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May 2020

Application and Professional Skills

Taxation of Individuals

SUGGESTED SOLUTION

REPORT TO JASON AND IRENE STERLING ON TAX PLANNING

INTRODUCTION

This report considers Jason's potential change of employment, the raising of funds for an extension to Jason and Irene's residence, and the structure of both Jason and Irene's tax affairs going forward.

This report has been prepared for and is addressed to Jason and Irene Sterling, and is intended for use by them only. No responsibility is accepted for any reliance placed on the contents of this report by third parties. It is based information provided by you and contained on our files and on tax legislation as it applies at the time of writing and any changes to the legislation may affect the conclusions of this report.

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July 2020

EXECUTIVE SUMMARY

Jason's Employment

We recommend that Jason should take the employment with Relative plc ('Relative').

Due to the savings on travel and care costs, employment with Relative will provide a similar level of disposable income to employment with Absolute plc ('Absolute') despite the lower salary or loss of the pension contribution.

The offer of additional salary from Absolute should not be accepted because, due to the high tax rate on the additional salary, it provides an increase of only £6,650 after tax, at the cost of the £20,000 pension contribution and without the additional savings made by moving to Relative.

In leaving Absolute Jason will make a loss of £13,320 through forfeiting his shares. However, this loss is more than recouped through the cost savings made by taking the employment with Relative.

Raising Funds

Taking out a mortgage of £175,000 would cost £7,000 per year in interest payments, which would be paid from post-tax income.

If funds are taken instead from Jason's pension pot, the entire £175,000 can be taken with no immediate tax consequences.

Taking funds from Jason's pension could trigger the Money Purchase Annual Allowance, reducing the amount of annual contributions he can obtain tax relief on to £4,000. Even if Jason were to remain with Absolute, he should review the level of his pension contributions as the level of his pension is close to the Lifetime Allowance. Rather than saving into Jason's pension, it is likely to be more tax efficient for funds to instead be invested in Irene's pension or into other tax-efficient savings vehicles such as an ISA.

The entire £175,000 should be taken tax free from Jason's pension pot. This will save paying £7,000 per year of post-tax income on mortgage interest.

Property Issues

Jason should transfer his shares of both 13 Lamppost Road and 14 Railings Way to Irene in order to save income tax of £4,200 per year. The transfer of 13 Lamppost Road will incur £500 of Stamp Duty Land Tax (SDLT)., You will still be able to make use of Jason's loss on his shares in Absolute Plc and his annual exempt amount to reduce capital gains tax on a future sale to a third party, by Irene transferring a portion of 14 Railings Way back to Jason before the sale.

JASON'S EMPLOYMENT

We have been asked to consider options relating to Jason's employment and the cost of providing care for Irene's parents. The options are:

1. Jason remains in his current employment with Absolute, receiving an annual salary of £90,000 plus an employer pension contribution of £20,000 each year, or;

2. Jason remains employed by Absolute, receiving an annual salary of £107,500 without any employer pension contribution, or;

3. Jason starts a new employment with Relative, receiving an annual salary of £90,000. If Jason takes this employment, you will make savings of £7,000 per year on commuting costs and £10,000 on care costs, in comparison with Jason remaining with Absolute.

Under any option, Irene will reduce her working hours and receive a salary of £10,000 per year.

Appendix 1 shows that your total remuneration after tax, travel and care costs are taken into account is highest if Jason remains in his current employment and continues to receive a pension contribution. This is because the pension contribution is exempt from tax.

Although the tax exempt £20,000 pension contribution is £3,000 higher than the £17,000 savings on travel and care costs which can be made by taking the job with Relative, it should be borne in mind that pension contributions are not available immediately as cash, and that 75% of Jason's pension fund will be taxed in future when funds are withdrawn. This will reduce the net value of the pension contribution by at least £6,000 if Jason is a higher rate taxpayer when he takes his pension, and £3,000 if he is a basic rate taxpayer. When tax on the eventual withdrawal is taken into account, the advantage of receiving the pension contribution from Absolute Plc over the savings on expenses if working for Relative Plc is removed if basic rate tax on the pension is taken into account, and reversed if the pension will in future be taxed at the higher rate.

Taking the optional salary of £17,500 instead of the pension contribution will add only £6,650 to Jason's earnings after tax and National Insurance (NIC) because all of the additional salary falls into the band of income above £100,000 where the personal allowance is withdrawn, giving an effective 60% tax rate on income between £100,000 and £125,000, plus 2% National Insurance. If Jason were to receive no rental income so that £10,000 of the additional salary was taxed at 40%, the £17,500 of additional salary would still only yield £8,650 of post-tax income. The possibility of transferring rental profit from Jason to Irene is discussed later in this report.

If Jason leaves Absolute and takes the employment with Relative, disposable income (after tax, NIC, travel, and care costs) will be £10,350 higher than if Jason remains with Absolute and takes the additional salary in place of the pension contribution. (Appendix 1-additional costs of £3,000 at Relative compared to £13,350 at Absolute)

However, Jason has employee shares in Absolute which will be forfeited if he leaves, and these also need to be taken into account.

<u>Shares in Absolute</u>

On 5 May 2018 Jason paid 50 pence per share for 5,000 ordinary shares in Absolute. These shares will be forfeited if Jason leaves Absolute before 5 May 2023. Appendix 2 shows the calculation of the loss which will result.

If Jason remains with Absolute, he will be able to sell the shares in May 2023. At the current market value of £4.20 per share Jason would receive £21,000 when the shares are sold. There would be no tax due on the proceeds because Jason paid tax on the full value of the shares when he received them. At that time the market value was £4.50 per share, so Jason would realise a small capital loss of £1,500 on the disposal.

If Jason leaves Absolute and forfeits the shares, he will receive only the 50p per share which he originally paid. The income tax Jason paid on acquisition of the shares is not refunded, but Jason will instead realise a capital loss of £20,000 on the transaction. The loss will be carried forward and, provided no other capital disposals are made in the meantime, set against Jason's gains when the rental properties are eventually sold. When that happens, the tax saving will be £5,600 (28% x £20,000).

After taking cash received and future capital gains tax savings into account, there will be a net cash loss of £13,320 (Appendix 2) made through forfeiting the shares. Without taking the future tax saving into account, the loss made through forfeiting the shares is £18,500.

Conclusion on Employment

If Jason gives up the pension contribution, he would be better off taking the job with Relative rather than staying with Absolute on the increased salary offered. Moving to Relative would give you between £8,350 and £10,350 more disposable income each year in comparison to staying at Absolute on the higher salary. Over the three years that Jason would have to remain at Absolute to not forfeit his shares on leaving, this difference would total £25,050 to £31,050, which exceeds the £13,320 (or £18,500 if the future tax saving is not taken in to account) lost by leaving Absolute now and forfeiting the shares.

This leaves Jason the option of either remaining with Absolute on his current package of salary plus pension contribution, or moving to Relative. The saving on travel and care costs if Jason moves to Relative means that both positions produce similar levels of income after tax, travel and care costs.

However, when your need to raise funds is taken into account, it becomes clear that it would be advantageous for Jason to take the job with Relative. This is because raising funds through a mortgage would result in mortgage interest of £7,000 per year being payable, while continuing to receive employer pension contributions of £20,000 per year could result in either a pension Annual Allowance charge of £6,400 per year becoming payable, or a Lifetime Allowance tax charge when Jason takes his pension. This is discussed further below.

Either mortgage interest payments or the Annual Allowance charge would, over the three years before the forfeiture restriction is removed on the shares, exceed the loss made through forfeiting the shares now.

Therefore, from a financial perspective, it is recommended that the employment with Relative is taken.

RAISING FUNDS

Mortgage

Raising funds through an interest-only mortgage of £175,000 will cost £7,000 interest per year at 4% and £7,875 at 4.5%.

Because the loan is not wholly and exclusively for the letting business and takes your borrowing above the capital value of the lettings business when the houses were first let, if the loan is raised against the rental property it will not be tax deductible. Therefore, if you wish to raise funds by mortgaging a property, the net of tax cost of the mortgage on your main residence will be cheaper. This should be discussed with your Independent Financial Adviser (IFA) before making a decision.

Pension

We can only comment on the tax consequences of a withdrawal of pension funds. Jason will need to take advice from an IFA in relation to the consequences of drawing funds from his pension from an investment perspective.

Jason can take up to 25% of his pension pot free of tax. Given the fund's current value of £940,000, the whole of the £175,000 can be withdrawn tax free as it is below 25% of the total value of Jason's pension pot. By taking £175,000 tax free now, Jason would be reducing the amount available to be drawn tax free in future and also losing the potential for future tax free growth of the funds withdrawn.

Annual Allowance

The Annual Allowance is the maximum amount of pension contributions which receive tax relief each year. Currently, the Annual Allowance is £40,000 pa, so the £20,000 pension contribution Jason's employer makes each year is fully exempt from tax.

When Jason withdraws funds from his pension, it's possible that this would trigger the Money Purchase Annual Allowance (MPAA).

If the MPAA is triggered, Jason's Annual Allowance will be restricted to £4,000. Therefore, tax of £6,400 (£16,000 @ 40%) would be charged on £16,000 of an employer pension contribution of £20,000. Although this is cheaper than paying £7,000 mortgage interest, there is no option for Jason to repay the funds into his pension and resume entitlement to the increased annual allowance, so if the MPAA is triggered, this charge will apply to all future contributions in excess of the reduced MPAA.

The MPAA is not normally triggered if a tax-free lump sum is taken and the remainder of the pension pot is either used to purchase an annuity or put into a flexi-access drawdown scheme and no income taken.

Regardless of the level of the Annual Allowance, pension contributions will be taxed in future when the funds are withdrawn from the scheme. Assuming withdrawals are made at the basic rate of tax, at least £3,000 tax (taking into account that 25% of the total withdrawal is tax free) will be payable when the £20,000 pension contribution is withdrawn. This is in addition to any Annual Allowance charge at the time the contribution is made.

As outlined previously, it would not be worth Jason opting to receive the £17,500 additional salary in place of the pension contribution, due to the high tax rate on this additional salary.

Lifetime Allowance

There is a limit on the total amount of pension benefits which can be accrued without triggering a tax charge. This limit is currently £1,055,000. If the capital value of Jason's pension rises above the Lifetime Allowance (LA), there is a tax charge on the excess, levied at the time the pension is accessed. This one-off charge is 55% if the excess is taken out as a lump sum, or 25% if the excess is left in your pension fund.

The value of Jason's fund, at £940,000, is currently fairly close to the LA. Whether the LA is breached in future will depend not only on contributions made, but also on the growth of funds already in the pension. It does seem likely that if Jason were to continue making contributions of £20,000 each year the value of the fund would soon exceed the Lifetime Allowance. Therefore, Jason may wish to consider reducing future contributions regardless of whether the MPAA is triggered or his employment changes.

Inheritance Tax

Raising funds through a mortgage against one of your properties would be neutral for Inheritance Tax (IHT) purposes, on the assumption that the value of your assets will increase by the same amount as the borrowings, so overall there would be no change in the value of your estate.

Taking funds from your pension could result in increased IHT becoming due after your death. This is because funds in your pension pot are exempt from IHT whereas cash taken out forms part of your estate.

This would only become an issue if you were both to die and the pension fund was inherited by your children. In the longer term you would presumably draw down pension funds, so provided one of you survives until the time when you would in any case have withdrawn the funds from the pension scheme, no additional IHT will become due as a result of the withdrawal.

Conclusion

Raising funds through a mortgage will cost £7,000 per year from your post-tax income.

This cost can be avoided by taking the funds from Jason's pension fund instead. The entire amount needed for the extension can be taken from Jason's pension fund with no immediate tax consequences.

Additionally, as has been outlined in the section on Jason's employment, there is no tax advantage in Jason remaining at Absolute Plc and continuing to receive the £20,000 pension contribution over taking the job with Relative Plc. Given that his pension fund is not far below the Lifetime Allowance, Jason would in any case need to consider the future level of his pension contributions.

It is therefore recommended that £175,000 is taken from Jason's pension fund rather than mortgaging one of the properties.

As an alternative to saving in Jason's pension, contributions of up to £10,000 pa can be made to Irene's pension, or Jason and Irene can each save up to £20,000 each year in an ISA. Although contributions to an ISA are made from taxed income, funds within the ISA grow free of tax in the same way as pensions do, and unlike pensions there is no tax when funds are withdrawn from the ISA.

PROPERTY ISSUES

Private Residence Relief

If you sell your main residence, gains are exempt from capital gains tax to the extent that the property has been your main residence throughout the time you have owned it. Provided the extension you are building is used as part of the home, which includes housing Irene's parents, it will qualify for private residence relief.

Rental Properties

Combined, you currently receive rental profits totalling £31,000 per year before the deduction of mortgage interest. As you are married and own the properties jointly, you are by default taxed on half the profit each.

Tax relief for mortgage interest payments has been progressively restricted and is no longer given against rental profit from 2020/21. It has been replaced by a 20% tax reduction. This means that going forward you will each be taxed on £15,500 of rental profit per year, provided profit remains at the current level..

Because the profit takes Jason over the £100,000 income band where his personal allowance is restricted, the effective tax rate for Jason on this income is 40% on the first £10,000 then 60% on the next £5,500. If Jason were to transfer his share in the properties to Irene, so that the income was taxed in her hands, it would all fall within the basic rate band and be taxed at 20%, resulting in a saving of £4,200 tax per year (Appendix 3). The 20% tax reduction is the same regardless of which of you holds the property. Therefore, Irene would receive full relief on mortgage interest as the 20% deduction is the same as her tax rate, whereas Jason would not receive full relief because rental profit in his hands is taxed at above 20%.

A transfer of property between spouses takes place at no gain-no loss for capital gains tax purposes. Irene would be deemed to have acquired the transferred property at the same cost as Jason acquired it. Additionally, transfers between spouses are exempt from inheritance tax. There is no exemption from Stamp Duty Land Tax (SDLT), which is payable based on the amount of the consideration given, however, the additional 3% rate of SDLT does not apply to transfers between spouses. By taking responsibility for Jason's share of the mortgages (assuming she is able to do so), Irene is giving consideration of that amount, so SDLT of £500 would be payable on the transfer of 13 Lamppost Road, but £nil on the transfer of 14 Railings Way (Appendix 4).

Most of the income tax saving can be achieved by Jason transferring just one of the properties to Irene, because this will prevent Jason falling into the income band where his personal allowance is withdrawn. Because of the zero SDLT charge Jason should transfer his share in 14 Railings Way to Irene in preference to 13 Lamppost Road, this will result in a tax saving of £2,650 per year (Appendix 3) for no SDLT charge.

Transferring 13 Lamppost Road as well would create a SDLT charge of £500 for an additional annual tax saving of £1,550 (£4,200 - £2,650).

Therefore, it is recommended that Jason should transfer his interests in both 14 Railings Way and 13 Lamppost Road to Irene. A portion of 14 Railings Way could be transferred back to Jason in five years' time prior to its sale to a third party, to enable Jason to set off the loss generated on forfeiting his shares to reduce CGT due on gains on this property by £5,600 (Appendix 2) and also use his annual exempt amount, reducing CGT by a further £3,360 (£12,000 x 28%) at current rates.

APPENDIX 1

Comparison of additional net income and costs under each of Jason's employment options.

	Absolute Plc – with pension contribution	Absolute Plc – with additional salary	Relative Plc
Additional salary (net of 60% tax and 2% NI)	-	6,650	-
Saving on travel costs	-	-	7,000
Care costs	(20,000)	(20,000)	(10,000)
	------------	------------	------------
Change in cash available to Jason	(20,000)	(13,350)	(3,000)
	=======	=======	========
Employer pension contribution	20,000	-	-
	---------	---------	---------
Cash plus pension contribution	-	(13,350)	(3,000)
	======	======	======

APPENDIX 2

Jason's loss if his shares in Absolute Plc are forfeited.

	Shares Forfeited 2020	Shares Sold in 2023 (using current MV of £4.20 per share)	
	£	£	
Cash received	2,500	21,000	
Cost – cash paid	(2,500)	(2,500)	
Cost – value subject to income tax	(20,000)	(20,000)	
	------------	------------	
Loss on disposal	(20,000)	(1,500)	
Future CGT saving @ 28% on loss	5,600	420	
	--------	---------	
Total value received – cash plus CGT saving	8,100	21,420	
	=====	======	
Net cash lost through forfeiting shares (£21,420 – £8,100)			£13,320
			=======

APPENDIX 3

Tax saving if Jason transfers his share of both properties to Irene

	£
Jason's Profit	15,500

If taxed on Jason	
Tax on £10,000 @ 40%	4,000
Tax on £5,500 @ 60%	3,300

Total tax Jason pays on profits	7,300
	======
If taxed on Irene	
Tax on £15,500 @ 20%	£3,100
	======
Annual tax saving if Jason's share in both rental properties is transferred to Irene	£4,200
	======

Tax saving if Jason transfers his share of one property to Irene

	£
Jason's Profit	7,750

If taxed on Jason	
Tax on £2,250 @ 40%	900
Tax on £5,500 @ 60%	3,300

Total tax Jason pays on profit	4,200
	======
If taxed on Irene	
Tax on £7,750 @ 20%	£1,550
	======
Annual tax saving if Jason's share in one property is transferred to Irene	£2,650
	======

APPENDIX 4

SDLT on transfer of rental properties from Jason to Irene

13 Lamppost Road	£
Value of mortgage transferred	150,000

£125,000 @ 0%	Nil
£25,000 @ 2%	500

SDLT due on transfer of 50% of 13 Lamppost Road	500
	=====
14 Railings Way	
Value of mortgage transferred	60,000
£60,000 @ 0%	Nil

SDLT due on transfer of 50% of 14 Railings Way	Nil
	=====