The Chartered Institute of Taxation

Application and Professional Skills

Human Capital Taxes

November 2023

Suggested solution

<u>Draft report to Richard Hutch, Managing Director of Eagle Kitchens Ltd, regarding the UK tax analysis of an incentive package proposal for the new management team</u>

Report for Eagle Kitchens Ltd

For the attention of Mr Richard Hutch

Date: 2 November 2023

Subject: New management incentive package and pension benefits

This report is based on our recent meeting and the information that you have provided to us in your email of 1 November 2023.

This report is based on legislation and guidance applicable at the time of writing of this report. The advice contained in this report is addressed to Eagle Kitchens Ltd on the terms agreed in our engagement letter. No other parties may rely on this advice, and we ask that you do not share this advice with any other parties without our consent.

1. Introduction and scope

In accordance with your instructions, we have focused our report on the UK tax implications of your management incentive plan, pension proposals and the counterproposal by the targeted management team. We have also included comments on some of the practical implications of these two proposals. We have not considered the legal or accounting implications of the proposals in detail and we recommend that you take professional accountancy and legal advice before executing any agreement.

Please do not hesitate to contact Mary Stone if you have any questions about this report.

2. Executive summary

Hereafter we will refer to your proposal as 'Option 1' and the counterproposal as 'Option 2'.

<u>2.1 Management Incentive Plan</u>

- We recommend Option 1 as it will cost Eagle Kitchens Ltd £423,450 less in tax and social security costs. Option 2 is more tax efficient for the employees but it is more expensive for Eagle Kitchens Ltd. You could agree to Option 2 and keep your costs neutral only if the overall award is reduced.

- Option 2 is more tax efficient for the employees/directors because they will pay Capital Gains Tax on any growth rather than income tax and national insurance contributions (NIC). There is also no employer's NIC.. However, as the shares will be acquired at market value, there will be no Corporation Tax deduction available on the gain made on the shares by the employees when they sell them. This contrasts with Option 1 (see below).

- Option 1 results in employees and directors receiving less due to the fact that the unapproved options will be subject to income tax and NIC when the options are exercised. Although the CSOP options are more tax efficient than Option 2 you are limited to awarding only £30,000 worth of options to each staff member. Option 1 is cheaper for Eagle Kitchens Ltd because when the CSOP and unapproved options are exercised, the growth in value above the exercise price is tax deductible for corporation tax purposes. This is even taking into account that Class 1 secondary NIC would be payable on the unapproved option gains.

- If you agree to Option 2 you should require that an election made under s.431 ITEPA 2003 is signed by all employees/directors who receive shares.

2.3 Pension contributions

- It is reasonable for management to not want to receive pension contributions above their Annual Allowance. Your proposal to make pension contributions to a 'Top-Up' plan would prevent Annual Allowance Charges arising.

- However, your proposal under Option 1 would delay your Corporation Tax deduction for the amounts paid into the Top Up plan. You will need to administer a new scheme and there is a risk that anti-avoidance legislation (Part 7A ITEPA 2003 'disguised remuneration') would create an immediate income tax and NIC charge if contributions are earmarked to a particular individual.

- Our recommendation is that you accept the proposals in Option 2, despite higher Class 1 NIC costs. However, to comply with the auto-enrolment rules all the employees would need to opt out of their pension. Alternatively, as you cannot force employees to opt out, you could agree that only the excess above the tapered annual allowance is paid as salary. This would reduce your Class 1 secondary NIC costs and avoid employees and directors needing to opt out. You may also be able to negotiate for a lower cash amount to account for the fact that you will incur higher NIC costs as a result of paying cash.

3.3 Practical and legal

- We recommend that an employment solicitor be engaged to draft up an employment contract and that the terms of any management incentive are carefully considered from a legal and commercial perspective (for example, ensuring there are suitable rights attached to the shares so that you do not have difficulty selling all the shares/listing them).

3. Management Incentive Plan

It is common for employers to award shares or share options to employees and statutory directors as part of a remuneration package. There are specific rules that determine the tax treatment and there are some significant differences between the taxation of securities options and restricted securities.

3.1 Option 1 - CSOP and unapproved share options

The granting of share options to employees or directors would be treated as employment related securities options. The tax treatment and reporting obligations for tax approved arrangements is different from non-approved arrangements.

CSOP: A CSOP is a form of tax-advantaged share plan which offers tax and NIC advantages provided various conditions are met. It appears that you meet the conditions to award options under a CSOP on the basis that:

- You propose to award options over ordinary shares
- Eagle Kitchens Ltd is not controlled by another company
- None of the intended recipients has a material interest (more than 30% of the ordinary share capital) in Eagle Kitchens Ltd.
- The exercise price is equal to the market value on grant.

Advantages

- No income tax/NIC when the CSOP options are granted or exercised, assuming they are exercised between three and ten years from grant.
- When the employee sells their shares, they will be liable to capital gains tax on the difference between the sales proceeds and the purchase cost.
- You will obtain a corporation tax deduction when the options are exercised on the difference between the market value of the shares at exercise and the amount the employee pays for them.
- You are allowed to include special conditions on the options such as your requirement to force their exercise if there is a transaction.

Disadvantages

- The limit on the amount of the value of the shares on grant under option is £30,000 per employee.
- You will need to set up and administer a CSOP. It must be registered with HMRC and the organiser must certify compliance. The deadline for doing this is the 6 July following the end of the tax year of the first grant.

Unapproved share options: A market value share option is a non-tax advantaged share plan and there are not any conditions that need to be met for you to offer them to employees. The tax treatment compared to a CSOP is not as good.

Advantages

- There is no income tax or NIC charge when the share options are granted.
- You will obtain a corporation tax deduction when the shares are exercised on the difference between the market value of the shares at exercise and the amount the employee pays for them.
- There is no need to register the plan with HMRC or make any certification. There is only a requirement to report the award and exercise of securities options granted to employees via HMRC's online portal for Employment Related Securities.

Disadvantages

- When share options are exercised the difference between the market value of the shares and the exercise price paid is treated as employment income subject to income tax.
- If the share options are exercised as part of a corporate transaction, as is planned, the shares acquired by the employee will be treated as a readily convertible asset (RCA). This means that Eagle Kitchens Ltd would have an obligation to operate PAYE and a liability to Class 1 NIC would arise for both employer and employee.
- This is because non-cash assets provided to employee are treated as RCAs if either:
    i. They are listed on a recognised stock exchange,
    ii. There are arrangements in place for them to be sold, or
    iii. The issuing company is not entitled to a corporation tax deduction.
- For the avoidance of doubt, a listing would mean that condition (i) would be met, and on a third-party sale it is likely that (ii) is met. If there is no sale or listing then a purchase by the existing shareholders would also likely meet condition (ii).

3.2 Option 2 - Award of shares

The award of shares to employees and statutory directors will be subject to the rules applying to employment related securities. As these shares are subject to forfeiture restrictions, they will be subject to the rules for restricted securities in s.423(2) ITEPA 2003. These restrictions will reduce the value of the shares on acquisition. When these forfeiture restrictions lift, after 5 years, the value of the shares will increase.

The rules for restricted securities mean, in general, that there can be a tax charge on acquisition of the shares and a tax charge when the restrictions lift, and the shares become more valuable. The length of the restrictions determines when the tax charge occurs:

- If the restrictions last for less than five years, then no tax charge arises on acquisition.
- If the restrictions last for five years or more, there is an immediate tax charge based on their then restricted market value.

As the shares are subject to restrictions lasting at least 5 years there will be tax charge at the point of acquisition based on their value taking into account the impact of the forfeiture restrictions. However, you have advised that the value on grant should be assumed to be nil.

When the restrictions lift, there will be a further tax charge based on a percentage of the value of the shares after the restriction is lifted. The rules are complex, but the charge is calculated based on the

impact of the restrictions on the shares at acquisition and then applied to the value of the shares immediately after the restrictions lift. It is possible to remove the possibility of a tax charge when the restrictions lift by making an election under s.431 ITEPA 2003. This election is a joint one that must be made by both employer and employee within 14 days of the securities being acquired. This election means that the impact of the restrictions on the shares are ignored at the acquisition date. Therefore, the income tax liability would (normally) be greater at acquisition. However, it also means that there is no further tax charge when restrictions lift.

This is generally considered to be advantageous for individuals if the securities are expected to grow in value because it means there are no further employment tax charges (i.e. income tax and NIC) arising when the shares are more valuable in the future. A common example of where this helps is where forfeiture restrictions lift at a time when shares are more valuable. The s.431 election means there is no employment tax charge on the increase in value of shares which happens as a result of the restrictions lifting. In the absence of any employment tax charges after acquisition, all growth would be subject to capital gains tax which is less expensive (20%) compared to income tax and Class 1 NIC (45%+3.25%).

For employers the election reduces the Class 1 secondary NIC that could arise in future. It also has the added benefit of not needing to process any PAYE liabilities that arise at that point if the securities are a readily convertible asset.

If the value of the shares at acquisition is nil, then both the restricted and unrestricted market value of the shares at acquisition will be nil. Although HMRC may not agree that the shares have no value, a s.431 election prevents the possibility of a tax and NIC charge when the restrictions lift but without bearing any additional tax and NIC liability on acquisition.

Advantages of Option 2 (assuming s.431 election made)

- If the shares grow in value, that growth would be subject to capital gains tax rather than income tax and NIC.
- This will also generate Class 1 secondary NIC savings for the employer.
- If you decide to offer restricted shares you should require the employee to make an election under s431 ITEPA 2003 in order to receive the shares. This reduces the administration and NIC liability for you when the share restrictions lift in future.

Disadvantages of Option 2 (assuming s.431 election made)

- Assuming the shares have a nil (or negligible) value at acquisition and a s.431 election is signed, there will be no (or a negligible) corporation tax deduction available.
- However, it is difficult to value privately held shares. Even though the shares only have value if the business grows, the expectation of future value would need to be recognised. We recommend that further advice is taken to determine an appropriate value for tax purposes before proceeding.
- The value of the shares, even if it is small, would be treated as earnings assuming that the employee pays nothing for them. There would be an income tax charge (and NIC, if the shares were considered RCAs on grant) on the basis that they are being given to employees/directors for free.

3.3 Our assessment of the financial impacts of Option 1 and Option 2

We have used your projected value of the shares assuming that the business plan is successfully implemented. These numbers are therefore only estimates which help illustrate the impact of share options compared to restricted shares.

	Option 1		Option 2
	CSOP	Unapproved options	Restricted shares
Number of securities options/securities	600	300	900
Growth in value when shares sold	£1,890,000	£945,000	£2,835,000
Income tax (at 45%)	0	£425,250	
Class 1 primary NIC (at 3.25%)	0	£30,713	0
Class 1 secondary NIC (at 15.05%)	0	£142,223	0
Capital gains tax (at 20%)	£378,000	0	£567,000
Net received by employee	£1,512,000	£489,038	£2,268,000
Net received by employee Total	**£2,001,038**		**£2,268,000**
Corporation tax deduction for cost of options	£1,890,000	£945,000	0
Corporation tax deduction for cost of Class 1 secondary NIC		£142,222	
Corporation tax saved (19%)	£359,100	£206,572	0
Cost to employer	£1,530,900 (£1,890,000 - £359,100)	£880,650 (£945,000 + £142,222 - £206,572)	£2,835,000
Cost to employer total	**£2,411,550**		**£2,835,000**

Please note these are estimates and the true numbers will differ for example due to the availability of the CGT annual exempt amount.

4. Pension contributions

Pension contributions to a UK registered pension scheme are a tax effective way to save for retirement. Employer pension contributions are a deductible expense for corporation tax purposes and from the employee's perspective they are also exempt from income tax and Class 1 NIC.

There are, however, limits on the amount of pension contributions that can be made tax efficiently. The current Annual Allowance is set at £40,000 p.a. Contributions exceeding the Annual Allowance are subject to an Annual Allowance Charge that is either paid by the pension scheme (through 'scheme pays') or by the individual when they file their self-assessment tax return. The Annual Allowance Charge applies at 20%, 40% or 45% depending on the marginal tax rate of the individual.

However, the Annual Allowance is reduced by £1 for every £2 of adjusted income exceeding a £240,000 threshold. Although neither Option 1 or Option 2 contemplate wholly contributing to a UK registered scheme this table illustrates the reduced Annual Allowance available for the MD and FD in respect of registered scheme contributions.

		MD		FD
Net income		£350,000		£240,000
Add: Employer contributions		£52,500		£36,000
Adjusted Income		£402,500		£276,000
Less		(£240,000)		(£240,000)
Excess income		£162,500		£36,000
Restriction	(£162,500/2)		(£36,000/2)	
Annual Allowance		£40,000		£40,000
Less restriction		(£81,250)		(£18,000)
Tapered Annual Allowance		**£4,000***		**£22,000**

*The Annual Allowance cannot be tapered below £4,000.

Although it is possible to bring forward unused Annual Allowance from the previous three years, no such carry-forward is available on the basis that they made contributions exceeding their Annual Allowance in the last three years.

Option 1 – Your proposal

You have proposed that an Employer Financed Retirement Benefits Scheme (EFRBS) is used instead of a registered pension scheme for contributions above the Annual Allowance. Only contributions to a UK registered pension scheme are entitled to tax relief and therefore tested for Annual Allowance purposes. Therefore, the contributions to the EFRBS above the tapered Annual Allowance not trigger Annual Allowance Charges.

However, there would be no Corporation Tax deduction until such time that the members pay income tax on the pension benefits provided. We would also need to consider whether the anti-avoidance provisions often referred to as 'disguised remuneration' would apply here. If the funds in the plan are 'earmarked' for the benefit of an individual either formally or informally this will result in an immediate income tax and Class 1 NIC liability (both primary and secondary). Given that there is a proposal to include only two members, the risk of earmarking would appear to be high.

You would also need to consider the practical costs of setting up a trust and the work involved in maintaining a second pension scheme like this.

Option 2 – Management counterproposal

If you replace all employer pension contributions and EFRBS contributions with salary, then there will be higher Class 1 NIC cost for the employer and employee. Class 1 secondary NIC for the employer would increase by £13,319 ((£52,500+ £36,000) * 15.05% = £13,319).

As an alternative, pension contributions might be made to exhaust the available tapered annual allowance and the excess could be paid as salary. Compared with Option 2, this would provide NIC savings for both employee and employer on the pension contribution element, though the benefits would only be accessible from age 55.

For the MD pension contributions up to the Annual Allowance of £4,000 could be made. The remaining £48,500 could be paid as salary.

For the FD, the maximum contributions up to the Annual Allowance would be £22,000. The remaining £14,000 could be paid as salary. Both pension contributions and salary increase the adjusted income and therefore reduce the AA to £22,000.

This would result in Class 1 secondary NIC costs of £9,406 ((£48,500+£14,000) * 15.05% = £9,406).

Given that this would cost you £9,406 of additional NIC, your counter-offer could include a reduction in the overall amounts paid to below 15% so this is closer to being cost neutral.

Auto-enrolment

The two statutory directors and the three new employees will be considered ‘eligible jobholders’ assuming they are all aged over 22. This means that you must automatically enrol them in a qualifying scheme. Your occupational pension scheme will count as a qualifying scheme.

The total contributions needed are based on the lower and upper earnings limit for NIC purposes (£6,240 and £50,268) and must be at least 8% of earnings in this range. Eagle Kitchens Ltd must fund at least 3%.

Therefore, if you accept management’s proposal to exchange pension contribution for additional salary, these employees and directors must opt out. After three years you would need to automatically re-enrol them in your occupational pension scheme, and they would need to opt out again.

If you were to pay contributions only up to their available annual allowance (£4,000 and £22,000 for Managing Director and Finance Director respectively) into a pension scheme, then that would satisfy the 8% minimum contribution and employees and directors would not need to opt out.

For example, the Managing Director would be entitled under the automatic enrolment rules to 8% x (£50,268-£6,240) = £3,522. A contribution of £4,000 exceeds this.

You would also need to ensure that you do not breach the pension auto-enrolment rules. It is possible for staff to voluntarily opt out of a pension scheme, but they must not be induced to do so.

There are financial penalties if Eagle Kitchens Ltd does not comply with the auto-enrolment rules.

5. Legal and Practical

The initial proposal you have prepared needs to be reviewed by an employment lawyer so that a proper employment contract is prepared for their signature. If the management team were asked to leave, the rights and obligations of that contract would be very important for protecting your business and you may want the options or shares to be forfeited. All conversations with the new team should be documented in detail.

If you were to offer the management team new shares, then you would need a lawyer to amend your Articles of Association and, if applicable, amend or create a shareholders’ agreement. The shares would need to be transferred by deed, and you should engage a solicitor to carefully draft the terms of the share award. An award of share options would also require a carefully drafted agreement explaining the terms of their grant.