The Chartered Institute of Taxation

Application and Professional Skills

Taxation of Individuals

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Suggested solution

DRAFT REPORT FOR STEPHEN HOOPER

INTRODUCTION

This report contains advice for Stephen Hooper relating to the tax implications of undertaking a new health & safety contract, a change to Stephen's employment terms, and the incorporation of Stephen's rental property business.

This report has been prepared for and is addressed to Stephen Hooper, and is intended for use by him only. No responsibility is accepted for any reliance placed on the contents of this report by third parties. It is based on tax legislation as it applies at the time of writing and any changes to the legislation may affect the conclusions of this report.

EXECUTIVE SUMMARY

<u>Hooper Ltd</u>

If the new contract is taken, the distributions already received from Hooper Ltd will be treated as dividends rather than capital and taxed at 33.75%.

Additionally, any child benefit received by your partner in 2022/23 will effectively become repayable, as your income will exceed the threshold to pay the High Income Child Benefit Charge (HICBC) once the dividends are taken into account.

The capital distribution of profits from the new contract will not be eligible for Business Asset Disposal Relief (BADR), so will be taxed at 20%.

After-tax profit from the new project will therefore be reduced to below £1,000. We recommend that you should not proceed with this contract, based on its current value and the additional tax liabilities which will result.

<u>King Enterprises plc</u>

Your travel to Sheffield will be considered ordinary commuting, because the journey is substantially the same whichever site you attend, therefore the costs will not be tax deductible.

The taxable value of the company car and fuel is £16,066. Due to high tax rates on company cars and fuel, and the costs of the additional travel, you will be worse off in your new role if you take the car and fuel benefit, even with the £10,000 pay increase.

If you opt for the £10,000 allowance you will be better off in your new role by approximately £4,200 after tax and expenses are taken into account, but this does not take into account the HICBC going forward, which reduces the benefit to £2,371.

We recommend that the new role is considered in conjunction with your plans for 12 Valerie Close and the possibility of making pension contributions to preserve your family's entitlement to child benefit. If you consider it worthwhile taking on the new role, we recommend the allowance is taken rather than the company car and fuel benefit-in-kind.

<u>12 Valerie Close</u>

Due to mortgage interest not being deductible from profit, the tax due on the rental income you receive is higher than the accounting profit. If the property was owned by a company, no tax would be due. The saving would be £2,400 per year, or £4,285 per year if incorporating the property meant that the HICBC was not due.

The transfer of 12 Valerie Close to a company would take place at market value for Capital Gains Tax (CGT) purposes. It could be sensible to crystallise your gain now, as 90% of the gain is exempt due to Private Residence Relief (PRR). However, Stamp Duty Land Tax (SDLT) would also be due and is a large expense at £22,000. As SDLT is paid by the purchaser, this is an expense you would not incur on a sale to an unconnected third party.

It is likely that you will become liable to the HICBC even before your rental income is taken into account, once your employment income exceeds £60,000, which halves the saving you could make through incorporating the property. If you do not take on the new role at King Enterprises plc, you may be able to avoid the HICBC through making sufficient pension contributions, even if the property is not incorporated.

Therefore it is not recommended that you transfer 12 Valerie Close to a company, mainly due to the high SDLT charge.

HOOPER LTD

When Hooper Ltd was wound up you were able, through a members' voluntary liquidation, to distribute the company's reserves as capital and claim BADR so that the rate of tax on the distributions was reduced to 10%.

The total amount distributed was £50,000 over two tax years, and the total tax payable on this is £2,690. No CGT is due on the distribution made on 10 April 2023 because it is below the annual exempt amount, on the assumption that you will not make other capital gains this tax year.

Since the tax rate on distributions when a company is wound up is lower than rates on income, there is a targeted anti-avoidance rule ('phoenixing rule'), specifically designed to prevent >5% shareholders from winding up a close company in order to take advantage of the lower tax rates and then continuing to carry out a similar type of business activity within two years of receiving the distribution. This rule potentially applies if you are involved with a similar trade or activity within two years of the date the distribution is made, so you will be caught by it even if the work is sub-contracted or if you carry it out as a sole trader rather than through another company. It would not apply if you were an employee, but given that you intend to subcontract the work it seems unlikely that the relationship will be of employment.

The phoenixing rule only applies if it is reasonable to assume that one of the main purposes of the winding up was to reduce your Income Tax liability. Given that the liquidation of Hooper Ltd was specifically carried out to access the company's funds tax efficiently, it appears likely that it will apply if the new contract is accepted. This means that distributions received from Hooper Ltd would be treated as dividend distributions, to the extent they exceed the CGT base cost, rather than capital. In 2022/23 this would result in additional tax on the distribution of £10,384 becoming due, and in 2023/24 £3,307 (**Appendix 1**). Additionally, because of the reclassification, your income would rise above £60,000, meaning you would be subject to the High Income Child Benefit Charge (HICBC) in full for that year. The child benefit of £1,885 received in 2022/23 would need to be repaid.

When SH Ltd is wound up BADR will not be available as the company will not have traded for at least two years. The £17,000 profit can be distributed as capital without a liquidator being appointed, as it is below £25,000. Without BADR, the tax rate on a capital distribution (after deducting the Annual Exempt Amount) will be 20%, but this is still lower than the higher tax rate on dividends. Assuming that you pay a dividend of £2,000 (taxed at 0%), £15,000 will be available to distribute as capital on which CGT due will be £540.

Therefore, the total Income Tax and CGT payable due to taking the new contract will be in the region of £16,116 (£10,384 + £1,885 + £3,307 + £540), leaving you with less than £1,000 as your post-tax profit from the contract, taking into account consequential liabilities.

Recommendation

We recommend that it would not be worthwhile taking on the new contract in light of the additional tax which would be payable. You should also consider the additional administrative costs for dealing with the amendment to your 2022/23 tax return, which was correct at the time of submission but will need to be amended to reflect the changed circumstances if you take the new contract.

KING ENTERPRISES PLC

For employees, the costs of work travel in the performance of duties and travel for necessary attendance at a workplace are generally tax deductible, but the costs of ordinary commuting (between home and a permanent workplace) are not. Travel costs for necessary attendance between home and a temporary workplace are deductible.

A temporary workplace is broadly one which you attend either for less than 24 months, or if attending for more than 24 months, one at which you spend 40% or less of your time. Although you will only spend one day per week at each site in Sheffield, the journey to any of the three sites is substantially the same in terms of travel time and expense, so all three sites will be treated as one workplace for the purpose of deciding whether or not your travel expenses are tax deductible.

As you are going to be spending 3 days a week in Sheffield for at least 3 years, the Sheffield sites will not count as a temporary workplace. Therefore, your travel costs will not be tax deductible. The provision of fuel by your employer would therefore be a taxable benefit if you choose the company car option, even if the fuel provided only covers travel from home to one of the sites in Sheffield. Even if these expenses qualified as business travel, the provision of the car would be a taxable benefit in any case, as you are taxed on the availability of the car for private use, rather than its actual use.

Since you have the choice between either the car and fuel benefit, or a £10,000 allowance, you will be taxed on the higher of the two if the benefit (car and fuel) is taken. Tax on company cars is based on a percentage of the list price, determined according to the car's emissions. The benefit value of the Hyundai Kona is 31% of the list price of £26,525, or £8,223 each year going forward (less in 2023/24 as you will not have the car for the whole year). The benefit value of the fuel is 31% of a fixed amount set by HMRC, currently £25,300, therefore the taxable amount is £7,843. The taxable value of the car and fuel combined is £16,066, which is higher than £10,000, so this is the amount that you will be taxed on if the car and fuel are chosen. If the allowance is chosen, the additional £10,000 is subject to tax and NI in the same way as the rest of your salary.

Appendix 2 shows the amount you will be left with after tax and costs, taking into account the additional salary for your new role plus either the company car and fuel, or the additional allowance. As you can see, you will be better off with the allowance rather than the company car. If you take the company car, you will actually be financially worse off in your new role than you are now (even after the increase in salary), due to the high rate of tax on the company car and fuel.

If the allowance is taken, you will be better off than you currently are by approximately £4,256 per year. However, the additional salary of £10,000 will bring you within the scope of the HICBC such that your partner's child benefit of £1,885 will effectively need to be repaid or disclaimed.

The HICBC is only an additional cost if it would not apply in any case due to your rental income, which may be the case (see 12 Valerie Close section below). Given the increase in your taxable pay of £20,000 it seems unlikely that you could avoid the HICBC if the new role is taken (see HICBC section below). With the HICBC taken into account, the benefit from the new role is reduced to just £2,371 from your additional income of £20,000.

Recommendation

Because you are not intending to use the car for your own private travel, the advantage to you of having a company car and fuel is minimal, therefore we recommend that of the two options you should take the cash allowance. The financial benefit of taking on the new role is negative with the car and fuel.

If the allowance is taken, the financial benefit to you of the new role, after tax and estimated costs, is £4,256 from the £20,000 additional income, but this reduces to £2,371 if the HICBC is payable, due to the increased taxable income. Therefore, we recommend that you consider whether taking on the new role is worthwhile in conjunction with the options for 12 Valerie Close and the possibility of making pension contributions to avoid the HICBC applying.

12 VALERIE CLOSE

In 2022/23 you were a basic rate taxpayer, so received tax relief in full for mortgage interest paid on 12 Valerie Close. Due to the level of your employment income, your rental profit in 2023/24 will be taxed wholly or mainly at the higher rate of 40%, but tax relief for mortgage interest is restricted to a maximum of the 20% basic rate.

Interest you pay on the mortgage of £250,000 all qualifies for tax relief at 20% because it does not exceed the value of the property when it was first let in June 2020 (£350,000). However, the additional £100,000 you intend to borrow will not be allowable, because the funds borrowed are not being used for the property business. After the increase in the mortgage rate due to the additional borrowing, the amount of interest given tax relief at 20% will be £10,000 (£250,000 x 4%).

Regardless of the amount of mortgage interest allowable as a 20% tax reducer, your taxable profit will remain around £11,000. When added to your employment income, this will bring your income above £60,000 so the HICBC will apply. Assuming it all falls into the higher rate tax band, tax on the rental profit will be £2,400 (£11,000 x 40% minus £10,000 x 20%) plus £1,885 of HICBC (if that doesn't already apply based on the increase in your employment income). Given that your accounting profit on the rental after allowable interest is just £1,000, this is a very high rate of tax (240% not including the HICBC).

If you were to transfer 12 Valerie Close to a company, all of the interest would be deductible. The company would be commencing its own new property business, so the additional £100,000 borrowed would form part of the initial capital invested and would therefore be allowable for the company. Therefore, the company would make no profit and would pay no tax.

The transfer of 12 Valerie Close to a company which you own would be deemed to take place at market value for CGT purposes, as you and the company would be connected to each other. The transfer of a single rental property let long-term to a company would not qualify for incorporation relief, which can defer tax on gains on the incorporation of a business.

Assuming a transfer on 1 June 2023, this would leave you with a chargeable gain of £25,568 (**Appendix 3**). Tax on this at 28% is £3,715 after the annual exempt amount is deducted. Additionally, £2,000 CGT would be due on the Hooper Ltd distribution if the new health and safety contract is not undertaken, as it would be better to set the annual exempt amount against the property gain due to the higher tax rate.

Additionally, Stamp Duty Land Tax (SDLT) of £22,000 would be payable by the company on the acquisition of the property (**Appendix 3**), bringing total tax on the transfer to £27,715.

Set against this you would save tax of £2,400 per year on the rental profit, or approximately £4,285 per year if incorporation means that the HICBC is not applicable. At a saving of £4,285 per year, it would take around 7 years to recoup the tax cost of the transfer, so may be worthwhile.

An advantage of transferring the property to a company now is that the increase in value of £250,000 since you bought the house will be crystallised for CGT purposes, while most of the gain is relieved under Private Residence Relief (PRR). PRR relieves the part of the gain which relates to time when the property was your main residence. The 19 years that you lived in the property as your main residence is relieved, and the last 9 months of ownership are also relieved. Currently, this covers almost 90% of the time you have owned the property, but the longer it's rented out for the more this proportion will reduce, meaning that more of the gain becomes liable to CGT. For example, if you were to continue to let the property for the next twenty years before selling it, at the time of sale only around half of the gain above your purchase price of £150,000 would be covered by PRR.

On a future sale by the company only gains above the current market value will be taxable, as the current £400,000 value is being taxed now. The current Corporation Tax rate of 19% is lower than higher rate CGT of 28% on residential property, but after the future gain has been taxed within the company you may then suffer further tax on the withdrawal of the gain from the company, either as dividend or as capital. The closure of a property rental company would not qualify for BADR.

If you have any intention of living in the property again in future, then we do not recommend that it be transferred to a company. This is because if you live in a house owned by a company, you will either need to pay rent to the company at the market rate, or you will be taxable on the benefit of living in the property at a reduced rent.

Additionally, if you were to live in the property again as your main residence you would accumulate further PRR and also qualify for a further three years deemed occupation as a residence. This would reduce CGT due on a sale by you, but not by a company.

You should also note that residential properties owned by a company are subject to the Annual Tax on Enveloped Dwellings, an additional annual tax charge based on the value of the property. This would not have any immediate impact as it only applies to properties with a value over £500,000 and there is an exemption if the property is let to a third party.

Recommendation

The tax saving of £2,400 per year through incorporation comes at an up-front cost of £30,000 in CGT and SDLT and is therefore not worthwhile.

The advantage of realising the gain in the property now before PPR decays significantly is cancelled out by the SDLT payable, which would not be due on a future sale to a third party.

Therefore, it is not recommended that you incorporate the property business.

HIGH INCOME CHILD BENEFIT CHARGE

The HICBC applies to you even though you have no children, because you live with your partner who claims child benefit and your adjusted net income for 2023/24 will be higher than your partner's. Once your adjusted net income exceeds £50,000, child benefit is repaid at the rate of 1% for every £100 of adjusted net income above £50,000, until your income reaches £60,000 when the charge equals the total amount of child benefit received. As you would be the high earner out of you and your partner if your income exceeds £50,000, the charge would be paid by you even though the child benefit is received by your partner.

Given that your salary is currently £50,000, either your rental profit or the increase in salary for your new role will bring your income beyond £60,000, meaning that all the child benefit received will need to be repaid via the HICBC.

Gross pension contributions (and gross Gift Aid donations) are deducted for the purpose of calculating your adjusted net income. If you take the new role at King Enterprises plc your salary will increase to £70,000, including the £10,000 allowance. With the addition of £11,100 rental profit your income will be £81,100 and you would need to make additional pension contributions of £31,100 to avoid having to repay any child benefit. This seems unrealistic, therefore it appears that the HICBC will apply.

If you do not take the new role at King Enterprises plc, you would need to make pension contributions equal to your rental profit and any other income above £50,000 in order to keep all child benefit. This would be worth considering, as, assuming you make pension contributions of £13,100 (to match rental profit of £11,100 plus dividends from SH Ltd of £2,000), you would save tax of £7,071 ((270 x 20%) + (12,830 x 40%) + £1,885 child benefit) giving you tax relief of 54% on contributions

We recommend that once the likely level of your income is clarified, consideration should be given to making additional pension contributions to maximise tax relief and reduce the HICBC. Contributions need to be made before the end of the tax year to obtain relief in that year.

APPENDIX 1 – Hooper Ltd

Additional tax due on distributions under phoenixing rules

	2022/23	2023/24
Distribution made	£40,000	£10,000
CGT payable	£2,690	£0
Distribution chargeable as dividend income (less base cost)	£39,200	£9,800
Income Tax:		
Dividends at basic rate (remaining basic rate band £37,700 less £37,078)	£622 x 8.75%	
Dividends at higher rate	£38,578 x 33.75%	£9,800 x 33.75%
Income Tax payable	£13,074	£3,307
Additional tax on the distribution above CGT already paid	£10,384	£3,307
HICBC	£1,885	
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Total additional amount due	£12,269	£3,307

APPENDIX 2 – King Enterprises plc

Tax on company car and petrol

	Benefit value	Tax on benefit at 40%
	£	£
Petrol	7,843 (£25,300 x 31%)	3,137
Car	8,223 (£26,525 x 31%)	3,289
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Total	16,066	6,426

Tax and NI payable on increase in salary and company car and petrol / car allowance (ignoring any possible HICBC effect)

	Company car	Car allowance
	£	£
Income:		
Additional Salary	10,000	10,000
Car and fuel allowance	0	10,000
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	10,000	20,000
Less:		
Tax on additional salary (£270 x 20%, £9,730 x 40%)	(3,946)	(3,946)
NI on additional salary (£270 x 12%, £9,730 x 2%)	(227)	(227)
Health and Social Care Levy on additional salary (£10,000 x 1.25%)	(125)	(125)
Tax, NI and HSCL on car allowance (£10,000 x 43.25%)		(4,325)
Tax on car and fuel benefit (£16,066 x 40%)	(6,426)	
Cost of car (£429 x 12)		(5,148)
Cost of petrol (not tax deductible)		(2,000)
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	(10,724)	(15,744)
Net additional cash	(724)	4,204
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APPENDIX 3 – 12 Valerie Close

CGT on sale of 12 Valerie Close

	£
Market value	400,000
Less cost	(150,000)

Gain	250,000
Less PRR (19.75/22 years)	(224,432)

Gain	25,568
Less annual exempt amount	(12,300)

Chargeable gain	13,268
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Tax at 28%	3,715
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Stamp Duty Land Tax on purchase of 12 Valerie Close by company

	£
3% on first £125,000	3,750
5% to £250,000	6,250
8% to £400,000	12,000

Total due	22,000
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