per year unless this was corrected.

4. HOW TO CHECK IF YOU ARE PAYING THE RIGHT AMOUNT OF TAX, AND WHAT TO DO IF YOUR TAX CODE IS WRONG

HMRC offers an online service which allows you to check if you are paying the right amount of tax which can be found here:

https://www.gov.uk/check-income-tax-current-year

Note that you will need to sign up for a 'Government gateway' account to use this service.

If you would prefer not to use this service, the following steps can help you to assess whether you are paying the right amount of income tax[6].

Step 1 - Add up all of your taxable income from all sources for the whole of the tax year, which runs from 6th April to the following 5th April.

Taxable income includes things like earnings from employment and self-employment, state pensions, private pensions and income from property. Add the value of any taxable 'benefits in kind' from your employer such as company cars and so on. Also add the value of any Child Benefit which is to be clawed back through the High Income Child Benefit Charge. The tax treatment of savings is quite complex but is summarised below.

How is income from savings taxed?

The majority of people pay no tax on their savings income. Since April 2016 there has been a 'personal savings allowance' which allows basic rate taxpayers to receive £1,000 per year (and higher rate taxpayers £500 per year) tax-free in income from savings or interest. You only pay tax at your normal tax rate on any savings income in excess of these limits.

In addition, income from Individual Savings Accounts (ISAs) does not count because it is already tax-free.

Furthermore, a special 0% tax band applies on the first slice of your savings income – up to £5,000 in 2020/21. This means that if your total taxable income is less than £18,500 per year (£12,500 personal allowance plus £5,000 zero rate band plus £1,000 personal savings allowance) you are not liable to pay any tax on your savings income.

Note, however, that even though the interest is not taxed, nevertheless it is added to your total taxable income and may push you into the next tax band. For example someone with £49,500 of taxable income and therefore a basic rate taxpayer may receive savings interest of, say, £1,000 which propels him to total income of £50,500 and therefore a higher rate taxpayer with a reduced personal savings allowance of £500.

[6] Inevitably this is a simplified version of the process, as UK tax law runs to many thousands of pages, but it is designed to give you a sense of whether you are paying roughly the right amount of tax or if you need to seek further clarification.

4. HOW TO CHECK IF YOU ARE PAYING THE RIGHT AMOUNT OF TAX, AND WHAT TO DO IF YOUR TAX CODE IS WRONG

Step 2 - Deduct other tax-deductible items.

If you have any other expense items which can be deducted from your taxable income, they should be deducted at this stage.

Step 3 - Apply the tax bands and rates as shown in Table 1, page 3 of this guide.

The first £12,500 of your annual income is tax free, and the balance of your taxable income being taxed first at 20%, then 40% and then 45%.

Step 4 - Add on any under-paid tax from previous years which is being collected through your tax code this year.

If the total tax due from this calculation is less than the amount of tax you are actually paying, you may be paying too much tax.

If you think you may be paying too much tax, you can contact HMRC.

You can phone on 0300 200 3300

or you can write to HMRC at:

HM Revenue & Customs
Pay As You Earn and SA
BX9 1AS

If you think that your tax code is incorrect and want to alert HMRC, there is information here on how to do this: https://www.gov.uk/tax-codes/updating-tax-code

5. HOW MANY PEOPLE MIGHT BE AFFECTED?

For those who submit an annual tax return, HMRC should be in a position to check whether the right amount of tax has been paid and to make adjustments up or down if it has not. But the majority of taxpayers do not file a tax return. In 2019/20 HMRC estimated that there were around 31 million taxpayers[7], and only around 11 million[8] of these complete a self-assessment tax return. This means that for the remaining 20 million, if the PAYE system is not working correctly, incorrect tax may be paid and this may not be picked up.

One group at greater risk is those with multiple sources of taxable income, such as those with a combination of wages and pension income.

Royal London estimates that there are over 800,000[9] people under state pension age who are drawing an occupational pension and who have total taxable income under the tax threshold. They should not be paying income tax. If any of these people is having tax withdrawn from their pension payment, they should check this with HMRC.

[7]Source: https://www.gov.uk/government/statistics/number-of-individual-income-taxpayers-by-marginal-rate-gender-and-age

[8]Source: https://www.gov.uk/government/news/record-breaking-104-million-customers-filed-online

[9]Source: https://www.royallondon.com/media/press-releases/press-releases-2017/april/800000-people-at-risk-of-being-over-taxed-on-their-pensions---steve-webb-royal-london/

6. USEFUL CONTACT DETAILS

Useful information about how the tax system works and free support for older taxpayers on modest incomes is offered by the charity Tax Help for Older People whose website is: http://www.taxvol.org.uk/ or telephone 01308 488066.

The charity was original set up by the campaigning organisation, the Low Income Tax Reform Group whose website (www.litrg.org.uk) contains useful information.

For general information about how the tax system works, it is always worth starting at the main government website – www.gov.uk.

If you think you may be entitled to a tax refund, it is always worth dealing directly with HMRC, and you should be wary of using claims companies who may charge a high proportion of the overpaid tax that you are owed.

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All details in this guide were correct at the time of updating in April 2020

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