The Chartered Institute of Taxation

Application and Professional Skills

Taxation of Individuals

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Suggested answer

DRAFT REPORT FOR SARAH MASTERS

Introduction

This report has been prepared for and is addressed to Sarah Masters, and is intended for use by her 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.

This report considers the tax implications of Sarah either accepting termination from Tea & Biscuits Ltd (Tea & Biscuits) or continuing to work part-time, and the implications of each option on her employment-related EMI share options. It also considers whether Sarah should make a pension contribution of £150,000 or should use the funds to finance SM Rental Ltd (SM Rental). We cannot provide detailed advice on financial products such as pensions and can only advise on the general tax consequences of such investments. You should consult your Financial Adviser for any detailed investment advice.

Termination

If you accept the termination in June 2024, the £60,000 ex-gratia payment will be entirely tax free provided the relevant conditions are met. If you stay at Tea & Biscuits until December 2024, you will lose the £60,000 tax-free payment and will only receive £12,500 additional gross salary for the extra seven months worked.

Enterprise Management Incentive Scheme

Under the EMI Scheme your profit on the exercise of your share options in Tea & Biscuits will only be subject to Capital Gains Tax, which is charged at a lower rate than Income Tax and National Insurance. After you leave Tea & Biscuits, you have 90 days to exercise your share options before some of the tax advantages are lost, in which case any additional profit above the share price when you leave is taxed at the same rate as employment income. Therefore, if you leave Tea & Biscuits in June 2024 but don't exercise your options until December 2024 additional tax will be due.

Pension Contributions

Although you have £150,000 Annual Allowance available, pension contributions are limited to the amount of your relevant earnings in the year. This means that you can only make a £150,000 pension contribution if your total income, including the part of the profit on exercise of your share options which is subject to income tax, reaches this amount. Tax relief on the pension contribution would mitigate much of the disadvantage of losing EMI tax relief.

If you withdraw funds from your SIPP, 25% of the withdrawals will be tax-free, the remainder is taxed at 20% within the basic rate tax band, insofar as it exceeds the personal allowance. Therefore, a withdrawal of £15,000 would be completely free of tax if this is your only income.

Loan to SM Rental

If funds are lent to SM Rental, money can be withdrawn from the company tax-efficiently in the form of interest on your loan to the company. The full £15,000 profit can be received by you as interest completely free of tax if it is your only income.

Recommendations

Your Financial Adviser should be consulted prior to a final decision on when you exercise your share options or the amount of pension contributions. In order to minimise the tax consequences, we make the following recommendations:

We recommend that you should take the termination option from Tea & Biscuits in June, in order to benefit from the tax-free ex-gratia payment.

If you believe the value of your shares will rise by more than 3.8p per share, you should keep the options and exercise them in December. This rise will cover the additional capital gains tax due and any additional increase in value will increase your post-tax receipts. If you don't expect the shares to increase in value by more than 3.8p per share you will be better off exercising your options before leaving Tea & Biscuits in order to benefit from the 10% tax rate on your gains on exercising the options.

We recommend that you should contribute the maximum amount that you can to your pension, based on your relevant earnings, up to £150,000. This will mitigate the loss of EMI tax advantages on your share options (if exercised post-termination), provided that both the option exercise and the pension contribution occur in the 2024/25 tax year.

Only remaining funds after the pension contribution should be lent to SM Rental.

If funds are lent to SM Rental, we recommend that profit is withdrawn by paying interest on your loan to the company. For the next five years until you start to receive your occupational pension, no tax will be payable if you receive £15,000 either as interest, pension income, or a combination of the two. Any funds you take from your ISA are tax exempt and have no tax implications.

Termination Payment

If you accept the termination, the amounts you receive will be taxed as follows:

The three months' salary you receive to cover your notice period will be subject to income tax and NIC in the same way as the rest of your salary.

The additional £60,000 will be exempt from tax and NIC provided that you have a medical condition which prevents you from carrying out the duties of your employment, and the payment is made on account of your medical condition. You should ensure that your doctor provides a letter outlining the medical condition and why it prevents you from working in your current role/full-time. You should also ensure that it is documented in your termination agreement with Tea & Biscuits that the payment is made on the grounds of ill-health and not for any other reason.

If you don't leave, but continue to work part-time at Tea & Biscuits until December 2024, your additional salary for the period worked after your notice period ends on 31 August 2024 will be just £12,500 less tax and NIC, for the four months you will work.

However, depending on how high you expect the Tea & Biscuits share price to rise, you may consider the loss of the termination payment a worthwhile price to preserve the tax-advantaged status of your share options (see Enterprise Management Incentive Scheme section below). The total value of your shares would need to rise by £66,667 (10 pence per share) to provide a post-tax profit equal to the £60,000 you lose if you do not take the termination, assuming you remain at Tea & Biscuits and the option gain is taxed at 10%.

Enterprise Management Incentive Scheme

<u>Income Tax and National Insurance at time of Exercise</u>

Share options qualifying under the conditions of an Enterprise Management Incentive (EMI) scheme bring certain tax advantages. Provided the EMI conditions continue to be met, there will be no Income Tax or National Insurance Contributions (NIC) due when you exercise your options. If the options cease to qualify, the discount between the option price and the market value of the shares at the time of exercise is subject to tax and NIC as employment income. The Income Tax and NIC charges could be as much as 45% and 13.8% respectively.

<u>Capital Gains Tax at time of Sale</u>

When you sell your shares, Capital Gains Tax (CGT) is charged on the increase over the amount you pay for the shares plus any amount charged to income tax, regardless of whether the options qualify under the EMI scheme.

The CGT rate for higher rate taxpayers is 20%, but the sale of shares from EMI options held for more than two years can qualify for Business Asset Disposal Relief (BADR) which reduces the CGT rate to 10% on the first £1 million of gains. To qualify for BADR on sale of your Tea & Biscuits shares you must be an employee of Tea & Biscuits at the time your shares are sold.

Impact of termination or working part-time on the qualifying conditions

One of the conditions for options to qualify under the EMI scheme is that recipients must be employees working for the company, whose shares are subject to the option, at least 25 hours per week or, if less, 75% of their working time. Once you leave Tea & Biscuits your options need to be exercised within 90 days or these tax advantages are lost.

i. Accepting the termination and exercising options in June

If you exercise your options in June 2024, within 14 days of accepting the termination, you will still benefit from the EMI income tax/NIC advantages available, because you have 90 days to exercise under EMI rules.

However, when you sell the shares, BADR will not be available to reduce CGT to 10% because you will have already left Tea & Biscuits, even if it was only 14 days previously.

Tax due will be as follows:

Repurchase by Tea & Biscuits	667,098 shares @ 27p=	£180,116
Option price paid		(£50,000)
Profit		£130,116
Income tax	Nil	
NIC	Nil	
CGT @ 20%	Appendix 1	£25,423

If possible, you should approach Tea & Biscuits about selling the shares back to them before 1 June, rather than after. If you are still in employment with them at the time they repurchase them, you could still obtain BADR and the CGT charge would be reduced to 10%, saving £12,712.

ii. Accepting the termination and exercising options in December

If you leave Tea & Biscuits in June but wait until December to exercise your options, some of the Income Tax and NIC advantages will be lost because you will be exercising your options more than 90 days after leaving Tea & Biscuits. The Option agreement also makes you liable for employer NI, which is charged at 13.8% on top of the NI you have to pay as an employee. This is commonly written into share option agreements, because the liability arises on your exercise of the options, so is not under the control of your employer.

In addition to CGT of £25,423, any value you receive above 27p per share will be subject to income tax and NI. Employer NI is payable on the gross amount at 13.8%, then tax and employee NI are applied, totalling 42% so far as your gains are within the higher rate tax band when added to your income and 47% in the additional rate, which starts at £125,140.

At higher rate, the overall rate of tax and NI on gains above 27p is 50%, and at additional rate it is 54%. Though this rate is high, on the assumption that their value will rise as you expect, there is not a lot to lose by retaining your options until December as the additional tax is only applied to the increased value. The value of your shares would need to rise by £25,424 (or 3.8p per share) to cover the additional CGT of £12,712 due if the shares are exercised after you leave Tea & Biscuits.

iii. Working part time and exercising options in December

If you remain with Tea & Biscuits part-time, your share options will continue to qualify for the EMI tax advantages, provided that you meet the condition that at least 75% of your working time is spent working for Tea & Biscuits. Therefore, you will be able to exercise your share options in December 2024 with no Income tax and NIC due.

The only tax charge will be CGT on the profit made when you sell the shares. If you exercise your options in December while still working for Tea & Biscuits, your gains will qualify for BADR and the CGT rate will be 10%.

Profit	As above	£130,116
Income tax	Nil	
NIC	Nil	
CGT	Appendix 1	£12,712

<u>Recommendations</u>

The tax-free lump sum is clearly more valuable than the extra salary up to December. The EMI relief on exercise of shares is also very valuable. The only way you can get both of them is by leaving in June and then exercising your share options within 90 days of that date.

If you lose EMI relief, the tax payable on exercise of your options can be mitigated through making a pension contribution (outlined in the following sections). However, there is no way of mitigating the loss of the ex-gratia payment unless the share price rises significantly. As already discussed, this needs to be at least 10p per share.

Therefore, we recommend that, regardless of when you intend to exercise your share options, you should leave Tea & Biscuits in June 2024 in order to benefit from the ex-gratia payment.

If you decide to exercise on departure, you should also discuss with Tea & Biscuits whether they will repurchase the shares before 1 June to preserve the BADR tax relief.

Options for use of £150,000

1. <u>Pension Contribution</u>

Although you have sufficient Annual Allowance available to make a pension contribution of £150,000, the maximum pension contribution on which tax relief is given is your 'relevant earnings' for the year, which are generally your earned income. Dividends, interest, and exempt income (on exercise of your options or termination) are not part of relevant earnings.

Your relevant earnings will only reach £150,000 if your share option profit subject to income tax is sufficiently high to bring your total income up to this amount.. This may be the case if you leave Tea & Biscuits in June but don't exercise your options until December.

Basic rate tax relief on your pension contribution is claimed from HMRC by your SIPP and added to your contribution. Therefore, your cash payment to the SIPP will be 80% of the amount you wish to contribute. Higher and additional rate tax relief are given in your tax return.

i. Accepting the termination and exercising options in June

If you leave Tea & Biscuits in June and exercise your options in June, your relevant earnings will be £62,500. This amount can be contributed to your pension, saving Income tax of £14,946 (Appendix 1).,If the options are exercised after termination so taxed at 20%, an additional £5,027 capital gains tax will be saved as the basic rate will be available to set against gains if it is not used against income.

ii. Accepting the termination and exercising options in December

The tax relief available on a £150,000 pension contribution gets you back most of the additional tax paid on the exercise of your share options if EMI relief is lost, but not the NIC.

Therefore, if you stop work in June you could wait to see if the share price rises and sell your shares back to Tea & Biscuits in December, provided you use the proceeds to make the pension contribution. To be relieved against 2024/25 income, your pension contribution needs to be made before the end of the 2024/25 tax year on 5 April 2025.

iii. Working part time and exercising options in December

Continuing to work part-time at Tea & Biscuits will preserve the EMI tax status of your share options until December, but at the cost of losing the tax-free redundancy payment. This is therefore the least efficient option for you.

Your relevant income will be £75,000, so you could make a pension contribution of this amount, on which you would receive tax relief of £19,946 (Appendix 1).

Tax on income from your SIPP for 2025/26 onwards

You can withdraw 25% of your pension tax-free, either in one go or in stages. If it is taken in one go, the whole amount drawn is tax-free and further withdrawals fully taxable. Otherwise, 25% of each withdrawal is tax free. This means that if you have no other pension or employment income, you can withdraw £16,760 per year, being the personal allowance of £12,570 plus 25%, with no tax due. Additional amounts withdrawn are taxed at 20% within the basic rate band.

2. Loan to SM Rental

If you lend £150,000 to SM Rental, the company will save 10% interest (£15,000 per year). Mortgage interest is tax deductible for companies, so the after-tax saving for SM Rental is £12,150 per year, assuming a corporation tax rate of 19%.

You can withdraw funds from SM Rental as either dividends, salary, interest on your loan to the company, or pension contributions. The tax treatment of each of these is as follows:

	Dividends	Salary	Interest	Pension contributions
Tax rates for recipient (basic/ higher/ additional rate)	8.75% / 33.75% / 39.35%	20% / 40% / 45%	20% / 40% / 45%	0 / 0 / 0
Subject to NIC	No	Yes, if salary paid is more than £9,100	No	No
Tax deductible for company	No	Yes	Yes	Yes

Tax on withdrawal of profits from SM Rental

Dividends are not tax deductible, so you would have approximately £12,150 available for dividends once the company paid tax on its £15,000 profit. Dividends are taxed at a lower rate than salary or interest, to reflect that they are paid out of funds that the company has already paid corporation tax on. The overall tax rate on dividends within the basic rate band, assuming 19% corporation tax, is 26%.

Salary and interest are both tax deductible for SM Rental, therefore if the company's mortgage is repaid there would be approximately £15,000 available to withdraw in either of these forms.

Interest is not subject to NIC and is also given zero-tax allowances that are not available for salary, therefore it would be preferable to pay interest on your loan to the company, not salary. For basic rate taxpayers, £1,000 interest received is taxed at 0%, this is the Savings Allowance. If interest is your first income above the personal allowance (excluding dividends) the first £5,000 is also taxed at 0%, this is the Starting Rate for Savings.

Therefore, from 2025/26 when you have no employment income, you could receive up to £18,570 of interest income with no tax due. Assuming SM Rental pays you 10% on £150,000, the interest you receive will be below the threshold where tax becomes due. Therefore, payment of interest would be a tax efficient way to withdraw funds.

3. A combination of pension contributions and loan

If your relevant income is not sufficient to enable you to contribute the full £150,000 to your pension, you could contribute up to your relevant income to your SIPP to obtain tax relief, and lend the remaining funds to SM Rental. You could then draw a combination of pension income and interest from SM Rental. Pension income is taxed first and will use your personal allowance, reducing the amount of interest you can receive tax free. However, if your pension income is no more than £16,760 (including the tax-free portion) the Savings Allowance and the Starting Rate for Savings are still available, meaning that you could draw a total of up to £22,760 per year tax free, made up of £16,760 pension income and £6,000 interest

Withdrawal of capital

Once funds have been contributed to your pension, they cannot be withdrawn without being taxed as pension income, at the rates outlined above. This is because tax relief is given on the funds contributed. A loan to SM Rental, on the other hand, would receive no tax relief and accordingly there is also no tax charge if the loan is repaid.

Inheritance Tax (IHT)

Funds held within your SIPP are not included in your estate for inheritance tax purposes, so are not subject to IHT on your death.

A loan to SM Rental would be included as part of your estate, but would be offset by the reduction in the amount of cash you hold.

Therefore, from an IHT perspective a contribution to your SIPP is preferable as it would reduce the value of your estate for IHT whereas a loan to SM Rental would be neutral.

However, all of your estate is left to the Shopshire Cat Sanctuary and if this is a charity, your entire estate will be exempt from IHT so IHT will not be relevant to your investment choice.

Cash Savings

The savings you have in your ISA are exempt from tax. You can withdraw as much as you like from your ISA with no tax consequences.

Recommendations

Pension contributions made from your relevant income and within your annual allowance will be more tax efficient than lending funds to SM Rental, as no direct tax relief is given for a loan to SM Rental.

With either option, your capital will remain intact, either in the value of your pension or the value of your loan to the company (and the company's ownership of the rental property), but with a pension contribution your total capital is increased due to the tax relief, although that capital cannot be withdrawn without being taxed as pension income. Funds you contribute to your SIPP can be invested within the scheme to provide an ongoing income stream in the same way that repaying the mortgage provides ongoing rental profit – this is an area that your Financial Adviser will advise on.

We recommend therefore that you should make a pension contribution of the maximum amount that will receive tax relief, in preference to lending funds to SM Rental. If you leave Tea & Biscuits in June, you can contribute either £62,500 or £150,000, depending on when you exercise your share options, and if you continue to work until December you can contribute £75,000.

While you have no other income, you will be able to draw the £15,000 you were seeking entirely tax free either from your pension or as interest from SM Rental , or a combination of the two.

APPENDIX 1

Calculation of tax due and net amounts received

	Termination Jun 2024 Exercise options Jun 2024	Leave Tea & Biscuits Dec 2024 Exercise options Dec 2024
Salary 5 months to 31 Aug	62,500	62,500
Salary further 4 months to 31 Dec		12,500
Option profit taxable as income		
Less employer NI payable		
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Total	62,500	75,000
Less personal allowance	(12,570)	(12,570)
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Taxable employment income	49,930	62,430
Tax at 20% on £37,700	7,540	7,540
Tax at 40% to £125,140	4,892	9,892
Tax at 45%		
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Total tax due	12,432	17,432
NI on salary to 31 Aug	2,715	2,715
NI on salary to 31 Dec		996
NI on option profit		
	--------------	-------------
Total tax and NI due	15,147	21,143
Capital gains	130,116	130,116
Annual exemption	(3,000)	(3,000)
Taxable gain	127,116	127,116
CGT at 20% / 10%	25,423	12,712
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Net income and gains	152,046	171,261
Tax free ex-gratia payment	60,000	0
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After-tax total income without pension contribution	212,046	171,261
Gross pension contribution that can be made	62,500	75,000
Tax relief on pension contribution	14,946 (£12,500 basic rate tax claimed by pension plus £2,446 higher rate relief)	19,946 (£15,000 basic rate tax claimed by pension plus £4,946 higher rate relief)
CGT saved due to pension contribution (£50,270 x 10%)	5,027	0
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Total saving from pension contribution	19,973	19,946
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After-tax total income with pension contribution (including funds in SIPP)	232,019	191,207
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