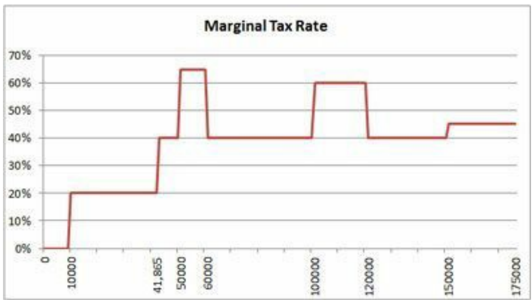
# Marginal tax rates explained

Contractors can pay wildly different marginal tax rates, depending on their earnings and business and personal circumstances. The definition of the marginal rate of tax paid is the percentage of tax paid on earnings for the next pound earned. So, for contractors earning £50,000 have entered the higher rate tax band and their marginal rate of income tax is 40%, because the contractor will be paying 40% on the next pound earned.

In an ideal 'progressive' tax regime, a taxpayer's marginal rate of tax would increase as their earnings grow, so lower earners pay a lower proportion of their income in taxes. In the UK, when you look at income tax bands, it appears that way. For example, lower earners pay no tax, then the rate starts at 20%, growing to 40% for higher rate taxpayers. For each pound that a contractor earns over £150,000, the marginal rate becomes 45%, so higher earners pay more tax.

However, as James Abbott, founder and head of tax at contractor accountant Abbott Moore explains, this is not the full story: "As can be seen from the graph below, it is those contractors and other taxpayers earning between £100,000 and £120,000, or who have Child Benefit withdrawn, who can pay much higher marginal rates on their incomes."

Abbott highlights that there are strategies contractors can adopt to mitigate excessive marginal rates. But he notes that the fundamentals of tax planning still apply, and that contractors should not rely on a more friendly tax regime in the future. He explains: "Contractors should always ask if the rate they pay now is going to be less than what it will cost them in the future?"




## Effective, marginal and total tax – what do they mean?

A contractor's marginal rate of tax is the rate they pay on the next pound they earn. That marginal rate should not be confused with the effective tax rate or the total amount of tax: "The effective rate of tax takes into account that a taxpayer's earnings will also be effectively taxed due to other allowances that are removed as earnings increase," explains Abbott.

Some income will not be taxed at all, because of the personal allowance. Other income will be taxed at 20%, 40%, some possibly as high as 64.75%, when Child Benefit is withdrawn, and then 45% as a contractor's earnings increase above £150,000. So, the effective rate of tax is defined as the rate at which a contractor's income is taxed, taking into account all of these tax bands and reductions in allowances.

"The total amount of tax is, as its name suggests, the full amount of tax – expressed as a sum and not a percentage – that a contractor pays out to HMRC during an accounting period, less any allowances or credits. The accounting period for individual taxation is the UK tax year, from April to March. The total tax an individual contractor should pay will be calculated in their self-assessment tax return, and take into account their income from all sources."

## Marginal rate examples

So, for example an employee, or an umbrella company contractor who claims no expenses:

Can earn up to £10,000 before paying any income tax. Their marginal rate is zero (disregarding National Insurance Contributions).

Between £10,000 and £41,865 (2014/15 rates), a contractor pays 20% income tax on their earnings, so the marginal rate is 20%

Earnings of £41,866 to £150,000 are taxed at 40%, and the marginal rate is 40%

Earnings above £150,000 are taxed at 45%, so the marginal rate is 45%.

Freelancers working through and paying dividends out of their own limited companies face similar marginal rates when corporation tax and income tax are combined.

## Where marginal rates exceed the published rates – the highest rate of tax

"Unfortunately, the UK tax code is not so simple that the marginal rates outlined above apply in all cases," highlights Abbott. "There are some circumstances where the marginal rate can reach 60%, and, counter-intuitively that happens when a contractor is not earning very high sums."

Abbott explains that two of the classic marginal rate tax traps most likely to impact on contractors are because of the withdrawal of Child Benefit and when the personal allowance is withdrawn for those earning over £100,000.

"Tax rules state that for every two pounds a taxpayer earns over £100,000, their tax-free personal allowance is reduced by one pound. What this means in practice is that a contractor's income between £100,000 and £120,000 is actually taxed at a marginal rate of 60%."

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>
> James Abbott, Abbott Moore

The same situation applies to Child Benefit if there are one or more earners with one or more children in the household. Child benefit is gradually withdrawn between £50,000 and £60,000. Because of the formula used to withdraw Child Benefit from higher earners, a contractor earning over £50,000 will see their marginal rate increase from 40%, with their marginal rate dependent on their personal circumstances, such as the number of children they have.

For example, a contractor claiming Child Benefit for three children and earning £60,000 will suffer the higher marginal rate of 64.75%.

### Contractor tax strategies to beat the excessive marginal rates

"There are a range of strategies available to limited company contractors to avoid falling into the marginal rate traps," says Abbott. "Because limited company contractors can choose when and how to remunerate themselves, they can adjust their earnings over different years to mitigate the impact of higher rates."

So, rather than pay themselves £115,000 year after year and suffer 60% tax on the £15,000 over £100,000, they can opt to pay themselves only £100,000, which has a marginal rate of 40%. The following year, they could choose to pay themselves £140,000, which means they only take the 60% hit once every other year.

In the Child Benefit scenario, a contractor could adopt a similar strategy of phasing payments so that their income does not fall into the band that attracts the highest marginal rate every year. In year one, the contractor could earn £50,000 and in year two pay themselves £70,000. That way the high marginal rate only occurs once every other year.

And contractors with modest income requirements have the option of leaving cash in their business rather than taking it out as dividends, to use for other business purposes. However, Abbott urges contractors to take note of close investment company rules if they do this, and also the rules on extracting large sums of cash from a company when closing it down.

### Income splitting and salaries

"Of course, depending on their personal circumstances, contractors could also consider paying a spouse or partner a salary as long as the sum can be justified by the work actually done, or income splitting with a spouse via dividends. This will have the same impact of keeping the contractors earnings out of the high marginal rate hot spots."

However, Abbott warns that if the spouse has their own income from contracting or other sources, they may also fall into the same traps, so careful tax planning is required by all concerned.



James Abbott

Owner

Abbott Moore LLP


James Abbott is the owner of Abbott Moore LLP and often speaks on freelancer / contractor tax matters. He has his own growing portfolio of contractor clients.

Abbott Moore LLP are PCG Accredited Accountants and specialise in providing tax advice to freelancers as well as dealing with their year end accounts and tax returns. Read Full Profile...

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Unfortunately, employees and umbrella company contractors do not have this flexibility, so are forced to pay the full marginal rates.

Abbott concludes: "Understanding how marginal rates work and adopting the right tax strategy can usually result in a contractor keeping the lion's share of their earnings."

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