Institute for Fiscal Studies

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Bill Dodwell
Patricia Mock
Sally Campbell

Tax Law Review Committee

Thresholds in the tax system: Policy and administrative considerations

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This discussion paper was written for the Tax Law Review Committee by Bill Dodwell, Patricia Mock and Sally Campbell. The Committee has authorised its publication to inform and promote debate in this area. The views expressed do not necessarily represent the views of the Committee. The Institute for Fiscal Studies has no corporate views.

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Executive summary

Thresholds are an integral part of the tax system. They apply to exempt some taxpayers from a charge; define when tax is levied, or a higher rate applies; or define when an allowance or other benefit is withdrawn. Thresholds can define administrative savings (those with income, gains or sales below a threshold may not need to register and comply with a tax or may be able to file in a simpler way). Yet thresholds also present challenges for taxpayers. Going over a threshold may result in very high tax costs, as well as administrative costs and burdens.

The purpose of this paper is to discuss the difficulties in the main tax threshold rules as they affect individuals and small businesses and to consider a range of principles and tools that would assist in the design of future tax policy.[1]

Chapter 1 gives background to the issues and suggests some general principles which may be helpful, with more specific detail relating to Income Tax, savings, pensions, Corporation Tax, VAT and capital taxes being set out in Chapters 2 - 7 respectively. Chapter 8 considers thresholds relating to tax administration.

Key Discussion Points

Higher marginal rate or higher overall rate?

There is a distinction between a threshold where a higher tax rate applies if the threshold is exceeded, for example the tapering of the Personal Allowance for incomes of over £100,000 where a higher marginal tax rate applies across a band of income, and one where exceeding the threshold means that the taxpayer is overall worse off, for example the removal of Tax-Free Childcare, the threshold for which is also £100,000. Put another way, the marginal tax rate on a band of income is over 100%. Economists refer to the former as kinks and the latter as notches.

Policymakers should take particular care to minimise the occasions (and ideally avoid completely) where exceeding a threshold makes a taxpayer noticeably worse off. These types of threshold create economic barriers and unfairness. The rational response by a parent with income in the £100,000-£134,500 range (see Chapter 2 para 2.56) is to reduce their adjusted net income to retain their childcare benefits. For most, this will involve reducing their level of work. Some self-employed people (and landlords) could incorporate their business, enabling them to manage their level of taxable income. Others could increase their pension contributions, although there is no evidence yet that significant numbers do so. A few may choose not to report all their income. None of these responses is desirable.

However, there are no easy solutions. For childcare costs, the policy choice is between retaining the universality of the benefit (perhaps with the expectation that high-earning parents would be more likely simply to pay in full for childcare) or introducing a tax charge along the lines of the High Income Child Benefit Charge. There is no obvious way to apply a tapered means test to publicly funded nursery places. A tax charge could be even more complicated to administer than the High

[1] We do not consider the thresholds inherent in the basic design of the progressive tax system, for example the Personal Allowance and rate band thresholds but rather the additional thresholds layered onto the basic system, such as the tapering of the Personal Allowance for incomes of over £100,000 etc. The paper notes the interaction between benefits and tax but is not primarily focussed on thresholds directly applicable to benefits.

Income Child Benefit Charge, as there would be no easy way for HMRC to receive information from local authorities about childcare places, which have a variable value.

A similar issue applies to the VAT registration threshold, as discussed in Chapter 6; it is not possible to have tapered rates of VAT.

Taper rate

Policymakers should consider how rapidly to recover a benefit once income etc. exceeds a specified level. A lower taper rate may reduce the barrier to work, but it will affect more people and have a higher exchequer cost. The long taper for the small profits rate of Corporation Tax makes it unlikely that a company would be incentivised to keep its profits below a certain level. The taper rate at 26.5% is only 1.5% above the main level of Corporation Tax. However, the taper for the withdrawal of Child Benefit is steep and works in an unfair manner since the parent faces a higher effective rate if they have more children and thus more Child Benefit to be recaptured. A better design would be to set a fixed taper rate, rather than a defined income range, for withdrawing Child Benefit.

Multiple tax charges

Policymakers should avoid creating multiple tax charges at similar income/profit levels. One example is the link in some cases between the VAT registration threshold and the small business exemption from business rates. Where a business needs premises from which to operate, growth could mean that not only must VAT be charged on sales, with the potential impact on business profits, but also that bigger or more premises are needed, so that business rates relief no longer applies. Another example is the £100,000 threshold where both the Personal Allowance begins to be withdrawn and Tax-Free Childcare is no longer available.

Periodic review

The main Income Tax thresholds (the Personal Allowance and the higher rate threshold outside Scotland) are traditionally indexed annually to recognise the impact of inflation. This policy dates back to 1977 – although governments are free to override the statutory increase[2]. Not all exemptions or thresholds are indexed, though. For example, the level at which the High Income Child Benefit applies, and the level at which the Personal Allowance is withdrawn, have not been increased since their introduction. There are numerous gift exemptions for Inheritance Tax which have not changed for decades and now are merely an annoying complexity.

There is a good case for not increasing every limit in the tax system annually. It would add complexity, as taxpayers would find it hard to follow. However, it is important for there to be periodic positive review of exemptions and thresholds, say, every five years. This should not prevent governments deciding that the ambit of an exemption should be narrowed, by applying a charge to more taxpayers through inflation[3]. Nonetheless, a positive choice is needed – and the impact of periodic review should be announced, with a note of the increasing numbers affected[4] where the limit is not increased.

[2] The 2010 Coalition government and the succeeding Conservative government increased the Personal Allowance by more than inflation. More recently, allowances and rate bands for individuals have been frozen as a policy choice to increase taxes.
[3] See, for example, the policy announced in 2017 and refreshed more recently, to retain the existing VAT registration level of £85,000.
[4] The current government has said on a number of occasions it wishes to retain the level at which the High Income Child Benefit Charge applies, but it has not explained how many additional families are affected. The IFS estimates that more than double the number of households are affected since the introduction of the HICBC charge.

Administrative thresholds

Thresholds are also used to set administrative requirements. It is inevitable that these will have to be set by reference to an exact amount[5]. However, it remains important to keep administrative thresholds under review to ensure that they continue to meet their purpose and are not whittled away by inflation. At the same time, increasing an exemption needs also to make sense. For example, HMRC announced[6] in summer 2023 that for those taxed through PAYE only, it will lift the threshold for filing a Self Assessment tax return to someone with income over £150,000. The limit was removed entirely in the Autumn Statement 2023. This may reduce the numbers required to file but, given the number of tax events which occur below £150,000, could actually add complexity and traps, unless at the same time HMRC delivers easier ways to report single items.

Specific areas

Savings income

The Personal Savings Allowance sounds like a simplification benefit, but it operates in a peculiarly complicated way. HMRC estimated that 12 million individuals benefited from the allowance in 2022-23 and that number will increase in 2023-24 due to increasing interest rates. The allowance does not reduce ‘adjusted net income’, which is a measure for calculating whether the High Income Child Benefit Charge or the Personal Allowance withdrawal applies. Only a well-informed tax expert will understand this unnecessary nuance. There can also be a high marginal rate for an individual with total income just over the higher rate or additional rate thresholds. These issues could have been removed with a different design.

The 0% savings rate of tax applies in a limited number of cases and the desired class of beneficiaries of this tax relief is unclear. Most qualifying for the benefit of up to £1,000 do not have earned or pension income, which is contrary to most tax policy considerations.

Pensions

The current pension system commenced in 2006 and was intended to simplify the range of different reliefs that preceded it by providing a single scheme. Limits were placed on contributions to and benefits from the new pension scheme. These took the form of an annual allowance for contributions and a lifetime limit on the size of the pension fund. Since the limits applied both to defined contribution pensions and to defined benefit pensions, a conversion factor was needed. The limits were reduced since introduction, including the introduction of a tapered annual allowance of £4,000 for high earners, until the March 2023 Budget, when the annual limit was increased to £60,000; the income levels for the high earner taper increased and the minimum contribution amount lifted to £10,000; and the lifetime allowance charge abolished. Applying an annual charge to an accrual of benefits remains highly complicated and impossible for high-income taxpayers to understand (and thus take appropriate actions). It has been suggested that the lifetime allowance could be reinstated by a new government. A broad review of pension tax relief is needed to end up with a system that is easier to understand and to administer, whilst no doubt capping benefits to manage the exchequer cost.

[5] There is an information taper for self-employment, where those with sales below the £85,000 VAT threshold aggregate expenses and provide so-called 3-line disclosure (sales, expenses, profit/loss). It is questionable whether this is a big saving for taxpayers; it clearly means that HMRC have insufficient information.

[6] https://www.gov.uk/government/publications/agent-update-issue-108/issue-108-of-agent-update#sa-threshold-change

Recommendations

General recommendations

1. Policymakers should take particular care to minimise (and ideally avoid completely) occasions when exceeding a threshold makes a taxpayer noticeably worse off - i.e. the tax liability is greater than the additional income.

2. Policymakers should take care when setting taper rates not to create significant barriers to taxpayers increasing their income. In general, a lower taper rate is preferable, even though this will increase the numbers of taxpayers subject to the taper and receiving a benefit whilst also increasing the exchequer cost.

3. Research should be undertaken or commissioned by HMRC to understand better the impact of thresholds and higher marginal rates on different types of individual decisions. This could support better decisions on the rate and length of tapers, which at present appear arbitrary.

4. Policymakers should consider whether multiple events could occur at broadly similar income levels and ideally avoid the potential for multiple charges.

5. Policymakers should review thresholds and exemptions periodically to assess whether they continue to meet the policy intent. A standard review period of, say, five years should be established, and the result of the review announced. Where after a review policymakers decide not to increase a threshold or exemption (thus making more people liable to a charge, due to the impact of inflation), policymakers should indicate the additional numbers affected and the exchequer impact – just as is done when a new policy is introduced.

6. Policymakers should consider the impacts of future inflation when designing new thresholds or allowances. Compromises in design that might be accepted when few taxpayers are affected may not remain acceptable when applied to many more taxpayers.

7. Policymakers should keep administrative thresholds under review, in the same way as substantive thresholds. Whilst minimising administrative burdens is in principle desirable, there are cases where administrative thresholds have been set too high. This can result in insufficient information collection at a point when it could be done cheaply and conveniently, and therefore introduce additional costs due to compliance checks or the lack of a suitable alternative reporting mechanism.

Specific area recommendations

8. The variable taper rate applying to the High Income Child Benefit Charge is unfair and complicated for individuals to understand. It should be replaced with a fixed taper rate.

9. The current approach to childcare costs is complex and can appear unfair. Once an individual earns £100,000 or more, eligibility for Tax-Free Childcare is removed, as is some entitlement to publicly funded nursery places. A parent can be better off earning a lower amount and keeping child support than earning a higher amount. This acts as a deterrent to work and encourages other tax driven behavioural changes. It is recommended that the government look again at these restrictions and consider restoring at least publicly funded nursery places as a universal benefit. As an alternative, it is recommended that the threshold for removing the entitlements be significantly increased to reduce the numbers affected. The government should publish its estimate of the numbers of families affected, as well as the costs involved.

10. The starter or savings rate of 0% on up to £5,000 of savings income has no obvious policy target. For some, it could discourage work. It is recommended that the rate should be abolished, and the savings used to improve the design of the Personal Savings Allowance.

11. A broad review of pension tax relief is needed to end up with a system that is easier to understand and to administer, whilst presumably capping benefits to manage the exchequer cost.

12. More work is needed on the VAT registration threshold, to consider how best to reduce the barrier to growth it presents. Once digital record keeping has been introduced for the self-employed population, part of the administrative barrier may be reduced, but it is unlikely there will be material change to simplify the VAT base. Offering some form of allowance to businesses moving above the threshold will reduce one of the barriers, although it will not solve the administrative issues.

Chapter 1 - Introduction and general principles

Overview

Numerical thresholds are a basic part of the design of most taxes. They are commonly used as part of a progressive tax system i.e., one where higher rates are levied on higher levels of income or gains, or more valuable assets (although there are examples, such as National Insurance, where lower rates are charged at higher income levels). Many taxes exempt an initial slice of income or gains (for example the Personal Allowance for Income Tax) or an asset-based charge (for example the Inheritance Tax nil rate band), either through an allowance or a zero rate.

The use of an initial exemption, or zero-rate band, can offer a simplification for those whose income or activity falls within that band. Administration is reduced, as typically tax authorities do not require returns from those not actually liable to pay a tax (although some records may need to be kept to demonstrate that the tax does not apply). Increasing activity so that tax starts to be levied brings not only the tax cost, but also extra administrative costs in complying with a new reporting requirement.

In addition to the systems described above, some thresholds require a different basis of taxation once a threshold is exceeded, such as the VAT registration threshold, where once the threshold is exceeded, all sales are liable to VAT – not just those sales above the threshold.

Thresholds are also used to define administrative reporting, such as the requirement for an individual to file a Self Assessment tax return.

Most would agree that thresholds are necessary to ensure a smooth running and as far as possible, a progressive tax system. The level of the various thresholds and indeed the design of the relevant taxes are policy matters and must be considered as part of wider policy issues, such as the approach to the state pension and other benefits.

However, the existence of thresholds can create distortions in behaviour, as taxpayers seek to use thresholds to their best advantage – usually by remaining under the relevant threshold.

Furthermore, the piecemeal approach to tax design has meant that many more thresholds now apply than those relating to basic tax design, and the evolving system means that the interaction of the various thresholds can result in considerable complexity for taxpayers with many being unaware of the relevance of the various thresholds to their own circumstances.

The purpose of this paper is not to look at the basic elements of thresholds – such as the Income Tax Personal Allowance and the higher rate threshold. Instead, it considers the practical issues which arise from the many other thresholds layered on top of the basic system and it sets out some considerations for policymakers and administrators.

Effect of exceeding a threshold

1.1. In the basic system outlined above, exceeding a threshold normally gives rise to a higher marginal rate of tax, for example in the progressive Income Tax system. In many areas though, exceeding a threshold means that the benefit of an exemption or relief is gradually scaled back, normally through the use of a higher than expected tax rate over a band of income. These higher than the expected baseline rates are a fundamental part of offering a benefit only to those with income or profits below a certain level. The only way to limit that benefit is to charge a higher 'tax' rate on income above the desired level for receiving the benefit in full.

1.2. For example, the tapered rate of Corporation Tax on profits between £50,000-250,000 imposes a higher than expected effective rate to a slice of profits. The Corporation Tax rate on profits up to £50,000 is 19%; the effective marginal rate on profits between £50,000-250,000 is 26.5%; and thereafter the 25% rate applies to all profits. Viewed differently though, a company with profits up to £50,000 pays a 19% rate; and thereafter the average rate climbs slowly to 25% at £250,000.

1.3. For individuals, examples are the tapering away of the personal Income Tax allowance when income exceeds £100,000, where there is an effective marginal rate of Income Tax of 60% over the Income Tax band £100,000 - £125,400, and the High Income Child Benefit Charge which effectively withdraws Child Benefit for those with income of between £50,000 and £60,000, with a higher effective rate depending on the number of children. More detail is given in Chapter 2.

1.4. A further example is in the design of benefits, such as Universal Credit, which offer financial help to those considered by government to be in need of financial support. The so-called withdrawal rate where earned income exceeds the threshold is 55%[7], although taking account of Income Tax/National Insurance means the total rate is much higher[8]. Governments could offer the same benefit to everyone, no matter how high their total income – such as with the state pension. However, in most cases, it is desired to restrict those who can benefit, when the only choice is how rapidly to withdraw that benefit. A high withdrawal rate means that the numbers benefitting are lower, but it can act as an effective barrier to seeking or increasing work, as the return from earning more is very low. A low withdrawal rate reduces that barrier, but means that more people receive the benefit (which may be a complexity in itself), with a related higher cost to the Exchequer.

1.5. In general, the narrower the income or profit range across which the benefit is withdrawn, the higher the marginal rate will be in that range. For example the Personal Allowance could be withdrawn over the range of £50,800 rather than the current £25,400 and this would give an effective rate in the range of 50% rather than the current 60%. However it would mean that even those paying the highest rate of Income Tax of 45% would still benefit from part of their Personal Allowance.

Higher overall rate

1.6. Some thresholds are much more disadvantageous and impose a higher overall (average) rate of tax, rather than a higher marginal rate on a specified slice. Where the sales of a business exceed the VAT registration threshold, VAT must be levied on all sales – not just those above the current £85,000 limit. For businesses selling to consumers, it may not be possible to increase prices to cover the new VAT element. Thus, for some businesses, increasing sales could actually reduce the owner's profits. There is evidence from the Office of Tax Simplification's 2017 VAT report of businesses 'bunching' just below the registration level. The Office of Budget Responsibility published in March 2023 a forecast showing an even greater impact looking forward, due to recent high levels of inflation.

1.7. An even more extreme issue arises in relation to childcare costs, where the benefits of Tax-Free Childcare and free places for very young children are immediately withdrawn in full where expected adjusted net income exceeds the £100,000 threshold by a single pound. The Institute for Fiscal Studies has highlighted that for some people an increase in pay from £100,000 to £134,500 is needed to cover the costs of withdrawing publicly-supported childcare. There is unfortunately no data on the numbers affected, although there is anecdotal evidence that some individuals are reducing their work hours and pay to remain below the £100,000 threshold.

[7] Higher withdrawal rates can apply in some circumstances e.g., where council tax benefit is also withdrawn.

[8] The taper rate for Universal Credit may affect both earners in a two-earner household. The IFS has pointed out that a lower taper rate may incentivise the first earner, but disincentivise the second earner, unless the work allowance is adjusted https://ifs.org.uk/publications/submission-work-and-pensions-committees-universal-credit-rollout-inquiry

Multiple charges

1.8. Greater complexity occurs where two or more thresholds can apply to a broadly similar taxable amount. For example, the withdrawal of childcare noted above occurs at the same income level (£100,000) as that for withdrawing the Personal Allowance, making this a key income level in terms of potential distortive behaviour.

1.9. The High Income Child Benefit Charge starts to apply at roughly the same level as higher rate of Income Tax (other than in Scotland) and so the individual's effective rate of tax jumps from 29% or 32%[9] to something typically between 54-71%, for income between £50,000 and £60,000, before settling back to 42% (all rates include National Insurance).

Economic theory and threshold design

1.10. Economic theory considers the potential impact of a threshold: does the individual or company consider the return from higher income or profit levels worth the additional endeavour, when part of that return is reduced by taxation, or the withdrawal of benefits. Economists refer to a threshold which results in a higher marginal rate over a band of income to gradually withdraw the benefit as a kink, and threshold which results in a drop in overall post tax income as a notch.

1.11. This is an area where more research is needed in the context of the UK tax and benefit system. A body or research already exists but more specific UK research is needed. Anecdotal evidence suggests that individuals respond by not seeking to increase their income if it means going above a threshold – but inevitably such evidence will reflect the problems, rather than taking account of those who simply accept a lower return on additional work. This could support better decisions on the rate and length of tapers, which at present appear arbitrary.

1.12. As the tax system evolves, more and more thresholds are being introduced into the system, and the policy objective for each new threshold is not always clear. A particular threshold may be introduced affecting few taxpayers, but the effect of inflation can mean a wider application which is not always acceptable.

1.13. Policymakers should take particular care to minimise the occasions (and ideally avoid completely) where exceeding a threshold makes a taxpayer noticeably worse off. These types of threshold create economic barriers and unfairness.

Periodic review of thresholds, allowances and reliefs

1.14. Traditionally the Personal Allowance and, other than in Scotland, the higher rate thresholds have been indexed for inflation[10] . Governments have of course overridden indexation, but this has required enactment in annual Finance Acts.

1.15. Many thresholds, reliefs and allowances have not been indexed, though. This has meant that, over time, either the value of a relief is reduced or that a greater number of people are brought within the scope of a charge.

1.16. Some allowances have been ignored for decades. The most egregious examples occur in Inheritance Tax, where it is highly unlikely that anyone keeps records of small gifts of £251 or more, yet executors are supposed to make enquiries so as to submit a tax return which complies with the law. The £250 small gift limit was introduced in 1980 and has not been increased since.

1.17. The Institute for Fiscal Studies listed some of the main amounts which have not been indexed in its 2022 Green Budget[11] .

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[9] For 2024-25, the rates will be 28% for a self-employed person and 30% for an employee.

[10] The 1977 Rooker-Wise amendment, supported by Nigel Lawson, introduced statutory indexation. This used the RPI until Finance Act 2014, when CPI was substituted.

[11] https://ifs.org.uk/sites/default/files/2022-11/IFS%20Green%20Budget%202022-final.pdf – see pages 210, 211

1.18. More recent examples are the threshold for the High Income Child Benefit Charge and for the withdrawal of the Personal Allowance, where the limits have remained in place for at least a decade. The result is that many more individuals are liable to pay the High Income Child Benefit Charge or lose the Personal Allowance.

1.19. Thresholds and reliefs do not need to be changed every year. There is a simplicity in keeping a threshold or relief at the same level for several years, so that taxpayers are familiar with something that may not routinely affect them. However, there should be a periodic review – say, every five years. This should not impose a requirement on governments to increase the amounts, but it should impose a requirement to consider changes and whether the policy intent continues to be met or has changed. Where no changes are made, governments should say so and indicate how many people are now affected, with a costing and potentially a distributional analysis – just as happens when a threshold, relief or allowance is introduced.

Chapter 2 – Income Tax and National Insurance

Overview

This Chapter describes the four main threshold issues relating to Income Tax and National Insurance which overlay the basic progressive system of Income Tax. These are the withdrawal of the Personal Allowance from those with incomes (as defined) of over £100,000, the High Income Child Benefit Charge, which effectively withdraws Child Benefit from those with incomes of over £50,000, childcare costs, where Tax-Free Childcare and free places for very young children are immediately withdrawn in full where expected adjusted net income exceeds a £100,000 threshold, and the interaction of benefits and taxation.

In general, the existence of the threshold means a higher than expected marginal rate on income over the threshold, but the withdrawal of Tax-Free Childcare gives a cliff edge where the taxpayer is overall worse off by exceeding the threshold.

Basic design of Income Tax

2.1. Income Tax is the biggest source of the UK's tax revenue. In 2023-24 this is estimated to be £268 billion, which is 25.3% of all receipts, equivalent to around £9,400 per household and 10.4% of national income[12]. National Insurance is the second biggest source of revenue, estimated to raise £172.3 billion in the same year, which is 16.3% of all receipts and equivalent to around £6,100 per household and 6.7% of national income[13].

2.2. In the UK an individual's Income Tax liability is (in broad terms) calculated by adding up their income from all sources, such as employment, self-employment, income from property, and savings and dividend income. There are a range of reliefs and deductions allowed, such as for pension contributions and donations to charities. Against the resulting total, a Personal Allowance is given, and the remaining taxable income is taxed at progressive rates of 20% (basic rate) 40% (higher rate) and 45% (additional rate). Different rates of 8.75%, 33.75% and 39.35% respectively apply to dividend income. The Personal Allowance is restricted for those with incomes over £100,000. The Personal Allowance and rate thresholds for 2023-24 (i.e., the tax year from 6 April 2023 to 5 April 2024) are:

Taxable income	Band	Tax rate
Up to £12,570	Personal Allowance	0%
£12,571-£50,270	Basic rate	20%
£50,270-£125,140	Higher rate	40%
Over £125,140	Additional rate	45%

2.3. A starting rate for savings income of 0% for a band of £5,000 may apply; this is covered later in this Chapter.

2.4. Different thresholds and rates apply to non-savings and non-dividend income in Scotland. The Welsh Government also has the power to impose different rates (but not thresholds) on non-savings and non-dividend income but has not so far chosen to do so.

2.5. The Scottish rates and thresholds (which apply to non-savings and non-dividend income only) for 2023-24 are:

[12] https://obr.uk/forecasts-in-depth/tax-by-tax-spend-by-spend/income-tax/
[13] https://obr.uk/forecasts-in-depth/tax-by-tax-spend-by-spend/national-insurance-contributions-nics/

Taxable income	Band	Tax rate
Up to £12,570	Personal Allowance	0%
£12,571-£14,732	Starter rate	19%
£14,733- £25,688	Scottish basic rate	20%
£25,689-£43,662	Intermediate rate	21%
£43,663- £125,140	Higher rate	42%
Over £125,140	Top rate	47%

The Scottish Budget in December 2023 proposed the introduction of an advanced rate of income tax of 45% from £75,000-£125,140 and an increase in the top rate to 48%.

2.6. Since the 1977 Rooker-Wise amendment, legislation has provided that the Personal Allowance and the higher rate threshold should increase annually by rate of increase in the CPI[14], although this can and frequently has been overruled by parliament, resulting in changes of more or less than the indexed amount. The Personal Allowance and higher rate threshold have been frozen in monetary terms since 2021-22 and this is planned to continue until 2027-28.

Basic design of National Insurance

2.7. National Insurance contributions are charged on earned income, whether from employment (Class 1) or self-employment (Classes 2 and 4). Those over 16 and under state pension age are liable.

2.8. The rates[15] for 2023-24 are:

Annual earnings/profits	Class 1 (employed)		Class 4 (self-employed)		Class 2 (self-employed)
Up to £12,570	Primary threshold	0%[16]	Lower profits limit	0%[17]	At £3.45 per week if profits exceed £12,570
£12,571- £50,270	Upper earnings limit	12%	Upper profits limit	9%	
Over £50,270		2%		2%	

2.9. The upper earnings limit and upper profits limits have been aligned with the higher rate of Income Tax since 2009-10, although the alignment of the lower limits did not fully take place until 2023-24. This gives a combined marginal rate of 32% in the band £12,571 to £50,270 and 42% above this level.

2.10. Scotland received the power to set both Income Tax rates and thresholds from 2017-18. Scotland has set its higher rate threshold below the UK-wide threshold and has set a higher rate (42%), which means that between the Scottish threshold of £43,663 employed Scottish taxpayers pay both higher rate Income Tax of 42% and National Insurance contributions of 12%, giving an overall rate of 54% in the band £43,663 to £50,270. This higher marginal rate is a policy choice.

Effect of freezing Income Tax and National Insurance thresholds

2.11. Assuming that the rates and thresholds for 2027-28 are implemented as planned, the amounts for 2018-19 and 2027-28 are shown below for comparison purposes over the ten year period[18].

[14] Previously the Retail Prices index until Finance Act 2014

[15] The same rates apply throughout the UK. Employee rates are reduced to 10% from 6 January 2024, following the Autumn Statement 2023

[16] Contributions are credited for certain benefits if earnings are between £6,396 and £12,570.

[17] Contributions are credited for certain benefits if earnings are between £6,725 and £12,570.

[18] Ignoring the different rates and thresholds which apply in Scotland.

	2018-19	2027-28
Personal Allowance	£11,850	£12,570
Basic rate band	£34,500	£37,700
Higher rate threshold	£46,350	£50,270
Additional rate threshold	£150,000	£125,140
NIC – primary threshold	£8,424	£12,570
NIC – upper earnings limit	£46,350	£50,270

2.12. The rates of tax and the thresholds at which they apply are of course policy choices by government.

2.13. However, it is worth noting that a combination of wage inflation and freezing of allowances has meant that an increasing proportion of taxpayers are now within the higher rate bands. The Institute for Fiscal Studies has noted that in 1991–92 just 3.5% of UK adults paid the 40% higher rate of Income Tax. By 2022–23 11% were paying higher rates, with that figure set to reach 14% by 2027–28[19]. This represents a policy choice to increase taxes.

2.14. The freezing of the higher rate threshold also erodes the number of people who are able to claim the transferable Marriage Allowance[20]. The transferable Marriage Allowance enables one party to a marriage or civil partnership to transfer up to 10% of their Personal Allowance (i.e., £1,260) to the other party providing a tax credit of £252. The transfer cannot be made if either party is a higher rate taxpayer[21] so there is an immediate overall tax increase of up to £252 at the higher rate threshold for affected couples.

Withdrawal of the Personal Allowance

Background

2.15. The principle of withdrawing the Personal Allowance for incomes of over £100,000 overlays the progressive rates increase for Income Tax described above. It was announced in 2008 by the then Labour government and introduced in 2010-11[22], when the Personal Allowance was £6,475. The underlying policy context was – at the time of the financial crisis - to help lower-paid individuals by increasing the Personal Allowance and effectively pay for the increase by restricting or removing the allowance at higher income levels. The anticipated yield for 2010-11 was £830 million, rising to £1.3 billion in 2011-12[23]. The threshold has not been indexed or increased since its introduction. Indexing the threshold by CPI would have produced a threshold of about £142,700 in 2023-24.

2.16. HMRC have calculated in response to a Freedom of Information request[24] that the pre-behavioural yield in 2020-21 from withdrawing the Personal Allowance was around £4 billion.

2.17. It applies to those with adjusted net income of over £100,000 and rather than an immediate withdrawal of all the allowance at this level of income, the allowance is tapered over an income range of twice the Personal Allowance. £1 of allowance is withdrawn for every £2 of income over the threshold. This can cause practical difficulties for those paid under PAYE when payment of bonuses or other fluctuating earnings can mean that coding notices are adjusted wrongly (or not at all) by HMRC's automated system (which may assume that the

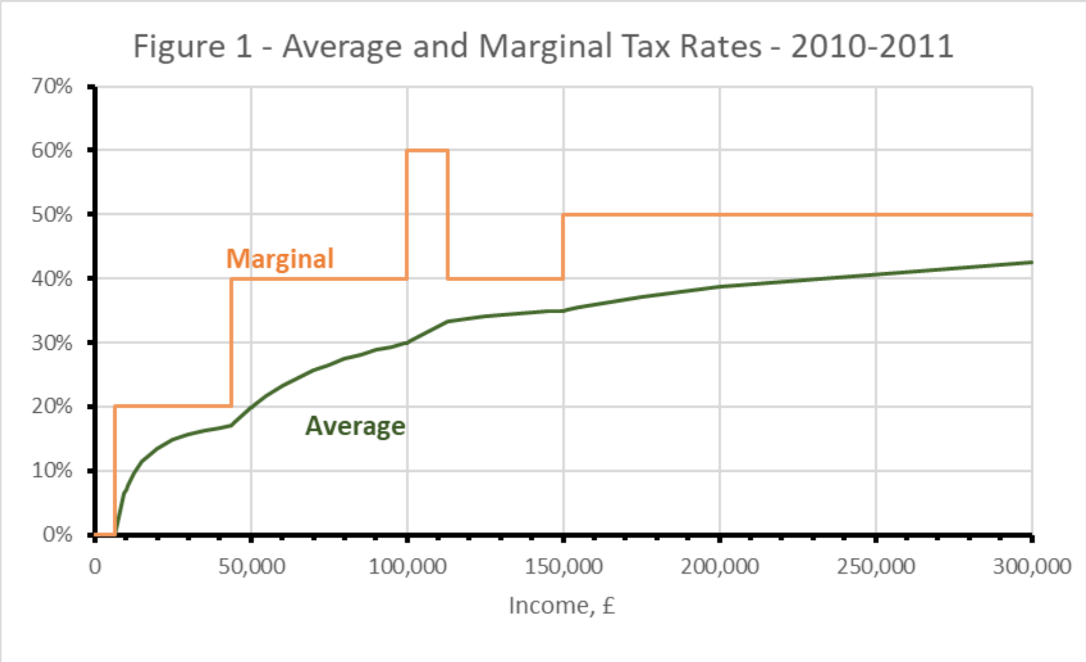
[19] A deepening freeze: more adults than ever are paying higher-rate tax (ifs.org.uk) The percentages are of the total adult population, including about 35% who do not pay Income Tax.
[20] Chapter 3A ITA 2007
[21] Ignoring savings and Dividend Allowances
[22] FA 2009 s4(1)
[23] https://assets.publishing.service.gov.uk/media/5a7c199eed915d210ade194d/7484.pdf page 94
[24] HMRC response dated 22 September 2023 to the authors.

bonus etc. is a regular pay rise), so that contact with HMRC may be needed to amend the notice prior to the end of the tax year. Those who file Self Assessment tax returns will ultimately receive the correct Personal Allowance by filing their return. It should be noted that from 2023-24 onwards the threshold for PAYE taxpayers to submit returns will be raised from £100,000 to £150,000, so many of those affected will no longer be submitting Self Assessment returns. This will impose additional challenges on HMRC systems to calculate and process refunds correctly.

Effect on rates

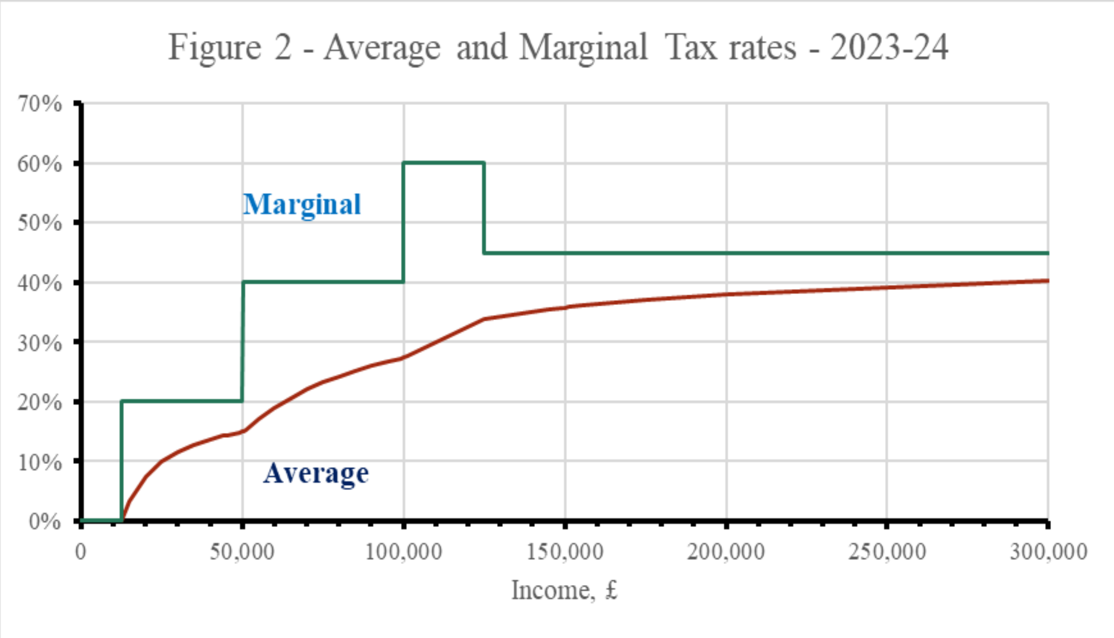
2.18. The effect of the Personal Allowance taper is to create an effective 60% tax rate over the income band £100,000 - £125,140 (2023-24 rates).

2.19. When the taper was introduced the top of the taper band was less than the 50% threshold which applied at that time, resulting in marginal rates across the income range of 20%, 40%, 60%, 40% and 50% as shown in Figure 1.



2.20. Since the reduction in the 45% threshold in the 2023 budget the marginal rates are now 20%, 40%, 60% and 45% as shown in Figure 2.[25]

[25] Ignoring Scottish rates, where a top marginal rate of 63% applies



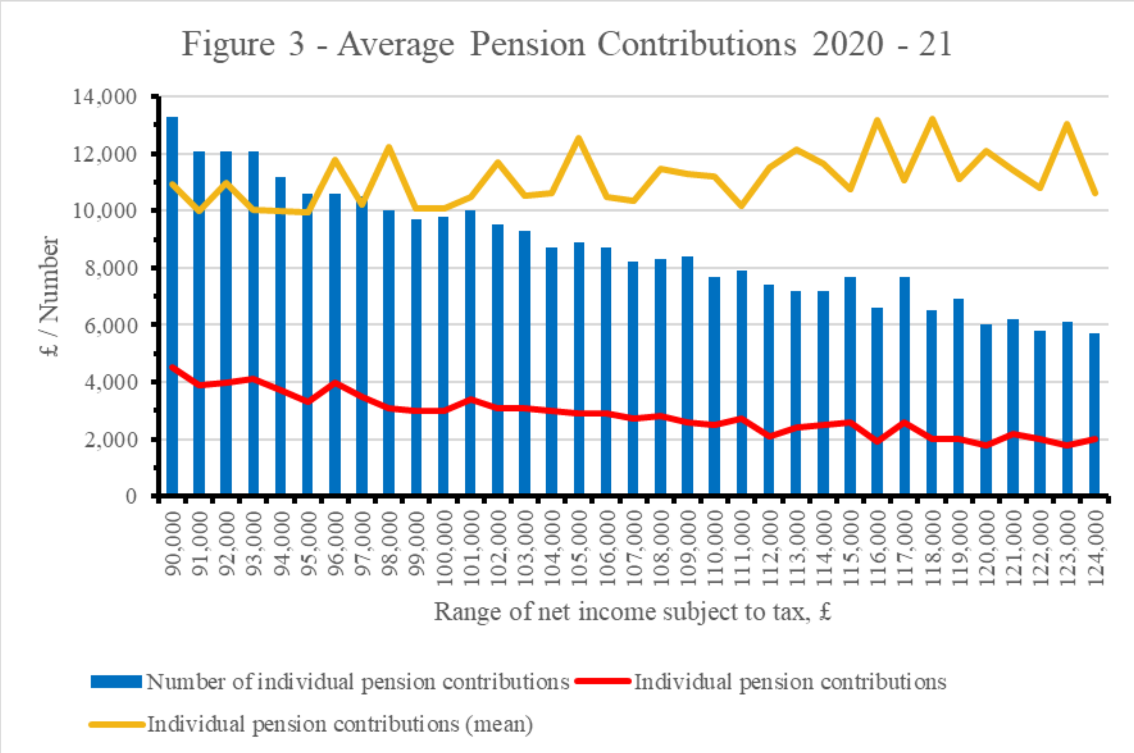
2.21. The 60% rate is not a statutory rate, but rather an effective or marginal rate, taking account of the tapered withdrawal of the Personal Allowance[26]. The reduction of the Personal Allowance for those with income over £100,000 is mentioned in the Gov.uk document referred to above but the effect on marginal rates is not discussed explicitly.

Behaviours

2.22. The taper threshold is based on adjusted net income, which broadly means all taxable income, less trading losses, less the gross equivalent of both Gift Aid payments and pension contributions (excluding pension payments paid through payroll where full relief is given under net pay arrangements)[27]. This means that taxpayers can reduce their adjusted net income and escape the charge by making pension contributions and/or Gift Aid payments, or by managing their income by refusing bonuses or working fewer hours, particularly if they are also affected by the withdrawal of Tax-Free Childcare which applies at the same threshold (see below). For those whose circumstances allow, incorporation of a self-employed business may also reduce adjusted net income (see Chapter 3).

2.23. HMRC have provided information relating to average (mean) individual pension contributions made by taxpayers in income bands between £90,000 and £124,000 for 2020-21[28] and this is shown in Figure 3 below. Interestingly, despite anecdotal evidence to the contrary, the information does not provide evidence for increased pension contributions by taxpayers in the affected income range, which in 2020-21 was £100,000 to £125,000.

[26] https://www.gov.uk/income-tax-rates
[27] Additional complexities apply for those who have transition profits due to basis period reform – see FA 2022, Sch 1, pt 6
[28] HMRC letter 22 September 2023 to the authors, under FOI.



Example

In 2023-24 Peter expects his taxable earnings to be £110,000 after his pension contributions which are deducted by his employer from his gross pay, so that tax relief is given at source. He has no other income. He decides to make a further contribution to his pension of £8,000 gross and a charitable donation under Gift Aid of £1,600 net, so a gross amount of £2,000.

His taxable income is reduced by both these payments, so his adjusted net income is therefore £100,000 and his Personal Allowance is available in full. Peter's net cost after Income Tax of making these additional payments is £4,000.

Different approaches to allowances

2.24. The long-standing UK approach to the Personal Allowance has been to express it as an allowance, to be deducted from taxable income. The effect is that a higher rate taxpayer receives a greater monetary benefit than a basic rate taxpayer. This approach is easy for taxpayers to understand.

2.25. A different option would be to give the Personal Allowance as a basic rate tax reducer, a concept used elsewhere in Income Tax legislation[29], which would equalise the benefit it gives for all taxpayers. For example, the current Personal Allowance of £12,570 could be converted into a tax reduction of up to £2,514. This would reduce the benefit of the allowance to higher rate taxpayers, for whom it is currently worth up to £5,028. It could restore the benefit to those with income over £100,000.

2.26. It would not be easy to find a way to compensate higher earners (those with income between £50,270 and £100,000[30]), at least in part. The threshold for the additional rate could be

[29] For example, the basic rate reducer for interest costs on residential property letting.
[30] Based on UK rates. Scotland's higher rate currently commences at £43,663.

reduced to pay for the new benefit going to those with income of £100,000 or more – but overall, there would be different effects compared to the current system.

2.27. The other area for broader consideration is the issue of multiple allowances. An individual taxpayer receives a Personal Allowance, a Personal Savings Allowance, a Dividend Allowance and a Capital Gains Tax Annual Exempt Amount. These multiple allowances are more likely to be used by those with greater assets[31]. There may be contradictions between having higher allowances to reduce administration and offering greater levels of tax exemption to those more likely to be able to use them.

High Income Child Benefit Charge

Background

2.28. Since January 2013 Child Benefit has been withdrawn if the higher earner in the family has income of over £50,000. Like the Personal Allowance taper, the withdrawal is made over a band of income, in this case £10,000, by charging a High Income Child Benefit Charge (referred to in this section as HICBC) of one per cent of a family's Child Benefit received for every £100 of income that is over £50,000. If income is over £60,000 then the full Child Benefit received is charged.

2.29. The rate of tax in the marginal band therefore depends on the level of Child Benefit received. This operates unfairly and creates a much more significant barrier to work for a parent with several children. A much better design would have been a flat rate of withdrawal, acknowledging that this would have extended the group still receiving Child Benefit in part.

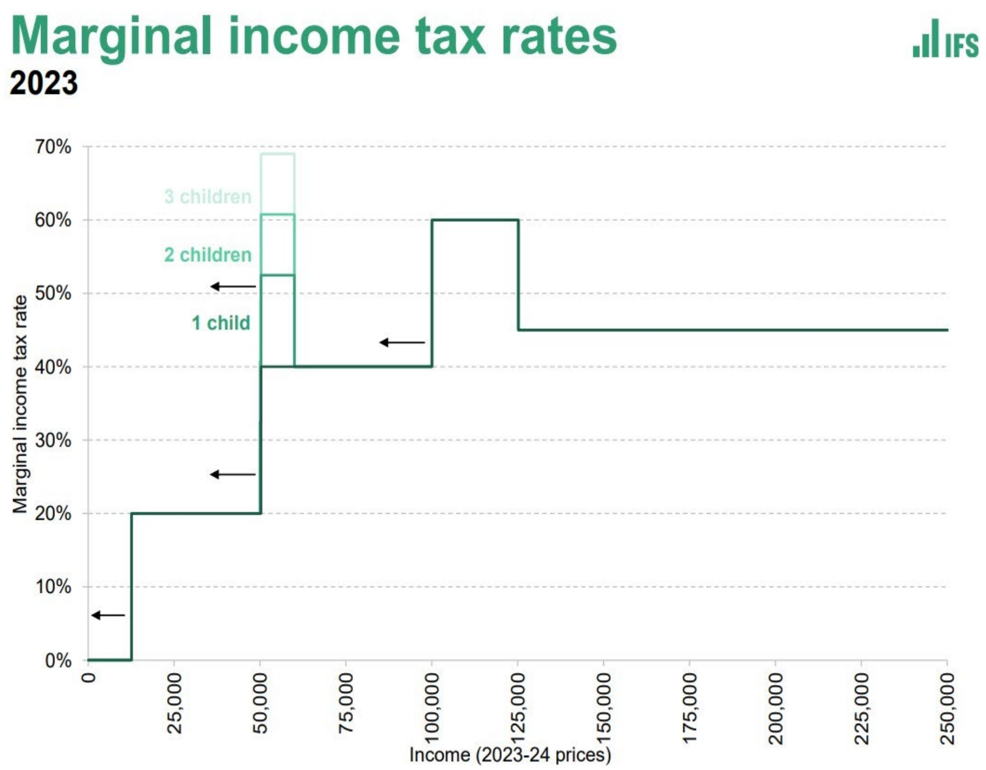
2.30. In 2023-24 the weekly rates of Child Benefit are £24.00 for the eldest child and £15.90 for subsequent children. A family with one child would be eligible to claim £1,248 in 2023-24. Families with two and three children can claim £2074.80 and £2,901.60 respectively in 2023-24. This means an additional marginal rate of 12% (one child), 21% (two children) or 29% (three children) in the taper band. Assuming that the higher earner is within the higher rate band[32] this gives a combined marginal Income Tax rate of 52% (one child) 61% (two children) and 69% (three children) within the band. If National Insurance contributions are included the rate increases to 54%, 63% or 71%. If Child Benefit rates increase so will the rate of HICBC. In 2022-23 the corresponding rates were 51%, 59% and 66% (or 53%, 61% and 68% if National Insurance contributions are included).

2.31. The effect is shown in the IFS chart below[33], which assumes Child Benefit is being claimed for children in 2023-24. As can be seen, the HICBC creates a hump in the marginal tax rate at this income range which is poorly understood.

[31] In 2022-23 an individual could have earned/pension income of £12,570; savings income of £6,000; dividend income of £2,000 and capital gains of £12,300 without paying any tax – a total of £32,570 (there could be a small amount of National Insurance on any earned income due to the threshold changes during that year).

[32] The higher rate threshold is £50,270 for 2023-24 so some taxpayers affected by the HICBC will pay basic rate on a small part of their HICBC.

[33] CIOT/IFS debate: Where next for income tax? | Institute for Fiscal Studies



2.32. As an alternative to paying the charge the claimant should register for Child Benefit but opt out of receiving the benefit payment. This simplifies the reporting position for those with income over £60,000 but is not appropriate for those earning between £50,000 and £60,000, as it is not possible to claim part of the amount due.

Difficulties inherent in the design of the charge

2.33. The charge is based on the circumstances of a couple[34], as is the case for benefits generally. However, Income Tax is calculated on an individual basis (with some rules and reliefs for married couples and civil partners). This difference is one of the reasons why the charge has proved to be complex in practice.

2.34. The income threshold of £50,000 applies to the higher earner in the couple. This can mean differences between couples, as a household with two earners each earning less than £50,000 (so potentially a joint income of nearly £100,000) would not be liable for the charge whereas a household with one earner earning say £60,000 and the other £40,000 would be. In 2019, the government rejected the idea of basing the charge on total household income[35], saying it would be too complicated to gather income details on all 8 million households receiving Child Benefit, when only a minority were liable for the charge.

2.35. The £50,000 limit and the withdrawal range of £10,000 have not been increased since the introduction of HICBC in January 2013. At that time the higher rate threshold was £43,875. The higher rate threshold has gradually increased over this period to £50,270 (2023-24) which means that HICBC now has a small overlap with basic rate taxpayers. The IFS calculated in October 2022[36] that as a result of the freeze in the thresholds 26% of families with children (2 million families) would then be affected, rising to 31% (2.5 million) in 2025–26 if the freeze

[34] Additional complexities can apply in cases of divorce or separation.
[35] https://questions-statements.parliament.uk/written-questions/detail/2019-07-15/277264
[36] https://ifs.org.uk/sites/default/files/2022-10/Reforms%2C%20roll-outs%20and%20freezes%20in%20the%20tax%20and%20benefit%20system_0.pdf

continues. The IFS also state that when the policy was announced, 13% of families with children (1 million) lost some or all of their child benefit.

2.36. The government has not published an updated estimate of how much is raised by the HICBC, but it is likely to be £3-4 billion annually. The original estimates published by the OBR in 2010 and 2012 estimated yield of £2.8 billion in 2023-24, but their estimates for uprating the thresholds are not known.

2.37. There have been several written questions to ministers, including in 2022 and 2023, when the government confirmed that the limit has been reviewed and considered appropriate[37]. However, if the limit had been increased by inflation[38] since its introduction it would be £64,212 in 2023-24.

2.38. It is particularly complex that the marginal rate within the clawback range depends on the number of children that the taxpayer has. A better choice would have been to set a fixed withdrawal rate.

2.39. Many of these difficulties were highlighted by the Office of Tax Simplification in its HICBC Evaluation Note published in March 2022[39].

Practical difficulties arising

2.40. Quite apart from the impact on the marginal tax rate, HICBC has proved a difficult tax charge to administer. Many have chosen simply not to register for Child Benefit (rather than register and then not claim), but this has meant that National Insurance credits are not available for the period a parent does not work when looking after children, and difficulties in obtaining a National Insurance number at 16 for the child, as both are based on Child Benefit records. However, the government has recently announced that those affected will be able to claim National Insurance credits, although details are not yet available[40].

2.41. Due to the complexities of the system many of those who need to pay HICBC are not aware of their responsibilities, in particular what income is relevant for the purposes of calculating the charge[41], how to calculate the relevant Child Benefit and the need to file a Self Assessment tax return to pay the charge. In 2019-20 HMRC statistics show that 373,000 taxpayers had a HICBC charge, raising £416m. However over 120,000 compliance checks were opened into incorrect returns or the tax affairs of those who had not filed at all[42]. There were also 624,000 taxpayers who had opted out of receiving Child Benefit as at August 2020.

2.42. On 18 July 2023 the government announced that the process for collecting the HICBC would be simplified, with employees able to pay HICBC through PAYE by adjustments to their tax code, rather than needing to file a Self Assessment tax return, although details are not yet available[43]. Given the obvious difficulties highlighted in the previous paragraph, this review is welcome. It would also be helpful if HMRC advised taxpayers of the amount of taxable Child Benefit, since this is based on amounts receivable, rather than actual payments.

Behavioural issues

2.43. The £50,000 threshold is based on adjusted net income. This is a tax term of art and unlikely to be understood by most taxpayers. It is the same measure as that used for the Personal Allowance taper (see above) and broadly means all taxable income, less trading losses, less the gross equivalent of both Gift Aid payments and pension contributions (excluding pension payments paid through payroll where full relief is given under net pay arrangements). It is

[37] https://researchbriefings.files.parliament.uk/documents/CBP-8631/CBP-8631.pdf (page 11)
[38] CPI inflation
[39] https://www.gov.uk/government/publications/ots-evaluation-paper-on-the-high-income-child-benefit-charge
[40] https://www.gov.uk/government/news/savers-set-to-benefit-from-simpler-tax-system#:~:text=When%20parents%20claim%20Child%20Benefit,still%20able%20to%20do%20that .
[41] The charge is based on adjusted net income as for Personal Allowance clawback
[42] https://www.gov.uk/government/publications/high-income-child-benefit-charge-data/high-income-child-benefit-charge
[43] https://questions-statements.parliament.uk/written-statements/detail/2023-07-18/hcws972

possible for individuals to manage their income by the payment of pension contributions or Gift Aid donations to remain below the limit. However, there is no evidence of this behaviour on a wide scale. It is more likely that some reduce their working hours; again, there is no clear evidence.

Tax-Free Childcare

2.44. Tax-Free Childcare is a UK-wide Government scheme which allows eligible claimants to claim up to £2,000[44] per year in respect of qualifying childcare costs. There are several conditions for the scheme, the most relevant for this paper being the upper income threshold of £100,000 above which the benefit is completely withdrawn, creating a very large disincentive to increase income.

2.45. The scheme requires the claimant to open a childcare account which is used for paying for qualifying childcare. Amounts paid in by the claimant are topped up by 25% by government up to a maximum of £500 per quarter or £2,000 per annum.

Example

Ann pays £600 into her childcare account each month, so £1,800 per quarter. Each quarter this is topped up by 25% i.e., £450, giving a gross amount in the account of £2,250. Effectively therefore, Ann's income paid into the account has received tax relief of 20%. If Ann were to pay £2,400 per quarter the top up would be the maximum amount of £500.

The balance in the account can then be used to pay qualifying childcare costs.

Conditions of the scheme

2.46. The scheme can only be used for approved childcare, broadly nurseries, childminders, nannies and after school clubs, and the provider must be registered.

2.47. Broadly, children are covered up to the September after their 11th birthday.

2.48. Different rates apply for disabled children.

2.49. The scheme cannot be used if Universal Credit or tax credits are being claimed by either the claimant or their partner, or if childcare vouchers are being provided by the employer. Employer childcare vouchers closed to new applicants from 4 October 2018 but those who can continue to claim them will need to consider which is their best option.

Earnings thresholds

2.50. The scheme is designed to give help with childcare to enable parents to work. Hence there is a minimum expected earnings threshold for both the claimant and their partner of at least £2,167 over the three-month entitlement period. Lower amounts apply for younger claimants. Earnings from employment and self-employment qualify and some averaging over a year may be allowed for those with irregular incomes. Those not working and claiming statutory sick pay or statutory maternity pay can qualify.

2.51. If one of a couple is in qualifying paid work and the other partner is unable to work and claiming certain benefits, then a claim for Tax-Free Childcare can still be made.

2.52. There is also an upper threshold of £100,000; if either the claimant or their partner have adjusted net income of more than this amount, they cannot benefit from the scheme.

Difficulties with earnings thresholds

2.53. The definitions for the upper and lower thresholds are not the same, which can lead to confusion. The minimum earnings threshold is based on expected earnings from employment

[44] £4,000 if the child is disabled.

or self-employment before pension contributions. The upper threshold uses the tax definition of expected adjusted net income (the same measure as that used for the withdrawal of the Personal Allowance and the High Income Child Benefit Charge). This is (broadly) all taxable income, less trading losses, less the gross equivalent of both Gift Aid payments and pension contributions (excluding pension payments paid through payroll where full relief is given under net pay arrangements). For an example see the tapered Personal Allowance section above.

2.54. If either threshold is breached, then the claimant cannot remain in the scheme. This is made worse by the withdrawal of the free childcare hours for three and four year olds from 30 to 15 at this same income level. Plans were announced at Budget 2023 to extend free childcare to children of two and under which will accentuate the problem[45].

2.55. In theory, using the same threshold for both the withdrawal of Tax-Free Childcare and publicly funded childcare hours sounds simpler. In practice, it creates an almost insurmountable barrier, where any parent increasing their income over £100,000 finds their household to be much worse off. The position is exacerbated by the fact that the Personal Allowance is tapered for incomes of over £100,000.

2.56. The IFS has noted that[46]

> The distortions that this can create are among the most severe you will ever see within a tax and benefit system. A parent with two children under 3 whose childcare provider charges England's average hourly rate for 40 hours per week would, after these reforms, find that their disposable income (i.e., earnings net of tax and childcare outgoings) falls by £14,500 if their pre-tax pay crosses £100,000. Disposable income would not recover its previous level until pre-tax pay reached £134,500, meaning a parent earning £130,000 would be worse off than one earning £99,000.
>
> For those with higher childcare costs the distortions are even more absurd. A similar parent paying average London rates for childcare, using 50 hours per week, would see a £20,000 fall in disposable income when their pre-tax earnings cross £100,000. Disposable income would not recover its previous level until pre-tax pay reached £144,500.
>
> This provides a massive incentive to keep taxable income below £100,000 while children are young. For many, the obvious way to do this is via pension contributions. The example London parent above could, if earning £139,000, put £40,000 into their pension pot and still have higher disposable income today than if they contributed nothing. It is notable that, in the same budget, the government has raised the annual limit on pension contributions qualifying for tax relief to £60,000. Even parents with young children earning £160,000 would have large incentives to use all of that new annual allowance. Many of them would effectively be able to buy a £60,000 pension pot while only reducing their current disposable income by a small fraction of that. Responses of this kind are inevitable.

2.57. Quite apart from this obvious distortion at income of £100,000 there is an issue of differences between families in that a family can have two earners each earning up to £100,000 without Tax-Free Childcare being withdrawn, as compared to another family with the same total earnings but one earner in excess of the £100,000 threshold. Like the High Income Child Benefit Charge, this is another example of the challenge of calculating tax on an independent basis but benefits on a family or household basis.

2.58. The lower threshold may also cause practical problems if one of the couple loses their job. If a new job has not been found by the time of the next three-monthly declaration or the claimant

[45] Different rules for free childcare apply in Scotland, Wales and Northern Ireland.

[46] https://ifs.org.uk/news/childcare-reforms-create-new-branch-welfare-state-also-huge-risks-market - the analysis includes the effect of income tax and National Insurance as well as the withdrawal of tax-free childcare and funded childcare hours.

intends to start a new job within 31 days of the declaration eligibility is lost until a new job is secured. Whilst arguably a nursery place might not be required if one parent is not working, many parents will be reluctant to take their children out of nursery at such a time.

Possible solutions

2.59. The existence of the cliff edge explained above is clearly distortionary. Affected taxpayers may need to reduce their income by reducing working hours, declining bonuses or turning down promotions. Some may be able to manage their income by making pension contributions and Gift Aid donations, although evidence suggests that to date few are choosing to do this. Such a disincentive to work is not desirable.

2.60. The exchequer savings from the £100,000 cliff edge are not known, and nor is the size of the population affected.

2.61. The universality of the benefit could have been retained, perhaps with the expectation that very high earning taxpayers would be more likely to pay childcare costs in full. It could have been supported by a modest reduction to the additional rate threshold, say to £120,000.

2.62. Alternatively, and less desirably, it would be possible to reduce the cliff edge for Tax-Free Childcare by retaining the benefit and introducing a tapered tax charge. This would have similar challenges to those in relation to the High Income Child Benefit Charge. Introducing a taper for the free childcare hours would require that those be valued, which varies across England (with different rules for the other nations), or a standard notional charge made. It is also not clear how HMRC would receive childcare details from local authorities, which would be needed to administer any such charge.

Benefits

Universal Credit

2.63. The focus of this discussion paper is on tax thresholds and the effect these can have on marginal rates of taxation. However, the impact of the withdrawal of benefits on marginal overall rates cannot be ignored.

2.64. The main benefit to be considered is Universal Credit which now applies nationwide to new claimants. In broad terms Universal Credit is awarded for a monthly assessment period and is based on household circumstances. Elements of Universal Credit are applied depending on age, children (up to two[47]), childcare and housing costs. These elements may then be reduced based on household earnings, savings and the overall benefits cap.

2.65. The key point for this paper is that earnings over a 'work allowance[48]' will reduce Universal Credit by 55%, so giving an effective 55% marginal clawback rate on net earnings over the relevant amounts. These amounts are lower than the personal tax allowance. Once income reaches the Personal Allowance and lower earnings limit for National Insurance an effective overall marginal rate of 69%[49] will apply.

[47] With exceptions, and only if third child is born on or after 6 April 2017

[48] If work allowance applies it is £379 per month if Universal Credit includes help with housing costs or £631 if it does not. (£4,548 and £7,572 annually).

[49] This rate is a combination of income tax and Universal Credit clawback. Different effective rates will apply in Scotland due to differing Scottish income tax rates. National Insurance rates are changing from 6 January 2024 for employees and from 6 April 2024 for self-employed individuals. In practice the cost can be even higher, since passported benefits such as prescription, dental and optician fees may be lost.

Example

Deidre receives Universal Credit of £800 per month. She is currently employed part time and earns £12,570 per annum. She has no other income and so pays no Income Tax or National Insurance. She is considering increasing her hours so that she will earn an additional £1,000 per annum. Her marginal tax rate on this income is:

Additional income		£1,000
Income Tax - 20% on £1,000	200	
National Insurance - 12% on £1,000	120	
Reduction of Universal Credit - 55% on net earnings of £680	374	
Total costs		694
Net income remaining		£306
Overall marginal rate on this income		69.40%

2.66. It could be argued that this marginal cost is unacceptably high and it will act as a disincentive to employment. However, if the taper rate for Universal Credit is reduced, so reducing the overall marginal rate, this overall rate will apply across a wider range of income. Universal Credit can be claimed at high income levels – it is possible for a single parent in London with childcare and housing needs to claim Universal Credit at income levels of up to £120,000.

2.67. Some claimants of Universal Credit now have income of over £50,000 and so are liable for High Income Child Benefit Charge or decide not to claim Child Benefit (see para 2.28 et seq.). They may therefore be in a position where there is a clawback of both Universal Credit and Child Benefit resulting in even higher marginal rates. The Resolution Foundation has calculated that the collision of the two systems in this way can give marginal overall rates of 80% for families with one child, 83% for those with two children, and 87% for three children. The Resolution Foundation goes on to note that[50]:

> The collision of these two systems has led to the creation of the highest marginal deduction rates in the UK, at 80 per cent for families with one child, 83 per cent for those with two children, and 87 per cent for three children.
>
> Accounting for student loan repayments and pension contributions, these rates rise even further, to 89 per cent with one child, 93 per cent with two children and 96 per cent with three. A hypothetical earner who falls into this category, with an income of £50,000 and two children, would take home only £800 more if they received a £10,000 pay rise.
>
> These exceptionally high rates are set to affect increasing numbers of families over the next decade, rising from 50,000 in 2022 to around 90,000 by 2030, with a further 250,000 people (who earn between £40,000 and £50,000) at risk of being pulled into these high tax rates if they receive a pay rise.

2.68. According to HMRC figures[51] around 3m people were forecast to be making student loan repayments in 2022-23.

[50] https://www.resolutionfoundation.org/press-releases/childrens-benefits-mess-leaves-families-facing-effective-tax-rates-of-80-to-96-per-cent/

[51] https://www.gov.uk/government/statistics/student-loans-in-england-2022-to-2023/student-loans-in-england-financial-year-2022-23#introduction - table 4A(i)(ii)

2.69. It is also worth noting that access to free school meals is available for families claiming Universal Credit, but this is lost if household post-tax income exceeds £7,400. If income is over this amount, the full amount is lost so that the family is worse off if earnings exceed this level.

2.70. The threshold has been frozen in cash terms since it was introduced in 2018–19 and the IFS has noted that this means that 1.7 million pupils in England whose families are entitled to Universal Credit are not eligible for free lunches, worth about £460 per pupil per year. The IFS has calculated that for a single parent with two school-aged children, the 'cliff edge' means that earning £7,399 a year and keeping free school meals would be financially preferable to earning anything up to £9,400.[52]

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https://ifs.org.uk/news/seven-ten-school-children-universal-credit-are-not-eligible-free-school-meals

Chapter 3 - Taxation of savings, property and trading income

Overview

This chapter describes the additional rules[53] and thresholds which apply to savings[54] and dividend income and which overlay the basic system of Income Tax. It also covers the special allowances for property and trading income.

The existence of the Personal Savings and Dividend Allowances, which give a 0% tax rate on certain amounts of savings and dividend income, and the £5,000 starting rate of taxation for savings income is difficult to understand. The policy intent of the starting rate is unclear. Further detail and our recommendations in this area are below.

Personal Savings and Dividend Allowances

3.1. There are two allowances relating to investment income: the Personal Savings Allowance and the Dividend Allowance. Both these allowances were introduced in April 2016. The Personal Savings Allowance is £1,000 for basic rate taxpayers, £500 for higher rate taxpayers and nil for additional rate taxpayers[55]. HMRC estimates that in 2022-23 12 million individuals benefitted from the Personal Savings Allowance, at a cost of £590 million[56]. Due to poor design, there are cases where an individual just moves into the higher rate band, which switches on the £500 allowance rather than the £1,000 allowance. The impact can thus be a high marginal tax rate on interest income. Since the intention was to give both higher and basic rate taxpayers an allowance of up to £200 against their tax liability, it is unfortunate that expressing the relief as an allowance unnecessarily creates a high marginal rate for some taxpayers.

3.2. The Dividend Allowance has varied since its introduction, as follows:

2016-17 and 2017-18	£5,000
2018-19 to 2022-23	£2,000
2023-24	£1,000
2024-25	£500

3.3. However, rather than being an exemption for the relevant amount of income, the allowances are applied by including the relevant income in the total income calculation and then taxing it at 0%.

[53] These rules also apply to Scottish taxpayers.
[54] Broadly bank and building society interest although the full definition is at ITA 2017 s18
[55] Additional complexities apply for those who have transition profits due to basis period reform – see FA 2022, Sch 1, pt 6
[56] https://www.gov.uk/government/statistics/main-tax-expenditures-and-structural-reliefs

Example

Beatrice's income in 2023-24 is made up of earnings of £50,270, bank interest of £3,000 and dividends of £2,000. In 2023-24 the Personal Allowance is £12,570 and the basic rate band is £37,700, giving a higher rate threshold of £50,270.

Beatrice's tax liability is:

Earned income				50,270
Savings				3,000
Dividends				2,000
Total income				55,270
Less: Personal Allowance				-12,570
Taxable income				£42,700
On earned income				
(50,270-12,570)	37,700	at	20%	7,540.00
On savings	500	at	0%	0.00
	2,500	at	40%	1,000.00
On dividends	1,000	at	0%	0.00
	1,000	at	33.75%	337.50
	42,700			
Total tax				£8,877.50

3.4. In most cases this required method of calculation gives the same results as simply exempting the amounts covered by the Personal Savings Allowance and the Dividend Allowance. This is not always the case though, where thresholds for higher and additional rate tax are involved, or where the High Income Child Benefit Charge or the withdrawal of the Personal Allowance applies.

3.5. The income covered by the allowances is treated as part of 'income' for calculating tax. It is also part of 'adjusted net income' for the purposes of various clawbacks based on this amount covered earlier in this paper, such as reduction in Personal Allowance, withdrawal of tax-free childcare and the High Income Child Benefit Charge (HICBC). Beatrice's income for HICBC purposes is £55,270 so if Child Benefit is being claimed, she would be liable for HICBC.

3.6. This effect of the Personal Savings and Dividend Allowances is very poorly understood by taxpayers and is likely to be a contributory factor to the poor compliance with the HICBC referred to in paragraph 2.41.

3.7. It would be helpful if the allowances were either operated as a full exemption so that income within the limits is ignored altogether, although this would of course have cost implications, or re-named to more closely reflect how they operate.

3.8. Apart from operational complexities the level of the allowances may be worth reviewing. When the Personal Savings Allowance was introduced in 2016 the interest rate on bank deposits was around 1.3%[57] so a basic rate taxpayer would need non-ISA savings of over £75,000 to exceed the allowance. HMRC figures at the time suggested that 95% of taxpayers

[57] https://www.bankofengland.co.uk/-/media/boe/files/statistics/effective-interest-rates/2016/april-2016.pdf

would have no tax to pay on savings income[58]. By June 2023 interest rates were around 4%[59] so the £1,000 threshold would be reached with savings of £25,000. As such it neither provides simplicity or the tax exemption that was originally planned and many more taxpayers will need to interact with HMRC as a result. Freedom of Information data released by HMRC in July 2023[60] estimated that there would be an additional 1 million taxpayers (a total of 2.7 million) paying tax on interest income in 2023-24, compared to 2022-23. The estimated tax yield is £6.6 billion in 2023-24, up from £3.4 billion. HMRC have not announced how they expect individuals to notify their savings income without the necessity of a full Self Assessment tax return.

3.9. As discussed at paras 1.14 to 1.19 above there is a need for all thresholds to be kept under review and the Personal Savings Allowance is a good example of the need for this review.

3.10. The reduction of the Dividend Allowance is a series of policy choices. The reductions from 2023-24 are expected to raise nearly £1 billion per year and affect over 4 million taxpayers. No data has been published on how many taxpayers might need to report dividends to HMRC for the first time.

Starting rate for savings income

3.11. Separately to the Personal Savings and Dividend Allowances there is a starting rate for savings income over a band of £5,000 which is taxed at 0% rather than the basic rate of Income Tax. However, this only applies if non-savings and non-dividend income is less than the Personal Allowance plus £5,000, as this type of income is treated as being taxed first for this purpose. If this is the case however, up to £6,000 of savings income can suffer no tax, as the Personal Savings Allowance applies in addition to the savings rate of tax. The example below shows how tax is calculated if only part of the savings starting band is available.

Example

Clarissa has income in 2023-24 of state pension £14,000 and bank interest of £6,000.

Her income is taxed as follows:

State pension				14,000
Savings income				6,000
Total income				20,000
Less: Personal Allowance				12,570
Taxable income				£7,430
Tax due				
On earned income (14,000-12,570)	1,430	at	20%	286
On savings income				
Balance of savings band (5,000-1,430)	3,570	at	0%	0
Personal Savings Allowance	1,000	at	0%	0
Remainder (6,000-3,570-1,000)	1,430	at	20%	286
	7,430			
Tax due				£572

[58] https://www.gov.uk/government/publications/income-tax-personal-savings-allowance/income-tax-personal-savings-allowance
[59] https://www.bankofengland.co.uk/statistics/effective-interest-rates/2023/june-2023
[60] https://www.ajbell.co.uk/group/news/aj-bell-reiterates-call-double-savings-allowance-further-1-million-brits-be-caught-tax-cash Data released to A J Bell

3.12. The savings starter band is of relatively limited application, although HMRC statistics show that in 2020-21 635,000 taxpayers (out of 31.7 million) benefitted from the savings rate. 538,000 of them had income from property and savings[61]; there were 78,000 employees; 3,000 self-employed individuals; and 16,000 pensioners.

3.13. The purpose of having a separate relief for individuals with low or no earned income and/or pension income has not been clearly explained. HMRC have not published the cost of this relief, which is likely to be £300-600 million, and there is no analysis of household income where one or more individuals benefit from the relief. Given that the majority of individuals benefiting from the zero rate have had (at least until recent rate increases) relatively high assets but no, or very low earned income, there must be a likelihood that the benefit is mainly received by wealthier households.

3.14. The band (and particularly the interaction with the Personal Savings Allowance) is complicated and not well understood. In some cases, they can be combined to provide tax free withdrawals from a personal company.

3.15. The government should consider the policy objectives of the savings rate. It should consider abolishing it and using the exchequer savings to support a better design of the Personal Savings Allowance.

Thresholds for trading and property income

3.16. Additional thresholds can apply to trading and property income.

Trading and property allowances

3.17. Since 2017 there has been a trading allowance and a property allowance, both of £1,000. They were designed to provide simplification and certainty for small operations by providing that those deriving gross income of £1,000 or less per tax year from trading or property need not declare the income or pay tax on it. They are mainly administration thresholds.

3.18. It is not known how many taxpayers have trading (or miscellaneous) income, or property income of £1,000 or less. There are likely to be many ‘small scale’ traders who can benefit, but maybe fewer property owners deriving less than £1,000 per annum from their property.

3.19. The most useful aspect of the allowances is that if income exceeds £1,000 per annum the allowance can be deducted from gross income so that full expense records do not need to be kept and we understand that many taxpayers take advantage of this. Expenses can be deducted under the normal rules if beneficial, although this does mean that taxpayers should ideally calculate tax under both options to determine the best outcome for them.

3.20. Whilst generally working well it is understood that there can be difficulty in ascertaining gross income particularly if platform sales are made, when typically amounts reported to the seller are net of the platform commission. This can lead to commission being deducted as well as the £1,000 allowance.

3.21. Some other detailed technical matters were highlighted in the Office of Tax Simplification’s Property Income review.[62]

3.22. A periodic review of the operation and level of the allowances is needed, to ensure that they continue to meet their policy objectives.

Rent a Room relief

3.23. Rent a Room relief is a long-standing relief which exempts up to £7,500 of rental income from furnished accommodation in an individual’s own home. Similar to the trading and property allowances set out above, it provides an administrative assistance in that those

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[61] https://www.gov.uk/government/statistics/income-tax-liabilities-of-starting-savers-basic-and-higher-rate-taxpayers-by-largest-source-of-income-2010-to-2011 (see 2020-21 table 3.4)

[62] https://www.gov.uk/government/publications/ots-review-of-residential-property-income

deriving gross income in this category of £7,500 or less do not need to declare the income or pay tax on it.

3.24. Again, like the property and trading allowances those with income of more than £7,500 can either deduct £7,500 from the gross income or deduct expenses under the normal rules. The relief cannot be claimed as well as either the trading or property allowance.

3.25. The relief works reasonably well although some operational issues in need of clarification were highlighted in the Office of Tax Simplification Property Income review[63].

3.26. The threshold for the allowance has been set at £7,500 since April 2016 when it was increased from £4,250. A government review into the operation of the relief in 2017 concluded that it was set at an appropriate level. However, rents have increased significantly since then and a further review would be helpful.

[63] https://www.gov.uk/government/publications/ots-review-of-residential-property-income

Chapter 4 – Pensions

Overview

There are limitations on the amount which taxpayers can contribute into a pension scheme and receive tax relief on it, as unlimited relief would be very expensive. The way those limits are calculated have evolved into very complicated legislation, which creates significant uncertainty for taxpayers - especially those in public sector pension schemes.

This is explained further below, and although a solution is not straightforward, it would seem clear that limitations for schemes where calculations are based on contributions made in the tax year, should be dealt with differently to schemes where calculations are based on the growth in value of the schemes during the tax year.

Pension thresholds

4.1. Contributions made by workers – whether employed or self-employed – towards registered pension schemes are given preferential tax treatment by giving Income Tax relief and, for pension contributions made by employers, exemption from National Insurance contributions.

4.2. Pension saving is, for Income Tax purposes on the 'exempt/exempt/taxed' model, which means that, broadly, Income Tax is not paid on the initial contributions to the scheme or any investment growth within the pension scheme itself, but tax is paid when those savings are withdrawn, and pension payments are made[64].

4.3. Pension savings schemes are of two main types:

- Defined contribution schemes – where the pension is based on the amount contributed to and investment growth within the scheme. These schemes can apply either to employees or self-employed individuals.
- Defined benefit schemes – these apply to employees only and the pension is based on specified rights, for example final salary or career average. Defined benefit schemes are common in the public sector, but private sector defined benefit schemes are in decline and most have now closed (or are closed to new entrants)[65].

4.4. Tax relief on pensions remains one of the UK's most significant reliefs. Gross Income Tax relief and National Insurance contribution relief is estimated at £68.8 billion for 2021-22[66]. This is mitigated by Income Tax collected when pension withdrawals are made – Income Tax paid on payments from registered private pensions was reported at £19.5 billion in 2021-22[67][68]. Government policy, at least over the last 50 years, has been to set limits on the total cost of pension relief.

4.5. The current pension system was introduced in 2006 and was intended to take the place of multiple different pension arrangements. It operates by setting an annual limit on contributions or fund growth and, until the March 2023 Budget, a lifetime limit on the total fund. Since the limits applied both to defined contribution and to defined benefit pensions, a conversion factor is needed. These different limits have changed frequently since their

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64 For National Insurance there is a difference between employer and individual contributions. For individuals, contributions are not deductible in levying NIC, so the model is taxed/exempt/exempt. For employers, National Insurance is not charged on pensions contributions, so the model is exempt/exempt/exempt.

65 https://www.thepensionsregulator.gov.uk/en/document-library/research-and-analysis/db-pensions-landscape-2022

66 https://www.gov.uk/government/statistics/personal-and-stakeholder-pensions-statistics/private-pension-statistics-commentary-september-2022#the-estimated-cost-of-pension-relief Para 4.1

67 https://www.gov.uk/government/statistics/personal-and-stakeholder-pensions-statistics/private-pension-statistics-commentary-september-2022#the-estimated-cost-of-pension-relief Para 4.1

68 The IFS calculated costs in a different way in its 2023 report https://ifs.org.uk/sites/default/files/2023-02/A-blueprint-for-a-better-tax-treatment-of-pensions.pdf

introduction, mainly by being reduced, including the introduction from 6 April 2016 of a tapered annual allowance of £4,000 for high earners instead of the normal allowance.

4.6. In the March 2023 Budget, the Chancellor decided to increase the annual limit to £60,000 from £40,000; to increase the income level to £260,000 (from £240,000) at which the taper starts to reduce the annual limit from £60,000 to £10,000; and to abolish the lifetime allowance charge. It is intended that the lifetime allowance itself will be abolished from April 2024, although this remains highly complicated in view of the number of different potential benefit withdrawal occasions possible (when Income Tax might apply).

Lifetime allowance

4.7. Until 5 April 2023, the lifetime allowance – set at £1,073,000 in most cases – limited the value an individual could build up within their overall pension pot(s) without incurring a further tax charge. Where the value was over that limit, a tax charge (broadly 25% on income and 55% on lump sum withdrawals) could apply when the pension was accessed – or a 25% charge at age 75 if the pension had not been accessed by that point. The lifetime allowance charge was abolished from 6 April 2023 in the March 2023 Budget where the Chancellor cited concerns about the impact of pension taxation, particularly for senior NHS clinicians (though the issue affects all high earners with defined benefit pension arrangements)[69]. The issue can also affect those with defined contribution pensions, especially where investment growth exceeded original expectations. The lifetime allowance limit itself is intended to be abolished as from 6 April 2024, although draft legislation indicates that it will be retitled ‘lump sum and death benefits allowance’ and remain relevant for calculating tax charges on the death of a pension fund owner.

4.8. Future withdrawals from the pension scheme will therefore simply be taxed at normal Income Tax rates. There has always been the facility to draw 25% of a pension fund tax-free; this will remain but, unless older pension protections apply, is capped at £268,275 i.e. 25% of the former lifetime allowance limit. The government has not indicated whether this limit is fixed indefinitely, or whether it is part of the broader freeze of allowances and thresholds until 2027-28.

4.9. Although the revenue raised through lifetime allowance tax charges was relatively modest, the expected cost of removing the lifetime allowance charge is £135 million in 2023-24, rising to £835 million for 2027-8[70]. The Labour Party has indicated that if elected to government it would restore the lifetime allowance in some form.

Annual allowance charges

4.10. The annual allowance is a maximum which an individual can save towards their pension in a tax year. If the maximum is exceeded, there is an Income Tax charge on the excess, at the individual’s highest Income Tax rate.

4.11. The calculation is complex and depends on:

- Type of pension scheme (whether defined contribution scheme or defined benefit scheme)
- The individual’s income level – the default annual allowance is restricted where income is above certain threshold levels
- Unused relief from earlier years[71]

[69] https://www.gov.uk/government/publications/spring-budget-2023/spring-budget-2023-html ‘Growing the economy’

[70] https://www.gov.uk/government/publications/abolition-of-lifetime-allowance-and-increases-to-pension-tax-limits/pension-tax-limits#summary-of-impacts

[71] Where a taxpayer hasn’t fully used their contribution limits in a tax year, any unused relief can be carried forward for up to 3 years.

4.12. The annual contribution limits are similar for both types of schemes, but the amounts contributed or which have accrued are calculated in different ways.

Defined contribution schemes

4.13. Currently (2023-24) the main limitations are:

- There is an annual pension contribution allowance of contributions of up to £60,000 per year (increased in the March 2023 Budget from £40,000).
- That allowance is tapered if 'threshold income'[72] is over £200,000 and 'adjusted income'[73], which includes pension contributions made by an employer, is more than £260,000 (increased from £240,000). The minimum tapered contribution amount is £10,000 (previously £4,000).
- If the taxpayer has already withdrawn savings from their defined contribution pension, the amount that can be subsequently contributed is limited to £10,000 a year (previously £4,000).
- The contribution limits are measured against amounts actually paid into the scheme, either by the individual or on their behalf (e.g., by an employer).

Defined benefit schemes

4.14. For defined benefit schemes the annual allowance calculations are more complicated as they are based on the increase in value of the individual's fund over the tax year ('pension growth'), rather than by the amounts contributed to the scheme. There is a conversion factor to link to the annual allowance limit: this is a complex calculation[74] and in practice the employee often has to rely on information being provided by the pension scheme, to enable them to calculate their annual allowance figures.

4.15. Further complications arise because typically, an employee could be in more than one scheme. For example, for NHS workers there is a pension scheme which started in 2015 and also a combined legacy scheme from 1995 and 2008.

4.16. Information from all schemes must be amalgamated in calculating the taxpayer's total pension growth for the year. Any contributions to defined contribution schemes are also added to the pension growth figures to arriving at the total annual pension savings.

4.17. There can be practical issues in collating the information needed to calculate pension growth: for example, the NHS pension scheme only produces statements automatically[75] for those members whose contributions exceed the standard annual allowance (i.e., £60,000 for the current tax year).

4.18. However, some employees would have had a reduced annual allowance due to tapering and would therefore have been unaware of their pension growth level, unless they had specifically requested a statement.

[72] https://www.gov.uk/guidance/pension-schemes-work-out-your-tapered-annual-allowance#work-out-your-threshold-income
[73] https://www.gov.uk/guidance/pension-schemes-work-out-your-tapered-annual-allowance#work-out-your-adjusted-income
[74] https://www.gov.uk/hmrc-internal-manuals/pensions-tax-manual/ptm053301
[75] https://www.nhsbsa.nhs.uk/member-hub/annual-allowance See 'informing you about your annual allowance'

Example:

Tim is a full-time NHS consultant and has been a member of the NHS pension scheme for many years.

His accountant has asked whether the NHS scheme has sent statements showing the annual growth in each scheme. Tim doesn't think they have, so he requests them. A few weeks later, reports are sent to him for the 1995/2008 scheme and the 2015 scheme.

Each scheme shows pension growth of £35,000, which is below the annual allowance level for each individual scheme, so statements were not issued to Tim automatically.

Tim has a tapered allowance of £25,000 for the year and no unused allowance brought forward, so the combined pension growth of £70,000 is well above his annual allowance and he has a significant tax charge.

4.19. For some, the position is currently further complicated by recent anti-discriminatory reforms to public sector schemes, which will include the need to re-visit the pension growth figures from 1 April 2014 to 31 March 2022[76].

4.20. Defined benefit schemes tend to have limited choice or flexibility for the employee over their pension rights. The employee has little or no control on the pension growth figures, which is based on the growth in the individual's accrued pension rights. It is therefore almost impossible for them to plan ahead for their likely pension charge.

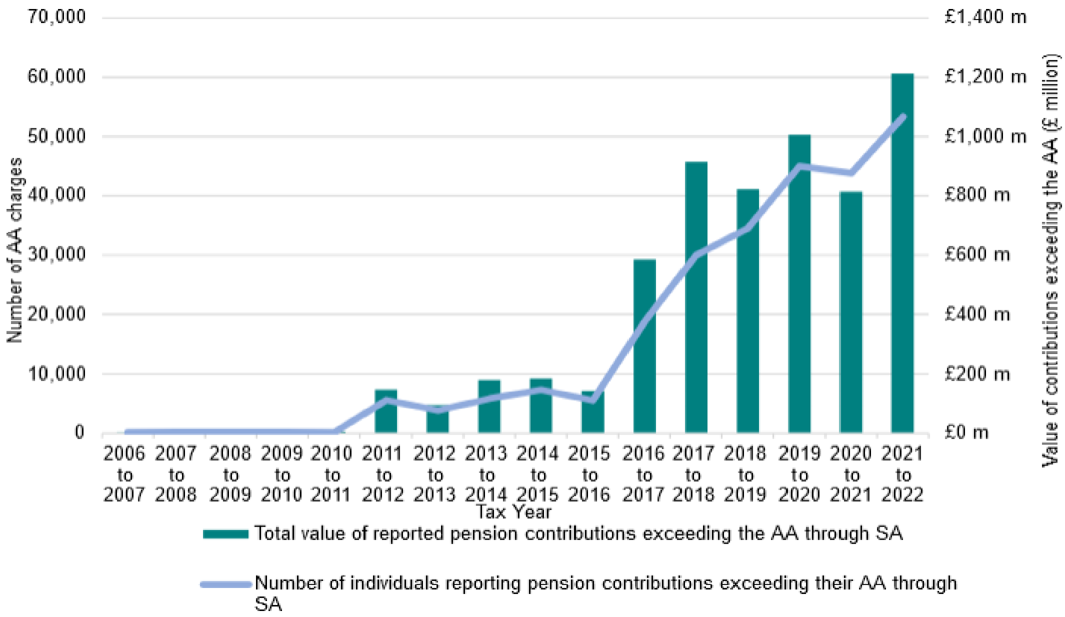
4.21. These limitations have been the subject of much debate recently, particularly for higher-paid public sector workers: exceeding the annual limits can produce an Income Tax charge which is difficult for an employee in a defined benefit scheme to predict and plan for – and which, in some cases, could exceed the value of a pay increase in the relevant year.

4.22. In 2020-21, around 43,870 individuals reported exceeding their annual allowance through the Self Assessment tax return[77], with a consequent pension charge. This was on a total value of pension contributions exceeding the annual allowance of around £814 million, or around an average (mean) of £18,000 per individual. This increased to 53,330 individuals in 2021-22, with excess contributions of £1.2 billion.

4.23. The chart below from HMRC highlights the increase in those exceeding the annual allowance and reporting through Self Assessment.

[76] https://www.gov.uk/government/publications/public-service-pensions-remedy-newsletter-august-2023
[77] https://www.gov.uk/government/statistics/personal-and-stakeholder-pensions-statistics/private-pension-statistics-commentary-september-2022#annual-allowance Para 6

Chart 6: Number of individuals and value of pension contributions exceeding the AA reported through SA 2006 to 2007 to 2021 to 2022



Scheme Pays

4.24. The government recognised that there will be cases where annual allowance tax charges are difficult to meet out of current income. It therefore introduced 'Scheme Pays' so that tax charges can be met from the pension scheme; the pension scheme effectively makes a loan to the taxpayer to pay the tax charge, in exchange for actuarily reduced pension benefits.

4.25. This can have a significant effect on future pension rights, especially if there has been a consistent pension charge met from the scheme each year over several years.

4.26. In 2020-21, pension providers reported 17,130 annual allowance charges paid from pension schemes using Scheme Pays[78], with a total value of £200 million, or an average (mean) of around £11,000 per individual. However, this rose to 49,380 individuals in 2021-22, with tax paid of £335 million. This is the tax due on excess contributions, rather than the value of the contributions and is in addition to annual allowance charges reported on Self Assessment tax returns.

4.27. Scheme Pays is mandatory for a scheme where the annual allowance (i.e., currently £60,000) has been exceeded and the tax due is more than £2,000. Many employees find they have an annual allowance charge because their allowance has been tapered: mandatory Scheme Pays does not apply in that situation. Some pension schemes (including the NHS) operate voluntary Scheme Pays which applies regardless of the annual allowance level, but in other non-mandatory circumstances, the taxpayer directly bears the cost of the pension charge.

Possible alternatives

4.28. The major questions for government are:

- How to encourage and support pension saving? The automatic enrolment of employees has broadened the numbers of employees saving for a pension but, for many, the amounts involved are modest[79].

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[78] https://www.gov.uk/government/statistics/personal-and-stakeholder-pensions-statistics See table 7

[79] https://www.gov.uk/government/statistics/personal-and-stakeholder-pensions-statistics/private-pension-statistics-commentary-september-2022#reported-annual-individual-contributions-to-personal-pension-schemes and

- How to set limits on the total exchequer cost of pension schemes? Some will point out that, with the exception of the tax free lump sum, everything going into a pension scheme is taxed when it is paid out. However, the upfront cost is large and there continue to be exceptions to this general rule where pension funds are passed on to beneficiaries on the death of the main pension fund holder below age 75[80].

4.29. There are range of questions on taxation. The cap on contributions by high earners does not allow them to have any effective pension benefits and the taper is calculated in a complicated manner. For higher rate taxpayers, deductions are given by reference to that higher rate – but the individual may only be liable to basic rate when the pension is taken.

4.30. There are questions on National Insurance. Employer pension contributions are not liable to National Insurance, which has incentivised salary sacrifice – where the individual 'sacrifices' salary in return for larger employer contributions to the pension fund. The resulting National Insurance saving is usually split between the employer and the individual (who receives it in the form of larger pension contributions). These opportunities are not available to all employees and not available at all to self-employed individuals. Pension income is not liable to National Insurance.

4.31. What is clear is that the current rules work relatively well for those saving in defined contribution pension schemes but work badly for higher earners in defined benefit schemes.

4.32. It has always been more logical to restrict defined contribution benefits by reference to contributions. It means that individuals do not need to be concerned by possible investment growth (which previously encouraged high contributors to scale back contributions in case high investment growth triggered a high lifetime allowance charge). However, the current model works best for those with relatively stable, growing, income. Someone with years of low income and a small number of high income years may find they cannot save sufficiently. One possible improvement could be to increase the number of years when pension capacity may be carried forward. Setting a lifetime contribution limit sounds attractive, but would be logistically challenging for pension companies, taxpayers and HMRC.

4.33. Equally, it is completely illogical to apply an annual charge to a benefit accrual under a defined benefit scheme. The annual allowance charge is too complicated for individuals to understand, or for pension schemes to administer. Instead, any cap should be on the potential lifetime fund, or on the pension payable, removing annual complexity and tax charges perceived to operate unfairly.

4.34. In some cases, private sector businesses use unfunded pensions for higher earners, essentially to cover earnings over the levels set for registered pension funds. These arrangements do not benefit from tax relief on building up a fund and they may lack the security and flexibility of a registered pension scheme. Tax relief for the payer is given only when pension payments are made. There may be scope to expand the use of similar arrangements in the public sector.

4.35. It will be for government to commission a broad review of the taxation treatment of pensions[81], which hopefully could result in removing or reducing some of the current barriers to pension saving.

https://www.ons.gov.uk/employmentandlabourmarket/peopleinwork/workplacepensions/articles/pensionparticipationatrecordhighbutcontributionsclusteratminimumlevels/2018-05-04

[80] Approximately 28% of men and 18% of women die before age 75 (England & Wales) https://www.ons.gov.uk/peoplepopulationandcommunity/birthsdeathsandmarriages/lifeexpectancies/datasets/numberssurvivingatexactagelxprincipalprojectionenglandandwales

[81] The IFS has published its own recommendations for changes to the pension system https://ifs.org.uk/sites/default/files/2023-02/A-blueprint-for-a-better-tax-treatment-of-pensions.pdf

Chapter 5 – Corporation Tax

Overview

The government has increased the main rate of Corporation Tax from 19% to 25% as from 1 April 2023 for companies with profits over £50,000. A graduated rate applies for profits from £50,000 to £250,000, replicating the position when there were previously two rates for mainstream Corporation Tax, prior to 1 April 2015. Companies and their advisers will be aware of the practical and administrative complexities which arise from having two rates rather than a single, unified rate.

Rates of tax are a policy decision by government but, as government are committed to embedding simplification into the tax system, this is an example of where it would have been useful to understand the thinking behind re-introducing these complexities, and what alternatives, if any, were considered.

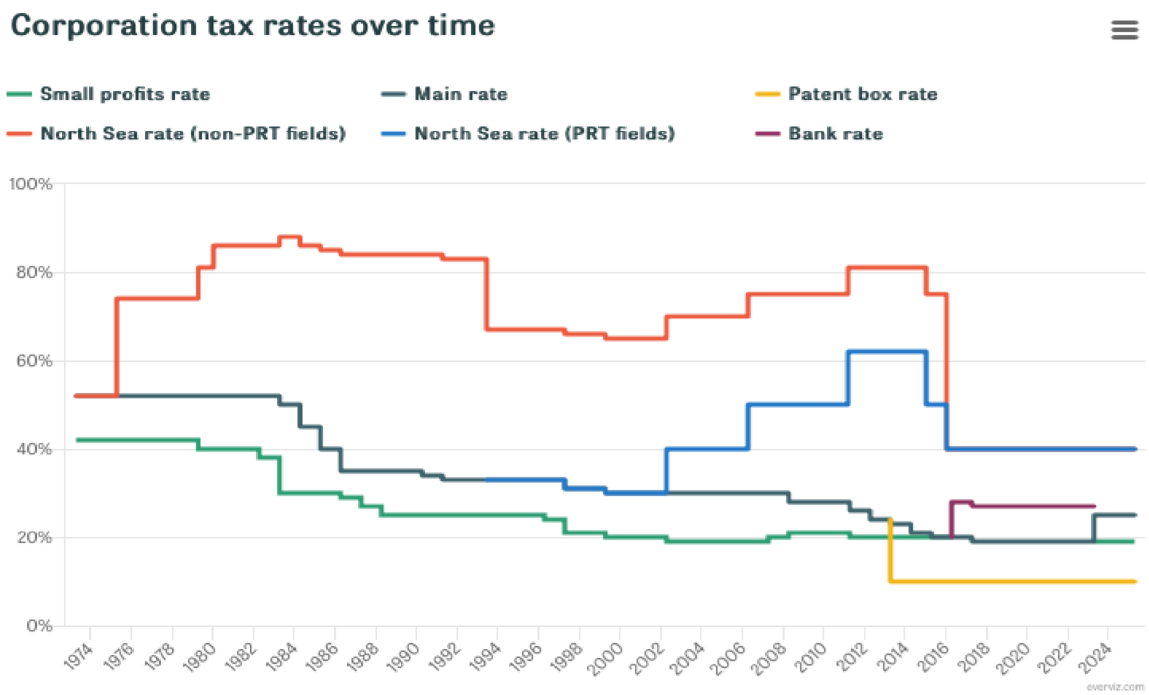
Basic design of Corporation Tax

5.1. Corporation Tax is a direct tax levied on the taxable profits made by companies (and some other organisations, such as trade associations and members clubs) and is a significant source of revenue for government. The Office for Budget Responsibility forecasts it will raise £76.9 billion in 2023-24, which represents 7.2% of all receipts[82].

5.2. Corporation Tax was introduced in 1965 with a rate of 40% on company profits. In 1973 the rate increased substantially to 52% but at the same time a rate of 42% was introduced for companies with a lower level of profits. To smooth the transition between the two rates, there was a 'marginal rate' which gradually increased the rate from the lower rate to the main rate, between those two thresholds.

5.3. As well as these 'headline' rates, there are also separate, higher, rates for banks and the UK oil and gas production industry. A lower effective 10% rate of Corporation Tax also applies where a company qualifies for the Patent Box, which is an effective 10% rate on that part of its profits attributable to patents and certain other intellectual property.

5.4. The various Corporation Tax rates since 1974 are shown below[83]:



[82] https://obr.uk/forecasts-in-depth/tax-by-tax-spend-by-spend/onshore-corporation-tax/
[83] https://ifs.org.uk/taxlab/taxlab-taxes-explained/corporation-tax-explained

5.5. Rates are set for a 'financial year' which runs from 1 April to the following 31 March.

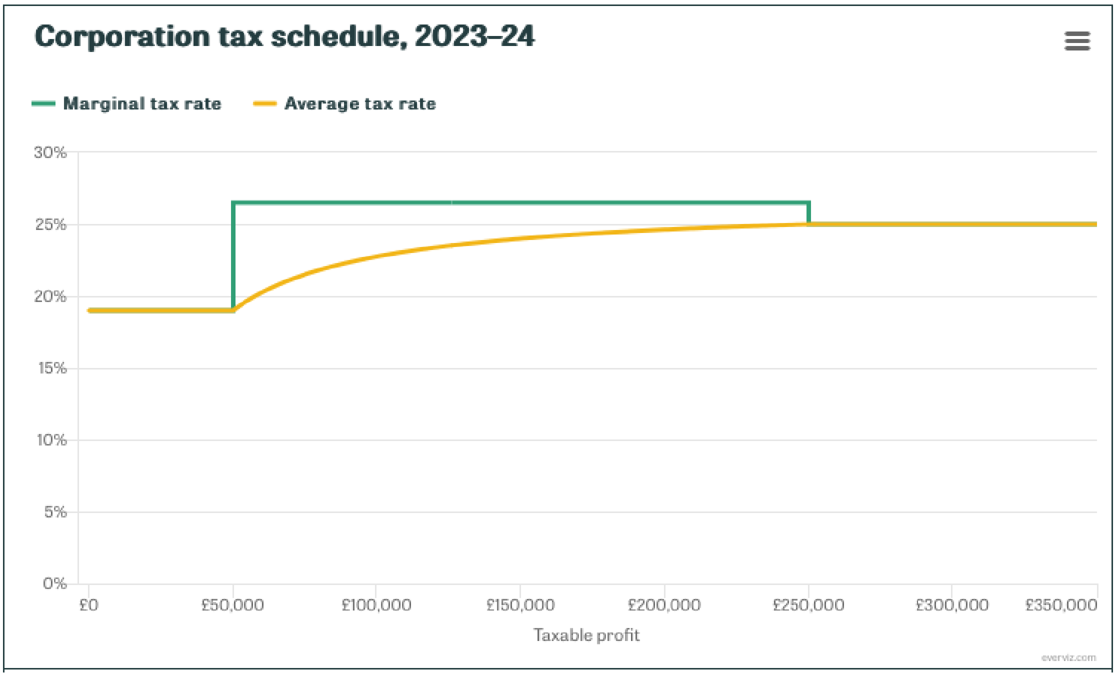
5.6. Since 1973, the main rate and small profits rate have gradually reduced over time and the rate of Corporation Tax has been a single unified rate from 1 April 2015. For that year it was set at 20% and the following year it was reduced to 19% and remained at that rate until 31 March 2023.

5.7. 1 April 2023 saw a move away from a single rate of Corporation Tax and the reintroduction of two rates, with a main rate of 25% for profits[84] over £250,000 and a lower rate of 19% for profits under £50,000. These thresholds are reduced proportionately if the company has an accounting period of less than 12 months, and/or if it has associated companies. Profits for these purposes includes dividends received (which are usually exempt from Corporation Tax), meaning that a company with large amounts of dividends is more likely not to qualify for the small profits rate. If the company's year-end straddles 1 April 2023, a hybrid rate applies.

5.8. Certain companies will always be taxed at the main rate regardless of profit levels – this includes, for example, the profits of close investment-holding companies (broadly, investment companies owed by five or fewer individuals).

5.9. For those companies within the regime, technically, the 25% rate applies to all profits above £50,000 with a tax reduction according to a formula[85] to smooth the rate between the two thresholds. The calculation is often conceptualised as applying a marginal rate of 26.5% to profits falling between £50,000 and £250,000.

5.10. The following graph [86] illustrates the transition between the two thresholds:



5.11. The relatively long transition between thresholds smooths the difference between the marginal and average tax rates for companies and the effect is therefore possibly less challenging in terms of explaining the effect to taxpayers than the much shorter transitions for High Income Child Benefit Charge and Personal Allowance clawback, as described in Chapter 2, which both produce a much higher marginal rate.

5.12. In general people will pay more attention to sharp changes than gradual ones, so that a sudden increase in marginal tax rate will be very noticeable, while a gradual change is less so[87].

[84] Profits include taxable profits plus exempt dividends
[85] CTA2010 S18B
[86] https://ifs.org.uk/taxlab/taxlab-taxes-explained/corporation-tax-explained#:~:text=the%20accounting%20year.-,Corporation%20tax%20rates,these%20in%20the%20following%20sections
[87] https://www.psychologytoday.com/gb/blog/adaptive-behavior/201605/bernoulli-and-the-taxman-part-ii-fair-and-painless

5.13. The apparently higher tax rate between the two thresholds is likely, however, to increase the amount of planning carried out by companies to keep profits below the higher rate – for example by accelerating expenditure or, particularly for smaller companies, careful attention to the combined tax position of the company and its directors.

5.14. The higher rates of Corporation Tax from 1 April 2023 are also expected to incentivise more companies to claim R&D tax relief[88], which may be particularly attractive for those companies seeking to reduce their profits from the marginal rate band to below the £50,000 threshold.

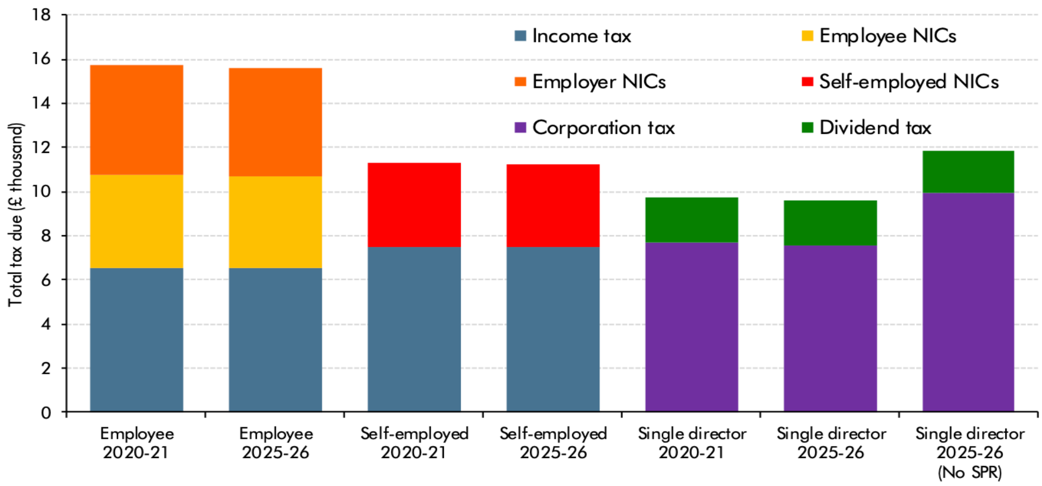
Effect on decision to incorporate

5.15. There are three main ways a business can be structured: as a sole trader, a partnership, or as a limited company. One of the issues to think about when deciding to incorporate either a new or an existing business is the overall tax position for the business owners.

5.16. Sole traders and partners in a partnership are taxed directly on the profits of the business and will pay Income Tax and National Insurance contributions on those profits. However, a company is a separate legal entity which will pay tax on its profits at Corporation Tax rates. The owners of the company are also taxed at the applicable Income Tax rates as and when they extract profits from the company – whether this is by way of, for example, a salary paid to them by the company or a dividend payment on their shareholding in the company. Or, if they sell their shareholdings or the company is wound up, they may pay Capital Gains Tax at the appropriate rate.

5.17. Having two headline Corporation Tax rates will undoubtedly complicate this decision. The main rate of Corporation Tax, i.e., 25%, is likely to act as a disincentive for incorporation but the small profits and marginal rates make the position less clear. A report by the Office for Budget Responsibility[89] indicated there would be little difference between being self-employed or being a director where the company is paying tax at the main rate, whereas for companies paying tax below that rate there is still likely to be a fiscal advantage to incorporation. For businesses with higher profits of £150,000 (unless significant profits are retained with the company, to be withdrawn at Capital Gains Tax rates when the company is eventually wound up) there is likely to be a fiscal disadvantage to incorporation, even where a marginal rate applies. This is illustrated in the charts below[90]:

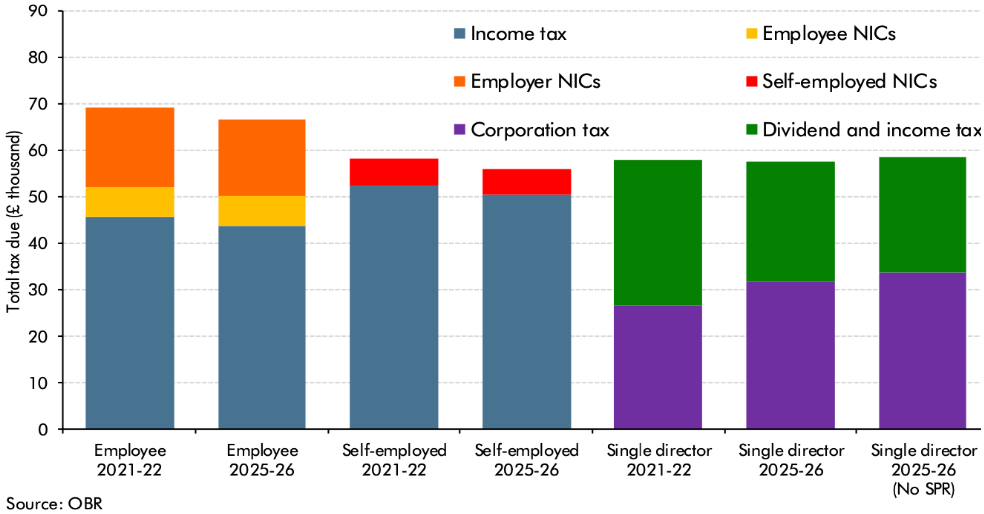
Chart A.1: Tax due on £50,000 of income in 2021-22 and 2025-26



Source: OBR

[88] https://obr.uk/docs/dlm_uploads/March-2021-Economic-and-fiscal-outlook-Corporation-tax-rate-increase.pdf
[89] https://obr.uk/docs/CCS207_CCS0221988872-001_CP-387-OBR-EFO-Web-Accessible.pdf Page 196 et seq
[90] The charts do not reflect the reduction in National Insurance rates from 6 January 2024 for employees and from 6 April 2024 for self-employed individuals.

Chart A.2: Tax due on £150,000 of income in 2021-22 and 2025-26



Source: OBR

Alternative approaches

5.18. Increasing the rate of Corporation Tax was forecast in 2021[91] to raise an additional £11.9 billion in 2023-24 and £16.2 billion in 2024-25. To offset this burden for companies, various reliefs have been introduced, such as retaining the £1m annual investment allowance and the 'full expensing' of qualifying capital expenditure on new plant and machinery. These were forecast at the Spring Budget 2023 to cost £7.9 billion in 2023-24 and £10.6 billion in 2024-25[92]. At the 2023 Autumn Statement, the Chancellor committed to make full expensing permanent and will consult on elements of the capital allowances rules.

5.19. Based on these forecasts the net effect of the Corporation Tax rate increase, after the cost of full expensing, is therefore additional revenue of £4 billion for 2023-24 and £5.6 billion for 2024-25.

5.20. The system of marginal relief between tax thresholds is undoubtedly a complication in the Corporation Tax calculation: even though software can be used to calculate the tax due, issues such as the need to consider associated companies cannot be dealt with by software alone.

5.21. When questioned[93] about this, Victoria Atkins, then Financial Secretary to the Treasury, explained:

> "So, I have set my officials three objectives: making tax fairer, simpler, and supportive of growth; and, for every single decision that we make, having explanations of how we will meet those three objectives. But we must acknowledge that, sometimes, there is a tension between the wish to make tax fairer and the wish to make tax simpler. The taper rate that I just described is an example of that. I appreciate that, for businesses with profits between £50,000 and £250,000 profits, their accountants will have to work out which tapering rate is available to them. But we do that precisely because we want to be fair to those businesses."

[91] https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/965777/Budget_2021_policy_costings_.pdf Page 20
[92] https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1142824/Costing_Document_-_Spring_Budget_2023.pdf Page 18
[93] See column 1046: https://hansard.parliament.uk/Commons/2023-03-29/debates/EE76DD85-892D-424D-87B1-50B933FEDF36/Finance(No2)Bill#contribution-978A61DC-C399-4E6C-A8D0-7904806A49C4

5.22. The alternative approach of giving all companies with total profits below £250,000 a slice of profit taxed at 19% would be costly – and would also be complicated for larger groups to calculate the number of associated companies for the purpose of setting the reduced thresholds[94]. The current system at least has the merit of familiarity, in that it operated before 2015.

[94] The £50,000 and £250,000 thresholds must be reduced by the number of associated companies and the lower effective rates can apply to some companies within a group with millions of profits.

Chapter 6 - Value Added Tax

Overview

The threshold at which businesses need to register for Value Added Tax (VAT) has been much debated, as many argue that the current threshold of £85,000 – which has been frozen at that level since 1 April 2017 - is distortionary and stops businesses growing. Some businesses deliberately stall their growth to avoid having to register for VAT.

The threshold is particularly problematic as it is effectively a cliff-edge: once past the threshold VAT has to be applied to all sales, creating a very high marginal tax rate. There is also widespread concern that complying with VAT law is administratively burdensome.

As discussed in this chapter there is no easy solution but some sort of smoothing mechanism, such as lower initial rate, would seem most likely to encourage businesses to cross the threshold.

Basic design of VAT

6.1. VAT is a tax charged on the supply (sale) of most goods and services made in the course of a business by a taxable person. VAT raises a substantial amount of revenue; in 2023-24, it is expected to raise £162.2 billion which would represent 15.3% of all receipts and is equivalent to £5,700 per household and 6.3% of national income[95].

6.2. All businesses with a taxable turnover (for VAT purposes) of over £85,000 must register with HMRC to be within the VAT regime, and therefore charge VAT on any sales. The business is, however, able to recover VAT it has paid on its purchases (input VAT). For businesses below the £85,000 threshold, registration is optional.

6.3. The VAT charge and equivalent VAT reclaim therefore spirals down through the business supply chain until the output VAT charge on sales is included in the price charged to someone who cannot reclaim it – either a consumer, or a business not registered for VAT. The precise incidence of taxation remains a matter of debate, with some research suggesting that manufacturers and retailers have not always passed on VAT reductions to consumers[96].

6.4. VAT was first introduced to the UK on 1 April 1973 in conjunction with the UK's entry into what is now the European Union. It replaced purchase tax, and a number of purchase tax exemptions were included in VAT. The then Chancellor of the Exchequer, Anthony Barber was determined to have 'the simplest VAT in Europe'. As part of this, he set the VAT threshold at what was then a relatively high level of £5,000 (although only equivalent to £51,520 today)[97].

6.5. The rate of VAT is usually 20% (the standard rate) but can be at a zero rate (e.g., on most foods) or 5% rate (e.g., on electricity & gas supplied for domestic use or to small businesses).

6.6. Some supplies, such as insurance, education and health services are exempt from VAT,[98] which means that the business does not charge VAT on those exempt services but equally cannot recover VAT on its own related purchases.

6.7. For a VAT registered business, any net output VAT must be accounted for and paid over to HMRC on a regular basis (usually quarterly, although large businesses pay monthly) or it may be that the business can reclaim net input VAT suffered, if that is greater than its output VAT.

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[95] https://obr.uk/forecasts-in-depth/tax-by-tax-spend-by-spend/vat/#:~:text=In%202023%2D24%2C%20we%20expect,per%20cent%20of%20national%20income
[96] See, for example, this report by Dan Neidle, Tax Policy Associates on whether the zero-rating of sanitary products resulted in price reductions https://www.taxpolicy.org.uk/2022/11/10/tampontax/
[97] https://hansard.parliament.uk/commons/1972-03-21/debates/999c4e5a-34d6-48ed-9e38-37cd07e4d350/OrdersOfTheDay
[98] https://www.gov.uk/guidance/vat-exemption-and-partial-exemption#exempt-goods-and-services

Flat Rate Scheme

6.8. To ease the administrative burden VAT registration imposes, a 'Flat Rate Scheme'[99] for smaller businesses was introduced in 2002. Businesses choosing to join the scheme pay a fixed percentage of their turnover, instead of calculating output and input VAT on a transaction-by-transaction basis. The rate depends on the type of business – for example, hairdressers' flat rate is 13%. There is a 1% reduction in the flat rate for the first year of being in the scheme.

6.9. The Flat Rate Scheme is available[100] to businesses with a taxable turnover of £150,000 or less. Businesses must leave the scheme once their turnover for a 12-month period is more than £230,000. Both thresholds have been in place since 2003 and the current equivalents would be around £260,800 and £400,000[101].

6.10. Businesses which have minimal purchases and are 'limited costs businesses' must use a flat rate of 16.5%, which was introduced to counter avoidance. This relatively recent restriction on the Flat Rate Scheme limits its usefulness, as the business must check whether the limited costs rules apply in any VAT quarter[102]. Limited costs businesses are typically 'labour only' businesses.

VAT registration threshold

6.11. The current threshold of £85,000 has been in place since 1 April 2017. Whereas previously the threshold was increased annually, usually in line with inflation,[103] the threshold was frozen at £85,000 for two years to 2019-20 in the Autumn Budget 2017, then for a further two years to 2021-22 in Budget 2018, then for another two years to 2023-24 in Spring Budget 2021, and most recently for two more years to 2025-26 in Autumn Statement 2022.

6.12. Under EU VAT law, increases in the VAT registration threshold could be no greater than the rate of inflation.[104] However, in the 1991 Budget a 40% increase in the UK threshold from £25,400 to £35,000 was announced, following discussions between the UK and the EU (then the European Community) commission.

6.13. The threshold thereafter increased steadily until 2017 when it was increased to £85,000 and has remained at that level since.[105]

6.14. This is currently one of the highest thresholds in Europe – typically, EU country VAT thresholds are much lower[106]. However, from 1 January 2025 EU countries will be permitted to apply for a threshold of up to Euro 85,000[107]: the Czech Republic increased its threshold to CZK2m (about Euro 80,000) as from 1 January 2023[108]. The increase in the VAT threshold is part of an EU simplification exercise aimed at SMEs.[109] [110]

6.15. Since the inception of VAT, there has always been a balance between the need to minimise the burden of tax collection on businesses, avoid distortions through some businesses not charging VAT, and maximising collection of tax from what is one of government's main revenue sources.

[99] https://www.gov.uk/vat-flat-rate-scheme
[100] https://www.gov.uk/vat-flat-rate-scheme/eligibility

[101] https://www.bankofengland.co.uk/monetary-policy/inflation/inflation-calculator 2003 to August 2023
[102] https://www.taxadvisermagazine.com/article/value-added-tax-it-time-leave-flat-rate-scheme
[103] https://www.gov.uk/government/publications/vat-notice-7001-should-i-be-registered-for-vat/vat-notice-7001-supplement--2#registration-limits---taxable-supplies
[104] https://www.legislation.gov.uk/eudr/2006/112/article/286
[105] https://www.gov.uk/hmrc-internal-manuals/vat-registration-manual/vatreg04100
[106] EU thresholds vary from nil to €85,000 https://www.vatcalc.com/eu/2023-eu-vat-registration-intrastat-thresholds/
[107] https://taxation-customs.ec.europa.eu/vat-scheme-small-businesses_en
[108] https://www.bdo.global/en-gb/microsites/tax-newsletters/indirect-tax-news/issue-4-2022/czech-republic-threshold-for-mandatory-vat-registration-to-increase
[109] https://taxation-customs.ec.europa.eu/vat-scheme-small-businesses_en
[110] https://www.taxadvisermagazine.com/article/upcoming-eu-vat-changes-2025-untangling-puzzle

6.16. Where a business charges VAT on its sales, and its customer is a consumer or unregistered business, the cost of the goods or services provided is increased by 20%. In practice, most businesses incur some VAT on purchases, which cannot be recovered if the business is not registered for VAT. If a business therefore has an annual turnover of under £85,000 and its main customers cannot recover the VAT they are charged, there can be a significant disincentive for the business to cross the £85,000 threshold and become VAT registered, especially if their main competitors are not VAT registered.

> *Example*
>
> Sam is a hairdresser, working in close proximity with other hairdressers, in a small market town. Sam works 4 days a week, has a turnover of £80,000, a profit of £55,000 and is not VAT registered.
>
> Sam wants to build her business and work up to 5 days a week, which would give her a turnover of £100,000. As this is over the VAT threshold of £85,000 she will need to think about the implications of registering for VAT and whether she is able to increase her prices, or if she is prepared to take a drop in profits.
>
> She decides initially to increase prices by 5% to £105,000 gross (£87,500 net of VAT), and to absorb the remaining VAT charge from profits (the exact amount depends on the VAT element of her purchases, but it likely to reduce profit by £5,000-10,000).

6.17. Crossing the threshold, even by £1, is a significant cliff-edge for a business. If Sam, for example, increases the number of hours worked and reaches an annual turnover of £85,001, VAT of £10,200 would be due the first year and £11,050 annually thereafter (assuming the flat rate scheme applicable to hairdressers is used). Unless Sam is also able to increase prices, this represents an immediate drop in profits.

6.18. Not only would the business need to increase prices (or alternatively bear the increase by reducing profits) but there is also a compliance cost - both in terms of time and money - in registering for VAT, keeping appropriate records (including those required for Making Tax Digital for VAT[111]) and filing regular VAT returns.

6.19. The business would also need to consider other issues, such as taking on staff to be able to increase profits sufficiently to cover the costs of VAT registration, or perhaps moving to bigger premises, which might then involve becoming liable for business rates – a charge on non-domestic properties levied by local councils.

6.20. Typically, a business run from home would not be liable for business rates[112], and small business rate relief[113] is available if the rateable value of the property is £15,000 or less. But if a bigger premises is needed, or the business has more than one premises, then business rates can be a significant cost. For example, premises in England (outside of the City of London) with a rateable value of £20,000 could be liable to a business rates charge of £9,980[114].

6.21. There has been much debate recently about how the VAT threshold can act as a barrier to growth: the disincentive to cross the VAT threshold may cause the business (ignoring those who act fraudulently, perhaps by underreporting or failing to register) to limit turnover, perhaps by restricting business hours, by taking longer holidays, or turning work away.

6.22. The VAT threshold applies to each business entity (e.g., sole trader/partnership/company). Business owners may therefore try to stay under the VAT threshold by operating separately –

[111] https://www.gov.uk/government/collections/making-tax-digital-for-vat
[112] https://www.gov.uk/introduction-to-business-rates/working-at-home
[113]https://www.gov.uk/apply-for-business-rate-relief/small-business-rate-relief
[114] https://www.gov.uk/calculate-your-business-rates

for example, two business owners working together may operate as two sole traders, each under the VAT threshold, rather than in a partnership with a combined turnover over the VAT threshold. There are anti-avoidance measures in place where the separation is artificial.[115]

6.23. The Office of Tax Simplification explored the issues of the VAT threshold in detail in its 2017 VAT report[116], including the following explanation of the 'bunching' effect:

> There is currently significant 'bunching' of businesses whose turnover is just below the threshold, particularly businesses with lower levels of inputs relative to supplies to consumers – such as labour-intensive businesses, and businesses operated by sole proprietors – for whom this bunching effect has the appearance of a cliff edge.
>
> The bunching in front of the threshold and the very significant fall-off in business numbers immediately after it, reflects the significance to a business of crossing the threshold, as when this happens all a businesses' supplies to customers potentially increase in sale price by up to 20%.
>
> For example, compare a business with a turnover of £84,000 which is not registered for VAT with a VAT-registered business having a turnover of £85,000. If VAT applied to the whole of the turnover, the VAT-registered business would be liable for an additional £17,000).
>
> Evidently, many businesses will not be able to pass this increase on to customers, especially when competing with unregistered businesses. Meanwhile, others fear the administrative impact of VAT registration.

6.24. Studies into the frozen VAT threshold show that this bunching effect has increased in scale: the chart below from the Office for Budget Responsibility estimates that, relative to 2017-18 the number of firms capping their expenditure is expected to almost double by 2025-26, from 23,000 to 44,000, with potentially 'lost' turnover of £350 million.

6.25. The VAT threshold level of £85,000 is likely to represent, particularly for service-based businesses with low costs, a good standard of living for many people, certainly well above the UK median household income of £35,000 for 2022[117]. Moving above that threshold and developing the business would entail increased administrative costs, as well as increased commitments such as perhaps moving to bigger premises and taking on staff.

6.26. An additional barrier to becoming VAT registered is the increased compliance needed. VAT-registered businesses must keep digital records and file VAT returns digitally[118]. Some will face the complexity of choosing the right method of accounting and others the challenge of identifying the right rate of VAT to levy on each sale.

6.27. The complexity of the UK VAT base undoubtedly adds cost for some types of business. A small café, for example, needs to distinguish between hot and cold food and drinks and where they are consumed. A construction business or a small 'corner shop' may need to distinguish between goods/services subject to 0%, 5% or 20% rates. In all cases, the penalties for getting it wrong could be significant. Despite academic encouragement, there is no pathway to a single

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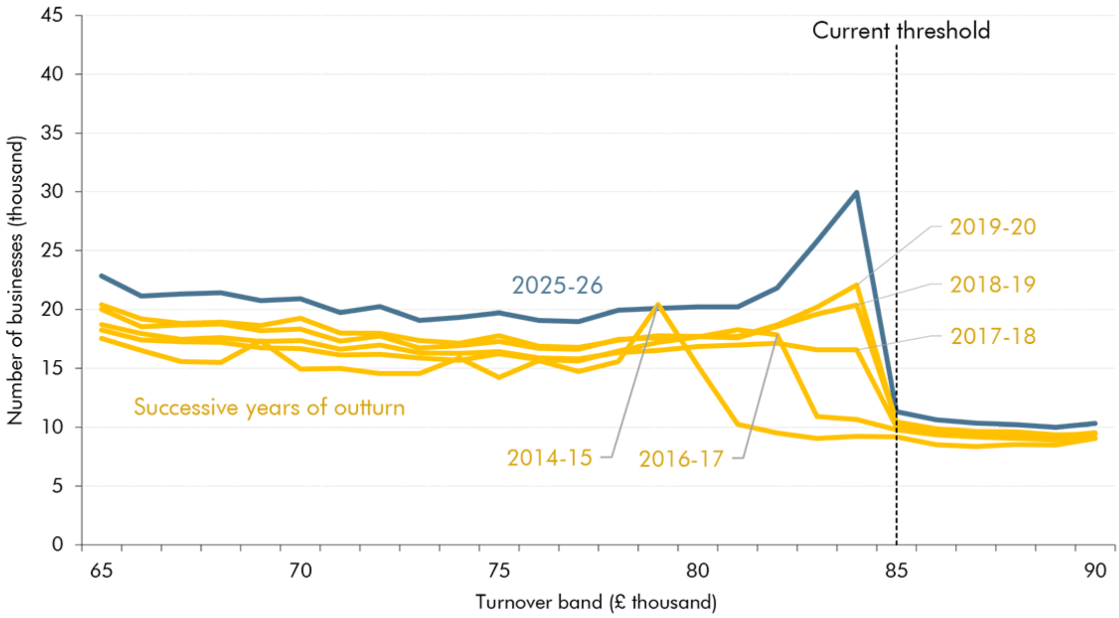
115 https://www.gov.uk/hmrc-internal-manuals/vat-single-entity-and-disaggregation-manual
116 https://www.gov.uk/government/publications/ots-report-on-routes-to-simplification-for-vat-is-published
117 https://www.ons.gov.uk/peoplepopulationandcommunity/personalandhouseholdfinances/incomeandwealth/bulletins/theeffectsoftaxesandbenefitsonhouseholdincome/financialyearending2022#:~:text=In%20the%20financial%20year%20ending%20(FYE)%202022%2C%20median%20household,poorest%20fifth%20(£8%2C200).
118 The government currently plans to introduce similar record-keeping and filing requirements for income tax from April 2026

VAT base. Instead, public support (and thus political leanings) is more towards introducing additional exemptions.

Bunching in the VAT turnover distribution at the registration threshold[119]



6.28. The VAT threshold in particular produces an extremely high marginal rate. If the VAT cannot be recovered from the customer, exceeding the VAT threshold by just £1 can produce a VAT charge. Depending on whether input VAT can be reclaimed, or if a flat rate scheme is used, the charge on £85,001 could be up to £17,000.

6.29. Studies have shown that higher marginal rates have a significant effect on under-reporting or can act as a disincentive to work[120]. There is likely to be a hesitation to cross the threshold, because the first step over it is perceived to have the biggest effect, either on profits, or by the business owner facing additional administrative complexities.

Possible approaches

6.30. Following on from the OTS report, other bodies have explored this issue, such as the Adam Smith Institute in 2017, which suggested reducing the VAT threshold[121], a report from the Federation of Small Businesses, which suggested increasing it[122] and Tax Policy Associates[123] which suggested giving businesses an allowance to offset the VAT payable to the exchequer.

6.31. The OTS report had previously considered all of these and made the following recommendation:

[119] https://obr.uk/efo/economic-and-fiscal-outlook-march-2023/
[120] Page 144 https://social-econ-psych.univie.ac.at/fileadmin/user_upload/p_wp_psy/files/Downloads_EK/Kirchler_2007_The_economic_psychology_of_tax_behaviour_Buchmanuskript.pdf
[121] https://www.adamsmith.org/blog/is-vat-to-blame-for-the-productivity-puzzle
[122] https://www.fsb.org.uk/resource-report/a-duty-to-reform.html
[123] https://www.taxpolicy.org.uk/2023/01/30/vat_brake2/

The government should examine the current approach to the level and design of the VAT registration threshold, with a view to setting out a future direction of travel for the threshold, including consideration of the potential benefits of a smoothing mechanism.

6.32. The then Chancellor agreed with the recommendation but decided to keep the registration at its level of £85,000 whilst the issue was considered[124].

6.33. A more detailed response[125] was given following a call for evidence in 2018. The potential for a smoothing mechanism was considered but the response explained that no decision could be made until the terms of the EU exit were clear.

6.34. The response also recognised the administration burden for businesses registering for VAT. At the same time, the relatively high registration threshold produces a distortion, in that an unregistered business has a cost advantage over a registered business, where sales are to consumers.

6.35. Freezing the VAT threshold at £85,000 could raise £1.4 billion a year in VAT revenues, based on figures produced by the OBR[126].

6.36. While lowering the threshold would bring more businesses into the VAT regime, it likely to be a significant cost burden for businesses. It could probably best be justified if brought in at the same time as other administrative changes – for example Making Tax Digital for Income Tax[127], which is due to start as from 6 April 2026 for businesses with sales (turnover) of more than £50,000 (falling to £30,000 from 6 April 2027). A lower threshold - particularly one set at a level where most viable businesses would need to register - also removes the competitive disadvantage for retailers who are trading above the threshold.

6.37. A more viable approach could be to offer some sort of positive incentive for businesses to cross the VAT threshold for the first time and become VAT registered. This could for example be an 'introductory' flat rate for the first year of being VAT registered; the 2017 OTS report suggested a reduction of 5% in the first year, 3% in the second year and 1% in the third.

6.38. Another variant would be to offer a sliding scale of tax rebates: this was introduced in Finland in 2004 - though with mixed results.[128] The Finnish results showed that offering an allowance to those going slightly above the registration threshold did reduce the level of bunching, but some bunching remained. The study suggested that administrative burdens also affected businesses and discouraged expansion.

6.39. Any smoothing mechanism used would need to be fully explored and costed, but the aim would be to bring into the VAT regime those businesses who currently see little or no benefit, (and a greater administrative burden), if they increase their turnover above the VAT threshold. Broadening the number of registered businesses would also have the effect of increasing VAT revenues.

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124 https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/661062/Letter_from_the_Chancellor_to_the_Office_of_Tax_Simplification__OTS__web.pdf

125 https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/752042/VAT_Threshold_Call_for_Evidence_Summary_of_Responses_digicomms.pdf

126 https://obr.uk/box/the-impact-of-the-frozen-vat-registration-threshold

127 As suggested in this report (see pages 8,14, 22 https://economy2030.resolutionfoundation.org/reports/tax-planning/

128 https://taxation-customs.ec.europa.eu/system/files/2016-09/report_evaluation_vat.pdf pages87-91

Chapter 7 – Capital taxes

Inheritance Tax

7.1. Inheritance Tax is charged on the value of an individual's estate at death, together with gifts made in the last seven years before death[129]. Tax is also charged on some lifetime transfers, typically transfers into trust. There are various exemptions for example gifts to a spouse, to charity and for certain business and agricultural property.

7.2. Tax is charged on the taxable amount as follows:

The nil rate band	£325,000	NIL
Remainder	Over £325,000	40%

7.3. Any unused nil rate band on the first death of a couple who are married or in a civil partnership can be transferred to the surviving spouse so that up to £650,000 is available for the couple.

7.4. A further nil rate band may be available in respect of residential property. The residential nil rate band was introduced in stages from 2017-18[130]. It is now £175,000 and can be used when residential property is left on death to children or remoter issue of the deceased. If not used on the first death of a spouse or civil partner, the unused proportion of the allowance can be transferred to the surviving spouse. Hence the maximum allowance for residential property is £350,000, which together with the nil rate band above can give an overall exemption of £1 million for married couples or civil partners.

Effect of freezing the nil rate bands

7.5. The legislation requires an annual increase in the nil rate bands based on CPI inflation[131]. However, this can be overruled by government and the £325,000 nil rate band has been frozen since 2009 and will remain frozen until 2027-28. No increases have been made to the residential nil rate band since 2020-21.

7.6. If these amounts had been increased for inflation since the relevant dates, it is estimated that they would be £492,000[132] and £200,000[133] respectively for 2023-24.

7.7. HMRC figures show that £7.1 billion was raised from Inheritance Tax in 2022-23, an increase from £6.1 billion for the previous year.[134] Around 41,000 estates paid Inheritance Tax in 2022-23 compared with 33,000 in 2021-22. The increases are considered to be due to a combination of higher asset values, more deaths as a result of COVID and the retention of the nil rate band at the same level.

7.8. A Freedom of Information request in July 2023 has established that the internal Treasury estimate of the number of additional estates liable for Inheritance Tax over the period of the freeze is now 49,400[135]. When the bands were frozen up to 2025-26 in the 2021 Budget official estimates were that 12,700 more estates would pay Inheritance Tax. [136]

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[129] The tax on gifts between 3 and 7 years of death is tapered.
[130] The band was introduced in the tax year 2017-18, starting at £100,000 and increasing by £25,000 each year until reaching £175,000 in 2020-21.
[131] S8 IHTA 1984
[132] Based on estimates in the OTS second report on IHT (https://www.gov.uk/government/publications/ots-inheritance-tax-review-simplifying-the-design-of-the-tax) and further CPI increases since that report.
[133] Based on CPI increases
[134] https://www.gov.uk/government/statistics/hmrc-tax-and-nics-receipts-for-the-uk/hmrc-tax-receipts-and-national-insurance-contributions-for-the-uk-new-annual-bulletin#inheritance-tax
[135] https://www.telegraph.co.uk/politics/2023/07/30/tens-of-thousands-more-families-to-pay-inheritance-tax/
[136] https://www.gov.uk/government/publications/inheritance-tax-nil-rate-band-and-residence-nil-rate-band-thresholds-from-6-april-2021/inheritance-tax-nil-rate-band-and-residence-nil-rate-band-thresholds-from-6-april-2021

Other Inheritance Tax thresholds

7.9. Various further monetary exemptions which apply to lifetime gifts. For gifts to individuals the exemptions will only be relevant if the gift is within the last seven years of life, so that they become chargeable on death.

7.10. These are:

Small gifts exemption[137]	£250
Annual exemption[138]	£3,000
Gifts in consideration of marriage[139]	£5,000, £2,500 or £1,000 depending on the donor's relationship with the couple

7.11. These limits have all been frozen for many years. If they had been increased to reflect inflation they would currently stand at:

Exemption	Date of introduction/last increase	Amount		Amount reflecting RPI/CPI
Small gifts exemption[140]	1980	£250	2023-24	£1,173
Annual exemption[141]	1981	£3,000	2023-24	£13,820
Marriage exemption[142] - parent	1975	£5,000	2023-24	£59,120
Marriage exemption - grandparent	1975	£2,500	2023-24	£29,560
Marriage exemption - other	1975	£1,000	2023-24	£11,824

7.12. Exemptions should be reviewed periodically, not only to consider whether the amount is appropriate but also to ensure that they continue to meet the required policy objectives.

Capital Gains Tax

Annual Exempt Amount

7.13. A threshold above which capital gains are taxed (and below which they are not) has applied in some form since 1977, when the government exempted annual gains below £1,000. This exemption was renamed the Annual Exempt Amount in 1980 when it was increased to £3,000; and in 1982 it was increased again to £5,000.

7.14. Legislation then provided that the Annual Exempt Amount would be adjusted annually in line with the Consumer Prices Index, (rounded up to the nearest multiple of £100 - which means that the allowance has increased by more than inflation over the years). By the 2020-21 tax year the Annual Exempt Amount was £12,300: it was then frozen at that level until 2022-23.

7.15. In the 2022 Autumn Statement[143], the Chancellor announced that the Annual Exempt Amount would be reduced to £6,000 for 2023-24 and £3,000 as from 2024-25 onwards for individuals:

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[137] S20 IHTA 1984- The small gift exemption allows up to £250 per tax year to be gifted to any number of individuals.

[138] S19 IHTA 1984 - The annual exemption exempts gifts of up to £3,000 per tax year. If it is not used in a particular tax year it can be carried forward to the following year only.

[139] S22 IHTA 1984

[140] Based on estimates in the OTS second report on IHT (https://www.gov.uk/government/publications/ots-inheritance-tax-review-simplifying-the-design-of-the-tax) and further CPI increases to September 2022 since that report.

[141] Based on estimates in the OTS second report on IHT (https://www.gov.uk/government/publications/ots-inheritance-tax-review-simplifying-the-design-of-the-tax) and further CPI increases to September 2022 since that report.

[142] Based on RPI and CPI to September 2022 as appropriate

[143] https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1118429/CCS1022065440-001_SECURE_HMT_Autumn_Statement_November_2022_BOOK.pdf (Exec Summary)

for most trusts, the amounts are one half of that for individuals[144]. Statutory indexation has been repealed for 2023-24 and subsequent years.

7.16. These changes are expected to affect around 500,000 individuals and trusts for 2023-24[145] and raise tax of £275 million initially, rising to £425 million in 2024-25[146].

7.17. In their Capital Gains Tax stage 1 report[147], published in November 2020, the Office of Tax Simplification explored the purpose of the Annual Exempt Amount.

> The Annual Exempt Amount could be considered to fulfil one or more purposes:
>
> - a substantive relief, comparable to the Income Tax Personal Allowance.
> - an administrative de minimis, to reduce the number of people who need to report Capital Gains Tax information; and
> - a means to compensate for inflation.

7.18. Respondents to the survey carried out by the OTS as part of the report thought that the level of the Annual Exempt Amount was more akin to a relief and was too high to be an administrative de minimis. The report noted a spike in the number of individuals with gains just below the Annual Exempt Amount, indicating planning to make best use of the relief.

7.19. The report used estimates provided by HMRC which indicated that a reduction to £3,000 would result in 330,000 more individuals needing to report a capital gain, of whom about 210,000 did not routinely file a Self Assessment tax return.

Reporting requirements

7.20. The OTS recommended that, if the Annual Exempt Amount was reduced, administrative aspects should be considered alongside that reduction.

7.21. Despite a welcome increase in the reporting threshold described in Chapter 8, as the Annual Exempt Amount has been reduced significantly there is likely to be an increased burden for those taxpayers, who will have to register for Self Assessment to report and pay tax on what could be a relatively small amount. This is a cost both for the taxpayer and HMRC.

7.22. HMRC do have an alternative stand-alone reporting process known as the ‘real time service’ but as the OTS pointed out, it is currently imperfect as it stands, as the legislation, including the enquiry and filing deadlines, is currently unclear. This is reflected in the small number of taxpayers who use the real time service (1,670 for disposals of assets other than residential property in 2018-19)[148]. It is to be hoped that HMRC will invest in an easier reporting process for individuals with small gains – perhaps as an addition to the forthcoming Single Customer Account.

Review of amount

7.23. When the first Annual Exempt Amount was introduced in 1980-81 it was increased annually in line with inflation. An Annual Exempt Amount set at £3,000 today does not need to be increased annually in line with inflation but, as discussed in Chapter 1, should be reviewed periodically to ensure it continues to meet its new policy purpose.

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144 https://www.gov.uk/guidance/capital-gains-tax-rates-and-allowances

145 https://www.gov.uk/government/publications/reducing-the-annual-exempt-amount-for-capital-gains-tax/capital-gains-tax-annual-exempt-amount

146 https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1118364/Autumn_Statement_2022_Policy_Costings_.pdf see page 23

147 https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/935073/Capital_Gains_Tax_stage_1_report_-_Nov_2020_-_web_copy.pdf See Chapter 4

148 https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/987994/Capital_Gains_Tax_stage_2_report_-_May_2021.pdf

Chapter 8 – Administration thresholds

Self Assessment thresholds

8.1. There are several thresholds and limits which are designed to ease the administration of the Self Assessment process. Some of these have been covered above as they are also thresholds for calculation purposes, but the main thresholds are summarised here for convenience.

Rent a Room .

8.2. If income from letting a furnished accommodation in one's own home is £7,500 or less in the tax year, no entry needs to be made on the tax return.

Trading and property allowances

8.3. If income from either trading or property is £1,000 or less in the tax year no entry needs to be made on the tax return.

Abbreviated entries for trading and property income

8.4. If turnover is less than £85,000 in the tax year only the total expenses need to be shown on the Self Assessment return.

Cash basis for trading and property income

8.5. The option to report income and expenses on a cash rather than accruals basis was introduced in 2013 for eligible trading and property businesses after work carried out by the Office of Tax Simplification[149]. The current limit for starting to report in this way is a turnover of less than £150,000 for both types of business. Once using the cash basis, this can continue for self-employed income until a turnover of £300,000 is reached.

8.6. The cash basis is the default method for property income within the limit, although the taxpayer can opt out. For self-employed businesses the accruals method is the default, with taxpayers needing to opt into the cash basis (and this can be changed every year).

8.7. HMRC report[150] that an estimated 1.2 million self-employed individuals currently choose to report on the cash basis, out of 4.2 million eligible businesses, giving a take up rate of 29%. A recent consultation discusses increasing the limits along with other changes to increase take up, but not making the cash basis mandatory for anyone[151].

Self Assessment filing criteria

8.8. HMRC publish criteria setting out who has a responsibility to file a Self Assessment tax return. These are not mirrored in legislation; the legislative requirement being that anyone who is chargeable to Income or Capital Gains Tax and has not received an HMRC notice to file must notify HMRC of their liability[152].

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149 https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/199180/02_ots_small_business_tax_review_simpler_income_tax_280212.pdf

150 https://www.gov.uk/government/consultations/expanding-the-cash-basis/expanding-the-cash-basis-for-the-self-employed--2

151 https://www.gov.uk/government/consultations/expanding-the-cash-basis/expanding-the-cash-basis-for-the-self-employed--2#summary

152 S7 TMA 1970

8.9. The HMRC criteria as shown on Gov.uk are[153]:

> **Who must send a tax return**
>
> You must send a tax return if, in the last tax year (6 April to 5 April), any of the following applied:
>
> you were self-employed as a 'sole trader' and earned more than £1,000 (before taking off anything you can claim tax relief on)
>
> you were a partner in a business partnership
>
> you earned £100,000 or more
>
> you had to pay the High Income Child Benefit Charge
>
> You may also need to send a tax return if you have any untaxed income, such as:
>
> - some COVID-19 grant or support payments
> - money from renting out a property
> - tips and commission
> - income from savings, investments and dividends
> - foreign income

8.10. There is also an online tool to enable taxpayers to check the position, although it has been pointed out that this does not fully comply with the law[154].

8.11. The criteria are not exhaustive and taxpayers who are outside the criteria but still have a liability are requested to contact HMRC who may collect through PAYE if possible or may require a return to be filed.

8.12. As non-statutory guidelines with limited guidance being available, the guidelines can cause confusion in practice, particularly in respect of the need to file a return to pay the High Income Child Benefit Charge, which is covered in Chapter 2 above. The recent consultation: Simplifying and modernising HMRC's Income Tax services through the tax administration framework[155] included discussion on the operation of the limits. It also includes as an Annex the full list of HMRC filing criteria, which is broader than that shown on Gov.uk

8.13. Separately HMRC have announced that for 2023-24 returns the limit for those paid under PAYE will increase from £100,000 to £150,000. However, as noted in Chapter 2, this is likely to mean that many of those affected by the tapered Personal Allowance will not need to file returns and HMRC will therefore need to ensure that their systems are able to capture cases where tapering is needed on a timely and accurate basis. The Autumn Statement abolishes this threshold altogether for those taxed only through PAYE from 2024-25[156].

Capital Gains Tax reporting limits

8.14. All capital gains must be reported to HMRC if the taxpayer's total gains (before deducting any losses) are above the Annual Exempt Amount. If gains are less than the Annual Exempt Amount, there is a further requirement[157] to report if total 'consideration' (broadly, sale

153 https://www.gov.uk/self-assessment-tax-returns/who-must-send-a-tax-return
154 https://www.litrg.org.uk/sites/default/files/00_Guidance_Report_2023_FINAL.pdf page 50
155 https://www.gov.uk/government/consultations/simplifying-and-modernising-hmrcs-income-tax-services-through-the-tax-administration-framework/discussion-document-simplifying-and-modernising-hmrcs-income-tax-services-through-the-tax-administration-framework#summary
156 https://assets.publishing.service.gov.uk/media/6568909c5936bb00133167cc/E02982473_Autumn_Statement_Nov_23_Accessible_Final.pdf page 99
157 https://www.gov.uk/hmrc-internal-manuals/capital-gains-manual/cg20220

proceeds but could also include the value of gifts made) exceeds a threshold. Until the current year, the reporting threshold was set at 4 times the Annual Exempt Amount but is now set at £50,000.

Coding out limit

8.15. HMRC will adjust PAYE tax codes to collect tax due from a Self Assessment return if the amount is less than £3,000. The taxpayer must be paid under PAYE (an employment or a pension) and the return submitted by 30 December if online, or 31 October if paper. There are certain other conditions, in particular the collection must not mean that the tax deducted is more than half the PAYE income[158]. The method is optional for the taxpayer. The £3,000 limit has not been increased since 2011[159], and given the 50% safeguard outlined above, a review of the amount would be useful.

Conclusion

8.16. Policymakers should keep administrative thresholds under review, in the same way as substantive thresholds. Whilst minimising administrative burdens is in principle desirable, there are cases where administrative thresholds have been set too high, such that insufficient information is provided routinely, when it may be done more cheaply and conveniently. This can introduce additional costs due to compliance checks or the lack of a suitable alternative reporting mechanism.

[158] https://www.gov.uk/pay-self-assessment-tax-bill/through-your-tax-code
[159] By SI 2011/1585, art 2(2) with effect from 20 July 2011