



Tax Efficient Remuneration Strategies

Introduction

Tax efficient remuneration strategies can be effective in motivating staff and minimising the impact of tax on the proprietors of businesses run as a limited company.

Whilst there are a limited number of restrictions in considering how a person should receive their remuneration such as the infamous IR35 rules, the managed services legislation introduced following FA 2006 and the National Minimum Wage, in most cases the choices are wide and there is nothing to prevent tax efficient structures being used.

The options open to employees who are not also shareholders are more restricted but careful choices can reap significant benefits.



Salary v dividends

The primary choice for the employee who is a shareholder is between a salary and a dividend.

A salary is paid by a company through the PAYE system and is subject to National Insurance on both the employee and the employer.



The cost of a salary including the employers NI is an allowable cost for Corporation Tax purposes. Therefore if a salary is paid, there is a saving in Corporation Tax for the employer.

In contrast a dividend is not allowable for Corporation Tax purposes but instead is treated as a distribution of profits which are already taxed. For this reason the dividend carries with it a tax credit of 10% of the total of the dividend and the tax credit, i.e. if a dividend of £900 is paid it carries a tax credit of £100 (being 10% x (£900+£100)).

More importantly dividends are not liable for National Insurance either for the company or the shareholder. This can represent a significant saving overall as the rate of National Insurance for employees is 11% and for employers is 12.8% (2007/2008).

The income tax treatment of dividends is also unusual particularly for basic rate tax payers. Whilst the tax credit on dividends is only 10% as compared with a basic rate of income tax at 22% (for 2007/08) the legislation says that no additional tax is charged on dividends for basic rate tax payers. In addition the top rate of tax for dividends is only 32.5% compared with the normal top rate of 40%. For the first time it is now more tax efficient to pay a dividend to a higher rate taxpayer than some other form of remuneration that is subject to PAYE and National Insurance in respect of the 2009/10 tax year. The reduction in the mainstream corporation tax rate from 30% to 28% and the reduction in the rate applying in the marginal band between £300K and £1.5m of

corporate profits in financial year 2008 has meant that a dividend will always be more tax efficient in terms of the total tax both the company and individual will pay, when compared to some other form of remuneration subject to PAYE and national insurance

There are some other factors to take into account which can affect the choices.

- If no National Insurance is paid this will affect the individual's entitlement to state benefits and in particular may mean that they are not entitled to a full state pension on retirement.
- Dividends must be paid out of 'distributable reserves'. That is the company must have sufficient accumulated profits to cover the dividend.
- Dividends must be paid to all shareholders within a class of shares. It is possible to waive dividends or to create new classes of shares where different dividends need to be paid to different individuals.
- Whilst a basic level of pension contribution can be made without reference to salary higher contributions require a salary to be paid at least once every five years.
- Some occupational pension schemes take account of the salary level in determining the level of pension to be paid on retirement.
- Certain sickness insurance schemes pay benefits based only on salary when you are unable to work.

Company Cars

Company cars have long been a popular benefit for many employees and often carry a status within the organisation. The tax on company cars and private fuel has been increased dramatically over the past few years to the point that many employees would be far better off purchasing their own car and claiming tax free mileage allowances for business travel. This is particularly true for those who do high business mileage and relatively low private mileage. In many cases the tax payable where a company pays for private fuel can be higher than the cost of that fuel itself.



The disadvantage for an employee providing his own car is the uncertainty of the costs of maintenance. To deal with this problem some employers are now establishing group leasing arrangements where the employer company stands as guarantor enabling the employee to obtain status free contract hire arrangements which include all maintenance for the vehicle. This has the benefit for the employer of also being able to indicate to employees the type of car which can be chosen under the scheme. A salary is paid instead of providing a car. No car benefit arises even though the salary is used to acquire a car through a leasing company.

Benefits in Kind

Whilst benefits in kind attract employers' National Insurance they are still free of employee's National Insurance. Benefits such as medical insurance may also have the advantage for the employee of being cheaper through a group scheme through their employer than on a private contract.

Interest free loans of up to £5,000 are tax free benefits but there are other consequences if loans are made to shareholders.

Other benefits in kind are still attractive but care must be taken to ensure that the anticipated tax treatment applies

Share Scheme

The Government is trying to encourage employee participation in their employer company. There are two main schemes to achieve this aim although it is also possible to have other 'unapproved' arrangements where appropriate.

Share Incentive Plans (SIP)

The share incentive plan effectively allows the employer to give shares to employees without a tax charge. Like all such schemes there are many rules and conditions to be met and specific specialist advice is needed to establish an effective

scheme. This helps to promote employee loyalty and allows for dividends to be paid. However the costs and complexities of this scheme make it unattractive to proprietary businesses.

Enterprise Management Incentive Scheme (EMI)

This is a share option scheme which grants special tax treatment in certain circumstances. The scheme allows up to £120,000 of options to be granted to an employee with no income tax charge arising as long as the options are granted at market value. Not all employees have to be offered options and specific performance conditions can be added to each employee's options that must be met prior to the option being exercisable. In addition, the shares subsequently issued to employees on exercise of the options may attract a reduced rate of Capital gains Tax of 10% (down from the standard rate of 18%) as long as an employee holds more than 5% of the company's shares, works for the company and holds the shares for more than twelve months.

This can be a useful incentive to keep key employees and motivate them to make the business successful. For instance where a company is looking for significant growth with a view to sale or float the employees can look to realise a gain taxed at only 10% at the time they exercise the option as long as the employee has held more than 5% of the shares for twelve months and works for the company.



Further Information

For help in devising the best remuneration strategy for your business, speak to your normal contact at Monahans.