

Bulletin

Remuneration Package Planning For Owner Managers

The remuneration options available to employers have developed over many years. In fact every year it seems that more schemes are marketed and further loopholes blocked!

Appropriate remuneration strategies will depend on the type of employee involved. For example, there are more alternatives open to the director/shareholder than to employees generally. In this bulletin we focus on owner managers. However, some of the alternatives mentioned will also be appropriate for employees more generally. Creative thinking is often the key.

Extracting funds from the family company

The question of how best to extract funds from a family company is central to much of the tax planning that can be undertaken for a company and its shareholder directors. Potential benefits of extracting profit from the company now as against retaining it within the business include:

- the current low income tax cost of extracting funds (income tax rates may rise in the future). If the funds are required by the company as working capital, they can always be lent back to the company and then repaid in the future tax-free
- the potential double tax charge where profits are retained; that is, taxing any appreciation in value both in the company and when the value is realised by the shareholders, perhaps on the sale or winding up of the company.

Capital versus income

In certain situations, particularly where a sale of the company, winding up or purchase of any shares is in prospect, it will often be possible to structure the transaction so that the most tax efficient result is achieved. For an unquoted trading company, a transaction that results in a capital gain is often the most efficient, due to the high rates of business asset

taper relief. In the case of a purchase of own shares or on the winding up of a company, it may be feasible to choose whether the proceeds are treated as income or capital. Consequently, large savings can be made if the appropriate planning is undertaken. However, from a day-to-day viewpoint, mitigating tax and National Insurance (NI) will be the main considerations and this is what we focus on in the remainder of the bulletin.

Bonus versus dividend

The most common methods for director/shareholders to reward themselves are bonuses and dividends. When directly comparing the cost of dividends and bonuses, it often appears as though dividends are cheaper. This is illustrated by the example overleaf.



Example - where the small companies rate of tax applies

Christie is to receive a bonus of £60,000 after all taxes from his family company. He has a marginal income tax rate of 40% (32.5% on dividends) for 2004/05 and already has earnings above the employees' upper earnings limit for NI purposes, so that any bonus will be liable to employees' NI at 1%. The company pays corporation tax at the small companies rate of 19%.

The calculation set out below compares the cost of paying a dividend rather than a bonus to Christie for the tax year 2004/05.

Christie	Dividend £	Bonus £
Dividend/bonus	80,000	101,695
Less: National Insurance (1%)		1,017
Add: Tax credit (1/9)	8,889	
	<u>88,889</u>	
Less: Income tax (32.5%/40%)	28,889	40,678
NET RECEIPT	<u>£60,000</u>	<u>£60,000</u>
Company	Dividend £	Bonus £
Payment by company	80,000	101,695
Add: Employers' NI (@ 12.8%)		13,017
		<u>114,712</u>
Less: Tax relief (@ 19%)		21,795
TRUE COST TO THE COMPANY	<u>£80,000</u>	<u>£92,917</u>

However, it should be borne in mind that there is no tax relief for the company on the payment of a dividend. In addition, without remuneration, state benefit and pension entitlements may be affected and it may also be difficult to make pension contributions. Consequently, a combination of both dividends and bonuses can create the best of both worlds.

Another consideration when thinking about dividends is that the Inland Revenue may challenge the legal validity of dividends, so that complying with the company law formalities of AGMs, relevant paperwork and the availability of company reserves are highly important and these formalities should not be overlooked.

Level of remuneration

There can sometimes be a problem in justifying a reasonable level of remuneration, especially for spouse shareholder/directors. Remuneration must be paid wholly and exclusively for the purposes of the trade but there is usually little difficulty in justifying a nominal salary on the basis that a few hours a week are worked. Of course, paying a salary in excess of the lower earnings limit but below the earnings threshold (between £79 and £91 per week for 2004/05) means that there is no tax or NI payable on this sum.

In addition, a quirk of the legislation means that the recipient is potentially entitled to statutory maternity pay and statutory sick pay. Also, they will be entitled to a state pension, based on earnings of approximately £11,000. Consequently, employing family members can be hugely advantageous to the individual in the long run.

Retirement

In the case of a director approaching retirement, it may sometimes be necessary to maximise their earnings so as to secure them the best possible level of pension. Obviously, in this case a bonus is undoubtedly preferable to a dividend payment, as dividends do not rank as pensionable earnings.

It should also be borne in mind that employer pension contributions are not subject to tax or NI. There is usually little difficulty in justifying the level of personal pension contributions, provided they are not excessive.

Under the existing personal pension rules, the maximum contributions payable in any tax year are the higher of £3,600 (gross) and the amount payable by reference to the personal age and earnings related limits.

One of the interesting rules introduced recently means that an individual can be locked into net relevant earnings (NRE) of a peak year by giving the pension provider evidence of the earnings of that year. This establishes the earnings that can be used as the basis for the contributions not only of that year but also the following five. See example below.

Pension premiums

% of Net Relevant Earnings (NRE)
2004/05

Age at the beginning of the tax year	*Personal Pensions (including stakeholder)	Retirement Annuities
35 or less	17.5	17.5
36 - 45	20	17.5
46 - 50	25	17.5
51 - 55	30	20
56 - 60	35	22.5
61 - 74	40	27.5

*Maximum contributions 2004/05: higher of
- £3,600 (gross)
- % of NRE capped at £102,000

Example - an individual has peak earnings in year 1 and a lesser peak in year 3

Year	Earnings £ 000	Year nominated	Basis year	NRE £000
1	50	1	1	50
2	30		1	50
3	40	3	1	50
4 - 6	25		1	50
7 - 8	20		3	40

In simple terms, this means that higher remuneration could be taken in an earlier year and then followed by five years of minimal salary and large dividends so as to obtain the best of both worlds.

However, the pension rules will be changed substantially from April 2006 and so planning in this area will be subject to major revision at that time.

Charging rent on personally owned assets used by the company

Where property is held outside the company, the proprietor can extract funds from the company by charging rent. The rent paid by the company is generally deductible against profits (provided that it is not excessive) and is taxable in the proprietor's hands. The tax effect is therefore similar to paying remuneration except that there is no PAYE to operate (the rent will be subject to income tax through the self assessment system) or NI payable.

In many cases the proprietor will have borrowed to purchase the property and the rental income will ensure immediate tax relief for the interest paid. In addition, owning property outside the company gives a large capital gains tax advantage, provided that the asset in question is used by an individual, partnership or unquoted trading company for trading purposes. If this is the case, business asset taper relief will be due on the gain arising on the eventual sale of the asset.

It would also be possible for the property to be owned jointly between spouses, therefore splitting the income and possibly making use of another personal allowance and lower rates of tax.

Transferring income to other members of the family

Most basic tax planning involving members of the same family is an attempt to utilise personal reliefs and starting, lower and basic rate tax bands of the persons involved. Income is therefore diverted from the higher rate taxpayer.

However, anti-avoidance legislation needs to be considered to ensure that the transfer of income is effective. Outright gifts of shares between husbands and wives were not thought to be affected by this legislation but the Inland Revenue is currently conducting an aggressive campaign aimed particularly at where income, mainly dividends, has been diverted from higher rate taxpayers to lower rate or non-taxpayers.

Consequently, extreme care should be exercised when looking to divert income to other members of the family.

Efficient remuneration planning for directors and employees

Usually, owner managers are also employees and there are several benefits that can be provided tax and/or NI efficiently. Thought should be given to reducing the salary of the individual and replacing it with a tax and/or NI efficient benefit.

One favoured method of doing this is by using a 'salary sacrifice scheme'. Provided such an arrangement is correctly implemented, there should be no problems with the Inland Revenue.

Attractive benefits

There are several benefits that can save costs both for the employer and employee and a summary follows:

Employer pension contributions

Employer pension contributions to an approved scheme (whether this is a company or personal scheme) are tax and NI free. As tax relief is available for individuals who contribute to approved personal pension schemes, the ultimate saving is NI, this being 12.8% for the employer and 11% or 1% for the employee, depending on their earnings. Some of the employer's savings could then be 'shared' with the employees.

Employer provided childcare

Unless the employer operates a workplace crèche or similar scheme, most forms of employer provided childcare are currently taxable. However, if the employer provides the childcare, then there is generally no NI due. The employer would need to take responsibility for arranging and paying the cost of the places. These include commercial nurseries, childminders or childcare vouchers. Once again, this is currently a NI friendly option but from April 2005 the rules will change, so that a maximum of £50 per week of approved childcare costs paid by the employer will be tax and NI free. The limit will apply to each parent if they are in employment. Clearly, there will be winners and losers from this change.

Finally, it should be borne in mind that part of the working tax credit award relates to eligible childcare costs paid by the individual. By moving to the above arrangements the employee would no longer be paying those costs and hence the working tax credit award may be reduced. This could actually mean that some employees become worse off and care should be taken in this area.

Computers

Where an employer makes a computer available to an employee for private use, the first £500 of any tax charge that would otherwise arise is exempted from tax and NI. So, if the employer makes available computer equipment with a market value of £1,000, the benefit-in-kind would usually be 20% of this figure. As the benefit of £200 is less than the £500 limit, there is no tax charge. However, the exemption is not given if the computer facility is confined to directors and their families only.

Personalised car number plates

The Inland Revenue has confirmed that the numberplate itself (that is the piece of metal or plastic with the numbers and letters upon it) is a taxable benefit. However, most of the value in personalised or cherished number plates lies in the intangible right to use a particular registration mark. This right is separate from the price of the plate itself and is not subject to tax or NI.

Car parking spaces

The provision of a car parking space at or near the employee's normal place of work is not subject to tax or NI. The interpretation of this is



extremely wide and covers season tickets, direct payment or reimbursement by the employer. Consequently, a substantial daily cost of the employee can be rearranged to save tax and NI.

Mobile phones

The provision of the use of an employer provided mobile phone does not result in a tax or NI charge, even where the employee is allowed to make private calls from the phone.

Reasonable removal or relocation expenses

There is a ceiling of £8,000 on the tax and NI relief available against the cost of a move. Whilst this may not be a common occurrence, the savings can be quite large. However, the definition of qualifying costs is extremely detailed and we would be pleased to discuss these in more detail if this is of particular interest to you.

Beneficial loans

Beneficial loans are not taxable where the total outstanding amount at any time in any given tax year is less than £5,000 per employee.

Company cars

The most commonly provided and the biggest perk for many employees is a company car. There is clearly a fundamental decision to be made at the outset as to whether to provide a company car or pay employees to use their own cars. The maximum tax-free mileage rate for employees who drive their own cars is 40p per mile for the first 10,000 miles and 25p thereafter. For NI purposes, 40p per mile is used irrespective of mileage. However, when considering company cars, there are several issues to bear in mind.

Car benefits and emissions

Car benefit-in-kind charges are calculated on the 'list price' of the vehicle, multiplying this by a percentage. The percentage is linked to the CO₂ emissions of the vehicle. The lower the emissions the lower the charge on the employee and the Class 1A NI charge on the employer. Encouraging employees to choose lower emission cars will therefore result in a saving for both the employer and the employee.

Clean cars

The government has been keen to encourage cleaner cars on to our roads and technology is now starting to move on. There are a variety of discounts on the benefits-in-kind for electric, electric/petrol, LPG and petrol/LPG vehicles. However, the most widely available discounts relate to 'clean' diesels. Most mainstream car manufacturers now produce 'clean' diesels (known as Euro IV), which means that the 3% diesel supplement for company cars does not apply. This will reduce the benefit-in-kind to the employee and the Class 1A NI to the employer.

Company cars and capital contributions

The maximum reduction in list price for a capital contribution towards the cost of the vehicle from an employee is £5,000. Provided that, on

the sale of the vehicle, the employee will only be entitled to a proportion of his or her original contribution, the yearly reduction in list price will stand. This could be combined with the £5,000 interest free loan mentioned above. At the end of the term of the loan when the car is sold, the balance of the loan could be waived, which would generate a tax and NI charge on the waiver. The figures need to be worked through fully but savings can be made, particularly where the emissions on the vehicle are high.



Private fuel

The basis of the benefit-in-kind charge where fuel is provided to an employee who drives a company car is the percentage that applies for working out the company car benefit, which is then applied to a pre-set figure of £14,400. This benefit may or may not be cost effective depending on the cost of fuel and the private mileage driven. If private mileage is very low, it is highly unlikely that this benefit will be tax efficient.

Vans

The provision of a company van is currently subject to a maximum benefit-in-kind of £500 per year, which includes private fuel. This includes unlimited private mileage and unlimited private fuel. Obviously, it is highly important to ensure that the vehicle is classed as a van for tax purposes. The definition currently used is that vehicles that can legally carry a load of one tonne or more will be classed as a van. One of the practical effects of this is that some 'double cab' pick-up trucks might well be classified as vans.

From April 2005, provided that private use (other than from home to office) is prohibited, there will be no benefit-in-kind on the provision of a van. Major increases in the benefit, up to £3,000 and an additional £500 for private fuel, are to be implemented in April 2007. You may wish to talk to us about the steps required to avoid the charge from April 2005.

And finally

As can be seen from this bulletin, there are many savings that can be made but this whole area is extremely complicated and professional advice should be sought before implementing any of the above suggestions. Please talk to us if you have any questions on anything we have covered in this bulletin.