Behind the numbers on income tax

New income tax statistics from HMRC appear to be good news, but the numbers are not what they seem.

Taxpayer's marginal rate	Basic Rate	Higher Rate	Additional Rate
2020/21 Average tax rate	9.5%	21.8%	38.3%
2023/24 Average tax rate	9.9%	20.8%	38.0%

Source: HMRC

This table, recently released by HMRC, shows the average income tax rate for the three main categories of taxpayer. For example, in 2020/21, on average, basic rate taxpayers paid 9.5% of their income in tax and in the current tax year are expected to pay a slightly larger share, 9.9%. At first sight, higher rate and additional rate taxpayers seem to be doing better, as their average income tax rate drops.

HMRC offers no real explanation for the difference, other than a statement that says, "Average rates of income tax vary over time depending on the number of overall income tax payers and the number in each marginal rate band, as well as growth in incomes and changes to income tax thresholds and allowances."

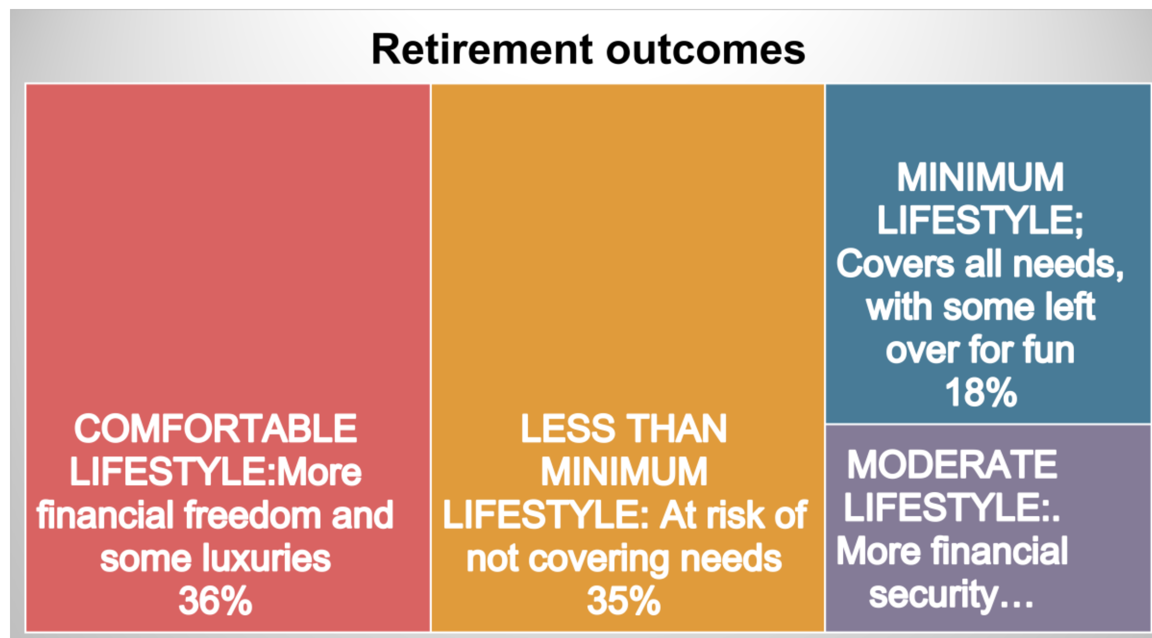
The story behind the changing numbers may be why HMRC is less than comprehensive in setting out what has happened:

- For basic rate taxpayers, the average rate has increased because the personal allowance has only risen by £70 (0.56%) since 2020/21, whereas average weekly earnings increased by 23% between April 2020 and April 2023. So a greater share of income is taxable in 2023/24 than in 2020/21 and the proportionate tax rate rises.
- The backdrop for higher rate taxpayers is the same, so why the falling average rate? What HMRC forgot to mention is that in 2020/21, the higher rate tax band ended at £150,000, whereas in 2023/24 it stops at £125,140. Many higher rate taxpayers towards the top of the band three years ago have now migrated into the additional rate band. The overall result is the lower average rate for higher rate taxpayers.
- The picture for additional rate taxpayers is almost a mirror image of the higher rate scenario. The near £25,000 lower starting point for additional rate in 2023/24 than 2020/21 means there are just about double the number of additional rate taxpayers in 2023/24 than in 2020/21. That extra, lower income population in the additional rate band drags down the average rate.

All of which should make you check what tax band you fall into for 2023/24 and seek professional advice if you have questions or concerns about how the changing rates might affect you.

The reality of retirement affordability

New research reveals that one in three people could face hardship in retirement.



Source: Frontier Economics based on Scottish Widows survey data

The “cost of living crisis” is a phrase that is hard to avoid in any media. High inflation, stealthily increasing taxation and constrained earnings growth are an unwelcome combination that leaves few of us unaffected. In time, the crisis should pass. It is easy to forget now that a little over two years ago, in July 2021, inflation was bang on the Bank of England’s target, at 2.0%.

The understandable focus on today’s living costs does not mean that future cost of living issues have disappeared. To examine this point, one of the UK’s major insurance companies has launched a National Retirement Forecast (NRF) designed to capture a snapshot of the UK’s future retirement landscape.

The forecast uses the Pension and Lifetime Savings Association’s (PLSA) ‘Retirement Living Standards’ levels to estimate the lifestyle that people are set to achieve when they stop working. These standards, covering minimum, moderate and comfortable retirement lifestyles, are updated each year to take account of price increases and changes in retirement spending patterns. The latest set, published in January 2023, show that in 2022 the yearly cost of a minimum retirement lifestyle increased from £10,900 to £12,800 (18%) for a single person and from £16,700 to £19,900 (19%) for a couple.

The new forecast starts with projections based on the current savings and behaviours of individuals and takes a comprehensive view of sources of retirement income, including pensions, other long-term savings, inheritance, and accounts for any housing costs. Those projections are then compared to the PLSA’s standards to show the distribution of lifestyles in the future retired population. All the calculations are made in today’s money terms.

The main conclusion is that over a third of the population are not on target to achieve even the minimum lifestyle standard when they reach retirement. However, an almost identical proportion are currently set for a comfortable retirement.

It makes sense to find out which retirement outcome you are on track to achieve, as the sooner you know, the more time you have to adjust your plans accordingly.

A banking crisis close to home?

Rising mortgage rates are posing some difficult questions for one of the major providers of housing finance.

You would think that a group estimated to have provided £8.8 billion of residential property finance to 170,000 first-time buyers in 2022 would be well known, with a high street presence and careful oversight from the Financial Conduct Authority (FCA) and the Bank of England. However, you would be wrong.

The group in question has its own acronym, BOMAD – the Bank of Mum and Dad – and has been a consistent supplier of gifts and/or loans to nearly half of first-time buyers for the last decade. While the BOMAD generally does not charge interest, the increase in interest rates that has occurred over the last 18 months could see it facing some difficult questions. With very few exceptions, the first-time buyers that the BOMAD financed will also have borrowed from mainstream lenders and thus be facing increased mortgage costs at some point, typically when their two-year or five-year fixed rate mortgage deal ends.

The FCA has already told mortgage providers that they should consider offering borrowers:

- A switch to interest-only payments for six months, or
- An extension to their mortgage term to reduce their monthly payments, with the option to switch back within six months.

If you are a member of the BOMAD group, what should you do when you are asked for mortgage assistance by your children or grandchildren? The answer will depend upon many factors including:

- What other actions your 'customer' has already taken to reduce their mortgage outlay;
- How long any support is likely to be required;
- How much capital, if any, you are willing and able to gift or lend; and
- Whether you have surplus income, for example, as the result of higher interest rates, that you can give away or lend.

Inevitably, inheritance tax is also a consideration, although other taxes might be relevant. For example, this tax year's lowered annual exemption means capital gains tax may be a problem if you are realising an investment to provide liquid funds.

The various options and their tax consequences make advice essential. Mainstream banks undertake due diligence before acting and so should the BOMAD.

Who is choosing your pension investments?

The Chancellor has announced a new initiative to stimulate higher risk pension investment, shifting focus to UK private companies.

"British pensioners should benefit from British business success. By unlocking investment, we will boost retirement income by over £1,000 a year for a typical earner over the course of their career."

Those are the words of the Chancellor, quoted in a recent press release from the Treasury launching the Mansion House Reforms on pension fund investment. The statement is a bold one that would probably attract criticism from the Financial Conduct Authority about unjustified performance claims, had it not been made by the regulator's ultimate boss. Suggesting that any particular investment action "will boost income" ignores the familiar caveat that the value of investments can fall as well as rise.

In the case of the Chancellor's proposed reforms, that warning is particularly relevant because of the investments being targeted. For example, a key part of the package was the announcement that by 2030, nine of the UK's largest Defined Contribution (DC) pension providers aim to place 5% of their default funds into UK private companies, that is companies whose shares are not listed on the London Stock Exchange. Such companies are generally small and often young. While they offer potential for high growth – think start-up technology businesses – they are often also high risk and not all of them succeed.

That risk means that such businesses can find raising capital difficult and governments have often stepped in with tax incentive schemes, such as Venture Capital Trusts, to encourage investors to commit funds. The Chancellor is adopting a less tax-costly approach by encouraging workplace pension funds to allocate part of their members' existing contributions to unlisted companies. If other DC pension providers follow suit, the government thinks "up to £50 billion of investment in high-growth companies" could be unlocked by the end of the decade.

The allocation will only apply to default funds, which are the funds where employer and employee pension contributions are directed if no fund choice is made. Most of the 18 million active members of DC workplace pension schemes end up invested in default funds. However, if you are in such a scheme, you will almost always have a choice of other funds. For example, for some, looking at sustainability and climate-related issues may be an important factor.

The Chancellor's latest move is another reminder that default may not be the best option and that, as with any investment, personally tailored advice should be your starting point.

What's next? Looking ahead to new tax policy

With a general election less than 18 months away, thoughts are turning towards the potential policies of a new occupant of 11 Downing Street.

With most opinion polls showing a lead for the Labour Party of around 20%, what the Shadow Chancellor, Rachel Reeves, says about her approach to public finances is gaining ever more attention. Her stance so far has been to talk only of three specific tax changes:

- Removing the current exemption from VAT for private school fees;
- Scrapping the rules that favour wealthy UK residents who are non-domiciled; and
- Ending the generous (28%) capital gains tax treatment of carried interest for private equity managers and replacing it with an income tax charge.

Like most politicians hoping to win power at the next election, Ms Reeves has studiously avoided proposing tax increases that could affect the broad electorate. However, given the level of government borrowing (about £130 billion in this financial year) and the pressures on public services, many economists see tax rises – beyond those already baked in – as inevitable.

One possible clue to what future tax changes might look like emerged in a recent report from the Resolution Foundation. The chief executive of the think tank, Torsten Bell, was formerly Ed Miliband's head of policy and a Treasury civil servant who became special adviser to the last Labour Chancellor, Alistair Darling. The Foundation's report listed a set of tax reforms which, as a complete package, did not raise any additional revenue but did reshape some tax structures.

For example, the report recommended that the phasing out of the personal allowance above £100,000 be scrapped because of the "regressive" 60% marginal rate of tax it created. For the same tax-rate-distorting reason, the report proposed scrapping the High Income Child Benefit Charge, triggered at £50,000. But, before you raise a cheer, the report's quid pro quos included lowering the starting point of the additional rate (45% outside Scotland and 47% in Scotland) to £100,000 (from its recently lowered £125,140) and raising the basic rate tax levied on dividends from 8.75% to 20%.

History suggests that Chancellors – of all hues – are more prone to co-opt sensible tax-raising ideas than those that cut Treasury income, so whoever wins the next election, the need for a regular review of your tax planning should remain a priority.