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It's no sacrifice…Tax Planning with Salary Sacrifices

A salary sacrifice is an arrangement whereby an employee agrees to a reduction in his salary, typically in exchange for some other payment or benefit which is not taxable in his hands.

If the sacrifice is done properly, then the employee's tax bill is reduced, and the employer saves on the NIC he would have had to pay on the amount of salary that has been sacrificed.

Typically, a salary sacrifice involves a benefit that is not taxable, and some common examples are:

- Training courses
- Removal expenses when taking up a new employment
- Childcare vouchers

For example:

Casey is employed by a firm of accountants in its tax department, earning £25,000 a year. He very much wants to go for his Chartered Tax Adviser qualification, and if his employers were to pay for an appropriate training course and his exam fees, it would cost them £2,500, and the cost would not be a taxable benefit on Casey. The firm cannot afford this cost, however, and so it is agreed with Casey that he will sacrifice £2,000 of his annual salary, and the employer will pay for the course and the exam fees.

Casey's salary is reduced by £2,000, which after taking his saving on tax and his NIC deductions into account means his monthly pay packet reduces by only £115. His employer saves just over £21 per month in employers' NIC, so over the year the net cost to the employer is only £244 (cost of training course = £2,500, less salary sacrifice and related employers NIC £2,256).

It is important to arrange the salary sacrifice properly. In order to be effective for tax purposes, the following conditions must be observed:

Contract of employment

The reduction in salary must be effected by a genuine change in the employee's contract of employment. Although in theory this can be done by word of mouth, it is sensible to have something in writing, signed by both employer and employee, to confirm the change in terms and conditions. An exchange of letters is usually sufficient.

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Timing

The salary must be sacrificed before the employee has become entitled to it. In a typical case where the employee is paid a monthly salary like Casey, the best way is for the sacrifice to be agreed (and the letters exchanged) before the start of the first month in which the sacrifice will take effect. If Casey will have his first reduced pay packet at the end of September, he should sign up for the sacrifice by the end of August.

Provision of benefit

It must be quite clear that it is the employer who is providing the benefit, rather than simply applying some of Casey's salary in a different way. A salary sacrifice where the employer agreed to pay Casey's mortgage, for example, would not be effective.

No going back

It must not be possible for the employee to reverse the salary sacrifice and go back to the original salary whenever he wishes. This is because there is a tax case (Heaton v Bell) which established that if an employee can give up a benefit at any time in exchange for a salary increase, then that benefit has a "money's worth" equivalent to the increase you can get by renouncing it.

Casey's agreement about his training costs is clearly for one year (assuming he passes his exams at the first go!), and at the end of the year, his salary will revert to its old level. In the case of childcare vouchers, for example, the period of the sacrifice may be uncertain at the start.

HMRC generally accept that where the sacrifice lasts for 12 months or more, they will not apply the Heaton v Bell principle. The employee should have the opportunity to continue or to end the salary sacrifice only once a year - the obvious time would be the annual salary review.

HMRC attitude

HMRC used to be very suspicious of salary sacrifices, but as remuneration arrangements for employees have become more flexible and sophisticated over the years, their attitude has mellowed and they now accept that they work. There is even a helpful page on their website explaining how a sacrifice works, and warning of the pitfalls: http://www.hmrc.gov.uk/specialist/salary_sacrifice.htm

Q&A

Q1. Someone has said buying new builders plant like a telehandler or a digger is 100% tax deductable could this be the case?

A1. Provided the plant is used exclusively for your business, there is an allowance of 100% on the first £50,000 spent on plant and machinery in the year. The balance is written off at 20% per year. This is new legislation which came in this April, and if your accounting period straddles 5 April 2008 (1 April for limited companies) the transitional provisions make things a bit more complicated and you should seek advice. The same applies if you have more than one business, as the £50K allowance may need to be divided between the different businesses.

Q2. I re-mortgaged my family home to buy a rental property. There was only £7k left on my original mortgage and all of the rental income and mortgage repayments go through a separate bank account. Can I still claim tax relief on the interest payments?

A2. If you used all the proceeds of the re-mortgage to invest in the rental property, the interest payments can be deducted from the rent. This does not apply to the part of the interest relating to the "old" £7k mortgage, nor to the capital repayment element of the mortgage payments.

Q3. My mother intends to gift her private residental property to me. There is no mortage on the property. Will I have to incur any transfer taxes, fees or duties and, if so, at what value. What would be the base value to me for any future CGT on a subsequent sale.

A3. This is a minefield, and you should consult a tax adviser. You do not say if your mother will continue to live in the property. If she does, there will be inheritance tax complications, and there could also be problems with CGT if the property is sold at a later date. To answer your basic question, assuming the property has been your mother's main residence throughout her ownership of it, the CGT exemption for a main residence will apply to her disposal of it. You will be deemed to acquire it at its market value on the day it is gifted to you, and because there is no mortgage and you are not paying anything for it, there will be no Stamp Duty Land Tax to pay. I must emphasise again, however, that if your mother continues to live in the property, you are going to have tax problems in the future as a result.

Q4. I rented my main home whilst living abroad for 3 years but now back living back in the property. I am due to move abroad again for 3 years (I will have lived in the house for 10 months) and work on extending the property will commence once I leave. Once finished, I will rent out the property again. Can I offset any of the building work against the rental income?

A4. No, because from your description this will be capital expenditure. It can only be added to the cost of the property for CGT purposes, to reduce any capital gain on a sale. Only repairs (rather than the capital cost of an extension) can be deducted from the rental income.

Q5. My husband inherited his father's share of 2 properties, for which they are tenants-in-common. Will there be any stamp duty incurred? He has been asked to fill in a TR1 form to complete the transfer.

A5. A transfer to a person in satisfaction of a legacy is exempt from Stamp Duty Land Tax.

Q6. We are renting out a house that we both used to live in, but which is owned in my husband's name only.

As he falls into the higher income tax bracket, to minimise our tax obligation can the rental income be put through my tax allowances only even though my name is not on the deeds? Or if we were to add my name to the deeds, would this be possible?

A6. Unless you own a share of the house, you cannot declare any of the rent on your return. If your husband gifts you a share of the house, then you and he will each be taxed on 50% of the rental profit. If you want to transfer more than 50% of the rent to you, then he can transfer more than 50% of the property to you (you will need to be "tenants in common" rather than "joint tenants" to achieve this) and you and he can complete and submit a "Form 17" to HMRC asking to be taxed on your actual ownership of the property instead of the default position of 50/50.

Be careful if the property has a mortgage - if it does, you may incur a liability to Stamp Duty Land Tax as a result of the transfer - take professional advice on this and also on how to execute the transfer.

Q7. We are considering accepting another house in part exchange for our house. The cash difference would be about £100,000. I understand that we have to pay full stamp duty on both properties now. How are the values for each house decided?

A7. If we assume your house is worth £300,000 and the one you are acquiring is worth £200,000, then you will pay SDLT of £2,000 (you have "paid" the value of your house (£300K) less the cash received of £100K, which equals £200K, which is within the 1% band for SDLT). The other party will pay SDLT of £9,000 (he has "paid" you the value of his house (£200K), plus cash of £100K, which equals £300K, which is within the 3% SDLT band).

On the Road Again… Employees' Travelling Expenses

I was highly amused to see in the news that the National Audit Office is facing a bill from HM Revenue and Customs for penalties and interest of some £8,000, in addition to tax of £98,000. This arises from the taxable benefit of a chauffer-driven car to take the former Comptroller and Auditor General, Sir John Bourn, to and from work. That will teach the NAO to qualify their audit report on HM Revenue and Customs' 2007/08 accounts!

Employee's travelling expenses can be a nightmare for employers. It is generally known that travel from your home to your work is not an allowable expense (though not, it appears, to the NAO), but the detailed rules are fiendishly complicated and almost every "Employer Compliance Review" conducted by HMRC turns up a few mistakes.

HMRC publish a book (the reference is 490) on the subject, which is more than 80 pages long, so it is quite a task to sum the rules up within the limits of this article, but let's see how we get on. I recommend a cold towel round the head while you read this.

In order to understand the rules, we need to learn a new language. There are a number of terms used in the legislation that have special meanings, and are a rich source of confusion. As this may be your first exposure to this new language, we will concentrate on four key phrases: "Permanent Workplace", "Temporary Workplace", "Limited Duration", and "Temporary Purpose".

Permanent Workplace

The most confusing is "permanent workplace". Travel from home to your "permanent workplace" is not an allowable expense. In the case of an employee who lives in town A and works every day at an office in Town B, this is fairly easy to cope with, but the problems start when an employee works in more than one place. I am not talking about someone such as a heating engineer who visits numerous customers during the day, but rather an employee who works (say) three days a week in one office, and two days a week in another office of the same employer. If he does this on a regular basis, then HMRC are likely to say that both offices are "permanent workplaces", and so travel to either is not allowable.

Temporary Workplace

In order to get your travel expenses allowed, the travel must be to a "temporary workplace" - and yes, you've guessed it - this too has a special meaning. A "temporary workplace" is one to which an employee goes to "perform a task of limited duration or other temporary purpose".

Limited Duration

"Limited duration" is the easiest to define - it means "less than 24 months". If an employee who normally works in Town A is asked to work in Town B for 18 months, that will be a task of "limited duration" and his travelling costs from home to Town B will be allowable, provided he returns to working in Town A at the end of the 18 month period.

There is however a nasty catch here, and one which bedevils certain seasonal industries such as the hotel trade. If the employment concerned is a fixed term contract, even if it is for less than 24 months, then if all or most of the duties are to be performed in one place, that is a permanent workplace and the travel expenses are not allowable. To take a common example, hotels hire temporary staff for the holiday season, and (particularly those in remote locations) pay for their summer staff's return tickets to the hotel. Those tickets are a taxable benefit because the hotel is not a "temporary workplace" for employees working there on fixed-term contracts.

The other aspect of "limited duration" which causes even more confusion is the so-called "40% rule". If an employee spends 40% or more of his working time at a particular workplace, then that will be a "permanent workplace" (unless the period during which this situation occurs is less than 24 months, as explained above).

Temporary Purpose

"Temporary purpose" is even more obscure. As we have seen, if you go regularly to a second workplace, say every Friday, then even though you are spending less than 40% of your working time there, it may still be a "permanent workplace".

The "get ot of jail card" in this situation is that you attend the second workplace for a "temporary purpose". HMRC's guidance on the meaning of this expression says:

"Where a visit is self-contained (that is, arranged for a particular reason rather than as part of a series of visits to the same workplace for the continuation of a particular task) it is likely to be for a temporary purpose." (Paragraph EIM32150 of their "Employment Income Manual").

Like much HMRC guidance, that explanation sounds as though it means something until you try to apply it to the real world! HMRC's own examples of a "temporary purpose" include a Safety Officer who visits a particular factory once a month to carry out a safety check (but surely, he is "continuing" the task of ensuring the factory complies with the safety rules?), and a director who visits Farnham on the last Friday of each month to attend a board meeting (but again, is he not "continuing" the task of running the company?).

It is an uncomfortable sensation arguing against HMRC's own examples of non-taxable expenses, and I will stop it immediately. You may have a headache by now, but at least you can say you know more about travelling expenses than the National Audit Office apparently did!

"Sorry Dad - Mum's left it all to me!" - Beware of the Transferable Nil Rate Band!

Shortly before the Pre Budget Report in October 2007, the Tories announced that they would increase the "nil rate band" for inheritance tax to £1million if they came to power. The Chancellor responded by introducing the right for a married couple to transfer the nil rate band of the first to die to the widow or widower, if it had not been used on the first death.

Inheritance Tax (IHT) is charged on your estate when you die, at a rate of 40%. The first £312,000, however, is charged at 0%. This is the "nil rate band" (NRB), and it increases each tax year, with the new amount announced in the Budget.

Legacies between spouses (and civil partners) are exempt from IHT, so if Mr X dies and leaves everything to his wife, no IHT will be payable, and his NRB will not have been used. Following the announcement in October 2007, when Mrs X dies, she can use not only her own NRB, but she can increase it by 100% to take account of Mr X's unused NRB.

If Mr X had used some but not all of his NRB by leaving a legacy to, say, his brother, then Mrs X could still use whatever percentage of the NRB that Mr X did not use. If his legacy to his brother had used half of the NRB in the year of his death, Mrs X could still add 50% to her NRB when she dies - giving her a NRB of £468,000 for the current year (£312,000 x 150%).

It does not matter when Mr X died - even if this was before October 2007 - Mrs X can have the unused percentage of his NRB. This can lead to some unexpected results.

Imagine that Mr X left everything to Mrs X when he died, so that potentially she has a NRB for the current year of £624,000. Mrs X is now Mrs Y, because she has remarried, and she decides that she would like to leave something to her children from her marriage to Mr X.

Her solicitor suggests she leave a sum equivalent to the NRB to her children, and the rest to her new husband, Mr Y. As Mrs Y reckons her assets are worth about £600,000, this seems fair to her and she agrees. The solicitor drafts a Will for her on these lines and she signs it. It was commonplace to leave a legacy equivalent to the NRB, perhaps to a family trust, and in many cases it is still a good idea even if you are a married couple, but that is beyond the scope of this article.

There are two common wordings used by solicitors drafting a Will for a "NRB legacy":

- **"I leave the largest sum that can pass without inheritance tax being payable to..."**
- **"I leave a sum equivalent to the nil rate band at the time of my death to..."**

Mr Y had better hope his wife's solicitor has used the second of these two wordings, because if he used the first, Mr Y will get nothing!

Just re-read those wordings - if the first one has been used, the "largest sum that can pass" free of IHT in Mrs Y's case is £624,000, because of the NRB she took over from the late Mr X. Her estate, you will remember, is only worth £600,000, so her children will get the lot!

The transferable NRB is good news for married couples, and for those who have lost their spouses already, but if your Will has a NRB legacy in it, check the wording to make sure it will still have the effect that you expect!

Tax Tips

A new power has been announced
For HMRC to visit a trader's premises and inspect his records and assets used in the trade – this can already be done for VAT purposes, but now it is being extended to direct tax (income tax, corporation tax, and CGT), with effect from April 2009.

Moving to new premises? Make sure you tell HMRC beforehand!
When we move premises, we remember to tell the telephone, gas and electricity companies about it. However, forgetting to tell HMRC could lead to a lot of unnecessary hassle. Legally, a business is required to tell HMRC of a change of address within 30 days.

Have you received a tax repayment from HMRC?
Was it too much? If you receive a larger repayment than you are entitled to, you MUST tell HMRC about it and repay the amount overpaid. Not doing this is an offence under the Theft Act!

Do you have a guilty conscience?
If you have not been declaring some of your income, or have underpaid tax for any other reason, contact HMRC and tell them about it before they catch you – the penalties you pay will be significantly lower if you do this, and in some cases they may be waived entirely.

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