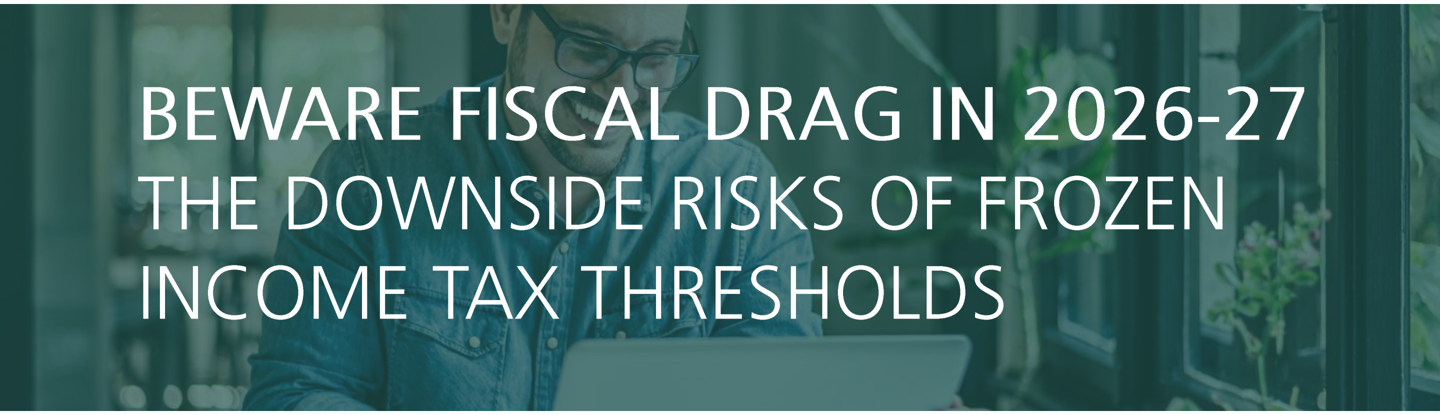

BEWARE FISCAL DRAG IN 2026-27
THE DOWNSIDE RISKS OF FROZEN INCOME TAX THRESHOLDS

The Government has confirmed that income tax thresholds will remain frozen until April 2031. While tax rates themselves have not changed, this freeze has important consequences for anyone whose income is increasing, even modestly, over the next few years.

This note explains what the threshold freeze means in practice, why it can lead to higher tax bills, and who should be paying particular attention as we move into the coming tax year.

WHAT DOES A FROZEN TAX THRESHOLD MEAN

Income tax is charged by applying tax rates to bands of income. The amount you can earn before moving into a higher tax band is set by income tax thresholds.

When thresholds are frozen, they do not increase in line with inflation, wage growth, or business profits. As a result, more of your income becomes taxable at higher rates over time, even if your real spending power does not improve.

This effect is often referred to as fiscal drag. It is not always obvious, because there is no single tax rise announced, but the outcome is the same, higher tax being paid as income increases.

WHY THIS MATTERS NOW

With thresholds frozen until 2031, any increase in income subject to income tax will generally be fully taxable. There is no automatic uplift in allowances to soften the impact.

If your income is close to the basic rate limit or the higher rate limit, even a relatively small pay rise, bonus, dividend increase, or profit uplift could push part of your income into a higher tax band in the coming tax year.

This means that future earnings increases may be taxed at higher rates than you might expect, particularly where income has historically sat just below a threshold.

WHO IS MOST AFFECTED

This change affects a wide range of people, but some groups are more exposed than others.

Employees whose salaries increase each year, whether through promotion, cost of living adjustments, or performance related pay, may find that more of their income is taxed at higher rates over time.

Business owners and directors who extract profits through a mix of salary and dividends may see more of their income falling into higher tax bands as profits grow.

Self-employed individuals and partners whose profits fluctuate year to year may cross thresholds more often, leading to less predictable tax outcomes.

Pensioners who continue to work part time, draw taxable pensions, or receive investment income may also be affected, particularly where multiple income sources combine to push total income over key limits.

Anyone already close to the higher rate threshold should be especially alert, as the marginal tax rate on income above that point is significantly higher.

AN EXAMPLE IN SIMPLE TERMS

Consider someone whose income currently sits just below the higher rate threshold. If their income increases next year due to a pay rise or stronger business performance, the excess over the threshold will be taxed at the higher rate.

The result is that the additional income is not taxed at the same rate as their existing income. Instead, it is taxed more heavily, reducing the benefit of the increase.

Over time, repeated small increases can lead to a steadily rising overall tax burden, even though headline tax rates have not changed.

WHY THIS IS RELEVANT FOR THE COMING TAX YEAR

As we move into the next tax year, many people are seeing upward pressure on income due to wage adjustments, price increases, or recovering profitability after a difficult period.

Because thresholds are fixed, these increases are more likely to translate directly into higher tax bills. In some cases, this may also affect entitlement to allowances or reliefs that are tapered or withdrawn at higher income levels.

This makes forward planning more important than it has been in periods where thresholds automatically rose each year.

PLANNING OPPORTUNITIES TO CONSIDER

While the threshold freeze cannot be avoided, its impact can often be managed with careful planning.
This may include reviewing the timing and structure of income, such as the balance between salary and dividends for company owners.

Pension contributions can, in some cases, reduce taxable income and help keep total income within a lower tax band.

Spreading income between spouses or civil partners, where appropriate, may improve overall household tax efficiency.

For self-employed individuals and business owners, planning around the timing of profits, capital expenditure, or other deductions may also help smooth taxable income across years.

The right approach will depend on individual circumstances, income sources, and future plans.

WHAT YOU SHOULD DO NEXT

If your income is rising, or if you are already close to a basic rate or higher rate income limit, now is a good time to review your position.

Understanding where your income sits in relation to the frozen thresholds can help avoid surprises and allow sensible planning before the end of the tax year.

WE CAN HELP

We are happy to help you look ahead, model the impact of income changes, and consider practical steps to manage your tax position over the coming years. If you have any concerns, or if you would like to discuss how the threshold freeze affects you personally, please get in touch so we can talk through your options.

Contact us on **01753 888 211** or email **info@nhllp.com**, we are here to help.