Professional Level – Options Module

Advanced Taxation (United Kingdom)

Monday 3 December 2007

Paper P6 (UK)

Time allowed
Reading and planning: 15 minutes
Writing: 3 hours

This paper is divided into two sections:

Section A – BOTH questions are compulsory and MUST be attempted

Section B – TWO questions ONLY to be attempted

Tax rates and allowances are on pages 3–5

Do NOT open this paper until instructed by the supervisor.
During reading and planning time only the question paper may be annotated. You must NOT write in your answer booklet until instructed by the supervisor.
This question paper must not be removed from the examination hall.

The Association of Chartered Certified Accountants

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The question paper begins on page 3.

SUPPLEMENTARY INSTRUCTIONS

1. You should assume that the tax rates and allowances for the tax year 2006/07 and for the financial year to 31 March 2007 will continue to apply for the foreseeable future unless you are instructed otherwise.
2. Calculations and workings need only to 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

		%
Starting rate	£1 – £2,150	10
Basic rate	£2,151 – £33,300	22
Higher rate	£33,301 and above	40

Personal allowances

		£
Personal allowance	Standard	5,035
	65–74	7,280
	75 and over	7,420
Income limit for age related allowances		20,100

Car benefit percentage

The base level of CO_2 emissions is 140 grams per kilometre.

Car fuel benefit

The base figure for calculating the car fuel benefit is £14,400.

Pension scheme limits

Annual allowance	£215,000
Lifetime allowance	£1,500,000
The maximum contribution that can qualify for tax relief without evidence of earnings	£3,600

Authorised mileage allowances

All cars:	
Up to 10,000 miles	40p
Over 10,000 miles	25p

Capital allowances

	%
Plant and machinery	
Writing down allowance	25
First year allowance	
– Plant and machinery	40
– Low emission motor cars (CO_2 emissions of less than 120 grams per kilometre)	100

For small businesses only:
The rate of plant and machinery first-year allowance is increased to 50% for the periods from 1 April 2004 to 31 March 2005 (6 April 2004 to 5 April 2005 for unincorporated businesses) and 1 April 2006 to 31 March 2007 (6 April 2006 to 5 April 2007 for unincorporated businesses).

Long life assets	
Writing-down allowance	6
Industrial buildings	
Writing-down allowance	4

Corporation tax

Financial year	2004	2005	2006
Starting rate	Nil	Nil	N/A
Small companies rate	19%	19%	19%
Full rate	30%	30%	30%
	£	£	£
Starting rate lower limit	10,000	10,000	N/A
Starting rate upper limit	50,000	50,000	N/A
Small companies rate lower limit	300,000	300,000	300,000
Small companies rate upper limit	1,500,000	1,500,000	1,500,000
Marginal relief fraction			
Starting rate	19/400	19/400	N/A
Small companies rate	11/400	11/400	11/400

Marginal Relief

(M – P) x I/P x Marginal relief fraction

Value added tax

	£
Registration limit	61,000
Deregistration limit	59,000

Inheritance tax

	%
£1–285,000	Nil
Excess	40

Capital gains tax: annual exemption

	£
Individuals	8,800

Capital gains tax: taper relief

Complete years after 5 April 1998 for which asset held	Gains on business assets	Gains on non-business assets
1	50%	100%
2	25%	100%
3	25%	95%
4	25%	90%
5	25%	85%
6	25%	80%
7	25%	75%
8	25%	70%
9	25%	65%
10	25%	60%

National insurance contributions (not contracted out rates)

			%
Class 1	Employee	£1 – £5,035 per year	Nil
		£5,036 – £33,540 per year	11·0
		£33,541 and above per year	1·0
Class 1	Employer	£1 – £5,035 per year	Nil
		£5,036 and above per year	12·8
Class 1A			12·8
Class 2		Small earnings exception limit – £4,465	
		£2·10 per week	
Class 4		£1 – £5,035 per year	Nil
		£5,036 – £33,540 per year	8·0
		£33,541 and above per year	1·0

Rates of interest

	%	
Official rate of interest	5·0	
Rate of interest on underpaid tax	7·5	(assumed)
Rate of interest on overpaid tax	3·5	(assumed)

Stamp duty land tax

	Rate
Ad valorem duty	
Residential property	
£125,000 or less (1)	Nil
£125,001 – £250,000	1%
£250,001 – £500,000	3%
£500,000 or more	4%

(1) For non-residential property, the nil rate is extended to £150,000.

Stamp duty

Shares	0·5%
Fixed duty	£5

Section A – BOTH questions are compulsory and MUST be attempted

1 Your manager has had a meeting with Adam Snook and has sent you a copy of the following memorandum.

To	The files
From	Tax manager
Date	1 December 2007
Subject	Adam Snook

Adam Snook (AS) has been entertaining children at parties as a hobby for the last two years. On 1 June 2007 his aunt gave him shares in Brill plc, a quoted company, worth £88,040. As a result, AS intends to give up his job on 31 December 2007 (he is a regional sales manager with Rheims Ltd) and purchase a small theatre from which he will carry on a business of providing entertainment for children's parties.

The business

AS will begin advertising and charging for attending children's parties on 1 January 2008. He estimates that his net profit for the first five months (until the theatre opens) will only be £400 per month. Accordingly, he has agreed to work part-time for his existing employer from 1 January 2008 until 31 May 2008 for a salary of £1,050 per month.

AS will purchase the theatre on 1 April 2008. He estimates that it will take six weeks or so to renovate the theatre such that it should be ready for business by 1 June 2008 at the latest. AS will seek to rent out the theatre for the days when it is not required for his business.

We agreed that the business should prepare accounts to 31 March each year. AS does not wish to form a limited company.

The supply of entertainment at the theatre will be standard rated for the purposes of value added tax (VAT) and AS will register for VAT on 1 June 2008.

The finance required

The costs of establishing the business, exclusive of recoverable VAT, are set out below.

	£
Purchase price of the theatre	215,000
Renovation of the theatre	45,000
Equipment and other costs	50,000
Finance required	310,000

The finance available

AS sold 42,600 shares in Snapper plc for £104,370 on 1 December 2007 and intends to sell £25,000 6% Snapper plc non-convertible loan stock next week for £29,900. He will use the net proceeds of these sales to finance the business and obtain the balance of the funds required via a bank overdraft at an annual interest rate of 15%.

The shares and loan stock in Snapper plc were acquired as follows:

– AS was given 14,200 shares in Brill plc by his aunt on 1 June 2007. At that time the shares were worth £88,040.
– On 1 November 2007 Brill plc was acquired by Snapper plc. Both Brill plc and Snapper plc are UK resident trading companies.
– AS received 42,600 shares in Snapper plc together with £25,000 6% Snapper plc non-convertible loan stock (a qualifying corporate bond) in exchange for his shares in Brill plc.
– The shares and the loan stock were worth £97,980 and £28,400 respectively as at 1 November 2007.

Other background information

AS is 35 years old. His full time salary with Rheims Ltd is £25,200 per annum. He is provided with a diesel company car which had a list price when new of £13,950 and a CO_2 emission rate of 182 grams per kilometre. He is not provided with free fuel. He will return the car to the company on 31 December 2007.

AS's aunt is 71 years old and is domiciled in the UK. This is the first substantial gift that she has made to AS although he suspects that she has made similar gifts to other relatives in the past.

Tax manager

An extract from an email from your manager is set out below.

> Please prepare a memorandum for me, incorporating the following:
>
> (a) (i) Calculations to support the amount of external finance required by Adam including a note of any assumptions made. Don't forget to take his capital gains tax liability into account but ignore any possible inheritance tax liability.
>
> (ii) – A proposal which will increase the after tax proceeds from the sale of the Snapper plc loan stock together with the amount of the increase.
> – A reasoned recommendation of a more appropriate form of external finance for the business.
>
> (b) Explanations of the following matters:
>
> (i) Adam's liability to class 2 and class 4 national insurance contributions in 2007/08.
>
> (ii) The income tax relief available in respect of **both** the cost of purchasing **and** renovating the theatre.
>
> (iii) For value added tax (VAT) purposes: the effect of renting out the theatre on Adam's ability to recover input tax, the implications of opting to tax the theatre and the factors affecting the decision to opt to tax.
>
> (c) An explanation of the inheritance tax payable by Adam in respect of the gift from his aunt depending on when his aunt dies.
>
> We will be under significant fee pressure on this job so please don't do any unnecessary work – I'm sure that time spent thinking about what needs to be done before you start will save you time in the long run.
>
> Tax manager

Required:

Prepare the memorandum requested by your manager.

Marks are available for the components of the memorandum as follows:

(a) (i) Calculations to support the amount of external finance required. You should state any assumptions you have made in preparing the calculations; (9 marks)

(ii) A proposal which will increase the after tax proceeds from the sale of the Snapper plc loan stock and a reasoned recommendation of a more appropriate form of external finance. (3 marks)

(b) Explanations of the various matters. (11 marks)

(c) The inheritance tax payable by Adam in respect of the gift from his aunt. (4 marks)

Additional marks will be awarded for the appropriateness of the format and presentation of the memorandum and the effectiveness with which the information is communicated. (2 marks)

Note: you should assume that the tax rates and allowances for the tax year 2006/07 will continue to apply for the foreseeable future.

(29 marks)

2 You have received the following email from your manager, Kara Weddell.

From	Kara Weddell
Date	3 December 2007
To	Tax senior
Subject	Banda Ross

I've put a copy of a letter from a potential new client, Banda Ross, on your desk. I've arranged a meeting with Banda for Friday this week to discuss the most appropriate structure for her new business, 'Aral'.

I spoke to Banda yesterday and obtained the following additional information.

– Banda has owned the whole of the ordinary share capital of Flores Ltd since 1 January 2004.
– Flores Ltd pays Banda a salary of £11,700 per annum and pays dividends to her of £20,250 on 31 July each year.
– Banda does not intend to take any income from Aral until the tax year 2010/11 at the earliest.
– Flores Ltd is Banda's only source of income.

Banda also mentioned that Flores Ltd made some sort of 'informal loan' to her in 2004 of £21,000 to pay for improvements to her house. I decided not to press her about this over the phone but I need to discuss with her what she meant by 'informal' and whether or not the loan has been disclosed to HM Revenue and Customs.

Please prepare the following schedules for me to use as a basis for our discussions. I will give Banda copies of schedules (a) and (b) but not schedule (c), as some of its contents may be sensitive.

(a) Calculations of the anticipated tax adjusted trading profit/loss of Aral for its first three trading periods.

(b) Explanations, together with relevant supporting calculations, of the tax relief available in respect of the anticipated trading losses depending on whether the business is run as a sole trader or a limited company. When considering the use of a limited company, don't forget that it could be owned by Banda or by Flores Ltd.

Please include a recommendation based on your figures but **do not** address any other issues regarding the differences between trading as a sole trader and as a company; I just want to focus on the losses for the moment.

(c) Explanatory notes of the tax implications of there being a loan from Flores Ltd to Banda and whether or not such a loan might affect our willingness to provide her with tax advice.

Take some time to think about your approach to this before you start; I want you to avoid preparing any unnecessary calculations and to keep the schedules brief.

Thank you

Kara

The letter referred to in Kara's email is set out below.

Dear Kara

Aral business

I am the managing director of Flores Ltd, a company that manufactures waterskiing equipment. I am looking for a tax adviser to help me with my next business venture.

When I began the Flores business in 2002 it was expected to make losses for the first year or so. I was advised not to form a company but to trade as a sole trader and to offset the losses against my income of earlier years. I followed that advice and transferred the business to Flores Ltd on 1 January 2004, once it had become profitable. Flores Ltd has made taxable trading profits of approximately £120,000 each year since it was formed. It prepares accounts to 30 June each year.

For the past few months I have been researching the windsurfing market. I must have spent at least £6,000 travelling around the UK visiting retailers and windsurfing clubs (half of which was spent on buying people lunch!). However, it was all worth while as on 1 January 2008 I intend to start a new business, 'Aral', manufacturing windsurfing equipment.

The budgeted results for the first three trading periods of the Aral business are set out below:

		£
6 months ending 30 June 2008	Trading loss	(28,000)
Year ending 30 June 2009	Trading loss	(13,000)
Year ending 30 June 2010	Trading profit	77,000

The figures above have been adjusted for tax purposes but take no account of the tax relief available in respect of the premises and equipment to be acquired on 2 January 2008.

I have negotiated the purchase of a small industrial unit for £140,000. The building was constructed for its current owner on 1 April 2000 at a cost of £90,000. It has been used for industrial purposes since that date with the exception of the period from 1 January 2002 to 31 December 2004 when it was used as a retail unit. The vendor prepares accounts to 31 March each year.

The business will also purchase equipment (machinery, computers, shelving etc) at a cost of £13,500. The equipment should last approximately three years so there will be no further acquisitions until the year ending 30 June 2011.

The next decision I need to make is whether the new business should trade as a company or as an unincorporated entity. It would make more sense commercially to form a company immediately but I would be willing to use the same approach as I used when establishing the Flores business if this maximises the relief obtained in respect of the trading losses. I want to obtain relief for the losses now; I do not want the losses carried forward for relief in the future unless there are no other options available.

Yours sincerely

Banda

Required:

Prepare the schedules requested by Kara.

Marks are available for the three schedules as follows:

(a) Tax adjusted trading profit/loss of the new business (Aral) for its first three trading periods. (8 marks)

(b) The tax relief available in respect of the anticipated trading losses, together with supporting calculations and a recommended structure for the business. (16 marks)

(c) Explanatory notes, together with relevant supporting calculations, in connection with the loan. (8 marks)

Additional marks will be awarded for the appropriateness of the format and presentation of the schedules, the effectiveness with which the information is communicated and the extent to which the schedules are structured in a logical manner. (3 marks)

Notes: – you should assume that the tax rates and allowances for the tax year 2006/07 and for the financial year to 31 March 2007 apply throughout the question.
– you should ignore value added tax (VAT).

(35 marks)

Section B – TWO questions ONLY to be attempted

3 Palm plc recently acquired 100% of the ordinary share capital of Nikau Ltd from Facet Ltd. Palm plc intends to use Nikau Ltd to develop a new product range, under the name 'Project Sabal'. Nikau Ltd owns shares in a non-UK resident company, Date Inc.

The following information has been extracted from client files and from a meeting with the Finance Director of Palm plc.

Palm plc:
- Has more than 40 wholly owned subsidiaries such that all group companies pay corporation tax at 30%.
- All group companies prepare accounts to 31 March.
- Acquired Nikau Ltd on 1 November 2007 from Facet Ltd, an unrelated company.

Nikau Ltd:
- UK resident company that manufactures domestic electronic appliances for sale in the European Union (EU).
- Large enterprise for the purposes of the enhanced relief available for research and development expenditure.
- Trading losses brought forward as at 1 April 2007 of £195,700.
- Budgeted taxable trading profit of £360,000 for the year ending 31 March 2008 before taking account of 'Project Sabal'.
- Dividend income of £38,200 will be received in the year ending 31 March 2008 in respect of the shares in Date Inc.

'Project Sabal':
- Development of a range of electronic appliances, for sale in North America.
- Project Sabal will represent a significant advance in the technology of domestic appliances.
- Nikau Ltd will spend £70,000 on staffing costs and consumables researching and developing the necessary technology between now and 31 March 2008. Further costs will be incurred in the following year.
- Sales to North America will commence in 2009 and are expected to generate significant profits from that year.

Shares in Date Inc:
- Nikau Ltd owns 35% of the ordinary share capital of Date Inc.
- The shares were purchased from Facet Ltd on 1 June 2003 for their market value of £338,000.
- The sale was a no gain, no loss transfer for the purposes of corporation tax.
- Facet Ltd purchased the shares in Date Inc on 1 March 1994 for £137,000.

Date Inc:
- A controlled foreign company resident in the country of Palladia.
- Annual chargeable profits arising out of property investment activities are approximately £120,000, of which approximately £115,000 is distributed to its shareholders each year.

The tax system in Palladia:
- No taxes on income or capital profits.
- 4% withholding tax on dividends paid to shareholders resident outside Palladia.

Required:

(a) Prepare detailed explanatory notes, including relevant supporting calculations, on the effect of the following issues on the amount of corporation tax payable by Nikau Ltd for the year ending 31 March 2008.

(i) The costs of developing 'Project Sabal' and the significant commercial changes to the company's activities arising out of its implementation. (8 marks)

(ii) The shares held in Date Inc and the dividend income received from that company. (7 marks)

(b) Explain why making sales of Sabals in North America will have no effect on Nikau Ltd's ability to recover its input tax. (3 marks)

Notes: – you should assume that the corporation tax rates and allowances for the financial year to 31 March 2007 will continue to apply for the foreseeable future.
– you should ignore indexation allowance.

(18 marks)

4 Coral is the owner and managing director of Reef Ltd. She is considering the manner in which she will make her first pension contributions. In November 2007 she inherited her mother's house in the country of Kalania.

The following information has been extracted from client files and from telephone conversations with Coral.

Coral:
- 1972 – Born in the country of Kalania. Her father, who died in 2002, was domiciled in Kalania.
- 1999 – Moved to the UK and has lived and worked here since then.
- 2001 – Subscribed for 100% of the ordinary share capital of Reef Ltd.
- Intends to sell Reef Ltd and return to live in the country of Kalania in 2012.
- No income apart from that received from Reef Ltd.

Reef Ltd:
- A UK resident company with annual profits chargeable to corporation tax of approximately £70,000.
- Four employees including Coral.
- Provides scuba diving lessons to members of the public.

Payments from Reef Ltd to Coral in 2007/08:
- Director's fees of £460 per month.
- Dividends paid of £14,250 in June 2007 and £14,250 in September 2007.

Pension contributions:
- Coral has not so far made any pension contributions in the tax year 2007/08 but wishes to make gross pension contributions of £9,000.
- The contributions are to be made by Reef Ltd or Coral or a combination of the two in such a way as to minimise the total after tax cost.
- Any contributions made by Coral will be funded by an additional dividend from Reef Ltd.

House in the country of Kalania:
- Beachfront property with potential rental income of £550 per month after deduction of allowable expenditure.
- Coral will use it for holidays for two months each year.

The tax system in the country of Kalania:
- No capital gains tax or inheritance tax.
- Income tax at 8% on income arising in the country of Kalania.
- No double tax treaty with the UK.

Required:

(a) With the objective of minimising the total after tax cost, advise Coral as to whether the gross pension contributions of £9,000 should be made:

- **wholly by Reef Ltd; or**
- **by Coral to the extent that they are tax allowable with the balance made by Reef Ltd.**

Your answer should include supporting calculations where necessary. (9 marks)

(b) (i) Explain, by reference to Coral's residence, ordinary residence and domicile position, how the rental income arising in respect of the property in the country of Kalania will be taxed in the UK in the tax year 2007/08. State the strategy that Coral should adopt in order to minimise the total income tax suffered on the rental income. (7 marks)

(ii) Explain how the inclusion of rental income in Coral's UK income tax computation could affect the income tax due on her dividend income. (2 marks)

You are not required to prepare calculations for part (b) of this question.

Note: you should assume that the tax rates and allowances for the tax year 2006/07 and for the financial year to 31 March 2007 will continue to apply for the foreseeable future.

(18 marks)

5 Crusoe has contacted you following the death of his father, Noland. Crusoe has inherited the whole of his father's estate and is seeking advice on his father's capital gains tax position and the payment of inheritance tax following his death.

The following information has been extracted from client files and from telephone conversations with Crusoe.

Noland – personal information:
- Divorcee whose only other relatives are his sister, Avril, and two grandchildren.
- Died suddenly on 1 October 2007 without having made a will.
- Under the laws of intestacy, the whole of his estate passes to Crusoe.

Noland – income tax and capital gains tax:
- Has been a basic rate taxpayer since the tax year 2000/01.
- Sales of quoted shares resulted in:
  - Chargeable gains of £7,100 and allowable losses of £17,800 in the tax year 2007/08.
  - Chargeable gains of approximately £14,000 each tax year from 2000/01 to 2006/07.
  - None of the shares were held for long enough to qualify for taper relief.

Noland – gifts made during lifetime:
- On 1 December 1999 Noland gave his house to Crusoe.
  - Crusoe has allowed Noland to continue living in the house and has charged him rent of £120 per month since 1 December 1999. The market rent for the house would be £740 per month.
  - The house was worth £240,000 at the time of the gift and £310,000 on 1 October 2007.
- On 1 November 2004 Noland transferred quoted shares worth £232,000 to a discretionary trust for the benefit of his grandchildren.

Noland – probate values of assets held at death:	£
– Portfolio of quoted shares	370,000
Shares in Kurb Ltd	38,400
Chattels and cash	22,300
Domestic liabilities including income tax payable	(1,900)

- It should be assumed that these values will not change for the foreseeable future.

Kurb Ltd:
- Unquoted trading company
- Noland purchased the shares on 1 December 2005.

Crusoe:
- Long-standing personal tax client of your firm.
- Married with two young children.
- Successful investment banker with very high net worth.
- Intends to gift the portfolio of quoted shares inherited from Noland to his aunt, Avril, who has very little personal wealth.

Required:

(a) Prepare explanatory notes together with relevant supporting calculations in order to quantify the tax relief potentially available in respect of Noland's capital losses realised in 2007/08. (4 marks)

(b) State the immediate tax implications of the proposed gift of the share portfolio to Avril and identify an alternative strategy that would achieve Crusoe's objectives whilst avoiding a possible tax liability in the future. State any deadline(s) in connection with your proposed strategy. (5 marks)

(c) On the assumption that the administrators of Noland's estate will sell quoted shares in order to fund the inheritance tax due as a result of his death, calculate the value of the quoted shares that will be available to transfer to Avril. You should include brief notes of your treatment of the house and the shares in Kurb Ltd. (9 marks)

Note: you should assume that the tax rates and allowances for the tax year 2006/07 apply throughout this question.

(18 marks)

End of Question Paper