Professional Level – Options Module

Advanced Taxation (United Kingdom)

Monday 6 June 2011

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 2–4

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

Paper P6 (UK)

ACCA

SUPPLEMENTARY INSTRUCTIONS

1. You should assume that the tax rates and allowances for the tax year 2010/11 and for the financial year to 31 March 2011 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 – £37,400	20	10
Higher rate	£37,401 to £150,000	40	32·5
Additional rate	£150,001 and over	50	42·5

A starting rate of 10% applies to savings income where it falls within the first £2,440 of taxable income.

Personal allowances

		£
Personal allowance	Standard	6,475
	65 – 74	9,490
	75 and over	9,640
Income limit for age related allowances		22,900
Income limit for standard personal allowance		100,000

Car benefit percentage

The base level of CO_2 emissions is 130 grams per kilometre.

	%
Petrol cars with CO_2 emissions of 75 grams per kilometre or less	5
Petrol cars with CO_2 emissions between 76 and 120 grams per kilometre	10

Car fuel benefit

The base figure for calculating the car fuel benefit is £18,000.

Pension scheme limits

Annual allowance	£255,000
Lifetime allowance	£1,800,000
The maximum contribution that can qualify for tax relief without evidence of earnings	£3,600

Authorised mileage allowances: cars

Up to 10,000 miles	40p
Over 10,000 miles	25p

Capital allowances: rates of allowance

	%
Plant and machinery	
Main pool	20
Special rate pool	10
Motor cars (purchases since 6 April 2009 (1 April 2009 for limited companies))	
CO_2 emissions up to 110 grams per kilometre	100
CO_2 emissions between 111 and 160 grams per kilometre	20
CO_2 emissions over 160 grams per kilometre	10
Annual investment allowance	
First £100,000 of expenditure	100
Industrial buildings	
Writing-down allowance	1

Corporation tax

Financial year	**2008**	**2009**	**2010**
Small profits rate	21%	21%	21%
Main rate	28%	28%	28%
	£	**£**	**£**
Lower limit	300,000	300,000	300,000
Upper limit	1,500,000	1,500,000	1,500,000
Standard fraction	7/400	7/400	7/400

Marginal Relief

Standard fraction x (U – A) x N/A

Value added tax (VAT)

Standard rate	– up to 3 January 2011	17·5%
	– from 4 January onwards	20%
Registration limit		£70,000
Deregistration limit		£68,000

Inheritance tax: tax rates

£1 – £325,000		Nil
Excess	– Death rate	40%
	– Lifetime rate	20%

Inheritance tax: taper relief

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

Capital gains tax

Rate of tax – Lower rate	18%
– Higher rate	28%
Annual exempt amount	£10,100
Entrepreneurs' relief – Lifetime limit	£5,000,000
– Rate of tax	10%

National insurance contributions
(not contracted out rates)

			%
Class 1	Employee	£1 – £5,715 per year	Nil
		£5,716 – £43,875 per year	11·0
		£43,876 and above per year	1·0
Class 1	Employer	£1 – £5,715 per year	Nil
		£5,716 and above per year	12·8
Class 1A			12·8
Class 2		£2·40 per week	
		Small earnings exception limit – £5,075	
Class 4		£1 – £5,715 per year	Nil
		£5,716 – £43,875 per year	8·0
		£43,876 and above per year	1·0

Rates of interest (assumed)

Official rate of interest	4%
Rate of interest on underpaid tax	3%
Rate of interest on overpaid tax	0·5%

Stamp duty land tax

	%
£150,000 or less (1)	Nil
£150,001 – £250,000 (2)	1
£250,001 – £500,000	3
£500,001 or more	4

(1) For residential property the nil rate is restricted to £125,000.
(2) From 25 March 2010 to 24 March 2012 there is an exemption for first time buyers purchasing residential properties for no more than £250,000.

Stamp duty

Shares	0·5%

This is a blank page.
Question 1 begins on page 6.

Section A – BOTH questions are compulsory and MUST be attempted

1 Your manager has sent you an email with two attachments in respect of a new client called Calisia. The first attachment is an extract from a letter from Calisia, in which she has asked the firm to consider how she can increase the income of her daughter, Farfisa, and to review her own inheritance tax position.

The second attachment is a schedule setting out what your manager wants you to do in order to prepare for a meeting with Calisia.

Attachment 1 – Extract from letter from Calisia

(a) Farfisa – Additional income

My daughter, Farfisa, will leave home and start her first job on 1 October 2011 in London. She will be working for Jelmini Ltd and will be paid a salary of £28,000 (gross) per year. Jelmini Ltd will also provide Farfisa with an interest free loan of £2,700 in order for her to purchase suitable business clothing. The loan is to be repaid on 30 September 2013.

We have estimated that Farfisa's expenses will be £2,500 per month (of which £550 will be rent) so her salary after tax will be insufficient. At present Farfisa has no other income so I have identified three possible transfers of capital that I could make to her in order to generate the income she requires.

(i) Gift of shares quoted on the UK stock exchange

I would give Farfisa sufficient quoted shares to generate the additional income she requires. On average the quoted shares would generate dividends equal to 4% of their current market value. It can be assumed that, on average, the capital gain arising on the quoted shares will equal a quarter of their market value. I do not hold more than 1% of the share capital of any quoted company.

(ii) Sale of investment property followed by gift of proceeds

I own a two-bedroom investment property situated in London. I bought it in 2001 for £90,000 and it is now worth £260,000. I have always rented it out to tourists such that it qualifies as commercially let furnished holiday accommodation.

I would give Farfisa the net proceeds of the sale after paying any tax and other costs. Farfisa would place the cash on bank deposit; I estimate that the deposit would earn interest at 3% (gross). Farfisa would only spend the interest, not the capital, so I would then give Farfisa quoted shares to generate the remainder of the additional income she requires as in (i) above.

(iii) Gift of investment property

Under this option, instead of selling the property, I would give it to Farfisa who would then receive the annual rental income, after all allowable expenses, of £5,100. Again, I would then give Farfisa quoted shares to generate the remainder of the additional income she requires as in (i) above.

(b) Calisia – Inheritance tax

I would like to discuss my inheritance tax position with you so that I can understand the amount of tax that would be payable if I were to die now. I set out below the assets I own together with their current market values. I have not included my home as I assume that it is not subject to inheritance tax. I have never made any lifetime gifts and neither did my husband before he died. I intend to leave £150,000 to the Fairness for All political party when I die and the rest of my estate to Farfisa.

	£
Investment property in London	260,000
Investment property in the country of Sakura	380,000
Share (25%) in the 'Therson Partnership'	700,000
Building used by the 'Therson Partnership'	440,000
Shares quoted on the UK stock exchange	1,300,000
Art and antiques	200,000
Motor cars	100,000
Cash and other possessions	320,000

Attachment 2 – Schedule from your manager

Preparation for the meeting with Calisia

(a) Farfisa – Additional income

During the meeting I only want to focus on any immediate tax liabilities as opposed to liabilities that may or may not arise in the future.

Prepare notes, with supporting calculations, showing Calisia's capital gains tax liability in respect of:

– each of the three possibilities identified by her; and
– a fourth possibility (which I expect to be more tax efficient) whereby Calisia gifts the property to Farfisa who then lives in it. Any shortfall in income could then be satisfied by renting out the second bedroom. You should include a calculation of the minimum monthly rent that would need to be charged in order to provide sufficient income for Farfisa.

Start by calculating the excess of Farfisa's budgeted expenditure over her salary after all taxes for a 12-month period. This will enable you to determine the value of shares she will need to be given under each of the possibilities in order to provide her with the income she needs. Remember to take into account any income tax due on the income received by Farfisa when calculating the income she will retain in respect of the assets transferred.

Conclude with a summary, showing the capital gains tax payable in respect of each of the four alternatives.

Please include a note of the stamp duty or stamp duty land tax implications of each proposal.

You should assume the following:

– a sale or gift of the investment property will result in legal fees of £6,000;
– there will be no disposal costs in relation to any gift of shares;
– all claims and elections necessary to reduce immediate tax liabilities will be made.

Further information

Calisia and Farfisa are resident and ordinarily resident in the UK.

Calisia is a higher rate taxpayer who makes sufficient capital gains every year to utilise her annual exempt amount.

Calisia has not made a claim for entrepreneurs' relief in the past.

(b) Calisia – Inheritance tax

Calisia is domiciled in the UK and has not made any lifetime gifts. I want you to prepare a comprehensive explanation of how Calisia's inheritance tax liability would be calculated if she were to die today. Please try to identify all of the issues that are relevant to Calisia's situation together with any matters that need to be confirmed with her in order for reliefs and/or exemptions to be available. I do not want you to perform any calculations as we do not have sufficient information at present.

Further information

Calisia's husband died in 2002. He had not made any lifetime gifts and he left the whole of his estate, consisting principally of quoted shares and UK property, to Calisia.

Required:

(a) Farfisa – Additional income

Prepare the notes and supporting calculations as set out in the schedule from your manager. (21 marks)

(b) Calisia – Inheritance tax

Prepare the explanation as set out in the schedule from your manager. (10 marks)

Professional marks will be awarded in question 1 for the effectiveness with which the information is communicated and the extent to which the calculations are approached in a logical manner. (3 marks)

(34 marks)

2 Your manager has sent you an email concerning a client, Petzold. An extract from the email together with two schedules of information from Petzold are set out below.

Email from your manager

Petzold has owned 100% of the ordinary share capital of Glenz Ltd for many years. Glenz Ltd is a profitable trading company that provides Petzold with the majority of his income. However, the company is currently suffering from a short-term cash flow problem.

Petzold also owns 100% of the ordinary share capital of Clementi Ltd. Clementi Ltd has three wholly owned trading subsidiaries but all of the companies in the group are very small. Petzold purchased Clementi Ltd in December 2010.

I want you to draft a letter to Petzold from me that deals with the following issues.

(a) Glenz Ltd – Payments to the tax authorities

(i) Calculations of the payments that will be made by Glenz Ltd to the tax authorities in respect of the three months ended 30 June 2011 and the equivalent figure for the three months ended 30 September 2011 based on the company's budgeted figures as set out in Schedule 1 from Petzold.

Petzold is only interested in those payments which affect the company's cash flow position. Accordingly, as the annual salaries shown represent the gross salaries earned there is no need to calculate the income tax or employees' national insurance contributions payable in respect of them.

Glenz Ltd is partially exempt for the purposes of value added tax (VAT) and was unable to recover all of its input tax in the year ending 31 March 2011.

Please provide explanations of the amount of input tax recoverable by Glenz Ltd but do not include any other narrative.

(ii) Confirmation, or otherwise, of the accuracy of Petzold's calculation of the company's corporation tax liability for the year ending 31 March 2011 (see Schedule 1) including an explanation of any difference and a reminder of when the tax is payable.

(b) Glenz Ltd – Cash flow

(i) The implications of the following suggestions from Petzold to improve the company's cash flow position.

– Paying Glenz Ltd's VAT liabilities in respect of the quarters ending 30 June 2011 and 30 September 2011 late. Glenz Ltd's previous four VAT returns have been submitted on time with the exception of the return for the three months ended 30 June 2010.

– The retention by Glenz Ltd of a refund of corporation tax of £21,000 that it received from HM Revenue and Customs in May 2011. Petzold has not been able to identify any reason for this refund.

(ii) I have suggested to Petzold that Glenz Ltd could improve its cash flow position by selling its warehouse and then renting it back. I have agreed to provide him with a summary of the corporation tax implications of this proposal together with supporting calculations.

The summary should include a detailed explanation of how the chargeable gain arising on the sale of the warehouse could be relieved via rollover relief.

You should assume that any sale of the warehouse will take place on 1 July 2011 and that rent will be paid from that date. Base your calculations on the figures provided by Petzold in Schedule 2.

I do not want you to address the VAT or the stamp duty land tax implications of this proposal.

Tax manager

Schedules provided by Petzold

Schedule 1

Glenz Ltd – Budgeted figures

	Three months ending 30 June 2011	Three months ending 30 September 2011
	£	£
Sales revenue – Standard rated (excluding VAT)	360,000	365,000
Sales revenue – Exempt	24,500	23,400
Input tax:		
Attributable to taxable supplies	40,000	42,000
Attributable to exempt supplies	950	2,200
Non-attributable	800	1,500
Total	41,750	45,700

Total annual salaries for the company's eight full-time employees – £332,000
Corporation tax liability for the year ended 31 March 2011 – £17,535 (£83,500 x 21%)

Schedule 2

The warehouse

Cost (1 February 2001)	£180,000
Current market value	£330,000
Estimated commercial annual rent payable to the new owner	£22,000

Required:

Prepare the letter to Petzold requested in the email from your manager. The following marks are available.

(a) Glenz Ltd – Payments to the tax authorities. (12 marks)

(b) Glenz Ltd – Cash flow. (16 marks)

Professional marks will be awarded in question 2 for the appropriateness of the format of the letter and the effectiveness with which the information is communicated. (2 marks)

Note: The following figures from the Retail Prices Index should be used.

February 2001	172·0
July 2011	235·5 (assumed)

(30 marks)

Section B – TWO questions ONLY to be attempted

3 Faure expects her new business to make a loss in its first trading period. She requires advice on the choice of year end and on the difference between employing her husband in the business and running the business as a partnership.

The following information has been obtained from discussions with Faure.

Faure:
– Is 44 years old and married to Ravel.
– Has not had an income tax liability since the tax year 2002/03.
– Intends to start a new business on 1 July 2011 under the trading name 'Bah-Tock'.
– 'Bah-Tock' will be Faure's only source of income.

The 'Bah-Tock' business:
– Is expected to make a loss throughout the first 12 months of trading.
– Is expected to be profitable from 1 July 2012 onwards.

Structure of the 'Bah-Tock' business:
– The business will be unincorporated.
– Faure and Ravel will both work full-time on the affairs of the business.
– Faure will either employ Ravel, and pay him a commercial salary, or the two of them will run the business as a partnership.

Ravel:
– Is 47 years old.
– Inherited a significant portfolio of quoted shares on the death of his mother in February 2003.
– Has annual taxable income, after deduction of the personal allowance, of £35,000.
– This income consists of bank interest and dividends only.

Required:

(a) Explain why a year end of 30 June, as opposed to 31 March, is likely to delay the first tax year in which the 'Bah-Tock' business makes a taxable profit rather than an allowable loss. (4 marks)

(b) On the assumption that the 'Bah-Tock' business will have a 30 June year end, analyse the issues that Faure and Ravel should be aware of from a tax point of view if:

(i) Faure employs Ravel;
(ii) Faure and Ravel are partners in the business

and summarise your findings.

Notes in relation to part (b)

1 Your analysis should be based on the information provided and should be restricted to the situation where the business is loss-making.

2 You should address the effect of the choice of business structure on:

– the size of the loss made by the business;
– the reliefs available to Faure and Ravel in respect of the initial losses;
– the income tax and national insurance contributions liabilities of Faure and Ravel for the tax years 2011/12 and 2012/13. (14 marks)

(18 marks)

4 Capstan requires advice on the transfer of a property to a trust, the sale of shares in respect of which relief has been received under the Enterprise Investment Scheme (EIS) and the sale of shares and qualifying corporate bonds following a takeover.

The following information was obtained from a meeting with Capstan.

Capstan:
- Expects to have taxable income in the tax year 2011/12 of £80,000.
- Transferred a UK property to a discretionary trust on 1 May 2011.
- Plans to sell ordinary shares in Agraffe Ltd and loan stock and ordinary shares in Pinblock plc.
- Will make all available claims to reduce the tax due in respect of his planned disposals.
- Entrepreneurs' relief is not available in respect of any of these disposals.

Transfer of a UK property to a discretionary trust:
- Capstan acquired the property in May 2003 for £285,000.
- The market value of the property on 1 May 2011 was £425,000.
- Capstan had used the property as a second home throughout his period of ownership.
- Capstan will pay any inheritance tax due on the gift of the property to the trust.

Sale of ordinary shares in Agraffe Ltd:
- Capstan subscribed for 18,000 shares in Agraffe Ltd for £32,000 on 1 February 2009.
- He obtained EIS relief of £6,400 against his income tax liability.
- Capstan intends to sell all of the shares for £20,000 on 1 July 2011.
- Capstan will relieve the loss arising on the shares in the most tax efficient manner.

Sale of loan stock and ordinary shares in Pinblock plc:
- Capstan will sell £8,000 7% Pinblock plc non-convertible loan stock for £10,600.
- Capstan will also sell 12,000 shares in Pinblock plc for £69,000.
- The sales will take place on 1 August 2011.

Capstan's acquisition of loan stock and ordinary shares in Pinblock plc:
- Capstan purchased 15,000 shares in Wippen plc for £26,000 on 1 May 2004.
- Pinblock plc acquired 100% of the ordinary share capital of Wippen plc on 1 October 2007.
- The takeover was for *bona fide* commercial reasons and was not for the avoidance of tax.
- Capstan received £8,000 Pinblock plc non-convertible loan stock (a qualifying corporate bond) and 20,000 ordinary shares in Pinblock plc in exchange for his shares in Wippen plc.
- The loan stock and the shares were worth £9,000 and £40,000 respectively as at 1 October 2007.

Required:

(a) Set out, together with supporting calculations, the inheritance tax and capital gains tax implications of the transfer of the UK property to the trust and the date(s) on which any tax due will be payable. (6 marks)

(b) Explain, with supporting calculations, in connection with the sale of shares in Agraffe Ltd

- **the tax implications of selling them on 1 July 2011; and**
- **any advantages and disadvantages to Capstan of delaying the sale.** (7 marks)

(c) Calculate Capstan's taxable capital gains for the tax year 2011/12. (5 marks)

Note: in parts (a) and (b) you should clearly state any assumptions you have made together with any additional information that you would need to confirm with Capstan before finalising your calculations.

(18 marks)

5 The Loriod plc group intends to acquire an overseas business. It requires advice on the relief available in respect of any initial losses made by the business, the use of foreign tax credits and transfer pricing.

The following information has been obtained from the management of the Loriod plc group.

Loriod plc group:
– Loriod plc is a UK resident trading company.
– Loriod plc has a large number of wholly-owned UK resident trading subsidiary companies.
– It should be assumed that all group companies pay corporation tax at the main rate of 28%.
– Elivar Ltd, one of the Loriod plc group subsidiaries, is to acquire the 'Frager' business.
– The purchase of the 'Frager' business will follow either Strategy A or Strategy B.

Elivar Ltd:
– Makes gift aid payments of £2,000 each year.
– Has taxable total profits of approximately £90,000 per year.

The 'Frager' business:
– Is carried on in the country of Kuwata and is owned by Syme Inc, a company resident in Kuwata.
– Manufactures components used by Elivar Ltd and other Loriod plc group companies.
– Carries on the same trade as Elivar Ltd.
– Is expected to make a loss in the year following its acquisition by Elivar Ltd.
– Is expected to have taxable profits of £130,000 per year following the year of acquisition.

Strategy A:
– Elivar Ltd will purchase the trade and all of the assets of Syme Inc such that Elivar Ltd will be carrying on the 'Frager' business through a permanent establishment in Kuwata.
– The permanent establishment will be controlled from the UK.

Strategy B:
– Elivar Ltd will purchase the whole of the share capital of Syme Inc such that Syme Inc will be a subsidiary of Elivar Ltd resident in Kuwata.
– It has been determined that Syme Inc would not be a controlled foreign company.

The tax system in the country of Kuwata:
– Is broadly the same as that in the UK with a corporation tax rate of 22%.
– Trading losses may only be utilised by companies resident in Kuwata.
– Kuwata is not a member of the European Union and there is no double tax treaty between the UK and Kuwata.

Required:

(a) Provide a detailed explanation of the relief available in respect of the expected loss to be made by the 'Frager' business depending on whether the purchase follows Strategy A or Strategy B. (7 marks)

(b) For this part of the question it should be assumed that the purchase has followed Strategy A and that the 'Frager' business is now profitable.

Explain, with supporting calculations, how to determine the maximum loss that can be surrendered to Elivar Ltd by the Loriod plc group companies if relief in respect of the tax suffered in Kuwata is not to be wasted. (5 marks)

(c) For this part of the question it should be assumed that the purchase has followed Strategy B.

Explain the effect of the prices charged by the subsidiary in Kuwata to other companies in the Loriod plc group on the total tax paid by the group and the implications of the transfer pricing legislation. (6 marks)

(18 marks)

End of Question Paper