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Watch for taper traps that can leave you paying 60% taxes

Most people think that the highest rate you can pay in income tax is 45%. They are wrong. For some it can reach 60%. Most people think Inheritance Tax (IHT) is charged at 40%. Yet some will pay 60% on part of their estate.

These people – wealthy, but not the wealthiest in society – are the victims of HMRC's taper traps, and a greater number are being ensnared each year.

In 2007 Alistair Darling used his first speech as Labour Chancellor to promise tax simplification. Two years later, in his 2009 pre-Budget report, he introduced a new rule reducing your tax-free Personal Allowance by £1 for every £2 you earn over £100,000.

As a consequence of this personal allowance taper, you pay 60% tax on earnings between £100,000 and £125,140. Your marginal rate of tax then drops back to 40% until your income reaches £150,000, from where it rises to 45%. Simple?

Next up – George Osborne. One of his first steps on being appointed in 2010 was to set up the Office for Tax Simplification to streamline what he called the "spaghetti bowl" set of rules.

Osborne's tapers

It was Osborne who introduced the generous 'residence nil-rate band' in 2015. Today each of us has a basic IHT tax-free allowance of £325,000. If you leave your home to, broadly, children or grandchildren the threshold increases by £175,000 – the residence nil-rate band. It means that couples – those who are married or in civil partnerships – can have the equivalent of £1 million in IHT-free allowances between them.

However, taking a page out of Darling's tax book (or, rather, adding to it), Osborne ruled that you would lose £1 of this residence nil-rate band for every £2 your estate goes over a net value of £2 million.

As a result, today those couples with a net estate of over £2 million see their IHT bill rise sharply on the excess up to £2.7 million. Imagine your net estate was worth £2 million and you won £700,000 on the lottery but died a week later. Without this taper your beneficiaries would lose 40% of this £700,000 to IHT. That is £280,000. Because of the taper, they will lose £420,000 – 60%.

Osborne also introduced a third taper – to pension contributions. For every £2 of adjusted income over £240,000 an individual's annual £40,000 pension

allowance is now reduced by £1 till it reaches just £4,000. Suffice to say that by the time Osborne left office in 2016 the book of UK tax rules had risen from 11,500 pages to 17,806 pages.

These tapers are an insidious trap. And the fact that the thresholds have been frozen means a growing number of people are falling foul of them.

How to avoid the traps

There are steps you can take to mitigate the problems they cause. Those whose earnings breach £100,000 may consider investing any income between £100,000 and £125,140 into a pension – consider that you are getting the equivalent of 60% tax relief by doing so.

You can write off gift-aided charity donations, too, making it worth keeping a close record of gifts. Imagine your pay goes from £100,000 to £101,000. You will only receive £400 of that extra £1,000 if you take it as income. Give it to charity instead and the charity will receive the gross amount.

For those couples with an estate worth between £2 million and £2.7 million it can be worth considering how you might gift the money to your loved ones now. Most big gifts will be considered a potentially exempt transfer, but if you die within the first three years IHT is charged at 40%. Thereafter the rate tapers – yes, that word again – down.

I have advised clients with terminal illnesses in this position to make the gifts now. They will not be able to avoid the 40% charge being triggered on their death, but the money will be immediately out of their estate for residence nil rate band tapering – so at least they will avoid that 60% charge.

I encourage clients with wealthy adult children to consider giving straight to the grandchildren to avoid families being, potentially, hit twice with this 60% IHT across succeeding generations.

The value of pensions

An important thing to remember is that pensions are currently exempt from IHT. They do not count in your estate for residence nil rate band tapering either. Providing your pension is not close to breaching the, again, overly-complex lifetime allowance of £1,073,100 (another frozen threshold and a topic for another day), consider paying as much as you can into your pension – and that of your spouse.

When you come to take income in retirement, try to prioritise drawing money from other savings first, ISAs second – leaving pensions till last.

In 2018 the then Chancellor, Philip Hammond, commissioned a report from the Office of Tax Simplification to help simplify IHT. Suffice to say that the Treasury is still considering what to do about most of its recommendations.

Now it is Rishi Sunak's turn to simplify the system. There are plenty of measures he could take, but here is one short suggestion: scrap the tapers!

It is difficult to calculate just how much they actually generate for the Treasury. I would hazard a guess that it is not as much as they make for accountants, solicitors and financial planners whose advice is often essential in helping people hit by them. There must be easier ways to raise tax revenue – though perhaps not many that are quite so handily opaque.