COLLEGE OF ACCOUNTING

TAXATION | BASIC

Video Transctiption: Introduction to Income Tax for Individuals

Hi, I'm Shaun Parsons, and in this video I'm going to give you an overview of the income tax calculation for individuals. As you explore each of the complexities of this calculation in greater detail it is possible to be overwhelmed by the number of topics that you have to cover, or by the level of detail in each topic. For this reason it is important to keep coming back to this overview to remind yourself of where each topic fits into the bigger picture, and what the end goal of the calculation is.

Income tax is often referred to as an annual event, which means that taxable income is calculated once a year, and includes all for the tax consequences of the transactions occurring in that year. An individual's year of assessment begins on 1 March, and ends on the last day of February, of the following calendar year.

The only times when an individual's year of assessment is less than a full 12 months is when they are born, when they die, if they emigrate, or if their estate is sequestrated.

The calculation of an individual's taxable income begins with their gross income. Gross income would include the salary that they earn from their job, the turnover of the business they run, the rent they receive, or the income they earn on their investments, i.e interest and dividends. Amounts included in gross income that are exempt from income tax must be removed from the calculation.

There are a number of reasons why an amount included in gross income may be exempt from tax. For example, most South African dividends are exempt from tax because they are paid out of the after-tax income of the company declaring the dividend. Since the company's income has already been subject to income tax, the amount of the dividend should not be subject to income tax, again in the hands of the individual, and is therefore exempt.

Interest received by an individual is exempt up to a certain maximum limit. This exemption encourages individuals to save money, which allows them to be prepared for their retirement or for unexpected events, which reduces the likelihood that they will become dependent on the state for support.

Once we have reduced our gross income by the income that is exempt, what we are left with is called income. It is important to remember that when we use the term income in the context of income tax it is has a very specific meaning. We are not referring in general terms to what a person has earned, but specifically to an individual's gross income minus their exempt income.

An individual's income is then reduced by their deductible expenditure. With very limited exceptions, an individual may only deduct expenditure that has been incurred during the course of his or her trades. Trades are activities that they have undertaken with the goal of generating income. For example, owning a shop or painting houses are both trades and so is earning a salary. So the shop owner can deduct the cost of the trading stock that she sells, and the painter can deduct the cost of his paint. The employee, who earns a salary, is allowed very few deductions since he is unlikely to incur much expenditure in the course of his employment. The rules governing the deduction of expenditure are mostly contained in section 11 of the Income Tax Act.

An individual's income is also reduced by any capital allowances they are allowed to claim. Capital allowances refer to expenditure incurred to acquire capital assets used to produce income, such as manufacturing machines or delivery vehicles. Taxpayers are allowed to deduct this expenditure over time, reflecting the fact that although the expenditure is in respect of a capital asset, the asset is being consumed over time, as income is generated.

The concept of capital allowances is similar to that of depreciation, but it is important to recognise that income tax takes a rule-based rather than principle-based approach. A taxpayer is only allowed to claim a capital allowance if a specific section allows a deduction, and the amount of the allowance must be determined, in terms of the rules of that section.

It is also important to note that the deductions that a taxpayer may claim are sometimes limited by section 23. For example, section 23 prohibits the deduction of any fine arising from any unlawful activity, even if that activity was part of the taxpayer's trade. So the student delivering pizzas cannot deduct the traffic fines they incurred while making deliveries, even though they will be taxed on the money they make from delivering those pizzas.

An individual may reduce the amount of their taxable income in the current year of assessment by the balance of any assessed loss carried forward from the previous year of assessment, and so any assessed loss from the prior year must be brought into the calculation. An assessed loss occurs when a taxpayer's allowable deductions in a year of assessment is greater than their income.

Next, an individual must include the taxable portion of their capital gains arising during the year. Remember, almost every deduction that an individual is allowed to claim has to have been incurred in the course of a trade that generates income that will be subject to tax. There are, however, a limited number of exceptions to this. The first is the amounts contributed to a pension, provident or retirement fund. These contributions are probably made from income that is subject to income tax, but did not give rise to that income.

However, they are deductible because the individual will be subject to tax on the annuity or lump sum pension payout they receive when they retire. The deduction allowed when the contributions are made, delays the effect of income tax on these amounts until they are received during retirement. This deduction also encourages people to save for their retirement, as it allows them to reduce their current taxable income. The amount of the pension contributions that an individual may deduct is limited by the rules provided in section 11(k).

An individual is also allowed to claim a deduction for donations made during the year, but only for donations to charities (or public benefit organisations) involved in a limited number of activities listed in the Income Tax Act. This is also not expenditure that gave rise to any amounts included in income, but is allowed as deduction in order to encourage donations to these charities.

The deduction that the individual is allowed to claim is limited to 10% of their taxable income prior to this deduction, so it is important to bring in this deduction at the end of the income tax calculation. The result of this calculation is referred to as the individual's taxable income for the year of assessment, and it is on this taxable income that their income tax will be determined.

Unlike companies, individuals are taxed progressively, which means the more they earn, the higher the proportion of their income will have to be paid in income tax. An individual's income tax for the year is calculated using the tax table for individuals, which is revised each year. The individual must first locate where they fall on the table, based on their taxable income. This is referred to as their tax bracket. Each tax bracket provides the tax on the lower limit of the tax bracket as well as the marginal tax rate for that bracket, which is the rate at which any taxable income above the lower limit of the tax bracket will be taxed.

For example, a taxpayer with taxable income of R200 000 will fall into the second tax bracket, applicable to people earning between R181 900 and R284 100. This means the taxpayer will owe R32 742 plus a marginal rate of 26% on the difference between the R200 000 (his taxable income) and R181 900 (the lower limit of the second tax bracket).

An individual may then reduce his tax for the year by a number of rebates. A rebate is different from a deduction, because it reduces the individual's income tax for the year, rather than their taxable income. The first rebate is available to all individuals, and is based on the individual's age. All individuals qualify for the primary rebate. The amount of the rebate is increased if the individual is 65 years or older at the end of the year of assessment, and this is increased further if the taxpayer is 75 years or older. These two increases are known as the secondary and tertiary rebates.

The next available rebate is for medical aid contributions and is available only to individuals who belong to a medical aid. The amount by which their income tax is reduced depends on the number of months for which they belonged to a medical aid, and the number of dependants covered by their medical aid. These dependants are usually their spouse (i.e their husband or wife) and children.

The individual may also claim a rebate in respect of medical expenditure that they have actually incurred. This rebate is available whether they belong to a medical aid or not, although if they belong to a medical aid it is only available in respect of costs not paid for or refunded by their medical aid. They are only allowed to claim the rebate if the amount of medical expenditure exceeds specified limits. These limits are set higher for individuals younger than 65 and lower for individuals 65 or older, since medical expenditure typically increases with age.

Lastly, an individual may claim a rebate for any taxes that they have already been charged in another country, on amounts that have been included in their South African taxable income.

The final result is the individual's income tax for the year of assessment. This is reduced by any amounts of income tax that they have already paid in the form of employees' tax or provisional tax, and the remaining amount must either be paid to SARS or refunded by SARS.

This video refers to a number of topics covered in other videos, such as the distinction between capital and revenue, the deductibility of expenditure, assessed losses and capital gains, as well as employees' tax and provisional tax. We recommend that you watch these videos to ensure that you understand all the relevant concepts.

I hope you find this introduction helpful as you explore these topics further.

Thanks for watching.