

Institution **CIOT - CTA**  
Course / Session **APS Taxation of Individuals**  
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Course **APS Taxation of Individuals**

Event **NA**

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Answer-to-Question-\_1\_

2 May 2024

### **Draft Report to Sarah Masters**

The purpose of this report is to advise Sarah Masters on how to minimise her tax liabilities. This is with respect to either ending her employment with Tea & Biscuits Ltd or staying on in a part time role, and with respect to minimising the tax liabilities resulting from investing and withdrawing funds from SM Rental Ltd and investing and withdrawing from her pension.

This report is intended solely for Sarah Masters and should not be relied upon by a third party. It is based on the law as it stands on 2 May 2024 which may change in future.

### **Executive Summary**

Our recommendation would be to terminate the employment 1 June 2024. This is because the tax free termination payment of £60,000 would exceed the additional part-time salary offered until the intended date of resignation.

Advice should be sought regarding the intended share price of Tea & Biscuits Ltd. Any gains following the cessation of employment, or if applicable from when Sarah starts part-time work, would be taxable as employment income and there would be the cost of both employee and employer national insurance contributions. If the options are exercised and the shares sold within 14 days of

cessation then she would receive £130,116 tax free.

Investing £150,000 in a loan to SM Rental Ltd would save £15,000 in mortgage interest charges, and would enable Sarah to extract company funds via her own interest charges in future years that wouldn't be expected to be subject to tax due to both the savings allowance and the savings starting rate and the tax free allowance until she starts to receive her occupational pension.

Investing into the pension would enable Sarah to receive 20% tax relief at source on the gross contribution, totalling £30,000, which would be paid directly into the pension. She would also receive a credit of the £2,446 tax otherwise payable due to the higher tax rate via her self-assessment tax return. £3,600 can be contributed each year in following tax years regardless of the level of earnings.

Sarah could then, after the £150,000 investment into the pension, initiate a flex-access drawdown scheme that would allow her to withdraw 25% of her total pension from the scheme tax free. However advice should be sought from a financial advisor with regards to the lost return on investment from inside the scheme that would have been received tax free if not withdrawn until a later point.

We would suggest if possible investing the full £120,000 net contribution into the pension scheme and £150,000 via a loan to SM Rental Ltd. Otherwise advice should be sought from a financial advisor to determine the expected rate of return on the gross investment in the pension scheme of £150,000, factoring in the £32,446 tax relief given upfront through the pension.

There would be no inheritance tax implications of either the pension contribution or the investment in the property company.

### **Salary and Termination Payment with Tea & Biscuits Ltd**

The three months' salary over the notice period would be fully taxable and subject to national insurance regardless of whether the employment is terminated or the part-time role is taken. This is because it would fall within the definition of post employment notice pay rather than the provisions for termination payments under s401.

The non-contractual payment of £60,000 would be fully exempt from tax and national insurance, providing there was not a reasonable expectation that Sarah would receive such a payment on termination previously where it would be taxed as employment income rather than a termination payment under s401. Assuming there was no such reasonable expectation, the normal limit of £30,000 would not apply as the employment was terminated as a result of ill health, so under s401 the payment would be fully exempt from tax and national insurance.

If the part-time role were taken, the gross salary from September 2024 to December 2024 would be £12,500 (three months at £37,500) with the intended leaving date assumed to be 31 December 2024, this is far less than the alternative termination payment offered of £60,000 Sarah were to leave from 1 June 2024. Both options would offer her the £150,000 per year for three months from 1 June 2024 from which she either leaves or becomes part time.

It is therefore recommended that the employment is terminated as at 1 June 2024. As per the next section, this would not affect the availability of tax relief for the EMI shares, and gives the option to either excise and dispose of the shares immediately or wait until the shares gain a market listing.

### **Share Options with Tea and Biscuits Ltd**

Although the share options are currently eligible Enterprise Management Incentive (EMI) share options, they would cease to be eligible as such under either option. This is because full time employment is a condition of the scheme. From the point that the EMI conditions cease to be met, Sarah will have 90 days from which the shares could be disposed of to keep the tax benefits of the scheme, if the shares are disposed of after that point then there would be taxable employment income in respect of any further share price increases from the point that the conditions are no longer met.

The EMI shares, subject to above, are entitled to full relief from income tax as exercise price is in line with the unrestricted market value of those shares at the date of grant. They must also have been held for at least two years from grant and be in a trading company of which Sarah is an employee, all these conditions have been met for all of the shares.

If the shares were to be disposed of within 14 days of termination, the value received from those shares would be £130,116 as per **Appendix 1** with no tax charge. If the shares are disposed of when the company obtains a stock exchange listing then the value received would likely be higher based on your

expectation that the share price would increase. In this case there would be a tax charge upon exercise in line with the increase in value of the shares from the point that employment terminated to the exercise of those shares. Employer and employee national insurance would be due on this as from the date of listing those shares would be readily convertible into cash, and would also be taxable via PAYE. As per the agreement Sarah would be required to cover the cost of the employer national insurance due.

As the shares are currently subject to a disposal restriction, because any shares obtained would be required to be sold back to Tea & Biscuits Ltd for 27p, any income tax charge on exercise would be based on the restricted value at the date of exercise. Any remaining income tax charge would be when those restrictions are lifted, based on the percentage of the initial unrestricted value that was neither tax nor paid for, or based on the residual value if disposed of with the restriction still in place. However, the company has stated that they are willing to withdraw the disposal restriction if they are exercised after the company gains a stock listing, in which case at the point the shares are exercised there would be no disposal restriction so, if there is any taxable element, it would be based on the unrestricted value of the shares at that point of exercise.

There are risks with keeping the share options until December 2024, as the shares could fall in value, this would need to be referred to a financial advisor for further advice.

**Repaying the mortgage for SM Rental Ltd**

If Sarah were to lend the £150,000 to SM Rental Ltd so that it could repay the mortgage, this would not only save the company interest charges but would also enable Sarah to withdraw capital from the company via an interest charge. The interest charge would be taxable income for Rachel but as shown by **Appendix 2**, regardless of Rachel's marginal rate of tax the interest would be subject to a lower rate compared to dividends when factoring in corporation tax savings from interest charged. The interest charge would need to be up to a market rate of interest, which we can assume would be the 10% that would apply to the mortgage from the end of this year after the fixed rate ends. The 10% rate of interest on £150,000 would be £15,000 per year, which would bring company profits down to zero eliminating the need for dividends. However if the mortgage remains then there would be no profits available for distribution in future years, as it would be at the same 10% rate.

From when Sarah leaves the employment, as her non-savings income is expected to be reduced to nil, she would also have full use of the £5,000 starting rate on top of the £1,000 savings allowance she will likely have in future tax years. This means that £6,000 interest income could be received tax free, so only £9,000 would be subject to tax if in excess of the tax free allowance of £12,570, which is not expected to be the case. Therefore she would not be taxed on any of that income and she would have a buffer for unexpected income until she starts to withdraw from her occupational pension in 2030. She would still retain the benefit of the savings allowance of £1,000 (as a basic rate taxpayer) but not the starting rate which is reduced by non-savings income up to £5,000.

Alternatively, if the mortgage remains, she would have no profits available for distribution. This would cost her the £15,000 per year she would otherwise receive tax free.

The funds could be withdrawn from the company at any time. The interest charged to the company would need to be taxed at source at 20%, via quarterly returns submitted to HMRC, however any difference to the actual liability can be paid or reclaimed via a self-assessment return.

Sarah currently has £100,000 in an ISA, interest on this would continue to be free of tax even after withdrawing from her occupational pension so it may be better to keep this investment, subject to the advice of a financial advisor.

It is our recommendation that £150,000 are used to repay the mortgage, and that Sarah charges interest to the company, if the funds are available.

### **Pension Contribution**

When making personal pension contributions, tax relief is not only limited to the annual allowance, including brought forward amounts, it is also limited to relevant earnings. This would include gross pay from the employment with Tea & Biscuits ltd as well as earnings from EMI shares, but not any dividends or interest received from investments. Assuming that Sarah terminates her employment from 1 June 2024, the annual salary of £150,000 would apply from April to August 2024 which would result in total earnings of £62,500. She would also make a gain of at least £130,116 from the exercise of the EMI share options. This

means that her earnings would be in excess of the £150,000 suggested investment.

She could invest £3,600 per year from the following tax year onwards despite not having any earnings and receive tax relief at source on that contribution.

The net pension contribution would receive tax relief at source at 25% of the net amount paid in, which is 20% of the gross contribution. This means that 20% of the gross contribution of £150,000 would be added to the pension by HMRC. Sarah would therefore receive an extra £30,000 in 2024/25 into her pension regardless of whether she has actually paid any tax on any of her income. This would also apply to the following £3,600 contributions, which would receive tax relief at source at 20% even if she didn't pay any income tax in future years. Any higher rates of tax would also receive tax relief via self-assessment tax returns, so she would receive a credit of £2,446 (**Appendix 3**) which is the expected difference between the higher tax rate and the basic tax rate on taxable income over the higher rate threshold of £37,700.

The funds required to make a gross contribution of £150,000 would be £120,000.

She could make withdrawals from the pension at any time as Sarah is over the pension age of 55. This income would however reduce the starter rate for interest received from SM Rental ltd and would likely be subject to tax. However following the £150,000 pension investment she could initiate a flex-access drawdown scheme that would allow her to withdraw 25% of her total pension

tax free, but would not then receive any tax free returns on investment from within the pension scheme. This should be referred to a financial advisor.

We would suggest that she invests the full £120,000 (net) if possible in the pension and makes further £3,600 contributions in future years. By doing this she is receiving an extra 20% pension contribution from HMRC.

### **Cash available for Company Loan and Pension Contribution**

The expected take home pay from the employment is shown in **Appendix 3** which is £45,299. This assumes that employment ends from 1 June 2024 and the shares are disposed of within 14 days. There would also be the £60,000 termination payment and £130,116 from the sale of the shares which would be tax free.

Total funds would therefore be £235,415 from income for that year, plus potentially the £100,000 in the cash ISA subject to financial advice.

This means that there may not be the funds available to both lend the funds to SM Rental Ltd and to invest in the pension. That being £120,000 for the net contribution into the pension less £2,446 higher rate tax refund, totalling £115,108 plus £150,000 to be lent to SM Rental Ltd, totalling £265,108.

Lending the funds to SM Rental Ltd is expected to save £15,000 per year due to the mortgage interest savings as a result. Contributing £120,000 net into the pension would result in an additional £30,000 funds into the pension from HMRC, plus a

£2,446 refund from HMRC. Any gains on that pension would be tax free.

Advice should be sought from a financial advisor whether the return on £150,000 being in the pension scheme would exceed the £15,000 per year saving from the company investment, factoring in the £2,446 higher rate tax refund and £30,000 tax relief at source as a result of the pension contributon.

### **Inheritance tax implications**

Investment in SM Rental, whether as shares or as a loan, would not be eligible for business property relief so would be subject to inheritance tax on death. This is because investments are excluded assets for the purposes of the relief, which includes rental businesses.

Both the nil rate band and the property nil rate band have been utilised by her main residence worth £500,000.

The pension investment would also not be eligible for any specific relief from inheritance tax.

Becuae of this there would be no inheritance tax implications of either investing in the pension or the property company.

### **Appendix 1**

Value of shares obtained (restricted value) =  $0.27 \times 667,098 = 180,116$

Less the total combined option exercise prices (total) = 50,000

200,000 x 0.05 = 10,000

142,857 x 0.07 = 10,000

166,666 x 0.06 = 10,000

90,909 x 0.11 = 10,000

66,666 x 0.15 = 10,000

Therefore the total value received would be £130,116, this would be fully exempt from income tax, there would be no capital gains tax as the shares would be sold immediately at their deemed base cost, which was their restricted market value.

## **Appendix 2**

If basic rate taxpayer, dividends would be taxed at 8.75% plus at least 19% corporation tax that would not apply on that amount if interest were charged instead. This totals 27.75%. The tax rate on interest would be 20% with no national insurance charge or corporation tax on that amount.

If a higher rate tax payer, this would be 33.75% plus 19% totalling 42.75%, compared to 40% if interest were charged instead.

If an additional rate taxpayer, this would be 39.35% plus 19% totalling 48.35%, compared to 45% if interest were charged instead.

## **Appendix 3**

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	non-savings	savings	dividends		
Salary	62,500				
Total income	62,500				
Personal allowance	(12,570)				
Taxable income	49,930				
		37,700	20%	7,540	
		12,230	40%	4,892	
			total tax	12,432	

National insurance would be 12% for 37,700 and 2% for 12,230.  
Total NI would therefore be £4,769.

£62,500 less £12,432 less £4,769 leaves £45,299 take home pay.