The Chartered Institute of Taxation

Application and Professional Skills

Taxation of Individuals

November 2022

Suggested solution

REPORT FOR JEFF STONES

1 INTRODUCTION

We understand that you are being made redundant from Parsons Construction Ltd on 1 January 2023 and you are seeking advice on how to optimise your tax position in the 2022/23 and 2023/24 tax years, in light of the options under your termination agreement and a number of proposed investments and payments.

This report has been prepared based on current tax rates and rules and using information provided at a meeting held on 30 October 2022, including assumptions you have asked us to make about the following:

(a) the value of the share price in the following six months;

(b) the value of the bonus expected to be paid in December 2023;

(c) your expected profits from self-employment in 2023/24.

The optimum position may change if any of these assumptions turn out to be incorrect.

Please note we are unable to provide investment advice. Our recommendations are based purely on the tax consequences of the proposed transactions unless otherwise stated. You may wish to seek additional independent specialist advice on your investment decisions from a suitably qualified professional.

This report is not intended to be relied upon by any third party.

2 EXECUTIVE SUMMARY

The various elements of your termination package should be taxable as follows:

(a) the payment in lieu of notice will be taxable as general earnings in 2022/23;

(b) the first £30,000 of the compensation for loss of employment will be tax-free and the balance of £32,500 will be taxable in 2022/23;

(c) the share award will be treated as a nil-cost option and will be taxable in the year of exercise;

(d) the bonus will be taxable as general earnings in the tax year in which it is paid (2023/24).

The key points in respect of the various transactions proposed are as follows:

(a) The pension contribution will attract relief at your marginal rate of tax. It is not possible to carry back the contribution to an earlier tax year.

(b) The Enterprise Investment Scheme (EIS)/Venture Capital Trust (VCT) investment will create a tax reducer equal to 30% of the amount subscribed, irrespective of the tax year in which it is made (subject to a sufficient tax liability for that year). It is possible to carry back an EIS subscription to the preceding tax year, but not a VCT subscription.

(c) The charitable donation should be made under Gift Aid. The gross donation (£12,500) will attract relief at the difference between your marginal rate of tax and 20%.

(d) Gross pension contributions and gross Gift Aid donations will reduce your adjusted net income. If adjusted net income is reduced in the range £100,000 to £125,140, the personal allowance is reinstated by £1 for each £2 in that range, equating to additional tax relief of 20% on the gross amount.

In seeking to optimise your position in light of the various choices you face, we have sought to maximise your net income across both 2022/23 and 2023/24. Our recommendations are as follows:

(a) Given you expect the value of the shares to decrease, the share award should be exercised as soon as possible and taken as cash. It will be taxed in 2022/23. This will maximise your gross income from the award.

(b) You should make your gross pension contribution in 2023/24, with a view to maximising the tax relief available by taking advantage of the additional personal allowance (resulting from a reduction of adjusted net income in the income range £100,000 to £125,140).

(c) You should make the EIS/VCT investment in 2022/23, to obtain tax relief sooner. An EIS subscription would give you greater flexibility from a tax perspective.

(d) You should make the Gift Aid payment in 2023/24, but with a view to carrying back the contribution to 2022/23 if it is tax-efficient to do so.

It is not clear how you intend to invest the remaining funds. There is an annual subscription limit of £20,000 into your ISA. If you invest the funds into a taxable savings account, you will have an Income Tax liability on the interest where your personal savings allowance (which may be nil) is exceeded. You may also consider further pension contributions.

We also recommend that you review your inheritance tax position as your estate on death may exceed your nil-rate band for inheritance tax purposes.

3 GENERAL COMMENTS

3.1 Termination Agreement

In order to determine your tax position in each of 2022/23 and 2023/24, we first need to understand how the different elements of your termination package will be subject to UK tax. We deal with the share award and bonus arrangement separately below.

Payments made on termination of employment are generally treated as either general earnings, which are taxable in full like your salary, or otherwise subject to a special tax regime. Payments that you are contractually entitled to receive will always be treated as general earnings.

Your termination agreement makes clear that the £25,000 payment in lieu of notice (PILON) is the amount that you would contractually have been entitled to receive had you been given your contractual notice of the termination of your employment. Therefore, this payment will be treated as general earnings and taxable in full. It was also be liable to Class 1 National Insurance Contributions (NIC).

The £62,500 appears to be a non-contractual, ex-gratia payment. On this basis, the payment will qualify for the special tax regime mentioned above, which means that the first £30,000 of the payment will be tax free and the balance of £32,500 will be taxable. However, this payment will not be liable to employee Class 1 NIC.

3.2 Share Award

As a ‘good leaver’, you continue to eligible to exercise the share award, which was granted to you on 1 December 2020, within the six months after the date of cessation of your employment, i.e. at any time between 1 January 2023 and 30 June 2023.

Because of your ability to choose when to exercise your share award, this element of your termination package is in fact a nil-cost option. This means that the full market value of the shares will be taxable on the date of exercise. Therefore, you can choose whether the share award will be taxable in 2022/23 (if you exercise on or before 5 April 2023) or otherwise taxable in 2023/24 (if you exercise between 6 April 2023 and 30 June 2023).

As arrangements are in place for the sale of the shares to a third party at any point, the share award will also be liable to Class 1 NIC.

Because the taxable value of the share award is significant (based on your expected market value of the share on 1 January 2023, the taxable value would be in the region of £250,000 – see section 3.8), this represents an important tax planning opportunity for you.

The choice of whether to exercise the share award in 2022/23 or 2023/24 will also be influenced by the changing share price. You have stated that you expect the share price of the company to fall in value by between 5% and 10% over the next six months and we have modelled our calculations on this basis. However, you should note that the optimum position will change if the actual share price actually increases or otherwise falls to a much lesser extent.

As the company must account for the Income Tax and National Insurance Contributions (NIC) on the share award at the point of exercise, you must decide whether to (a) pay the Income Tax and NIC out of your own funds, (b) 'sell to cover' – i.e. sell a sufficient quantity of shares to meet these liabilities and receive the balance in shares, or (c) sell the shares immediately after exercise and receive cash proceeds net of Income Tax and NIC.

It does not appear that you would have sufficient cash funds for option (a).

If you choose option (b) and retain the shares for a period of time after exercising the share award, and the shares decrease in value from the point of exercise to the point of sale, then you will realise a capital loss on sale for the tax year of disposal.

Income Tax relief for this loss would be available if the company were a qualifying trading company. However, one of the conditions is that the trading activity is not an 'excluded activity'. Property development – defined as the development of land on which the company has an interest – is one such excluded activity, so the relief is not available. Relief for the capital loss is therefore only available against future capital gains.

In any case, if you anticipate a fall in the share price, then it would make sense to choose the third option and receive the award in cash.

3.4 Bonus

You expect the bonus, which is due to be paid in December 2023, to be in the region of £100,000. This will be taxable as general earnings in 2023/24.

You expect your profits will be from self-employment in 2023/24 to be approximately £20,000. The sum of these two figures represents your taxable earnings in 2023/24 (excluding the share award, if that were to be exercised in 2022/23).

Although outside of scope of this report, you may wish to consider incorporating your business. This will give you greater flexibility to manage your personal tax liability on the extracted profits. However, there are several additional considerations to be made when incorporating a business. We can advise separately on this if required.

3.5 Pension contribution

You have stated that you wish to make a gross pension contribution of £20,000. This contribution will attract tax relief at your marginal rate of tax.

In the tax year in which you exercise the share award, your marginal rate of tax will be 45%. Your pensions annual allowance will also be tapered down to £4,000 in that year, though this will not impact on your ability to make a tax-relievable contribution of £20,000 because you should have sufficient annual allowance carry-forward from previous years.

However, it may be possible to increase the effective rate of tax relief on the pension contribution if it were to reduce your taxable income in the range £100,000 to £125,140. This is because gross pension

contributions will reduce your adjusted net income, which is the measure used to assess how much your personal allowance is withdrawn. For every £2 reduction of adjusted net income in the range stated, you will 'recover' an additional £1 of your personal allowance. This saves 40p of tax given that the marginal rate of tax in this range is 40%. Once the personal allowance withdrawal is accounted for, the overall effective marginal rate of tax (relief) becomes 60%.

The maximum tax relief which can be obtained from the £20,000 gross contribution is therefore £12,000. We should choose to make the contribution in the tax year which would generate this amount of relief if possible.

However, note that it is not possible to carry back the pension contribution to an earlier tax year. We must therefore decide prior to 5 April 2023 if the contribution is to be made in 2022/23 (or otherwise in 2023/24).

3.6 EIS/VCT investment

Subscriptions in Enterprise Investment Schemes or Venture Capital Trusts will each offer tax relief at 30% on the amount subscribed. There are limits to the maximum amount of relief available in each case, but these will not be in point for you.

Because the amount of tax relief is fixed and does not depend on your marginal rate of tax, it will be the same regardless of the year in which you make the investment.

The tax reducer cannot create a repayment of tax. A key difference for subscriptions under the EIS is that you can carry back the tax relief to the preceding tax year – this is not possible for subscriptions to a VCT. Therefore, EIS investments will give you slightly more flexibility. If you anticipate having a sufficient tax liability in both tax years to absorb the tax reducer, then this will not be any advantage. However, if you make an EIS subscription in 2023/24 and you do not have a sufficient tax liability in that year (because your self-employment profits and the bonus are not as high as you anticipate), then it may be of some comfort to know you can carry the subscription back to 2022/23.

You should be aware that if you make an EIS subscription and you sell the shares within three years of issue, then there will be a clawback of the Income Tax relief originally given.

For VCT investments, there is a clawback of Income Tax relief if you sell your shares within five years of issue. However, unlike EIS shares, dividends on VCT shares are specifically exempt from UK tax.

From a tax perspective, the optimum choice between EIS or VCT will therefore depend on:

(a) if the investment is made in 2023/24, the desirability of being able to carry-back the investment;

(b) how long you wish to retain the shares; and

(c) the expected dividend income from the investment (noting that the first £2,000 of dividends received per year will be tax free in any case under the dividend allowance).

In terms of the timing of the investment, as noted above this should not make a difference to the amount of tax relief available. It is therefore likely to be preferable to make the investment in 2022/23 – not only does this give you tax relief one year sooner, but you will have certainty of having a sufficient tax liability for that year.

Of course, we cannot advise you which type of subscription you should make from an investment perspective. You should note, for example, that EIS relief requires that there is a 'significant risk of loss to capital'. EIS subscriptions might also be considered a riskier investment than VCT because the risk is concentrated on one particular company, rather than spread across several. You should seek specialist independent advice on this point.

3.7 Charitable donation

The charitable donation to Greenpeace should be made under Gift Aid, by making the appropriate declaration at the time of the donation. Gift Aid donations made in a year affect your tax liability in that year in two ways.

First, the basic rate band is extended by the gross donation, meaning that an amount of income equal to the gross donation will be charged at 20% rather than at your marginal rate of tax. A net donation of £10,000 will equate to a gross donation of £12,500 (the difference being claimed from HMRC directly by the charity). For a 40% taxpayer, this will mean that an additional £12,500 is taxed at 20% rather than 40%, meaning tax relief of £12,500 * 20% = £2,500. For a 45% taxpayer, the amount increases to £3,125.

Second, the gross amount of the donation will reduce the taxpayer's adjusted net income. As explained above, this provides additional tax relief of 20% in the range £100,000 to £125,140 as a result of the additional personal allowance available.

If the personal allowance withdrawal is in point, the maximum tax relief available on the Gift Aid donation will therefore be at 40% of the gross donation. If not, the maximum tax relief will be at 25% of the gross donation as an additional rate taxpayer.

Gift Aid donations can be carried back to the tax year preceding that which they are made, but the claim must be made on the original tax return for the preceding tax year (i.e. the tax year which the relief is being claimed in) and no later than 31 January after the end of the tax year. Therefore, if the contribution is being made in 2023/24, it may be prudent to delay the completion of the 2022/23 return until such point that the amount of the bonus is known (in December 2023 or sooner) – so that it can be determined whether a carry-back claim is in your interest.

3.8 Analysis and recommendations

From a tax perspective, we should attempt to optimise the overall tax position across 2022/23 and 2023/24 by choosing in which tax year to:

(a) exercise the share award;

(b) make the pension contribution;

(c) make the EIS/VCT investment; and

(d) make the Gift Aid donation.

In exercising the share award, we are basing our recommendations on an estimated fall in value of the shares of 1.25% per month. This assumes a linear fall in the value of the shares at the midpoint of 5% and 10% over six months, i.e. 7.5%. We have estimated the share prices as follows:

Date	% fall in value	Value per share
30 October 2022	-	£12.48
1 January 2023	2.5% (2 * 1.25)	£12.17
6 April 2023	6.25% (5 * 1.25)	£11.70

As we have discussed, the EIS/VCT investment may be made in either tax year, but if the investment is made prior to 6 April 2023 then tax relief would be available 12 months sooner than if the investment were made in 2023/24.

If the share award were exercised in 2022/23, we would propose making the payments in the tax years as follows:

Tax year	2022/23	2023/24
Estimated gross taxable income (see Appendix 1)	£382,508	£120,000
Tax relief on £20,000 pension contribution	-	£8,000 (at 40%)

Tax relief on £10,000 Gift Aid donation	£3,125 (at 25% on the gross amount)	-
Tax relief because of additional personal allowance	-	£4,000 (20% of £20,000)

The total tax relief for the two payments would therefore be £15,125. This is the optimum timing across the tax years, as:

(a) if the pension contribution were made in 2022/23, relief would only be at 45% rather than effectively 60%; and

(b) if the Gift Aid donation were made in 2023/24, relief would only be at 20% not 25%.

It may be possible to obtain even more tax relief if gross taxable income in 2023/24 is higher than £120,000. This is because the Gift Aid donation might then be made in 2023/24 instead, increasing the tax relief because of the additional personal allowance (and thus the overall relief). To allow for this flexibility, the Gift Aid payment might be made in 2023/24 but potentially carried back to 2022/23.

If the share award were exercised in 2023/24, we would propose the following:

Tax year	2022/23	2023/24
Estimated gross taxable income (Appendix 2)	£132,500	£360,353
Tax relief on £20,000 pension contribution	£8,000 (at 40%)	-
Tax relief on £10,000 Gift Aid donation	£2,500 (at 20% on the gross amount)	-
Tax relief because of additional personal allowance	£5,028 (£12,570 at 40%)	-

The total tax relief for the two payments would therefore be £15,528. This is the optimum allocation across the tax years: while it is possible to obtain tax relief at 45% on the pension contribution (or 25% on the Gift Aid donation) if either were made in 2023/24, this would not compensate for the loss of the benefit resulting from the additional personal allowance.

The maximum *tax relief* might therefore be obtained by waiting to 2023/24 to exercise the share award and making both the pension contribution and Gift Aid payment in 2022/23. However, in maximising the *net income* we also need to consider (a) the potential fall in value of the shares, and (b) the fact that waiting to 2023/24 to exercise the share award, and making the payments proposed, means that across both years an additional £12,500 (£132,500 less £120,000) of income would be taxed at the higher rate rather than the additional rate.

Based on our assumptions, the fall in value of the shares would be equivalent to a reduction in gross income of £9,655 (£250,008 less £240,353, per Appendices 1 and 2) or £5,117 net of 45% tax and 2% NIC. The income taxed at the higher rate rather than the additional rate cushions this loss slightly by £625 (£12,500 * 5%), so the net effect is that you will be £4,492 worse off by waiting until 2023/24 to exercise the share award.

3.9 Other considerations

You do not mention how you plan to make use of the remaining funds after the investments have been made. Should you wish to invest these in your ISA, so the interest can be paid tax free, you should be aware that there is an annual subscription limit of £20,000 per year.

You can invest the balance in another savings account, but the interest will be taxable at your marginal rate after deducting your personal savings allowance for the year (£500 for higher-rate taxpayers and £1,000 for basic-rate taxpayers). If you are liable to tax at the additional rate tax in a year, you are not entitled to a personal savings allowance for that year.

If you can afford to lock away the remaining funds until you retire, you may also consider further pension contributions as your changing circumstances beyond 2023/24 suggest the tax relief available on those contributions will be less than you might get in 2022/23 or 2023/24.

Although outside of the scope of this report, we also recommend you give consideration to your Inheritance Tax position given that your wealth may exceed the nil-rate band (NRB), which is currently £325,000. In general, Inheritance Tax is payable at 40% on the value of your estate above the NRB.

Appendix 1: Gross taxable income assuming share award exercised in 2022/23

	2022/23		2023/24
	£		£
Salary (£100,000 * 9/12)	75,000	Profits	20,000
PILON	25,000	Bonus	100,000
Ex-gratia (excess over £30,000)	32,500		
Share award (20,543 * £12.17)	250,008		
Totals	£382,508		£120,000

Appendix 2: Gross taxable income assuming share award exercised in 2023/24

	2022/23		2023/24
	£		£
Salary (£100,000 * 9/12)	75,000	Profits	20,000
PILON	25,000	Bonus	100,000
Ex-gratia (excess over £30,000)	32,500	Share award (20,543 * £11.70)	240,353
Totals	£132,500		£360,353