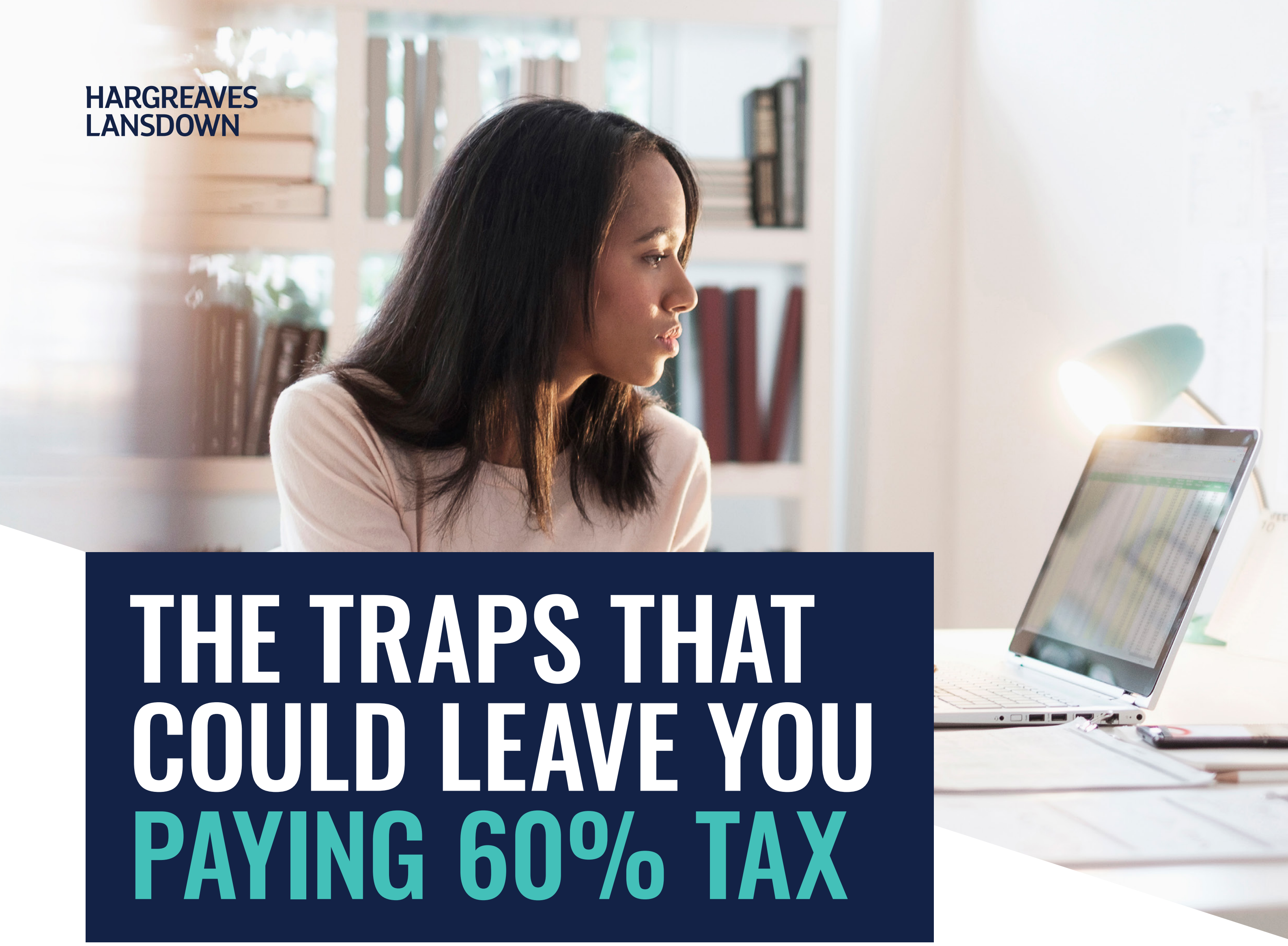

HARGREAVES LANSDOWN

THE TRAPS THAT COULD LEAVE YOU PAYING 60% TAX

Don't pay more tax than you need to.

ISABEL MCDOUGALL
Pensions writer

Most people think the highest rate of income tax in the UK is 45%.

But there are actually two situations where you could be paying much more, without even realising it.

A quirk in the UK tax system means that you could have to pay up to 60% effective tax rates on certain parts of your income. More people are affected than you might think. As soon as you start earning more than £50,000 you could be affected.

There's an easy way to avoid these traps while saving for retirement at the same time. In this factsheet we'll explain what to look out for.

Putting money in your pension could considerably reduce the tax you pay.

IMPORTANT INFORMATION:
This isn't personal advice. If you're not sure something is right for you, or you need help with financial planning decisions, please speak to a **financial adviser**. For help with complex taxation, please speak to an accountant. Pension and tax rules can change and benefits depend on personal circumstances. Scottish tax rates and bands are different and different benefits apply. Money in a pension isn't usually accessible until age 55 (57 from 2028). All information is correct at 17 February 2021 and relates to the 2020/2021 tax year.

The child benefit trap

Families where one person earns more than £50,000 a year face a tax charge of 1% of their child benefit for every £100 earned between £50,000 and £60,000.

Let's say you have two children and the higher earner earns £50,000 a year, you'll receive £1,855 in child benefit. If you earn £5,000 extra, this costs you £927, as well as £2,000 in income tax.

That's £2,927 in total, or an effective tax rate of just under 60%, **but what could you do about it?**

Making a personal contribution to a pension for your retirement reduces your income for tax purposes.

In the above example, making a £5,000 pension contribution could mean you don't pay the tax charge on your child benefit and you receive up to 40% tax relief on your contribution. Here's how:

- You make a £4,000 payment
- The government adds £1,000
- As a 40% taxpayer, you can claim back up to an extra £1,000 through your tax return
- This reduces the effective cost to as little as £2,000
- Your income is treated as if it's been reduced by £5,000 for the purpose of the child benefit tax charge.

Adding £5,000 to your pension effectively only costs you £3,000, and you'd also avoid a tax charge on any child benefit.

The personal allowance trap

If you earn under £100,000 per year, you'll benefit from an annual tax-free personal allowance of £12,500 this tax year. This means the first £12,500 of your income isn't taxed.

But once your income goes above £100,000, the tax-free personal allowance tapers away at a rate of £1 for every extra £2 you earn. This means your personal allowance is zero if you earn £125,000 or more.

If you're currently earning £100,000 and you get a £1,000 pay rise, not only will this cost you £400 in tax on the £1,000, but you'll lose £500 of your personal allowance. This means an extra £500 is now taxed at 40%, costing you another £200 in tax.

So, earning that extra £1,000 costs you £600 in tax. That's a 60% effective tax rate.

What could you do about it?

Again, pension contributions can help.

In the above example, making a £1,000 pension contribution can mean your personal allowance is reinstated and you also receive up to 40% tax relief on your contribution. Here's how:

- You make an £800 payment
- The government adds £200
- As a 40% taxpayer, you can claim back up to a further £200 through your tax return
- This reduces the effective cost to as little as £600
- Reducing your income to the £100,000 limit means your personal allowance is reinstated, saving you a further £200 in tax.

Adding £1,000 to your pension effectively costs you just £400, because you avoid the 60% tax trap on that part of your earnings.

Pension and tax rules can change and benefits depend on your circumstances. You'll normally only be able to take money from your pension from 55 (57 from 2028).

A Simple Way To Pay Less Tax

Putting money in your pension could considerably reduce the tax you pay. But it's important to be aware of pension rules and allowances.

If you're a UK resident under the age of 75 you can contribute as much as you earn and get tax relief. Contributions are also limited by the annual allowance, which for most people is £40,000. This includes any pension contributions from you, your employer, and any benefits accrued in a final salary scheme.

Those with adjusted income of over £210,000 may have their annual allowance reduced to as little as £4,000. If you've flexibly accessed your pension, you'll also have a reduced allowance of £4,000. This is known as the Money Purchase Annual Allowance.

MORE ON PENSION CONTRIBUTION LIMITS →

THE 'CARRY FORWARD' RULE

You could also carry forward any unused allowance from the last three tax years, which could mean you could make a contribution of up to £160,000. If you're a 45% taxpayer, this could mean up to £72,000 in tax relief. It's important to remember that you need to have been a member of a pension scheme in a tax year in order to carry forward its unused allowance.

TRY CARRY FORWARD CALCULATOR →

How To Make a Pension Contribution

OPEN AN HL SIPP

The HL SIPP offers the same generous tax benefits as any other pension. But you'll also have the freedom to invest where you want to.

You can open a SIPP by setting up monthly payments from as little as £25, or make one-off payments of £100 or more. Remember all investments can fall as well as rise in value, so you could get back less than you put in.

MORE ON THE HL SIPP →

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