MGP (Employee Benefits) Limited
16 The Courtyard, Common Lane,
Culcheth, Warrington WA3 4HA
Tel: 01925 765821
Fax: 01925 764871
Web: www.mgpeb.co.uk
Email: enquiries@mgpeb.co.uk

Do you fall into the 60% tax trap?

Making additional pension contributions could mean lowering your effective tax rate

For many earners in England, Wales or Northern Ireland, the highest Income Tax rate is 45%. However, while 45% is the highest 'official' rate, some individuals effectively pay a tax rate of 60% on part of their income. This phenomenon, commonly called the '60% tax trap,' affects those earning over £100,000 and applies to their income between £100,000 and £125,140.

To understand why this is the case, it is essential to grasp how Income Tax is structured and why the treatment of tax-free personal allowances is so significant. In this discussion, we will break down the mechanics of this trap and explore how pension contributions can effectively manage it.

HOW IS INCOME TAX CALCULATED?

Most individuals in the UK are entitled to a standard personal allowance of £12,570 each year, which represents the portion of their annual income that is exempt from tax. However, for higher earners, this allowance gradually decreases once their income surpasses £100,000.

For every £2 earned over the £100,000 threshold, the personal allowance decreases by £1. Once your income reaches £125,140 or more, the personal allowance is entirely eliminated. This tapering mechanism imposes a significant financial burden by subjecting income within this range to an effective tax rate of 60%.

IMPACT ON HIGHER EARNERS

For those earning between £100,000, the tapering of the personal allowance leads to an effective tax rate on income between £100,000 and £125,140, which is considerably higher than the standard rates. For instance, consider an individual earning £110,000—£10,000 above the £100,000 threshold. They would incur £4000 in tax on this portion of income (at 40%), in addition to an extra £2,000 due to the loss of the personal allowance. The total tax of £6,000 on £10,000 equates to a 60% effective tax rate.

The situation is even more pronounced in Scotland, where the Advanced tax rate applies. Here, taxpayers within this band face an effective rate of 67.5% due to the increased tax rates on the lost personal allowance.

ROLE OF PENSION CONTRIBUTIONS

Fortunately, there is a fairly straightforward strategy to alleviate the effects of the 60% tax trap: making pension contributions. This method enables individuals to reduce their adjusted net income, restore their personal allowance and thereby lower their effective rate of tax.

For example, a taxpayer earning £110,000 could make a gross pension contribution of £10,000. This would bring their adjusted net income down to £100,000, thus restoring the full personal allowance and resulting in a potential tax relief of 60% (or 67.5% in Scotland). In addition to the immediate tax benefits, this strategy boosts an individual's pension pot, which could lead to compounded investment growth over time.

THINGS TO CONSIDER WHEN CONTRIBUTING TO YOUR PENSION

It's important to note that tax-efficient pension contributions are capped each financial year by the pension annual allowance. For most individuals, the tax-efficient limit is the lower of £60,000 (less any employer contributions and plus any carry forward) or 100% of their relevant UK earnings. However, for high earners with an adjusted income exceeding £260,000, the pension annual allowance may be reduced.

If your contributions exceed the annual allowance, you may incur an annual allowance charge that effectively cancels out the tax relief on the excess contribution. There can be some variation on this. For example, if the 'scheme pays' system is used, the tax is paid out of the pension plan, or if they are employer contributions, corporation tax relief would still be kept. If you're uncertain about your allowance or worried about surpassing the limit, obtaining expert financial advice is crucial. ■

ARE YOU READY TO REFINE YOUR TAX PLANNING STRATEGY?

Understanding tax regulations, such as the 60% tax trap, can be overwhelming. The complexities of these rules, coupled with frequent changes to tax policies, make managing your financial planning challenging. We can assist you in staying informed, streamlining your tax strategy and designing a long-term plan that aligns with your financial goals. So, if you're worried about falling into the 60% tax trap or require professional advice to optimise your financial planning, please contact us.