

Strategic Professional – Options

Advanced Taxation

Specimen Exam applicable from June 2018



Time allowed: 3 hours 15 minutes

This question paper is divided into two sections:

Section A – BOTH questions are compulsory and MUST be attempted

Section B – BOTH questions are compulsory and MUST be attempted

Tax rates and allowances are on pages 2–5

Do NOT open this question paper until instructed by the supervisor.

This question paper must not be removed from the examination hall.

Think Ahead

ACCA

The Association of
Chartered Certified
Accountants

Advanced Taxation

SUPPLEMENTARY INSTRUCTIONS

1. You should assume that the tax rates and allowances for the tax year 2015/16 and for the financial year to 31 March 2016 will continue to apply for the foreseeable future unless you are instructed otherwise.
2. Calculations and workings need only be made to the nearest £.
3. All apportionments should be made to the nearest month.
4. All workings should be shown.

TAX RATES AND ALLOWANCES

The following tax rates and allowances are to be used in answering the questions.

	Income tax	Normal rates	Dividend rates
Basic rate	£1 – £31,785	20%	10%
Higher rate	£31,786 to £150,000	40%	32·5%
Additional rate	£150,001 and over	45%	37·5%

A starting rate of 0% applies to savings income where it falls within the first £5,000 of taxable income.

Personal allowances

Personal allowance

Personal allowance	£10,600
Transferable amount	£1,060
Income limit	£100,000

Residence status

Days in UK

Less than 16
16 to 45
46 to 90
91 to 120
121 to 182
183 or more

Previously resident

Automatically not resident
Resident if 4 UK ties (or more)
Resident if 3 UK ties (or more)
Resident if 2 UK ties (or more)
Resident if 1 UK tie (or more)
Automatically resident

Not previously resident

Automatically not resident
Automatically not resident
Resident if 4 UK ties
Resident if 3 UK ties (or more)
Resident if 2 UK ties (or more)
Automatically resident

Remittance basis charge

UK resident for

7 out of the last 9 years	£30,000
12 out of the last 14 years	£60,000
17 out of the last 20 years	£90,000

Child benefit income tax charge

Where income is between £50,000 and £60,000, the charge is 1% of the amount of child benefit received for every £100 of income over £50,000.

Car benefit percentage

The relevant base level of CO₂ emissions is 95 grams per kilometre.

The percentage rates applying to petrol cars with CO₂ emissions up to this level are:

50 grams per kilometre or less	5%
51 grams to 75 grams per kilometre	9%
76 grams to 94 grams per kilometre	13%
95 grams per kilometre	14%

Car fuel benefit

The base figure for calculating the car fuel benefit is £22,100.

Individual savings accounts (ISAs)

The overall investment limit is £15,240.

Pension scheme limits

Annual allowance – 2014/15 and 2015/16	£40,000
– 2012/13 and 2013/14	£50,000
Lifetime allowance	£1,250,000
Maximum contribution that can qualify for tax relief without any earnings	£3,600

Authorised mileage allowances: cars

Up to 10,000 miles	45p
Over 10,000 miles	25p

Capital allowances: rates of allowance

Plant and machinery	
Main pool	18%
Special rate pool	8%

Motor cars

New cars with CO ₂ emissions up to 75 grams per kilometre	100%
CO ₂ emissions between 76 and 130 grams per kilometre	18%
CO ₂ emissions over 130 grams per kilometre	8%

Annual investment allowance

Rate of allowance	100%
Expenditure limit	£500,000

Cap on income tax reliefs

Unless otherwise restricted, reliefs are capped at the higher of £50,000 or 25% of income.

Corporation tax

Rate of tax	20%
Profit threshold	£1,500,000

Patent box – deduction from net patent profit

Net patent profit x ((main rate – 10%)/main rate)

Value added tax (VAT)

Standard rate	20%
Registration limit	£82,000
Deregistration limit	£80,000

Inheritance tax: nil rate bands and tax rates

	£	
6 April 2015 to 5 April 2016	325,000	
6 April 2014 to 5 April 2015	325,000	
6 April 2013 to 5 April 2014	325,000	
6 April 2012 to 5 April 2013	325,000	
6 April 2011 to 5 April 2012	325,000	
6 April 2010 to 5 April 2011	325,000	
6 April 2009 to 5 April 2010	325,000	
6 April 2008 to 5 April 2009	312,000	
6 April 2007 to 5 April 2008	300,000	
6 April 2006 to 5 April 2007	285,000	
6 April 2005 to 5 April 2006	275,000	
6 April 2004 to 5 April 2005	263,000	
6 April 2003 to 5 April 2004	255,000	
6 April 2002 to 5 April 2003	250,000	
6 April 2001 to 5 April 2002	242,000	
Rate of tax on excess over nil rate band		
	– Lifetime rate	20%
	– Death rate	40%

Inheritance tax: taper relief

Years before death	Percentage reduction
More than 3 but less than 4 years	20%
More than 4 but less than 5 years	40%
More than 5 but less than 6 years	60%
More than 6 but less than 7 years	80%

Capital gains tax

Rates of tax – Lower rate	18%
– Higher rate	28%
Annual exempt amount	£11,100
Entrepreneurs’ relief – Lifetime limit	£10,000,000
– Rate of tax	10%

**National insurance contributions
(Not contracted out rates)**

Class 1	Employee	£1 – £8,060 per year	Nil
		£8,061 – £42,385 per year	12%
		£42,386 and above per year	2%
Class 1	Employer	£1 – £8,112 per year	Nil
		£8,113 and above per year	13.8%
		Employment allowance	£2,000
Class 1A			13.8%
Class 2		£2.80 per week	
		Small earnings exception limit	£5,965
Class 4		£1 – £8,060 per year	Nil
		£8,061 – £42,385 per year	9%
		£42,386 and above per year	2%

Rates of interest (assumed)

Official rate of interest	3%
Rate of interest on underpaid tax	3%
Rate of interest on overpaid tax	0.5%

Stamp duty land tax

Non-residential properties	
£150,000 or less	Nil
£150,001 – £250,000	1%
£250,001 – £500,000	3%
£500,001 and above	4%
Residential properties	
£125,000 or less	Nil
£125,001 – £250,000	2%
£250,001 – £925,000	5%
£925,001 – £1,500,000	10%
£1,500,001 and above	12%

Stamp duty

Shares	0.5%
--------	------

Section A – BOTH questions are compulsory and MUST be attempted

- 1 Your manager has had a meeting with Farina and Lauda, potential new clients, who are partners in the FL Partnership. The memorandum recording the matters discussed, together with an email from your manager, is set out below.

Memorandum

To The files
From Tax manager
Date 5 December 2017
Subject FL Partnership

Background

Farina and Lauda began trading as the FL Partnership on 1 May 2012. Accounts have always been prepared to 31 March each year. They are each entitled to 50% of the revenue profits and capital profits of the business.

On 1 March 2018, the whole of the FL Partnership business will be sold as a going concern to JH plc, a quoted trading company. The consideration for the sale will be a mixture of cash and shares. Capital gains tax relief on the transfer of a business to a company (incorporation relief) will be available in respect of the sale.

Farina and Lauda will both pay income tax at the additional rate in the tax year 2017/18 and anticipate continuing to do so in future years. They are very wealthy individuals, who use their capital gains tax annual exempt amounts every year. Both of them are resident and domiciled in the UK.

The sale of the business on 1 March 2018

The assets of the FL Partnership business have been valued as set out below. All of the equipment qualified for capital allowances.

	Value £	Cost £
Goodwill	1,300,000	Nil
Inventory and receivables	30,000	30,000
Equipment (no item to be sold for more than cost)	150,000	200,000
Total	1,480,000	

The total value of the consideration will be equal to the value of the assets sold. Farina and Lauda will **each** receive consideration of £740,000: £140,000 in cash and 200,000 shares in JH plc. Following the purchase of the FL Partnership, JH plc will have an issued share capital of 8,400,000 shares.

Future transactions

Farina:

On 1 August 2018, Farina will make a gift of 15,000 of her shares in JH plc to the trustees of a discretionary (relevant property) trust for the benefit of her nieces and nephews. Farina will pay any inheritance tax liability in respect of this gift. The trustees will transfer the shares to the beneficiaries over the life of the trust.

Farina has already made the following gifts:

- 1 May 2016 Cash of £300,000 to a discretionary (relevant property) trust
- 1 July 2017 Cash of £40,000 to one of her nephews

Lauda:

On 1 June 2019, Lauda will give 40,000 of her shares in JH plc to her son.

For the purposes of giving our advice, the value of a share in JH plc can be assumed to be:

	£
On 1 March 2018	3
On 1 August 2018	4
On 1 June 2019	5

Email from your manager

I want you to prepare a memorandum for the client file in respect of the following:

(i) Capital allowances

A DETAILED explanation of the calculation of the capital allowances of the FL Partnership for its final trading period ending with the sale of its equipment to JH plc for £150,000 on 1 March 2018.

(ii) Farina

(1) A calculation of the inheritance tax payable by Farina in her lifetime in respect of the gift of the shares to the trustees of the discretionary (relevant property) trust on 1 August 2018 and the date on which the tax would be payable.

(2) A brief explanation of the availability of capital gains tax gift relief in respect of the transfer of the shares to the trustees of the discretionary (relevant property) trust and the subsequent transfers of shares from the trustees to the beneficiaries.

(iii) Lauda

A review of whether or not Lauda should disclaim incorporation relief.

The review should encompass the sale of the FL Partnership business, the gift of the shares to Lauda's son and the effect of incorporation relief on the base cost of the remaining shares owned by Lauda, as she intends to sell all of her shares in JH plc in the next few years.

It is important that you include a summary of your calculations and a statement of the key issues for me to discuss with Lauda. You should also include BRIEF explanations of the amount of incorporation relief available, the availability of any additional or alternative reliefs, and the date(s) on which any capital gains tax will be payable.

Tax manager

- (a)** It is anticipated that Farina and Lauda will require some highly sophisticated and specialised tax planning work in the future.

Required:

Prepare a summary of the information which would be required, together with any action(s) which should be taken by the firm before it agrees to become the tax advisers to Farina and Lauda. (5 marks)

- (b) Prepare the memorandum requested in the email from your manager. The following marks are available:**

(i) Capital allowances. (5 marks)

(ii) Farina. (7 marks)

(iii) Lauda. (14 marks)

Note: Ignore value added tax (VAT).

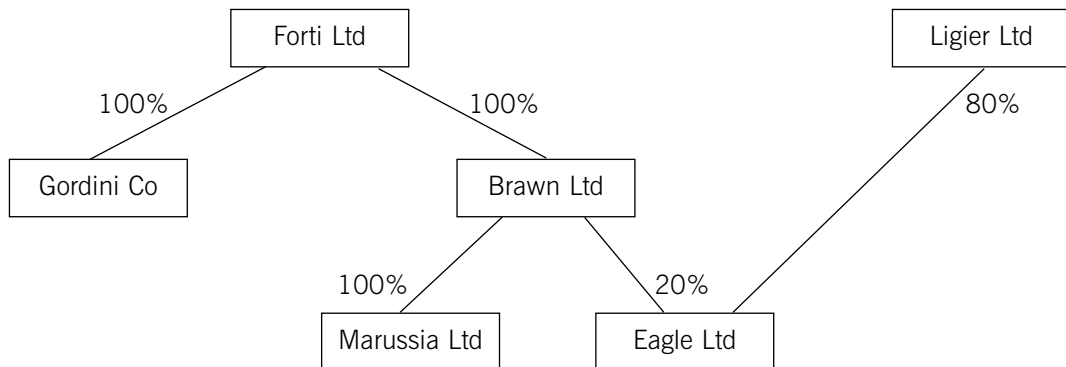
Professional marks will be awarded in part (b) for the overall presentation of the memorandum, the provision of relevant advice and the effectiveness with which the information is communicated. (4 marks)

(35 marks)

- 2 You have received an email from your manager with an attached schedule in connection with the Forti Ltd group of companies. The schedule and the email are set out below.

Email from your manager

The Forti Ltd group



Forti Ltd has an issued share capital of 120,000 ordinary shares. It is owned by 12 shareholders, each of whom owns 10,000 ordinary shares.

All six of the companies are trading companies. Gordini Co is resident in and trades in the country of Arrowsia; it does not carry out any activities in the UK. The other five companies are all resident in the UK. There is no double tax treaty between Arrowsia and the UK.

The only changes to the group structure in recent years relate to the purchase and subsequent sale of Marussia Ltd as set out in note 3 to the attached schedule.

Ligier Ltd has no links to the Forti Ltd group other than its shareholding in Eagle Ltd.

The work I require you to do is set out below.

(a) Brawn Ltd – Review of the corporation tax computation

I attach a schedule detailing the corporation tax computation for Brawn Ltd for the year ended 31 March 2017. This schedule has been prepared by an inexperienced tax assistant.

Brawn Ltd is a medium-sized enterprise for the purposes of tax relief on research and development expenditure relief. I can confirm that the substantial shareholding exemption is not available and that the figures given for the indexed cost of Marussia Ltd in the schedule, the degrouping charge in note 3, and the tax adjusted trading losses referred to in notes 4 and 5 have all been calculated correctly.

Review the computation and related notes in order to identify any errors and prepare a revised schedule showing calculations of the correct taxable total profits and the corporation tax liability. You should include notes explaining the errors you have identified and the changes you have made.

(b) Other corporate matters

- (i)** Brawn Ltd will only be a close company if Forti Ltd is a close company.

Set out the matters which need to be considered in order to determine whether or not Forti Ltd is a close company.

- (ii)** Set out the matters which need to be considered in connection with the sale of components to Gordini Co referred to in note 6 to the schedule.

(c) Value added tax (VAT) annual accounting scheme

The management of the Forti Ltd group has asked for advice on the annual accounting scheme.

State the conditions which must be satisfied by any company wishing to operate the annual accounting scheme and explain the operation of the scheme.

Tax manager

Schedule prepared by a tax assistant

Brawn Ltd – Corporation tax computation for the year ended 31 March 2017			
	Notes	£	£
Tax adjusted trading income	1, 2		240,500
Sale of Marussia Ltd – Proceeds	3	484,000	
Less: Indexed cost		(390,000)	
Annual exempt amount		(11,100)	
			<u>82,900</u>
			323,400
Less losses transferred from:			
Marussia Ltd (£60,000 x 5/12)	4		(25,000)
Eagle Ltd (£52,500 x 20%)	5		(10,500)
			<u>287,900</u>
Taxable total profits			287,900
Corporation tax at 20%			<u>57,580</u>
Notes			
1. The treatment of the following items of expenditure needs to be checked.			
		£	
The cost of establishing and obtaining HM Revenue and Customs' approval of a company share option plan (CSOP)		6,000	Disallowed
The cost of entertaining overseas customers		4,000	Disallowed
Accrued management bonuses to be paid on 1 February 2018		7,000	Allowed
2. The tax adjusted trading income is after deducting a total of £120,000 (£48,000 x 250%) in respect of research and development expenditure. The expenditure consisted of salaries paid to Brawn Ltd staff of £21,000 and payments for subcontracted labour of £27,000.			
3. Marussia Ltd was purchased on 1 August 2016. On 1 November 2016, Brawn Ltd signed a contract to sell Marussia Ltd for £484,000, and the sale took place on 31 December 2016. Accordingly, the substantial shareholding exemption was not available. The sale of Marussia Ltd resulted in a degrouping charge of £21,500. This has been included as a chargeable gain in the corporation tax computation of Marussia Ltd.			
4. Marussia Ltd made a tax adjusted trading loss of £60,000 in the year ended 31 March 2017.			
5. Eagle Ltd made a tax adjusted trading loss of £52,500 in the year ended 31 March 2017 and did not pay a dividend.			
6. During the year ended 31 March 2017, Brawn Ltd began selling components to Gordini Co. Are there any issues which need to be considered in respect of this in relation to Brawn Ltd's corporation tax liability?			

Required:

Carry out the work required as set out in the email from your manager. The following marks are available:

(a) Brawn Ltd – Review of the corporation tax computation.

Note: Ignore value added tax (VAT). (12 marks)

(b) Other corporate matters.

(i) Close companies. (5 marks)

(ii) Note 6 to the schedule. (3 marks)

(c) Value added tax (VAT) annual accounting scheme.

(5 marks)

(25 marks)

Section B – BOTH questions are compulsory and MUST be attempted

- 3** Kesme and Soba, a married couple, require advice on Kesme's taxable income and rent-a-room relief, the letting exemption available on a future sale of the family home, the remittance basis, and the assets which will be received by Soba under Kesme's will.

Kesme:

- Was born on 1 June 1953.
- Has been UK resident since the tax year 2013/14 but is non-UK domiciled.
- Is married to Soba.
- Has not made any lifetime gifts for the purposes of inheritance tax.

Soba:

- Has been UK resident since the tax year 2002/03 but is non-UK domiciled.

Kesme's income for the tax year 2016/17:

- Salary (gross) and benefits from Noodl plc, his current employer, of £48,500.
- Pension from a former employer of £24,100 (gross).
- Rental income of £14,400 in respect of a furnished room in the family home he owns jointly with Soba.
- Allowable expenses in respect of the rental income of £1,600.

Share-based remuneration provided to Kesme by Noodl plc in the tax year 2016/17:

- 400 shares in Noodl plc were issued to Kesme for £2,500.
- Kesme was granted unapproved share options to purchase 300 shares for £4 per share.
- Kesme exercised unapproved share options and purchased 250 shares for £3 per share. Kesme had paid 50 pence for each of these options.
- A share in Noodl plc can be assumed to be worth £12 throughout the tax year 2016/17.
- Noodle plc offers its staff share-based remuneration but does not operate any HM Revenue and Customs (HMRC) approved share schemes.

Income to be received in future years in respect of investments in the country of Penne:

- Kesme will receive £1,400 per year.
- Soba will receive £19,500 per year.
- Neither Kesme nor Soba plan to remit any of this income into the UK.
- There is no income tax in the country of Penne.

Kesme's estate and his will:

- Kesme's gross chargeable estate will have a value of £1,280,000.
- This value includes a plot of land situated in the UK worth £370,000.
- Kesme has left the plot of land to his daughter and the residue of his estate to his wife, Soba.

Required:

- (a) Explain the availability and operation of rent-a-room relief in relation to Kesme and calculate his taxable income for the tax year 2016/17 on the assumption that the relief is claimed. (8 marks)**
- (b) State, with reasons, whether or not the remittance basis is available to Kesme and Soba and, on the assumption that it is available to both of them, explain whether or not it is likely to be beneficial for each of them. (6 marks)**
- (c) Explain why it would not be beneficial for Soba to elect to be treated as UK domiciled for the purposes of inheritance tax and calculate the value of the residue of the estate which Soba would receive under Kesme's will if Kesme were to die today. (6 marks)**

(20 marks)

- 4 Spike requires advice on the loss relief available and the value added tax (VAT) position following the cessation of his business and on the tax implications of a relocation payment provided by his new employer.

Spike:

- Ceased to trade on 30 September 2016 and sold the assets used in his unincorporated business.
- Sold his house, 'Sea View', on 1 March 2017 for £125,000 more than he had paid for it.
- Began working for Set Ltd on 1 May 2017.
- Has no income or chargeable gains other than the amounts referred to in the information below.

Spike's unincorporated business:

- There are overlap profits from the commencement of the business of £8,300.
- The sale of the business assets resulted in net chargeable gains of £78,000.
- The tax adjusted profits/(loss) of the business have been:

		£
Year ended 31 December 2012	Profit	52,500
Year ended 31 December 2013	Profit	68,000
Year ended 31 December 2014	Profit	54,000
Year ended 31 December 2015	Profit	22,500
Nine months ending 30 September 2016	Loss	(13,500)

Sale of the business:

- The majority of the business assets were sold to unrelated purchasers during September and October 2016.
- Spike retained some of his business assets for his own use.

Remuneration from Set Ltd:

- Spike is being paid a salary of £65,000 per year.
- On 1 July 2017, Set Ltd will pay Spike a relocation payment of £33,500.

The relocation payment of £33,500:

- Spike sold 'Sea View', and purchased a new house, in order to live near the premises of Set Ltd.
- £22,000 of the payment is to compensate Spike for having to sell his house at short notice at a low price.
- £11,500 of the payment is in respect of the costs incurred by Spike in relation to moving house.

Required:

- (a) (i) Calculate the trading loss for the tax year 2016/17 and the terminal loss, on the cessation of Spike's unincorporated business. (4 marks)
- (ii) Explain the reliefs available in respect of the losses calculated in part (a)(i) and quantify the potential tax savings for each of them. (10 marks)
- (b) State the value added tax (VAT) implications of the cessation of the business and the sale of the business assets. (4 marks)
- (c) Explain the income tax implications for Spike of the relocation payment. (2 marks)

Notes

1. You should assume that the tax rates and allowances for the tax year 2016/17 apply to all tax years.
2. Ignore national insurance contributions throughout this question.

(20 marks)

End of Question Paper

Answers

1 The FL Partnership

(a) Becoming tax advisers to Farina and Lauda

Information required in respect of Farina and Lauda:

- evidence of their identities; and
- their addresses.

Action to be taken by the firm:

- The firm should contact their existing tax advisers. This is to ensure that there has been no action by either Farina or Lauda which would, on ethical grounds, preclude the acceptance of the appointment.
- The firm should consider whether becoming tax advisers to Farina and Lauda would create any threats to compliance with the fundamental principles of professional ethics. Where such threats exist, the appointment should not be accepted unless the threats can be reduced to an acceptable level via the implementation of safeguards.

With this in mind, the firm must ensure that it has sufficient competence to carry out the sophisticated tax planning required by Farina and Lauda.

In addition, it is possible that providing advice to Farina and Lauda on the sale of their business could give rise to a conflict of interest, as a course of action (for example, the timing of the sale) which is beneficial for one of them may not be beneficial for the other. The firm should obtain permission from both Farina and Lauda to act for both of them and should consider making a different member of the firm responsible for each of them.

(b) To The files
From Tax senior
Date 6 December 2017
Subject The FL Partnership

The purpose of this memorandum is to advise Farina and Lauda, the partners in the FL Partnership, on the sale of the business to JH plc and on the proposed disposals of shares in JH plc in the future.

(i) Capital allowances of the FL Partnership for its final trading period

There will be no annual investment allowance, first year allowances or writing down allowances in the period in which the business ceases. Instead, there will be a balancing adjustment: either a balancing allowance or a balancing charge.

The balancing adjustment will be calculated as follows:

	£
Tax written down value brought forward at the start of the period	X
Add: additions in the period	X
Less: disposals during the period at the lower of cost and sales proceeds	(X)
	X
Less: proceeds on the sale of the equipment on 1 March 2018	(150,000)
Balancing allowance/(balancing charge)	X/(X)

It will not be possible to elect to transfer the equipment to JH plc at tax written down value because Farina and Lauda will not be connected with JH plc. This is because they will not control the company.

(ii) Farina

(1) Inheritance tax

	£
Value of shares (15,000 x £4)	60,000
Less: annual exemption 2018/19	(3,000)
Chargeable lifetime transfer	57,000
£31,000 (£325,000 – £294,000 (£300,000 – £3,000 – £3,000)) x 0%	0
£26,000 (£57,000 – £31,000) x 25%	6,500
Inheritance tax liability	6,500

The inheritance tax will be payable on 30 April 2019.

Tutorial note: *Business property relief will not be available as JH plc is a quoted company and Farina will not be a controlling shareholder.*

(2) Capital gains tax gift relief

Gift relief will be available in respect of the transfer of the shares to the trustees because the transfer is immediately subject to inheritance tax. For the same reason, gift relief will also be available in respect of any subsequent transfers of shares from the trustees to the beneficiaries.

(iii) Lauda

The sale of the business will result in a chargeable gain in respect of the goodwill. The gain, equal to the market value of the goodwill of £1,300,000, will be split equally between Farina and Lauda, such that Lauda's chargeable gain will be £650,000. As all of the equipment qualified for capital allowances, no capital losses will arise on its sale.

With incorporation relief

The sale of the business on 1 March 2018

	£
Chargeable gain on the sale of the goodwill	650,000
Incorporation relief (£650,000 x £600,000/£740,000) (note 1)	(527,027)
	<u>122,973</u>
Capital gains tax at 10% (note 2)	<u>12,297</u>

The tax will be payable on 31 January 2019.

Lauda's base cost in the shares in JH plc

	£
Market value of the shares received (200,000 x £3)	600,000
Less: incorporation relief	(527,027)
	<u>72,973</u>

The gift of 40,000 shares on 1 June 2019 (note 3)

	£
Proceeds at market value (40,000 x £5)	200,000
Cost (£72,973 x 40,000/200,000)	(14,595)
	<u>185,405</u>
Capital gains tax at 28% (note 4)	<u>51,913</u>

The tax will be payable on 31 January 2021.

Notes

1. The relief is restricted by reference to the value of the shares divided by the value of the total consideration received. Lauda will receive a total of £740,000, consisting of cash of £140,000 and shares worth £600,000 (200,000 x £3).
2. Capital gains tax will be charged at 10% because entrepreneurs' relief will be available. This relief is available because the business is to be sold as a going concern, has been owned for at least a year and JH plc is not a close company. It is assumed that Lauda has not exceeded the lifetime limit of £10,000,000 and will claim this relief.
3. Gift relief will not be available in respect of this gift because the shares are quoted and Lauda will hold less than 5% of the company (200,000/8,400,000 = 2.38%).
4. Capital gains tax will be charged at 28% because Lauda pays income tax at the additional rate. Entrepreneurs' relief will not be available because Lauda will hold less than 5% of JH plc.

Tutorial note: *In order for entrepreneurs' relief to be available in respect of the gift of the shares, Lauda would also need to be an employee of JH plc.*

Without incorporation relief

The sale of the business on 1 March 2018

	£
Chargeable gain on the sale of the goodwill	650,000
Capital gains tax at 10% (note 2 above)	<u>65,000</u>

The tax will be payable on 31 January 2019.

Lauda's base cost in the shares in JH plc

	£
Market value of the shares received (200,000 x £3)	<u>600,000</u>

The gift of 40,000 shares on 1 June 2019 (note 3 above)

	£
Proceeds at market value (40,000 x £5)	200,000
Cost (£600,000 x 40,000/200,000)	<u>(120,000)</u>
	80,000
Capital gains tax at 28% (note 4 above)	<u>22,400</u>

The tax will be payable on 31 January 2021.

Summary

	With incorporation relief £	Without incorporation relief £
Capital gains tax on the sale of the business	12,297	65,000
Capital gains tax on the gift of the shares on 1 June 2019	<u>51,913</u>	<u>22,400</u>
	64,210	87,400

The effect of incorporation relief on the base cost of the shares

	£	£
Reduction in base cost due to incorporation relief		527,027
Base cost in respect of the gift of the shares on 1 June 2019		
Without incorporation relief	120,000	
With incorporation relief	<u>(14,595)</u>	
		<u>(105,405)</u>
		421,622
Additional tax at 28%		<u>118,054</u>

Key issues

If Lauda were to disclaim incorporation relief, she would have higher initial capital gains tax liabilities.

However, disclaiming incorporation relief will result in a higher base cost in the shares, such that on a sale of the shares there will be tax savings which will exceed the increased initial liability.

Tutorial notes:

- Incorporation relief reduces the capital gains tax payable on the sale of the business and the gift of the shares by £23,190 (£87,400 – £64,210). When this amount is deducted from the additional tax due because of the reduced base cost, we arrive at an overall increase in the capital gains tax liability of £94,864 (£118,054 – £23,190).*

This overall increase in the capital gains tax liability is simply the tax on the deferred gain of £527,027 at 28% in the future rather than at 10%, due to the availability of entrepreneurs' relief, now: £527,027 x 18% (28% – 10%) = £94,865 (and a rounding difference of £1).

- Capital gains tax holdover relief in respect of gifts of business assets will not be available on the sale of the business to JH plc, because Farina and Lauda are not going to gift the business to the company; they are going to sell the business at market value, which will be received in the form of cash and shares.*

2 Forti Ltd group

(a) Brawn Ltd – Corporation tax computation for the year ended 31 March 2017

	Notes	£
Tax adjusted trading income per original schedule		240,500
Costs relating to company share option plan	1	(6,000)
Accrued management bonuses	2	7,000
Research and development expenditure (£120,000 – £98,115)	3	21,885
		<u>263,385</u>
Sale of Marussia Ltd – Chargeable gain (£82,900 + £21,500 + £11,100)	4, 5	115,500
		<u>378,885</u>
Less losses transferred from:		
Marussia Ltd (£60,000 x 3/12)	6	(15,000)
Eagle Ltd	7	–
Taxable total profits		<u>363,885</u>
Corporation tax at 20%		<u>72,777</u>

Notes

1. The cost of establishing and obtaining HM Revenue and Customs' approval of a company share option plan is an allowable deduction when computing tax adjusted trading income.
2. The management bonuses are not an allowable cost as they have not been paid within nine months of the end of the accounting period.
3. The additional tax deduction in respect of research and development expenditure is 130%, not 150%. In relation to payments for subcontracted labour, this additional deduction is only available in respect of 65% of the amount paid. Accordingly, the total deduction is £98,115 (£21,000 + (£21,000 x 130%) + £27,000 + (£27,000 x 65% x 130%)).
4. The degrouping charge should be added to the sales proceeds on the sale of Marussia Ltd, such that it increases the chargeable gain arising.
5. The capital gains tax annual exempt amount of £11,100 is not available to companies.
6. For the purposes of group relief, Marussia Ltd is regarded as having left the group once there were arrangements in force for it to leave the group. The signing of the contract on 1 November 2016 amounts to such arrangements, such that the company is only a member of the group relief group for the three months from 1 August 2016 until 31 October 2016.
7. Eagle Ltd is not a consortium company because it is in a group relief group with Ligier Ltd. Accordingly, it is not possible for any of Eagle Ltd's trading losses to be transferred to Brawn Ltd.

(b) Other corporate matters

(i) Close companies

Forti Ltd will be a close company if it is controlled by:

- any number of directors who are shareholders, or
- its five largest shareholders.

A company is controlled by those shareholders who own more than half of the company's share capital.

When determining whether or not a company is close within this definition, each shareholder is regarded as owning any shares owned by their associates as well as the shares owned personally. A person's associates include their direct relatives, business partners and the trustees of certain trusts set up by the shareholder or their direct relatives.

Control of Forti Ltd can be exercised by seven shareholders holding 58.3% (7/12) of the shares.

Accordingly, unless Forti Ltd is controlled by shareholder directors, it will only be close if some of its shareholders are associated with each other.

Tutorial note: *There are further complexities when determining whether or not a company is close but the points set out above were sufficient to score full marks.*

(ii) Transfer pricing (note 6 to the schedule)

The transfer pricing rules will apply to the sale of components by Brawn Ltd to Gordini Co because these two companies are both controlled by Forti Ltd. The exemption for small and medium-sized enterprises is unlikely to be available, regardless of the size of the Forti Ltd group, as there is no double tax treaty between the UK and the country of Arrowsia.

Under the transfer pricing rules, if Brawn Ltd has sold components to Gordini Co for less than an arm's length price, it is required to increase its taxable profits by the excess of the arm's length price over the price charged.

(c) Value added tax (VAT) annual accounting scheme

Conditions

- The company's VAT reporting and payments must be up to date, such that its VAT debt is not increasing.
- Taxable supplies (excluding VAT) must not be expected to exceed £1,350,000 in the following 12 months.
- The company must notify HM Revenue and Customs (HMRC) if it expects its taxable supplies for a year to exceed £1,600,000. The company must leave the scheme if its taxable supplies for a year exceed £1,600,000.
- The scheme is not available where registration is in the name of a group.

Tutorial note: *Companies which are normally in a repayment situation can account for VAT annually if they wish, but this would not be advisable from a cash flow point of view as they would only receive one repayment for the whole year.*

Operation of the scheme

- The company will be required to make nine monthly payments starting at the end of the fourth month of the year.
- Each payment is equal to 10% of the company's liability for the previous year as adjusted for any additional information provided to HMRC.
- Alternatively, a company can choose to make three larger interim payments equal to 25% of its liability for the previous year.
- The company must submit its VAT return within two months of the end of the year together with any final balancing payment.

3 Kesme

(a) Income tax

Availability and operation of rent-a-room relief

Rent-a-room relief is available because Kesme and Soba are letting a furnished room in their main residence.

Claiming the relief will allow each of them to deduct £2,125 (£4,250/2), rather than their share of the allowable expenses (a smaller figure), from their share of the gross rental income.

This relief must be claimed by 31 January 2019 (22 months after the end of the tax year 2016/17). The claim will then continue to apply until it is withdrawn.

Tutorial note: *The election would also cease to apply in the unlikely event that the gross annual rent fell below £4,250.*

Taxable income for the tax year 2016/17

	£
Salary and benefits	48,500
Pension from former employer	24,100
Property business income ((£14,400/2) – £2,125)	5,075
Shares acquired ((400 x £12) – £2,500)	2,300
Grant of unapproved share options – no tax on grant	0
Exercise of unapproved options (250 x (£12 – £0.5 – £3))	2,125
	82,100
Less: personal allowance	(10,600)
Taxable income	71,500

(b) The remittance basis

The remittance basis is available to UK resident individuals who are not domiciled in the UK. Accordingly, it is available to both Kesme and Soba.

Kesme will have unremitted overseas income of less than £2,000. Accordingly, the remittance basis will apply automatically, such that there will be no loss of his personal allowance, and the unremitted income will not be subject to income tax in the UK. There will also be no remittance basis charge. This is clearly beneficial for Kesme, as the income will also not be subject to tax in the country of Penne.

Soba will have unremitted overseas income of more than £2,000, such that the remittance basis will not apply automatically. In addition, because she has been resident in the UK for 12 of the 14 tax years prior to 2017/18, if Soba were able to claim the remittance basis there would be a remittance basis charge of £60,000 as well as the loss of her personal allowance. This is clearly not beneficial for Soba as it exceeds the amount of income which she would be sheltering from UK tax.

(c) Soba

Election to be treated as UK domiciled

The limit of £325,000 on the 100% spouse exemption does not apply where both the transferor spouse and the transferee spouse are non-UK domiciled, as is the case here. Accordingly, the only effect of electing to be treated as UK domiciled would be that any overseas assets owned by Soba would be subject to UK inheritance tax in the future. This would not be beneficial.

Value of the residue of the estate

Soba will receive the residue of the estate, i.e. the estate less the gift to the daughter and the inheritance tax on that gift.

	£
Kesme's gross chargeable estate	1,280,000
Less: gross gift to daughter (W)	(400,000)
Residue of the estate received by Soba	<u>880,000</u>

Working

	£
Legacy to daughter	370,000
Less: nil rate band	(325,000)
	<u>45,000</u>
Inheritance tax at 40/60	<u>30,000</u>
Gross gift (£370,000 + £30,000)	<u>400,000</u>

Tutorial notes:

1. *Although Kesme is non-UK domiciled, the specific legacy to his daughter will be chargeable to UK IHT because it is a UK asset.*
2. *The inheritance tax due on the specific gift to the daughter will be paid out of the residue of the estate, such that it will be borne by Soba. Because the residue of the estate is exempt, due to the spouse exemption, the gift must be grossed up.*
3. **Proof of Kesme's IHT liability**

	£
Kesme's estate	1,280,000
Less: legacy to Soba (above) – spouse exemption	(880,000)
	<u>400,000</u>
Less: nil rate band	(325,000)
	<u>75,000</u>
Inheritance tax at 40%	<u>30,000</u>

4 Spike

(a) (i) Loss relief available on the cessation of the trade

Trading loss for the tax year 2016/17

	£
Loss for the period from 1 January 2016 to 30 September 2016	13,500
Add: overlap profits	8,300
	<u>21,800</u>

Tutorial note: *The basis period for the tax year 2016/17 runs from 1 January 2016 (the end of the basis period for the previous year) until 30 September 2016 (the cessation of trade).*

Terminal loss

	£	£
6 April 2016 to 30 September 2016:		
Loss (£13,500 x 6/9)		9,000
Add: overlap profits		8,300
		<u>17,300</u>
1 October 2015 to 5 April 2016:		
1 October 2015 to 31 December 2015 profit (£22,500 x 3/12)	5,625	
1 January 2016 to 5 April 2016 loss (£13,500 x 3/9)	<u>(4,500)</u>	
Net profit ignored for the purposes of the terminal loss	<u>1,125</u>	–
Terminal loss		<u>17,300</u>

(ii) The reliefs available in respect of the trading loss and the terminal loss

Relief of the loss for the tax year 2016/17

The loss for the tax year 2016/17 can be offset against Spike's general income of 2016/17 and/or 2015/16.

Once the loss has been offset against the general income of a particular tax year, it can also be offset against the chargeable gains of that same year.

Spike has no general income in the tax year 2016/17. But, a claim can be made for the whole of the loss to be relieved against his 2016/17 chargeable gains.

Relieving the loss against the gains on the sale of the business assets would save capital gains tax at the rate of 10% due to the availability of entrepreneurs' relief. The tax saved would be £2,180 (£21,800 x 10%).

Spike's sale of his house will be an exempt disposal of his principal private residence if he has always occupied it, or is deemed to have always occupied it. If part of the gain on the house is taxable, capital gains tax will be payable at 28% because the gains on the business assets will have used the basic rate band. Accordingly, if this is the case, the loss should be offset against any gain on the house in priority to the gain on the business assets.

In the tax year 2015/16, the loss would be offset against the general income of £22,500. The claim cannot be restricted in order to obtain relief for the personal allowance of that year. The tax saved would be £2,380 (£11,900 (£22,500 – £10,600) x 20%).

Relief of the terminal loss

The terminal loss can be offset against the trading profit of the business for 2016/17 and the three preceding tax years, starting with the latest year.

The trading profit in the tax year 2016/17 is nil, such that the terminal loss will be relieved in the tax year 2015/16. This would save tax of £2,380 (£11,900 (£22,500 – £10,600) x 20%).

The excess of the trading loss of 2016/17 over the terminal loss is £4,500 (£21,800 – £17,300). This amount can be offset against general income and chargeable gains in 2016/17 and 2015/16 as set out above. However, once the terminal loss has been relieved in the tax year 2015/16, Spike's remaining general income of £5,200 (£22,500 – £17,300) is less than the personal allowance, thus there is no taxable income and therefore, no further tax saving to be achieved in either of the two relevant years. Accordingly, the remaining loss should be relieved against the chargeable gains of 2016/17. This would save tax of £450 (£4,500 x 10%) if the loss is relieved against the gains on the sale of the business assets, or £1,260 (£4,500 x 28%) if it is relieved against a non-exempt gain arising on the sale of the house.

(b) Value added tax (VAT)

Spike should have notified HM Revenue and Customs of the cessation of his business within 30 days of ceasing to make taxable supplies, i.e. by 30 October 2016.

He may be liable to a penalty if he failed to do so.

Spike should have charged VAT on any machinery and inventory which he sold whilst he was still registered for VAT.

When Spike deregistered, he should have accounted for output tax on all business assets which he still owned in respect of which he had previously recovered input tax. There was no need to account for this output tax if it was less than £1,000.

(c) The relocation payment

The compensation in respect of the sale of the house at short notice at a low price will be regarded as having been derived from employment, such that it will be taxable in full.

£8,000 of the payment in respect of the costs of moving house will be exempt; the remaining £3,500 (£11,500 – £8,000) of the payment will be taxable.

**Professional Level – Options Module
Advanced Taxation**

Marking Scheme

	<i>Available</i>	<i>Maximum</i>
1 (a) Information required	1	
Contact existing tax adviser	1	
Fundamental principles	1	
Competence	1	
Conflict of interest	2	
	<u>6</u>	5
(b) (i) Allowances available	1.5	
Calculation of balancing adjustment	2	
Consideration of transfer at tax written down value	1.5	
	<u>5</u>	5
(ii) Inheritance tax		
Chargeable lifetime transfer	2	
Inheritance tax liability	3	
Due date	1	
Gift relief	1.5	
	<u>7.5</u>	7
(iii) Chargeable gain on sale of business	1.5	
With incorporation relief		
Incorporation relief	1.5	
Capital gains tax and due date	1	
Chargeable gain on gift of shares	2	
Capital gains tax and due date	1	
Without incorporation relief		
Capital gains tax on sale of business	1	
Capital gains tax on gift of shares	1.5	
Explanations	4	
Summary and key issues	4	
	<u>17.5</u>	14
Format and presentation	1	
Analysis	1	
Quality of explanations and calculations	2	
	<u>4</u>	4
Total		<u>35</u>

	<i>Available</i>	<i>Maximum</i>
2 (a) Notes		
Tax adjusted trading income – other matters	2	
Research and development	2	
Chargeable gains	2	
Losses transferred from Marussia Ltd	1.5	
Losses transferred from Eagle Ltd	2	
Calculation	<u>5</u>	
	14.5	12
(b) (i) Definition of close company	2.5	
Associates	1.5	
Application	<u>2</u>	
	6	5
(ii) Reasons why transfer pricing rules apply	2.5	
Adjustment required	<u>1</u>	
	3.5	3
(c) Conditions	3	
Operation of the scheme	<u>3</u>	
	6	5
Total		<u>25</u>
3 (a) Rent-a-room relief		
Availability	1	
Operation	1.5	
Claim	1.5	
Employment income	1	
Property business income	0.5	
Share options	3	
Personal allowance	<u>0.5</u>	
	9	8
(b) Availability of remittance basis	1	
Kesme	3	
Soba	<u>3</u>	
	7	6
(c) Election to be treated as UK domiciled	2.5	
Value of the residue of the estate		
Calculation of amount received by Soba	1.5	
Inheritance tax liability	<u>2</u>	
	6	6
Total		<u>20</u>

	<i>Available</i>	<i>Maximum</i>
4 (a) (i) Loss for the tax year 2016/17	1	
Terminal loss	3	
	<u>4</u>	4
(ii) Relief of the loss for the tax year 2016/17		
The reliefs available	2	
Tax savings – 2016/17		
Business assets	1.5	
House	2	
Tax savings – 2015/16	1	
Relief of the terminal loss		
The reliefs available	3	
Tax savings – terminal loss	1	
Tax savings – excess of trading loss over terminal loss	1.5	
	<u>12</u>	10
(b) Requirement to deregister	2	
Output tax	2	
	<u>4</u>	4
(c) Relocation payment	2	
	<u>2</u>	2
Total	<u>2</u>	<u>20</u>