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The 60% Tax Trap

How to make the most of your earnings

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What is the 60% Tax Trap?

Although it sounds ominous, the 60% - or 67.5%, if you live in Scotland – 'tax trap' for those earning between £100,000 and £125,140 per year is straight forward to navigate.

The reason why we refer to it as a trap is down to the subtlety of the spike in your effective Income Tax rate. The snare is down to a nuance which erodes your tax-free Personal Allowance by £1 for every £2 you earn over the £100,000 threshold.

While this income above £100,000 is already taxed at 40% (or 45% in Scotland), the gradual loss of your Personal Allowance means that potentially an additional £12,570 is also taxed at this Higher Rate tax banding.

So how does this work?

For example, if your total annual earnings are £120,000, you will pay the Higher Rate band of 40% on the £20,000 above the £100,000 threshold. Due to tapering, you will also lose £10,000 of your Personal Allowance (remember, £1 for every £2 above the threshold).

This £10,000 will then also be taxed at 40%, making your total tax liability for this portion £12,000 – or an equivalent rate of 60% on the £20,000 above the threshold. These figures are based on the Income Tax bands for England, Wales & Northern Ireland but the same theory applies to the Scottish tax bands, where the effective rate is 67.5%.

DAM good advice

The simplest way to avoid this punitive tax banding is to make contributions to your pension. Personal pension contributions push down your gross earnings, and therefore you will receive tax relief at your highest marginal rate.

Bear in mind there is Annual Allowance cap on what can be paid into your pension in each tax year. This is the lower of your UK relevant earnings or £60,000 but it is worth noting there may be tapering of this allowance if your adjusted net income exceeds £260,000.

If you would like to discuss your options, just reach out to your DAM consultant to arrange a call.