Institution **CIOT - CTA**
Course **APS Human Capital Taxes**

Event **NA**

Exam Mode **OPEN LAPTOP + NETWORK**

Answer-to-Question-_1_

DRAFT

REPORT ON THE TWO REMUNERATION PACKAGES PROPOSED FOR THE NEW MANAGEMENT TEAM

Report prepared by Chartered Tax Advisors for Eagle Kitchens Ltd on 3rd November 2023

A) INTRODUCTION

The contents of this report is in response to the email from Richard Hutch dated 1st November 2023 and covers:

- The proposed remuneration package of the new management team and the considerations surrounding the proposed options;

- Expected costs of both proposals;

- Advantages of the proposals;

This report has been prepared in accordance with the Law as of 3rd November 2023.

This report has been prepared solely for the benefit of Eagle Kitchens Ltd and no other entity may rely upon the contents of this report.

For the remainder of this report, Eagle Kitchens Ltd will be referred to as "EK".

B) EXECUTIVE SUMMARY

- EK must ensure that the entire management team are initially

auto-enroled into the occupational pension scheme, as this is a requirement under Employment Law.

- Andrew and Clare will likely trigger annual allowance charges equating to £21,825 and £6,300 respectively if the employer contributions are provided. Andrew and Clare may opt for the scheme pays route for the annual allowance charge, to prevent any personal tax obligations from arising.

- The EFRBS scheme must be considered as part of the Part 7A disguised remuneration rules, as this may trigger a tax charge upon contributing into the scheme by EK. The EFRBS also has a restriction on the benefits typically offered under an occupational pension scheme, such as tax relief on contributions and the 25% tax-free lump sum withdrawal.

- The cash allowance provided in substitution for pension contributions will be liable to Income Tax and Class 1 primary and secondary NIC.

- The CSOP scheme will provide the management team with exemption from Income Tax provided the shares are exercised within the 3-10 year qualifying window. EK as the employer must ensure the CSOP scheme is correctly registered with HMRC and that EK satisfy the conditions to arrange a CSOP scheme.

- The non-tax advantaged share options will be subject to an Income Tax charge upon exercise of the shares. This will equate to the market value upon exercise.

- The growth value shares will result in EK having to create a new share class which will require Legal advice and the correct documentation in place. The growth value shares will be charged to Income Tax upon award with Capital Gains tax being payable upon the eventual disposal of the shares.

- Consideration must be given as to how EK wishes to facilitate the proposed share option schemes, in light of Richard and Charles wishing to step away from the business and the growth ambitions in the 5-year business plan.

C) REMUNERATION PACKAGE - PENSION

The provision of the defined contribution pension scheme to all individuals is mandatory, as EK are obliged as their employer to auto-enrol the management team into a qualifying pension scheme.

The contributions into the pension scheme will provide the individuals with tax relief at source. This is achieved by deducting the employee pension contributions made against their gross income, reducing the overall income that is chargeable to Income Tax.

For a pension scheme to be qualifying, an employer is obliged to contribution 3% into the pension scheme and the employee must contribute 5%.

The employer contributions provided by EK are deemed a tax-exempt benefit on the management team, so the provision of the pension scheme in the package is a tax efficient incentive method to provide to the new management team.

EK are also entitled to a deduction against company profits for any employer pension contributions made, so the benefit in making the contributions expands to cover EK also.

An individual enrolled into a pension scheme is entitled to a £40,000 annual allowance, which covers both the employee and employer pension inputs.

However, where an individual is deemed a "high earner" the benefits associated in making the pension contributions are

restricted by the annual allowance provisions outlined in the proposed management package. An individual is deemed a high earner once their adjusted income exceeds £240,000.

Once adjusted income surpasses this limit, the £40,000 pension input limit is tapered by £1 for every £2 adjusted income surpasses the £240,000 adjusted income limit.

Nigel Crab and Enid Felines will not be caught under the annual allowance provisions by solely reviewing their salary levels, as their salary income is at or below £240,000. Therefore, both individuals will be entitled to the £40,000 pension input, which based upon the proposed employer contributions will not surpass this limit.

However, the £240,000 is based upon the relevant income of an individual, which includes income from patents, furnished holiday lettings. Therefore, it is recommended to clarify with these individuals whether they have any wider relevant income as this may impact the individuals remaining below the adjusted income.

It is also recommended to clarify with the individuals whether they intend to make employee pension contributions into the scheme, as this will also have influence over their pension input levels.

Andrew Tag has comfortably surpassed the adjusted income limit and will have the full tapering to his annual allowance of £4,000 as his adjusted income has exceeded £312,000.

Therefore, if Andrew and Clare wish not to obtain the "Top Up" offered then they are both likely to trigger annual allowance charges, especially given the individuals have confirmed they have no pension carry forward to reduce any future charges.

The annual allowance charges will trigger a tax charge at their

marginal rates of 45% which will be payable by self-assessment. However, there will be no Class 1 primary or secondary NIC payable on the charge and so there will be a NIC both for the management team and EK.

The expected annual allowance charges for Andrew is £21,825 and £6,300 for Clare as outlined in Appendix A.

Andrew can opt for the scheme to pay the annual alowance charge, provided the annual allowance charge exceeds £2,000 and the pension input exceeds £40,000. Andrew will be eligible for the "scheme pays" route as the employer contributions alone are £52,500. However, provided Clare does not personally contribute into the pension scheme her pension contributions will total £36,000 and may therefore not qualify for the scheme pays route.

The scheme pays route will prevent Andrew from having to fund any tax due on the annual allowance charge. Instead, the tax charge is paid by the pension provider by reducing the contributions made into his pension scheme. This of course has the benefit of avoiding the upfront tax charge for Andrew, but will result in reductions in his pension fund each tax year where a charge arises.

Alternatively, EK may consider funding the annual allowance charges on behalf of the individuals. This will prevent Andrew and Clare from being personally liable to any Income Tax charges.

This will however result in the charge being grossed up to account for EK funding the benefit on behalf of the individuals. The grossed up value will then be subject to Income Tax, which will increase costs for EK. The gross up on Andrew's charge would be £39,682 and so Income Tax would be payable of £17,857. The gross up on Clare's charge would be £11,455 with Income Tax payable of £5,155.

If EK did proceed in funding the charges on behalf of the individuals, it is recommended that an agreement is drawn up to outline the terms under the agreement. If the individuals also have relevant income or personal pension contributions which would increase the annual allowance charge, it should be outlined that the charge funded by EK only relates to the employment element of the charge to reduce costs for EK.

This arrangement may therefore not benefit Andrew and Clare from making the pension contributions and so the top-up and cash allowance options have been outlined below for your consideration.

C) REMUNERATION PACKAGE - PENSION TOP-UP

The employer financed retirement scheme (EFRBS) will be beneficial for EK as the scheme will enable the company to set their own terms for the pension scheme. For example, having the aged 55 pay-out to the individuals is something that EK may incorporate into the pension agreement.

Contributions into the EFRBS scheme are not subject to either the annual allowance or lifetime allowance provisions. Therefore, if Clare and Andrew have also surpassed the current pension lifetime allowance limit of £1,073,100 then contributions into the scheme will also avoid the lifetime allowance charge being triggered upon a benefit crystallisation event.

There is no tax relief available for the employer contributions provided into a EFBRS scheme. Furthermore, EK will lose the ability to claim relief against company profits for any contributions made.

However, upon arranging the EFRBS scheme consideration must be given as to whether the EFRBS scheme will be operated and managed by a 3rd party, for example a trust. If operated by a 3rd party, the disguised remuneration rules may apply given EK is regarded

as a close company by having less than 5 participators.

The disguised remuneration rules may apply in this situation as income is being earmarked for the individuals. It may also be viewed that a tax advantage would be obtained under the arrangement as the individuals will be avoiding the annual allowance charge.

If it is deemed that the disguised remuneration rules apply, there will be a tax charge based upon the value of the relevant step. The relevant step will likely equate to the amount of the "Top Up" provided by EK. Therefore, this will mitigate any benefit in operating the EFRBS scheme as both Andrew and Clare will still be liable to an income tax charge.

If EK did decide to implement the EFBRS route, it is recommended that legal advice is sought to ensure the trust arrangement is correctly implemented and that further consideration is provided to the disguised remuneration rules.

Upon reaching the retirement age set by EK, both Andrew and Clare will be liable to Income Tax on the full lump sum payment provided. There is no 25% tax-free lump sum which is available for registered pension schemes, so Andrew and Clare will eventually be taxable on the full payment.

C) REMUNERATION PACKAGE - PENSION CASH PAYMENT

If the cash payment route is adopted, Andrew will need to actively dis-enrol from the pension scheme to prevent further contributions. EK will be obliged to re-enrol Andrew every 3 years into the occupational pension scheme, so it is recommended that Andrew is notified prior to this date so he can dis-enrol again.

The counter-offer provided by Andrew Tag involves the payment of

additional salary to both Andrew and Clare.

The payment of the additional salary will be deductible from company profits for EK, but will of course result in further costs for EK.

The payment will be liable to Income Tax at their 45% marginal tax rate and also Class 1 primary and secondary NICs which will be payable by Andrew/Clare and EK respectively.

As provided in Appendix A, this will result in additional costs of £25,331 for Andrew, £17,370 for Clare and £101,819 for EK once the payments are also considered.

From providing consideration to all options proposed, it is recommended that the individuals proceed in having the pension contributions. This will provide EK with deductions against company profits for the employer contributions made. The expected Income Tax charge arising against the annual allowance charges are significantly less once factoring in both the Income Tax and NIC due on the cash payment. The EFRBS scheme also provides no benefits to the individuals, such as tax relief on pensions and the full amount of the pension upon withdrawal will be subject to Income Tax.

D) MANAGEMENT INCENTIVE PLAN - COMPANY SHARE OPTION SCHEME ("CSOP")

The CSOP scheme is a beneficial tax-advantaged share scheme to implement, as it will provide EK with the flexibility to select certain employees to participate. Therefore, EK will have the opportunity to exclude the other 410 full-time employees currently employed by EK from benefitting from the scheme.

There are administrative requirements prior to granting share options under the CSOP scheme, such as registering the scheme

with HMRC by 6th July following the end of the tax year and certifying that EK meets the conditions to register a CSOP scheme.

The set-up and administration costs are deductible for EK against company profits.

It is also recommended that a share agreement is drawn up and legal advice sought. This should outline the key requirements of the scheme to the management team so they are aware of the operation of the CSOP scheme.

The permitted limit for the grant of CSOP shares is £30,000. This does not provide much flexibility in trying to award key staff members such as Andrew Tag, but the grant of CSOP shares does present some tax advantages.

To qualify for the receipt of the CSOP shares, all individuals participating must be full-time employees. It is therefore recommended that the proposed employment contracts are reviewed to ensure the indivuduals will satisfy the full-time working condition.

There is also a restriction imposed where individuals with a material interest in EK will be restricted from benefit, in light of EK being a close company. Material interest is where an individual possesses more than 30% of the share capital in EK. None of the individuals will surpass this limit, but it will restrict Richard from benefitting in the CSOP scheme should he wish to participate in light of his 40% shareholding.

The shares must be ordinary shares in EK. They must also be fully paid up and non-redeemable.

The shares granted must not be greater than the market value of the shares upon grant.

The shares must also be regarded as qualifying shares. The shares will be regarded as qualifying, provided EK remains to not be controlled by another entity (by an entity acquiring a >51% holding).

EK are proposing to implement a 5 year and 1 day holding period on the shares. Under a CSOP scheme, provided shares remain in the scheme for between 3 and 10 years there is no Income Tax upon withdrawal. If the shares are exercised outside this time window, they will revert to being regarded as non-tax advantaged share options and no Income Tax exemption will be provided.

The CSOP scheme will therefore provide an incentive to the management team, as provided they remain within their positions at EK they will obtain the shares with no Income Tax payable.

The only tax the individuals would need to consider is Capital Gains Tax ("CGT") upon the eventual disposal of the shares. The CGT rates will be either 10% or 20% depending on whether the individuals are regarded as a basic or higher rate taxpayer at the time of disposal.

Provided the individuals are UK tax resident upon disposal, they will be eligible to the £12,300 annual exempt amount.

E) NON-TAX ADVANTAGED SHARE OPTIONS

The provision of non-tax advantaged share options will create a tax charge upon award of the shares. The tax charge will equate to the market value upon grant of the share option.

Upon exercise of the share options, there will be a tax charge arising. The tax charge will equate to the market value of the shares upon exercise. Therefore, any growth in the share value between grant of the share options and exercise of the share options will be subject to an Income Tax charge.

Depending on whether the shares are considered readily convertible assets ("RCAs") which is discussed in more detail below, there will be an Income Tax charge regardless of whether the shares are considered RCAs or not.

Appendix B outlines the expected Income Tax charges for both Andrew and Clare. The expected tax charges would be £283,500 for Andrew and £141,750 for Clare.

The shares issued under a non-tax advantaged share option scheme and the costs in setting-up and administering the scheme are not deductible from company profits for EK.

With Fitch & Squirrel having a heavy influence over the structure of the management incentive packages, it is recommeneded that advice is sought to ensure the incentive package is compliant with UK Employment Law and other Legal regulations surrounding the issuing of shares. With Fitch & Squirrel being US based, they will have limited knowledge on UK legislation and so EK must ensure that the arrangement is compliant.

F) GROWTH SHARES

The grant of the share awards under the growth share package proposed by the management team will result in a new class of shares from being awarded.

As the individuals would provide the nominal value of the shares, with the shares having no value upon award there would be no Income Tax payable by the employees. EK would have no obligations as an employer to have to withhold Income Tax.

The restriction would also have no tax implications upon award of the shares, as the individuals funded the nominal value of the shares at source.

The only tax the individuals would be liable to is Capital Gains tax upon disposal of the shares provided they do not leave EK within the restriction period, which will be charged based upon the growth of the shares realised upon award and the disposal of the shares.

The management team will be liable to pay Capital Gains Tax at a rate of 20% given they are all higher rate taxpayers. This will be payable by the individuals via self-assessment and EK will have no reporting or withholding obligations as the employer. Appendix B outlines the Capital Gains tax payable which would be £252,000 for Andrew, £189,000 for Clare and £126,000 for Nigel and Enid.

If the management team did leave EK within 5 years, then there will be an Income Tax charge equivalent to the market value of the shares upon leaving the company.

With more shares being issued by EK, this will also result in a dilution of the shareholding for Richard and Charles. With the individuals hoping to reduce their involvement in the company, having this separate class of shares may result in the individuals no longer have the joint majority shareholding in the company.

Of course any growth achieved by the management team will also contribute towards the growth in ordinary shares owned by the existing shareholders. However, the growth will be distributed amongst a greater share withholding and therefore the growth realised per share will be less than if the growth shares were not issued to the employees.

If EK do proceed in implementing this growth award scheme, it is recommended that advice is sought to draw up the share agreement. This will result in additional professional fees for EK to incur,

but will be crucial to ensure the agreement is structured correctly.

G) SHARE FUNDING

However, regard must be given as to the structuring of the share awards being provided to the individuals. With one of the exit goals being potentially disposing of the shares in 2029, EK would require the individuals to dispose of their shares simultaneously to the other shareholders disposing of their shares. This will require the agreement of the majority of the shareholders to agree to the disposal of the sale.

It is therefore recommended that EK consider implementing an agreement which requires the indviduals to dispose of their shares upon request of the majority shareholding, to prevent any disputes between shareholders upon the sale of the shares which then prevents the shares from being sold.

Furthermore, if the shares are provided from ordinary share capital then consideration must be given to how the shares will be provided.

An option available to facilitate this would be for the existing shareholders to perform a share buyback of the shares to sell them back to EK. Given Fitch & Squirrel would be unlikely to want to perform a share buy back on their shares, this would liklely be performed by either Richard or Charles Hutch as the majority shareholders.

Richard and Charles will be either taxable on the share buy-back as a dividend or a capital gains tax will arise if the conditions under the capital route are satisfied. The conditions are outlined below for reference, but if satisfied the buybck will be subject to capital gains tax at either 10% or 20%.

- The individuals must be UK tax resident upon disposal

- The shares must have been owned for at least 5 years

- The shareholding must be substantially reduced, being a 25% reduction in the shareholding

Alternatively, EK will need to issue more shares. This will dilute the current shareholdings of Fitch and Squirrel, Richard and Charles.

As Richard and Charles are hoping to shortly reduce their duties in EK, the dilution of the shareholding may not be beneficial. Currently, as the individuals own more than 5% of the shares in EK the disposal of shares will be subject to Capital Gains Tax at 10% under the Business Asset Disposal Relief provisions. However, if the dilution of shares results in the shareholding being reduced below 5% then there may be a higher capital gains tax payable which may result in a 20% capital gains tax charge.

This may cause issues, as if any of the management team do not agree to the sale of EK in 2029 as they will be regarded as shareholders in the business they may prevent any future sales of the company. Therefore, if the CSOP route is utilised it is recommended that EK consider how the shares will be provided to the individuals to align with the future goals of EK.

To conclude, it would be recommended to proceed in implementing the Management Incentive Plan originally proposed for EK being the combination of the CSOP and non-tax advantaged share option plan. The application of the CSOP scheme will provide the majority of the management team with a significant tax saving in comparison to the growth value shares. The proposal will also prevent EK from having to issue new classes or shares which will have an impact on the value of the current ordinary share capital.

H) SHARES - NATIONAL INSURANCE / REPORTING

Shares regarded as readily convertible assets are subject to Class 1A NIC which is payable by EK at 15.05% and there is also a PAYE reporting obligation for EK.

Shares are considered as readily convertible assets (RCAs) where:

- The shares are listed on a recognised stock exchange

- Trading arrangements are in place for the shares

- The company is controlled (>51%) by another company

Currently, EK does not satisfy any of the conditions which will result in the shares being considered RCAs. Therefore, the non-tax advantaged share options and the growth shares will not be liable to Class 1A NIC or PAYE reporting upon grant of the shares.

This will provide EK with a Class 1A NIC saving and also reduce the administrative requirements of having to withhold PAYE on the shares.

However, if within the next 5 years the shares are listed on the recognised stock exchange or there is an arrangement in place for the shares to be sold to a private company, the shares will be considered RCAs. As this will fall within the period in which the 5 year 1 month holding of the shares will still be in place, this will likely result in the shares being regarded as RCAs upon exercise of the shares.

This will result in EK being liable to fund Class 1A NIC on the market value of the shares upon exercise, which will result in additional costs for the company. Furthermore, EK will need to ensure PAYE is withheld on the shares. As calculated in Appendix B, the total Class 1A NIC payable if non-tax advantaged options

are granted would be £142,223.

The PAYE withheld on RCA shares is not restricted to 50% of the net pay provided to individuals that is in place for other payments, so the PAYE due on the shares may result in the individuals obtaining no net pay in that month.

If the shares are not considered RCA shares, then Andrew and Clare will be instead responsible in reporting and paying the Income Tax due via self-assessment.

Therefore, it is recommended that the holding period of the shares is reviewed and consideration provided on whether the holding period should be reduced slightly so it does not interfere with the 5 year business plan goals. Reducing the holding period slightly may result in the shares not being regarded as RCAs upon exercise which would then result in no Class 1A NIC being payable by EK.

I) NEXT STEPS

Once Eagle Kitchens Ltd has considered the contents of this report, we would suggest arranging a meeting with Chartered Tax Advisors to discuss the agreed approach and next steps.

Chartered Tax Advisors

November 2023

Appendix A

Pension - cash payment

	Andrew	**Clare**	**Total payable by EK**
Payment	52,500	36,000	88,500
Income Tax @ 45%	23,625	16,200	
Class 1 primary @ 3.25%	1,706	1,170	
Class 1 secondary @ 15.05%	7,901	5,418	13,319
Total			**101,819**

Pension - annual allowance charges

	Andrew	**Clare**	**Nigel**
Salary	350,000	240,000	100,000
Employer pension	52,500	36,000	15,000
Adjusted income	402,500	276,000	115,000
		(276,000-240,000) = 36,000 / 2 = 18,000	
Allowable pension input	4,000	22,000	40,000
Employer pension @ 15%	52,500	36,000	15,000
Annual allowance charge @ 45%	21,825	6,300	Nil

Appendix B

Non-tax advantaged share options

	Andrew	**Clare**	
No. shares	200	100	
Value in 2028	660,000	330,000 (£3,300 X 100)	
Exercise price	(30,000)	(15,000)	
Tax charge upon exercise	630,000	315,000	
Income tax charge @ 45%	283,500	141,750	
Potential Class 1A NIC @ 15.05%	94,815	47,408	142,223

Growth shares

	Andrew	**Clare**	**Nigel and Enid**
No. shares	400	300	200
Value of shares if business plan achieved	1,260,000	945,000	630,000
Less: price paid	Nil	Nil	Nil
Tax charge upon exercise	1,260,000	945,000	630,000
Capital Gains tax payable at 20%	252,000	189,000	126,000