
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 2013
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 2014	(150,000)
Balancing allowance/(balancing charge)	X/(X)

It will not be possible to elect to transfer the equipment to JH plc at its 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

The gift of the JH plc shares to the trustees will be a chargeable lifetime transfer, such that inheritance tax may be due at the time of the gift. Business property relief will not be available as JH plc is a quoted company and Farina will not be a controlling shareholder.

The shares will be valued at £4 per share, such that the value of the gift will be £60,000 (15,000 x £4). This will be reduced by the annual exemptions for the tax year 2014/15 and also for the tax year 2013/14 if they have not been used against any other gifts. The annual exemption is £3,000.

The excess of this value over the available nil rate band will be subject to inheritance tax at 25% because the tax will be paid by Farina. The available nil rate band will be £325,000 as reduced by any chargeable transfers made by Farina in the previous seven years.

Any inheritance tax due will be payable on 30 April 2015.

(2) Capital gains tax gift relief

Gift relief will be available in respect of the transfer of the shares to the trustees because, as noted above, 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 2014

	£
Capital 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 2015.

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 2015 (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 2017.

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 and has been owned for at least a year. 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 2014

	£
Capital 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 2015.

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 2015 (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 2017.

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 2015	<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 2015		
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 in the future, 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 2013

	Notes	£
Tax adjusted trading income per original schedule		250,100
Costs relating to company share option plan	1	(6,000)
Accrued management bonuses	2	7,000
		<hr/> 251,100
Sale of Marussia Ltd – Chargeable gain (£83,400 + £21,500 + £10,600)	3, 4	115,500
		<hr/> 366,600
Less losses transferred from:		
Marussia Ltd (£60,000 x 3/12)	5	(15,000)
Eagle Ltd	6	–
		<hr/> 351,600
Taxable total profits		351,600
Corporation tax at 24%		84,384
Less: Marginal relief ((£1,500,000/4 – £351,600) x 1/100)	7, 8	(234)
		<hr/> 84,150

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 degrouping charge should be added to the sales proceeds on the sale of Marussia Ltd, such that it increases the chargeable gain arising.
4. The capital gains tax annual exempt amount of £10,600 is not available to companies.
5. 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 2012 amounts to such arrangements, such that the company is only a member of the group relief group for the three months from 1 August 2012 until 31 October 2012.
6. 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.
7. The main rate of corporation tax applies automatically to close investment holding companies. However, Brawn Ltd is a trading company, such that it is not a close investment holding company.
8. There are only four associated companies; Eagle Ltd is not associated as it is not controlled by Brawn Ltd.

Tutorial note: *Marussia Ltd is associated with Brawn Ltd because it was controlled by Brawn Ltd for part of the accounting period.*

(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.*

(b) (i) Pescara – Capital gains tax liability for the tax year 2013/14

	£
Proceeds: sale of 1,000,000 shares	445,000
Less: Cost (W1)	(269,565)
	<u>175,435</u>
Less: EIS deferral relief	(50,000)
Annual exempt amount	(10,600)
	<u>114,835</u>
Capital gains tax at 28%	<u>32,154</u>

Working

1. Base cost of 1,000,000 shares in Zolder plc

	Number	£
Original shares in Sepang plc – Market value of gift (part (a))	<u>375,000</u>	<u>697,500</u>
Exchanged for shares in Zolder plc		
Cost of new shares: $\frac{\text{£}2}{\text{£}2 + \text{£}0.3} \times \text{£}697,500$	750,000	606,522
Bonus issue	<u>1,500,000</u>	<u>–</u>
	2,250,000	606,522
Cost of shares to be sold ($1,000,000/2,250,000 \times \text{£}606,522$)	<u>(1,000,000)</u>	<u>(269,565)</u>
	<u>1,250,000</u>	<u>336,957</u>

(ii) Pescara – Capital gains tax implications of selling the EIS shares

The gain deferred in respect of the sale of the shares in Zolder plc will be chargeable in the year the EIS shares are sold.

The treatment of the gain or loss arising on the EIS shares depends on when they are sold.

- If they are sold within three years of their purchase, any gain arising will be chargeable and any loss will be allowable.
- If they are sold more than three years after their purchase, any gain arising will be exempt but a loss will be allowable.

Regardless of when the shares are sold, any loss arising will be reduced by any EIS income tax relief obtained in respect of the shares which has not been withdrawn.

(c) Pescara – Gift of a UK property

The gift of a property will be a potentially exempt transfer (PET). The value of this PET will be the market value of the property at the time of the gift.

The amount which will be subject to inheritance tax in respect of this gift with reservation depends on whether or not the reservation of benefit is lifted, i.e. Pescara stops using the property rent-free, before she dies.

- (i) If the reservation of benefit is lifted prior to Pescara's death, there will be a further PET equal to the value of the property at that time. This will only be chargeable if Pescara dies within the subsequent seven years.
- (ii) If the reservation of benefit is still in place when Pescara dies, the value of the property at the time of her death will be included in her death estate.

Where Pescara dies within seven years of the original PET, such that it is chargeable to inheritance tax, **and** either (i) or (ii) applies, the original PET **or** (i)/(ii) will be taxed, whichever results in the higher tax liability.

Tutorial note: Pescara would be advised to stop using the property (or to start paying a market rent) if she wishes the gift to be advantageous from the point of view of inheritance tax.

4 Spetz Ltd group

(a) Novak Ltd – Value added tax (VAT) partial exemption annual adjustment

De minimis test 1 is not satisfied, as the total input tax exceeds an average of £625 per month ($\text{£}625 \times 12 = \text{£}7,500$).

De minimis test 2 is not satisfied, as the total input tax less that directly attributed to taxable supplies exceeds an average of £625 per month ($\text{£}12,200 + \text{£}4,900 + \text{£}16,100 - \text{£}12,200 = \text{£}21,000$, $\text{£}21,000/12 = \text{£}1,750$).

	£
Input tax attributed to taxable supplies	12,200
Unattributed input tax (£16,100 x 74% (W1))	11,914
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Recoverable input tax (W2)	24,114
Input tax recovered on quarterly returns	(23,200)
	<hr/>
Annual adjustment – additional input tax recoverable	914

The annual adjustment must be made on the final VAT return of the year, i.e. the return for the period ended 30 September 2013, or the first VAT return after the end of the year.

Workings

1. Recoverable unattributed input tax

$$£1,190,000/£1,620,000 (£1,190,000 + £430,000) = 73.4\%$$

This is rounded up to 74%.

2. Recoverable input tax

Exempt input tax of £9,086 (£4,900 + (£16,100 – £11,914)) exceeds the *de minimis* limit of £625 per month (*de minimis* test 3) and is therefore irrecoverable.

(b) (i) Residence status of Kraus Co

A company is regarded as resident in the UK if it is incorporated in the UK or if its central management and control is exercised in the UK.

Kraus Co was incorporated in the country of Mersano. Accordingly, it will only be resident in the UK if its central management and control is exercised in the UK. The central management and control of a company is usually regarded as being exercised in the place where the meetings of the board of directors are held.

(ii) Kraus Co

UK resident companies are subject to corporation tax on their worldwide income.

	£
Corporation tax at the main rate (£520,000 x 24%)	124,800
Unilateral double tax relief (£520,000 x 21%)	(109,200)
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UK corporation tax liability	15,600

Tutorial note: *The profits will be subject to tax because no election has been made to exempt the profits and losses of the overseas permanent establishment from UK corporation tax.*

Election to exempt the overseas profits from UK tax

The advantage of making such an election would be that the profits made in Mersano would not be subject to UK corporation tax. Based on the current rates of corporation tax in the two countries, this would save corporation tax at the rate of 3% (24% – 21%).

When considering this election, it should be recognised that it is irrevocable and would apply to all future overseas permanent establishments of Kraus Co. Accordingly, there would be no relief in the UK for any losses incurred in the trade in Mersano in the future or for any other losses incurred in any additional overseas trades operated by Kraus Co.

(c) Meyer's secondment to Kraus Co

The reimbursement of expenses by an employer represents taxable income for an employee. Accordingly, the cost of the flights at the start and end of the contract represents taxable income for Meyer. However, a deduction of an equal amount will be available because:

- it is necessary for Meyer to travel to Mersano in order to perform the duties of his employment; and
- the workplace in Mersano is a temporary workplace (the secondment is for less than 24 months), such that the travelling does not constitute ordinary commuting.

The cost of the return journey to the UK in February 2014 has no UK tax implications. Meyer will not be able to claim a tax deduction for the costs incurred because the journey is for a private purpose and he, rather than Spetz Ltd, will bear the cost.

The reimbursement of the cost of laundry and telephone calls home will be exempt from tax if the average cost is less than £10 per day. However, if this limit is exceeded, the whole of the amount reimbursed will be subject to UK income tax.

Tutorial note: *Credit was also available to candidates who focused their answers on the special rules relating to travel costs where duties are performed abroad.*

5 Monisha

(a) Monisha

(i) Furnished holiday accommodation in the UK – conditions

- The property must be available for commercial letting to the public as holiday accommodation for at least 210 days in the tax year.
- The property must be commercially let as holiday accommodation for at least 105 days in the tax year, excluding any periods of longer term occupation.
- There must be no more than 155 days of longer term occupation in the tax year.

Longer term occupation occurs where there is a continuous period of occupation by the same person for more than 31 days.

(ii) The total tax saving for the six years ending 5 April 2020

Income tax

	£
Income tax saved in the first five tax years ($£6,660 (W1) \times 40\% \times 5$)	13,320
Income tax saved in the final tax year ($£6,660 (W1) \times 20\% (40\% - 20\%)$)	1,332
Total income tax saved	14,652

Working

1. Taxable property income

	£
Rental income	20,000
Allowable expenses ($£1,600 + £1,200 + £2,000$)	(4,800)
Capital allowances equal to wear and tear allowance ($(£20,000 - £1,200) \times 10\%$)	(1,880)
	13,320
Amount subject to income tax in the hands of Asmat ($£13,320 \times 0.5$)	6,660

For the first five tax years, Asmat will not have any other income, such that his share of the property income will be covered by his personal allowance.

Capital gains tax

The gift of the 20% interest in the property will take place at no gain, no loss because Monisha and Asmat are married.

	£
Capital gains tax on the sale of the property if the proposals are not carried out: Monisha: $((£100,000 - (£10,600 - £6,000)) \times 28\%)$	26,712
Capital gains tax on the sale of the property if the proposals are carried out: Monisha: $((£80,000 (£100,000 \times 80\%) - (£10,600 - £6,000)) \times 10\%)$	7,540
Asmat: $((£20,000 (£100,000 \times 20\%) - £10,600) \times 10\%)$	940
	8,480
Capital gains tax saved ($£26,712 - £8,480$)	18,232

The total tax saved is £32,884 ($£14,652 + £18,232$).

Tutorial notes

1. *The income of a jointly held asset is automatically split equally between a married couple, regardless of their actual interests in the property. (Monisha and Asmat could elect to split the income between them in the ratio 80:20, but to do so would not be beneficial in their particular circumstances.) Accordingly, property income of £6,660 (W1) will be subject to income tax in the hands of Asmat, rather than at 40% in the hands of Monisha, in each of the six tax years.*
2. *For the final tax year, Asmat will have employment income, such that the property income will be taxed at 20%.*
3. *The gain on the sale of the property will be allocated between Monisha and Asmat in the ratio 80:20.*
4. *A gain on the sale of furnished holiday accommodation qualifies for entrepreneurs' relief.*

(b) Horner

(i) The circumstances in which the personal service company (IR 35) rules apply

1. A company enters into a contract to provide services to a client.
2. The services are carried out by an individual.
3. If the services were provided under a contract between the individual and the client, the individual would be regarded as an employee of the client.
4. The individual has an interest of at least 5% in the company or an entitlement to receive payments from the company, other than salary, in respect of the services provided to the client.

In respect of condition 3, when determining whether or not the individual would be regarded as an employee of the client, the rules used to distinguish between employees and the self-employed are used.

Tutorial note: *It is possible for a partnership, rather than a company, to enter into the contract with the client.*

(ii) Deemed employment income for the year ending 5 April 2014

	£
Otmar Ltd – income in respect of relevant engagements	85,000
Less: 5% deduction	(4,250)
Salary paid to Horner	(50,000)
Pension contributions	(2,000)
Employer's NIC ((£50,000 – £7,488) x 13.8%)	(5,867)
	<u>22,883</u>
Less: Employer's NIC on deemed employment income (£22,883 x 13.8/113.8)	(2,775)
Deemed employment income	<u>20,108</u>

**Professional Level – Options Module, Paper P6 (UK)
Advanced Taxation (United Kingdom)**

December 2013 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		
Tax may be payable at time of gift	1	
Business property relief	1.5	
Valuation and exemptions	1.5	
Inheritance tax and due date	3	
Gift relief	1.5	
	<u>8.5</u>	7
(iii) Capital gain on sale of business	1.5	
With incorporation relief		
Incorporation relief	1.5	
Capital gains tax and due date	1	
Capital 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	3	
Chargeable gains	2	
Losses transferred from Marussia Ltd	1	
Losses transferred from Eagle Ltd	1.5	
Rate of corporation tax	2	
Calculation		
Taxable total profits	3	
Corporation tax liability	1.5	
	<u>14</u>	12
(b) (i) Definition of close company	2.5	
Associates	1.5	
Application	2	
	<u>6</u>	5
(ii) Reasons why transfer pricing rules apply	2.5	
Adjustment required	1	
	<u>3.5</u>	3
(c) Conditions	3	
Operation of the scheme	3	
	<u>6</u>	5
Total		<u>25</u>
3 (a) Value of shares	2	
Annual exemptions	1	
Nil rate band	2.5	
Inheritance tax liability	1.5	
	<u>7</u>	7
(b) (i) Proceeds less cost	4	
EIS deferral relief, annual exempt amount and liability	2	
	<u>6</u>	6
(ii) Zolder plc shares	1	
EIS shares	3.5	
	<u>4.5</u>	3
(c) The initial gift	1	
Reservation lifted within seven years	1.5	
Reservation in place at death	1	
Avoidance of double taxation	1.5	
	<u>5</u>	4
Total		<u>20</u>

	<i>Available</i>	<i>Maximum</i>
4 (a) Test 1	1	
Test 2	1.5	
Input tax attributed to taxable supplies and unattributed input tax	1.5	
Test 3	1.5	
Adjustment and date	1.5	
	<u>7</u>	7
(b) (i) Not incorporated in the UK	1	
Central management and control	2	
	<u>3</u>	3
(ii) Calculation of liability	1.5	
Taxation of worldwide profits	1	
Discussion of election		
Advantage	1.5	
Disadvantages	2	
	<u>6</u>	5
(c) Flights at the start and end of the contract	3	
Return journey in February	1.5	
Laundry and telephone calls	2	
	<u>6.5</u>	5
Total		<u>20</u>
5 (a) (i) The conditions – one mark each	3	
Meaning of longer term occupation	1	
	<u>4</u>	3
(ii) Income tax		
Taxable property income	2	
Allocated equally	1	
First five tax years	1.5	
Final tax year	1	
Capital gains tax		
Gift of 20% interest is at no gain, no loss	1	
Capital gains tax if the proposals are not carried out	1.5	
Capital gains tax if the proposals are carried out	2.5	
Total saving	0.5	
	<u>11</u>	10
(b) (i) The conditions – one mark each	3	
Reference to rules used to determine employer, employee relationship	1	
	<u>4</u>	3
(ii) Income less 5%	1.5	
Deductions for:		
Salary and pension contributions	1	
Employer's NIC on salary	1	
Employer's NIC on deemed employment income	1	
	<u>4.5</u>	4
Total		<u>20</u>