Tax Report

To: Jason and Irene Sterling

From: [Tax advisor]

Subject: Tax advice for Jason and Irene

Date: [Today's date]

Introduction

The purpose of this report is to address the query raised by Jason and Irene Sterling during our meeting dated 27 April 2020.

This report is based on current tax law at the date of writing and 2019/20 tax rates apply.

The report will address the following topics:

A – Tax implications and income position for Jason in regards to his employment opportunities

B – Equalisation of income generating assets and Irene's taxation position

C – Source of funds and the tax implications on the proposed extension

Glossary and Abbreviations

IT = Income Tax

NIC = National Insurance Contribution

CGT = Capital Gains Tax

SDLT = Stamp Duty Land Tax

IHT = Inheritance Tax

PAYE = Pay as You Earn

ERS = Employment related securities

PPR = Principle Private Residence

Executive Summary

- Should Jason continue his employment in Absolute plc, the additional salary will be subject to income tax at an effective rate of 60% due to the abatement of his personal allowance. Jason will receive an additional take home amount of £6,500 net of IT and NIC.
- The addition £6,650 take home amount is insufficient to cover the newly incurred cost of £10,000 relating to the extensive care package.
- The 5,000 restricted shares held in Absolute plc will be forfeited for £2,500 in cash and £20,000 of capital losses should Jason cease employment.

- Jason will make an overall cash saving of £17,000 per annum should he accept the offer from Relative plc due to the cheaper care package and savings from commute.
- From a taxation and income perspective, it is my recommendation to accept employment in Relative plc as the net additional salary raise from Absolute plc is insufficient to cover the newly incurred costs.
- Buy-to-let mortgage interest is restricted from 50% in 2018/19 to 75% in 2019/20.
- There is scope to equalise Irene and Jason's' income derived from rental properties by transferring Jason's interest to Irene. This will ensure rental income is taxed at the basic rate band and reduce income taxed at a higher rate for Jason.
- There are no CGT and IHT implications on the transfer provided that Jason and Irene remain married.
- SDLT could be due over the outstanding mortgage attached to the rental properties. This could be avoided by paying off the mortgage prior to transfer and this could be funded by the release of Jason's pension funds.
- It is recommended that Jason transfer the rental property to Irene to be taxed at Irene's hands and pay off the mortgage prior to the transfer.
- To fund the extension of 65 Hilltop, Jason can release 25% of his pension fund free of tax, in the amount of £235,000.
- Under the re-mortgage, no tax relief is available over the interest expense in relation to the mortgage as the mortgage was not wholly and exclusively used for the purpose of the rental business.
- From a tax perspective, I recommend that the extension be funded by Jason's pension fund as 25% can be released free of tax. This will also save on any mortgage interest and expense.
- There is a risk of challenge from HMRC that the extension could fall outside of scope of principle private property relief in the event of a disposal.

Body of Report

A1 – Absolute plc Income Tax Discussion

Further to Irene's email dated 31 April 2020 regarding Jason's job offer, we understand that Absolute plc is keen to retain Jason and has made financial offers to entice his stay. I understand that Jason will have his overall salary increased to £107,500 but will lose his £20,000 pension contribution entitlement.

Employer pension contributions are not taxable and therefore Jason's income tax position will only be altered by the salary increment of £17,500. As Jason is a higher rate tax payer, this additional income is taxable at 40%. The amount to take home in respect of £17,500 will be £10,500. However, because Jason's salary range is between £100,000 to £125,000, his personal allowance is abated by £1 for every £2 above £125,000, this will mean that any additional income in this range will be taxed at an effective rate of 60%. His true take home pay will be £6,650 after Income Tax and NIC.

Salary	17,500
Tax at 60% Effective rate =	(10,500)
NIC at 2%	(350)
Net amount:	6,650

A2 – Jason’s expenses if employed by Absolute plc

There are other financial decisions to consider. Jason will incur commuting expense in the amount of £7,000 per year. For the avoidance of doubt, commute to the office is ordinary commute for tax purpose and no relief is available.

In addition, Jason and Irene will need to opt for the more expensive care package costing £20,000 as more extensive care is required since Jason will be spending less time at home working in Absolute Plc.

Considering the above, the addition £6,650 take home amount is insufficient to cover the newly incurred cost of £20,000 in relation to the care package.

A3 – Jason’s May 2018 Absolute plc Award

The Absolute plc shares Jason holds are considered ERS for tax purposes, this is because the opportunity for Jason to acquire the shares was available by reason Jason’s employment. ERS are subject to taxation provisions which impose an income tax charge where shares are not transferred at market value.

The 5,000 Absolute plc shares held by Jason are ERS and are restricted securities. Shares are restricted securities if they have a restriction attached to them which reduces their economic value. Jason’s case, the shares are restricted because you are prevented from disposing them other than to your employer at a disadvantaged price of 50p per share. Should Jason choose to leave employment, the disposal will be subject to these disadvantaged terms.

Under the terms of Jason’s award, Jason will receive a cash sum of £2,500, being the amount paid as consideration when Jason acquire the shares. Should Jason remain your employment in Absolute until the end of the vesting period (till the date the restrictions no longer apply) Jason will be able to dispose the shares at the unrestricted market value at the date of disposal. This could be attractive should share price in Absolute plc increases in the next 5 years. Currently, share price has dropped. Any amounts of growth will be subject to CGT as you’ve entered into a s431 election, this is discussed below.

A4 – No IT relief over s431 election signed, CGT losses realised

Jason entered into an S431 election when he acquired the shares in May 2018. The S431 is a joint election between the employer and the employee. It must be entered into within 14 days of share acquisition and is irrevocable. The effect of entering into a S431 election is that, at the date of share acquisition, Jason was treated as having acquired an unrestricted share for tax purposes. Meaning that Jason were tax on the unrestricted market value of the share, being £4.50 per share instead of the restricted price of £1.0 per share.

Unfortunately, at the time of the report, Absolute plc share price has reduced to £4.20 (unrestricted). Although Jason was taxed at £4.50 per share at award, there is no income tax relief on the loss incurred. Instead, relief is sought when you dispose of your shares. The CGT base cost of your 5,000 Absolute plc shares will be £4.50 based on the following:

- Amount of consideration paid: 50p per share; and
- Amount subject to Income Tax: £4.00 per share

In the event that Jason dispose of his shares while restricted, he will make a CGT loss of £20,000 which can be used against other capital gains. This can be carried forward to future years if there are no capital gains arising in the tax year of disposal.

A5 – Relative plc Discussion

Under the terms of offer from Relative plc, Jason will receive £90,000 per year and will not be entitled to an employer pension contribution. As the income is the same as Jason's earning in previous years, there are no additional income tax implications to consider.

Further to Irene's email dated 31 April 2020, I understand Jason will save £7,000 in commuting costs and will not require the more extensive care package costing £20,000.

A6 – Comparison and Recommendations

Based on a review of Jason's' income tax position, should he continue his employment in Absolute plc, the additional income will be taxed at a 60% effective rate and Jason will take home £6,650 net. However, he will be required to spend an additional £10,000 for the extensive care package and £7,000 commuting cost.

Jason's share in Absolute plc will be forfeited for a cash consideration of £2,500. However, should he stay until the end of the vesting period, there is a possibility of making a large sum of capital gain which will be taxed at CGT rates at the time. Please note that I am not an investment advisor and cannot advise you on your investments.

On the other hand, should Jason move employment to Relative plc, there will be no additional take home cash. Albeit, Jason can opt for the cheaper care package and saving £10,000. He will also save £7,000 in commuting costs. However, Jason will no longer participate in Absolute plc shares.

Having considered the income tax implications and the cash position, I recommend that Jason ceases his employment in Absolute plc and accept the offer in Relative plc. This is because Jason will make more cash savings, in the amount of £17,000, than the additional net income he will receive from Absolute plc. In addition, Jason will also realise a capital loss in the amount of £20,000 to be used against future gains.

I appreciate that under both circumstances, Jason will lose his pension entitlement. However, Jason's pension fund is near the life time limit of £1,055,000 and will no longer be a source of tax-advantaged investment, this is discussed in a later section.

B1 – Irene Income Tax position

I understand from the meeting dated 27 April 2020 that Irene's salary will be reduced to £10,000. As a result of this, Irene's income tax liability will be reduced by £2,000 per annum due to the loss of employment income. In addition to the income tax reduction, Irene will also pay less national insurance contribution, giving a class 1 NIC saving of c£175 per annum. Please note that these will be adjusted via PAYE.

Irene's other income is derived from the rental properties. I understand that the rental properties were purchased fully by a mortgage and the interest covers 100% of the purchase price. Please note that in the 2019/20 tax year, the amount of buy-to-let mortgage interest deduction is further restricted.

You may note that in the 2018/19 tax year, 50% of the mortgage can be used as an allowable deduction when calculating the profits of the rental income. In the 2019/20 tax year, only 25% can be deducted. Furthermore, no amounts can be deducted in the 2020/21 tax year.

Relief is sought as on amounts not deducted, but only at 20% on the lower of:

- Amounts disallowed
- Property income less any losses
- Any non-savings income less personal allowance.

It is therefore, disadvantaged for Jason to receive employment income as mortgage interest will no longer receive relief at Jason's marginal tax rate and instead only at basic rate.

B2 – Tax Equalisation of Income

It could be possible to structure your tax affairs to improve the overall tax position between Irene and Jason. Currently, the rental properties are jointly owned between Jason and Irene. As a result of this, any income is taxed at the hands of both owners. However, Jason is a higher rate tax payer and Irene is a basic rate band tax payer. There is scope to transfer some income to be taxed at the hands of Irene to reduce the overall tax paid.

Jason and Irene can consider transferring the ownership of the rental properties to Irene so that the Income is taxable solely on Irene, at 20% instead of 40%. In addition, Jason will also regain his personal tax allowance, further reducing his tax liability.

Should it be the case that Jason wishes to retain an equity stake in the property, this can be done via a 5% holding by Jason and 95% holding by Irene. Provided that Form 17 is entered into and submitted to HMRC within 60 days, income derived will be taxed in accordance to the beneficial interest held by each party, thus achieving similar effects.

B3 – CGT, IHT, SDLT consideration

The transfer of Jason's interest in the property to Irene will have no CGT implications. This is because Jason and Irene are married and transfer between spouses take place on a 'no gain no loss' basis, meaning that the base cost of the property is transferred and no capital gains is realised.

There is a loss to Jason, as a donor in the transfer of property to Irene. This is known as a potential exempted transfer for IHT purposes. However, there should be no IHT implications on the basis that this is covered by a spousal exemption. No IHT should arise provided that Jason and Irene continue to be married for the next 7 years from the date of gift.

There are SDLT implications on the transfer of rental property. This is because there is a mortgage attached to the properties. SDLT is payable by the purchaser on the consideration of the property transfer. The mortgage is treated as consideration for SDLT purposes. I will require more information on the outstanding mortgage to provide an accurate figure on the SDLT payable. Please note that as Irene already has more than one property to her name, she will be paying the additional +3% rate of SDLT so amounts could be substantial.

It is possible to avoid SDLT if the mortgage is paid off in full prior to the transfer. I am aware that Jason and Irene have no significant cash savings to achieve this. Albeit, Jason has a large pension fund which he intends to utilise now that he is 55. If permissible, Jason can release 25% of his pension fund free of tax which could pay off the mortgage.

I understand there is the intention to pay off the mortgage prior to the disposal of the rental properties in the next five years. There could be scope for the repayment to accelerate to save mortgage interest in the next five years while saving on SDLT.

B4 – Recommendation to Irene

I recommend that Jason transfer his beneficial interest, or a majority of his beneficial interest in the rental properties to Irene such that any rental income derived is taxed on Irene at the basic rate. This is supportable due to the ever-reducing amount of buy-to-let interest deduction available.

To mitigate the SDLT payable on the transfer, I recommend that the mortgage to be paid off ahead of the transaction. This could be funded by Jason's large pension portfolio which he intends to access now that he is over 55. This will also have the positive effect of eradicating any interest expenses incurred by the mortgage.

C1 – Plan to build an extension

I understand our meeting dated 27 April 2020 that Jason and Irene plan to extend their main residential property 65 Hilltop. Further to your discussion with your independent financial advisor, you are considering to fund the extension either via a re-mortgage of the properties held, or to access Jason's pension fund. I layout below the tax implications of either options. Please note that I am not a pension advisor nor an investment advisor, my recommendation is solely based on the tax implications of each option.

C2 – Release of Jason's pension

Jason is over 55 and is able to access his large pension fund. At the moment, the fund is standing at 940,000 which is below the life time allowance of £1,055,000. Should the total value of the pension fund exceed the life time limit, the excess is treated as 'unauthorised fund' and is subject to punitive taxation. HMRC will seek to reverse any tax relief available to the unauthorised fund on a benefit crystallisation event, usually at the date the funds are extracted.

On this basis, I do not advise Jason to continue contributing towards his pension even though he is eligible to do so. Although any growth in the value in the pension is tax free, should the pension fund perform well and exceeds the life time limit, the excess will be taxed.

C3 – Withdrawal from Pension

There are various ways to draw down from a pension fund. It is not to Jason's interest to leave the fund untouched due to the value of his fund nearing the life time limit.

Jason could extract the entirety of the funds in cash. The first 25% of the funds will be free of taxation, however the remainder will be taxable at Jason's marginal rate of tax, taking him to the additional rate band of 45%. This is highly tax inefficient.

Instead, for the remainder 75%, Jason can opt to buy an annuity, the annuity will sit outside of his death estate, which could have IHT benefits. His income from the annuity will be taxed at the marginal rate of tax. Alternatively, Jason can invest in a flexi-access drawdown. The drawback is that the income is not for life but the investment will provide regular income.

On the basis that Jason requires only £175,000 to fund his extension, I cannot recommend taking the full pension fund out in full. From a tax perspective, it would be beneficial to take 25% out tax free to fund the extension and the rest in an annuity or flexi-drawdown to utilise the annual allowance and the lowered marginal rate of tax. By way of calculation, 25% of Jason's pension fund will yield: £235,000. (940,000 @25%) This is sufficient to cover the funds required for the project.

C4 – Mortgage on Properties held by Jason and Irene

There are no income tax implications on the re-mortgage of the property. Albeit, there will be CGT implications as the amount of chargeable gains will take account into the mortgage attached to the property on a disposal event. This could be beneficial to reduce CGT liability but the mortgage will generate interest expense throughout the lifetime of the mortgage.

No relief is available for the mortgage expense incurred. This is also the case for 14 Railing way even though it is a buy-to-let property in which relief is currently sought at 25% (2019/20 tax year). The reason the expense is blocked from deduction is because the mortgage is not incurred wholly and exclusively for the buy-to-let. Instead, it is used to fund the expansion.

C5 – Recommendation

Based on the above analysis, I recommend that the extension be funded by Jason's pension fund. I suggest Jason to release 25% of his pension fund as this can be release free from income tax, which is highly tax efficient. On the other hand, the mortgage expense will be blocked from deduction which is an additional cost to consider.

To link in with SDLT consideration discussed earlier in relation to the equalisation of rental income in which a transfer of property from Jason to Irene is discussed. The released fund in the amount of £235,000 is excessive of the £175,000 needed which could be used to cover the repayment of the outstanding mortgage to avoid SDLT.

C6 – Other CGT consideration

In a future disposal event, the extension implemented to the property will form the base cost of the property. This will reduce any potential CGT liability, although this will likely be none due to the eligibility of PPR relief discussed below.

65 Hilltop currently benefits from principle private residence relief in which no CGT should be payable should the property be disposed, this is because 65 Hilltop is the main residential property used by Jason and Irene.

I should inform you that there could be a risk of challenge by HMRC that the extension does not form part of the building for PPR purposes. I've raised this because you have told us that the building has its own bathroom and kitchen which provide privacy and independence. We have not fully examined the situation in full and cannot examine the significance of this risk.

Should any capital gain arise, Jason can utilise the £20,000 capital losses from the disposal of restricted shares in Absolute plc (should he cease employment) to offset any gains.

Sign off

Date: [Today's' date]

[Tax advisor contact]