BLACKFINCH

Helping High-Earning Clients Beat the '60% Tax Trap'

In 2023/24, 634,00 taxpayers in the UK were caught by what is known as the '60% tax trap', according to a HMRC information request from Bowmore Financial Planning[1].

How does anyone pay an Income Tax rate of 60%? It's all down to how an individual's personal tax allowance is calculated. Most individuals have a personal allowance is £12,570. In other words, the first £12,570 of income earned is tax free. However, individuals will see their personal tax allowance reduced by £1 for every £2 earned above £100,000. When a person's income reaches £125,140, their personal allowance is reduced down to zero.

With so many taxpayers being caught each year by this hidden quirk in the tax system, It's certainly one for you and clients to be aware of. In this client planning scenario, we explain the financial impact of the 60% tax trap, and how clients can use tax-efficient investments, such as Venture Capital Trusts (VCTs) and the Enterprise Investment Scheme (EIS) to help mitigate it.

Benefits of tax-efficient investments are subject to change and personal circumstances.

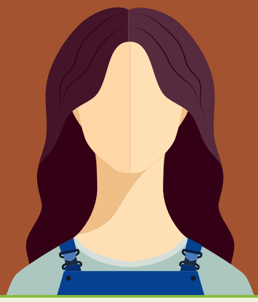
[1]www.bowmorefp.com/uk-taxpayers-earning-100k-125k-are-now-caught-in-the-notorious-60-tax-trap/

Don't invest unless you're prepared to lose all the money you invest. This is a high-risk investment and you are unlikely to be protected if something goes wrong.

Take 2 minutes to learn more on page 4

Meet Christine

Christine is a director at a manufacturing business and earns an annual salary of £115,000. She is concerned about the amount of Income Tax she is paying, and talks to her financial planner about her options.



CASE STUDY

Christine's earnings are £15,000 above the £100,000 personal allowance limit, she faces two adverse tax situations. First, she will pay £6,000 in higher rate tax on the £15,000. Second, she will also lose £7,500 of her personal allowance, resulting in £7,5000 of her income being taxed at 40%, resulting in a further £3,000 of tax to pay.

	Amount	Tax Rate	Tax Paid
Additional Income	£15,000	40%	£6,000
Lost Personal Allowance	£7,5000	40%	£3,000

Total Tax Paid	**£9,000**
Net Income (after tax)	**£6,000**
Effective Tax Rate	**60%**

Overall, the £15,000 of income Christine earns over £100,000 gives her an adverse outcome where she pays additional tax of £9,000 and is left with £6,000, meaning she is paying Income Tax at a 60% rate on her earnings up to £125,140.

If Christine lived in Scotland, her effective rate of tax would be even higher. This is because income in the Advanced Rate tax band is taxed at 45% in Scotland. Using the same example, Christine would pay £6,750 in tax on the £15,000 of income that exceeds £100,000, plus £3,375 in tax on her lost personal allowance. Out of the £15,000, Christine would pay £10,125 in tax and be left with just £4,875, an effective tax rate of 67.5%.

Using Tax-Efficient Investments to Mitigate the '60% Tax Trap'

One way clients can help mitigate the 60% tax trap is by making pension contributions. In Christine's example, simply making a £15,000 pension contribution immediately reduces her net income to £100,000. Christine can then claim back her full personal allowance, and the 60% tax trap works in her favour as her pension contribution receives an effective rate of tax relief of 60% (or 67.5% in Scotland).

What if clients have exceeded their pension annual allowance?

For clients who are comfortable with the risk, investing in a VCT or EIS lets them offset their Income Tax bill and diversify by investing in private, early-stage companies.

Revisiting our case study, Christine can claim 30% Income Tax relief on a £30,000 (£33,750 in Scotland) EIS or VCT investment, giving her £9,000 of tax relief. This can then be used to offset her 60% (£9,000) Income Tax liability.

	Investment	Tax Relief Rate	Amount of Tax Relief
EIS or VCT investment (England, Wales & Northern Ireland)	£30,000	30%	**£9,000**
EIS & VCT investment (Scotland)	£33,750	30%	**£10,125**

Please note: This example is an illustration that assumes no gain or loss on the VCT or EIS investment. It also does not take into account the initial fees and ongoing charges associated with investing in a VCT or EIS portfolio. Investors should be reminded that VCTs and the EIS are high-risk investments and are fundamentally different to a pension or Individual Savings Account (ISA).

Background

Since its introduction over 30 years ago, the EIS has become a valuable tax-planning tool. The UK Government launched it in 1994 to encourage investment in start-ups and early stage companies.

Tax Reliefs

The EIS offers a range of valuable tax reliefs to encourage investment and reduce the risks involved. Investors must have a sufficient income tax liability to benefit from the tax reliefs available.

Supporting the UK Economy

Investing in EIS-qualifying businesses positively contributes to the UK's economic growth, enhances innovation reputation, actively supports entrepreneurial ventures, fostering job creation and economic productivity.

EIS Tax Benefits

Up to 30% Income Tax relief
In the current or previous tax year, providing investments are held for a minimum of three years.

Up to 100% Inheritance Tax (IHT) Exemption
On qualifying investments in as little as two years (and if held at time of death).

Capital Gains Tax (CGT) deferral relief
The EIS shares you subscribe for must be issued to you in the period beginning one year before, and ending three years after, the date of the disposal for which you wish to claim relief.

New Business Relief rates will apply from April 2026. Please refer to the Guide to Business Relief for further information.

Offsetting of capital losses up to 45%
Dependent on marginal rate of Income Tax at time of loss. Capital losses of one portfolio company can be claimed irrespective of the performance of other

Growth free of CGT
If Income Tax relief has been claimed.

Carry back to previous tax year
(For Income Tax relief).

BLACKFINCH

Risks

Due to the potential for losses, the Financial Conduct Authority (FCA) considers this investment to be high risk.

What are the FCA key risks?

1 - You could lose all the money you invest
If the business you invest in fails, you are likely to lose 100% of the money you invested. Most start-up businesses fail.

2 - You are unlikely to be protected if something goes wrong
Protection from the Financial Services Compensation Scheme (FSCS), in relation to claims against failed regulated firms, does not cover poor investment performance. Try the FSCS investment protection checker. (https://www.fscs.org.uk/check/investment-protection-checker)

Protection from the Financial Ombudsman Service (FOS) does not cover poor investment performance. If you have a complaint against an FCA-regulated firm, FOS may be able to consider it. Learn more about FOS protection. (https://www.financial-ombudsman.org.uk/consumers)

3 - You won't get your money back quickly
Even if the business you invest in is successful, it may take several years to get your money back. You are unlikely to be able to sell your investment early.

The most likely way to get your money back is if the business is bought by another business or lists its shares on an exchange such as the London Stock Exchange. These events are not common.

If you are investing in a start-up business, you should not expect to get your money back through dividends. Start-up businesses rarely pay these. (https://www.financial-ombudsman.org.uk/consumers)

4 - Don't put all your eggs in one basket
Putting all your money into a single business or type of investment for example, is risky. Spreading your money across different investments makes you less dependent on any one to do well.

A good rule of thumb is not to invest more than 10% of your money in high-risk investments. (https://www.fca.org.uk/investsmart/5-questions-ask-you-invest)

5 - The value of your investment can be reduced
The percentage of the business that you own will decrease if the business issues more shares. This could mean that the value of your investment reduces, depending on how much the business grows. Most start-up businesses issue multiple rounds of shares.

These new shares could have additional rights that your shares don't have, such as the right to receive a fixed dividend, which could further reduce your chances of getting a return on your investment.

If you are interested in learning more about how to protect yourself, visit the FCA's website. (https://www.fca.org.uk/investsmart)