

Professional Level – Options Module

Advanced Taxation (United Kingdom)

Monday 1 December 2008

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 2007/08 and for the financial year to 31 March 2008 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		
		%
Starting rate	£1 – £2,230	10
Basic rate	£2,231 – £34,600	22
Higher rate	£34,601 and above	40

Personal allowances		
		£
Personal allowance	Standard	5,225
	65–74	7,550
	75 and over	7,690
Income limit for age related allowances		20,900

Car benefit percentage

The base level of CO₂ 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	£225,000
Lifetime allowance	£1,600,000
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

	%
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 2006 to 31 March 2008 (6 April 2006 to 5 April 2008 for unincorporated businesses).

Long-life assets

Writing down allowance	6
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Industrial buildings

Writing down allowance	4
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Corporation tax

Financial year	2005	2006	2007
Small companies rate	19%	19%	20%
Full rate	30%	30%	30%
	£	£	£
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	11/400	11/400	1/40

Marginal Relief

$$(M - P) \times I/P \times \text{Marginal relief fraction}$$

Value added tax

	£
Registration limit	64,000
Deregistration limit	62,000

Inheritance tax

	%
£1 – £300,000	Nil
Excess	40

Capital gains tax: annual exemption

Individuals	£9,200
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Capital gains tax: taper relief

Complete years after 5 April 1998 for which asset held	Percentage of gain chargeable after relief	
	Business assets	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 – £5,225 per year	Nil
		£5,226 – £34,840 per year	11·0
		£34,841 and above per year	1·0
Class 1	Employer	£1 – £5,225 per year	Nil
		£5,226 and above per year	12·8
Class 1A			12·8
Class 2		Small earnings exception limit – £4,635 £2·20 per week	
Class 4		£1 – £5,225 per year	Nil
		£5,226 – £34,840 per year	8·0
		£34,841 and above per year	1·0

Rates of interest

Official rate of interest	6·25%
Rate of interest on underpaid tax	7·5% (assumed)
Rate of interest on overpaid tax	3·0% (assumed)

Stamp duty land tax

Ad valorem duty	Rate
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 You have received the following memorandum from your manager.

To Tax senior
From Tax manager
Date 28 November 2008
Subject Maria Copenhagen and Nucleus Resources

I spoke to Maria Copenhagen this morning. We arranged to meet on Thursday 4 December to discuss the following matters.

Nucleus Resources

Maria is planning a major expansion of her business, Nucleus Resources. I attach a schedule, prepared by Maria, showing the budgeted income and expenditure of the business for a full year. Maria wants to know how much additional after tax income the expansion of the business will create depending on whether she employs the two additional employees or uses a sub-contractor, Quantum Ltd.

Quoted shares

In October 2006 Niels, Maria's husband, received a gift of shares with a value of £170,000 from his uncle. The shares are quoted on the Heisenbergia Stock Exchange. The uncle died in November 2008 and Maria wants to know whether there will be any UK inheritance tax in respect of the gift. The uncle had been living in the country of Heisenbergia since moving there from the UK in 1988 and had made substantial gifts to other close relatives in 2005 and 2006. Inheritance tax of £30,600 has been charged in Heisenbergia in respect of the gift to Niels.

According to Maria, Niels is considering transferring the shares to a trust for the benefit of their two sons.

Please prepare the following:

- (a) In respect of Nucleus Resources:

Calculations of the additional annual after tax income that would be generated by the expansion of the business under the two alternatives i.e. the recruitment of the additional employees and the use of the sub-contractor. You should check to see if Maria is currently a higher rate taxpayer. If she is, you can simply deduct tax and national insurance at the marginal rates from the additional profits.

Don't worry about the precise timing of the capital allowances in respect of the car, just spread their effect equally. Also, watch out for the VAT implications of the expansion; there is bound to be an effect on the recoverability of input tax due to the business being partially exempt.

- (b) In respect of the quoted shares:

- (i) A list of the issues to be considered in order to determine whether or not the gift from the uncle is within the scope of UK inheritance tax and the treatment of any inheritance tax suffered in the country of Heisenbergia.
- (ii) A brief outline of the tax implications of transferring the shares to the trust and the taxation of the trust income paid to the beneficiaries. The shares are currently worth £210,000.
- (iii) Notes on the extent to which it is professionally acceptable for me to discuss issues relating to the shares with Maria.

I want to be able to use the calculations and notes in my meeting with Maria (or in a subsequent meeting with Niels) and I may not have much time to study them beforehand so please make sure that they are clear, concise and that I can find my way around them easily.

Thank you

Tax manager

The schedule prepared by Maria is set out below.

Nucleus Resources – Estimated income and expenditure for a full year			
Notes			
1. The figures in the ‘expansion’ column relate to the expansion only and will be in addition to the existing business.			
2. Nucleus Resources is registered for VAT.			
3. All amounts are stated exclusive of VAT.			
4. Materials and overheads are subject to VAT at 17·5%. The expenditure cannot be attributed to particular supplies.			
		Existing business	Expansion
		£	£
Turnover:	Standard rated	40,000	190,000
	Exempt	90,000	–
Expenditure:	Materials and overheads	37,000	See
	Wages	35,000	below
Costs relating to the expansion			
In order to expand the business I will either recruit two additional employees or sub-contract the work to Quantum Ltd, an unconnected company. Details of the expenditure relating to these two possibilities are set out below.			
Employees			
Employee 1 would be paid a salary of £55,000. He would also be provided with a petrol driven car with a list price when new of £12,800 (including VAT) and a CO ₂ emission rate of 148 grams per kilometre. It can be assumed that the car will be sold in five years time for £2,000. Employee 2 would be paid a salary of £40,000 and would not be provided with a car.			
There would also be additional materials and overheads, net of VAT at 17·5%, of £20,000.			
Quantum Ltd			
Quantum Ltd would charge an annual fee of £140,000 plus VAT.			
There would be no additional materials or overheads.			

Niels and Maria Copenhagen are both clients of your firm. The following information has been obtained from their files.

Niels Copenhagen

- Resident, ordinarily resident and domiciled in the UK.
- Niels has not made any previous transfers for the purposes of inheritance tax.
- Married to Maria. They have two children; Hans (11 years old) and Erik (8 years old).

Maria Copenhagen

- Resident, ordinarily resident and domiciled in the UK.
- Trades as ‘Nucleus Resources’, an unincorporated business.

Required:

Prepare the meeting notes requested by your manager. The following marks are available.

- (a) Calculations of the annual additional after tax income generated by the expansion of Maria's business under each of the two alternatives. (14 marks)**

- (b) (i) The issues to be considered in order to determine whether or not the gift from the uncle is within the scope of UK inheritance tax and the treatment of any inheritance tax suffered in the country of Heisenbergia. (6 marks)**
- (ii) The tax implications of transferring the shares to the trust and the taxation of any trust income paid to the beneficiaries, Hans and Erik. (7 marks)**
- (iii) The extent to which it is professionally acceptable to discuss issues relating to the shares with Maria. (4 marks)**

Appropriateness of the format and presentation of the notes and the effectiveness with which the information is communicated. (2 marks)

(33 marks)

**This is a blank page.
Question 2 begins on page 9.**

2 An extract from an e-mail from your manager is set out below.

I attach a schedule I received this morning from Max Constant, the new managing director of the Particle Ltd group of companies. With Max in charge this client has recently become a lot more lively! This e-mail will make more sense when you have read Max's schedule so I suggest you read that first.

Report

Please prepare a report to the management of Particle Ltd addressing the three areas of advice requested by Max. The report should also cover the following additional points.

Sale of Kaon Ltd – the value added tax (VAT) implications of selling the trade and assets of the business.

Muon Inc – any tax problems in connection with the loan.

Payment of corporation tax – the advantage of group payment arrangements.

Further information

The information in Max's schedule is pretty clear but you will see that there are two question marks in connection with the assets of Kaon Ltd. I've spoken to him about this and to check on a couple of other things and I set out below some additional information that you will need.

- All of the companies are UK resident with the exception of Muon Inc, which is resident in the country of Newtonia. Newtonia is not in the European Union (EU) and there is no double tax treaty between Newtonia and the UK.
- Shortly after its acquisition, Muon Inc approached a number of financial institutions for a loan. However, the interest rates demanded were so high that Particle Ltd has made the loan to Muon Inc instead. Particle Ltd is charging 4% interest on the loan. By the way, Muon Inc is not a controlled foreign company.
- The goodwill of Kaon Ltd has been created within the company since its formation on 1 May 2001.
- Kaon Ltd purchased its premises (Atom House) from Baryon Ltd on 1 March 2002 for its market value at that time of £490,000. Baryon Ltd purchased Atom House on 1 July 1998 for £272,000. Three months later, on 1 October 1998, Baryon Ltd sold another building (Bohr Square) for £309,400 making a capital gain of £89,000 and claimed rollover relief in respect of the purchase of Atom House. No option to tax for VAT purposes has been made in respect of Atom House.

Max has a reasonable knowledge of the UK tax system so keep the narrative in the report brief. As always, assume that all beneficial claims will be made and include a reference to them in the report.

A final thought; watch out for the impact of the sale of the business on the rate of corporation tax payable by Kaon Ltd.

Tax manager

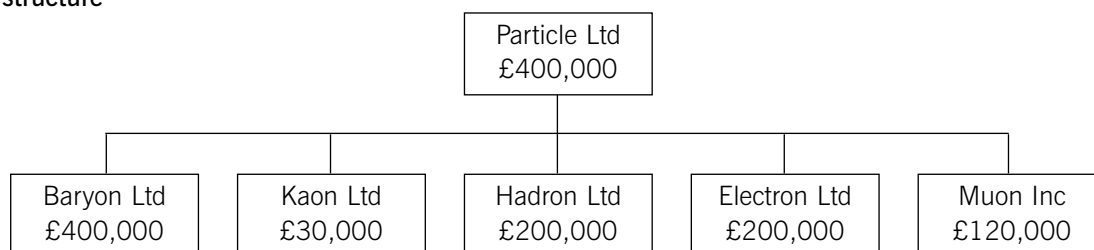
The schedule from Max Constant is set out below.

Particle Ltd Group – Situation as at 1 December 2008

Background information

- Particle Ltd owns 100% of its five subsidiaries. All six companies are trading companies preparing accounts to 31 March.
- Their approximate annual taxable profits are included in the group structure below.
- None of the companies receive any franked investment income and there are no unused trading losses within the group.
- Baryon Ltd has a capital loss of £37,100 brought forward in respect of a disposal on 1 May 2003.
- Particle Ltd, Baryon Ltd and Kaon Ltd have a group VAT registration.

Group structure



Notes

1. Baryon Ltd has been a subsidiary since 1994.
2. Kaon Ltd was incorporated by Particle Ltd on 1 May 2001. This company is to be sold – see below.
3. Hadron Ltd, Electron Ltd and Muon Inc were all purchased on 1 August 2008 from three unrelated individual vendors.

The sale of Kaon Ltd

The sale will take place on 31 January 2009. We have received offers from two separate purchasers.

Offer 1 – Sale of shares

We have been offered £650,000 for the whole of the company's share capital.

Offer 2 – Sale of trade and assets of the business

We have been offered £770,000 for the company's trade and assets as follows:

	Offer	Cost	Tax written down value
	£	£	£
Office premises (Atom House)	604,000	490,000?	N/A
Machinery and equipment	46,000	80,000	65,000
Goodwill	120,000	Nil	?
	<u>770,000</u>		

This will leave Kaon Ltd with net current liabilities of £25,000, which it will pay out of the sale proceeds of the business.

Advice required

- (a) Sale of Kaon Ltd – the after tax proceeds in respect of each of the two offers.
- (b) Muon Inc – the possibility of avoiding any VAT problems on the future sale of components by Baryon Ltd to Muon Inc by bringing Muon Inc into the Particle Ltd VAT group with Baryon Ltd.
- (c) Payment of corporation tax – whether the recent corporate acquisitions will change the dates on which the group companies are required to pay corporation tax.

Required:

Prepare the report requested by your manager. The report should include explanations together with supporting calculations. The following marks are available for the three areas of the report.

(i) The sale of Kaon Ltd – after tax proceeds and VAT.

Note: Marks for (i) are allocated as follows: sale of the share capital – 2 marks, sale of the trade and assets of the business – 12 marks. (14 marks)

(ii) Muon Inc – VAT and issues in connection with the loan. (5 marks)

(iii) Payment of corporation tax – payment dates and group payment arrangements. (7 marks)

Appropriateness of the format and presentation of the report and the effectiveness with which the information is communicated. (3 marks)

Note: The following indexation factors should be used.

July 1998 to March 2002	0·071
July 1998 to January 2009	0·288
May 2001 to January 2009	0·187
March 2002 to January 2009	0·203

(29 marks)

Section B – TWO questions ONLY to be attempted

- 3 Ernest intends to sell a capital asset on 1 February 2009 and wishes to maximise his after tax sales proceeds. He is also seeking advice on his inheritance tax position and on his will.

The following information has been obtained from a telephone conversation with Ernest and from client files.

Ernest:

- Is 54 years old and unmarried.
- Lives with Georgina, who is 48 years old, and her adult daughter, Eileen.
- Earns a salary of £130,000 per year.
- Has as yet made no disposals of capital assets in the tax year 2008/09.
- Intends to sell either an oil painting or 7,700 shares in Neutron Ltd on 1 February 2009.

Oil painting:

- Ernest inherited the painting on the death of his uncle on 1 May 2004 when it was worth £23,800.
- Ernest's uncle purchased the painting on 1 July 1990 for £19,500.
- The painting is expected to be worth £47,000 on 1 February 2009.

Shares in Neutron Ltd:

- Qualified for income tax relief under the enterprise investment scheme (EIS) although Ernest did not claim any relief.
- 1 April 2001 Ernest subscribed for 18,600 shares at £8.90 per share.
- 1 March 2003 Ernest received a 1 for 4 bonus issue.
- 1 July 2006 Ernest purchased his full entitlement under a 1 for 10 rights issue at £4.20 per share.
- The shares are expected to be worth £5 each on 1 February 2009.

Neutron Ltd:

- Has an issued share capital of two million £1 ordinary shares.
- Is not quoted on any stock exchange.
- Manufactures and distributes radiation measuring equipment.

Inheritance tax planning and wills:

- Neither Ernest nor Georgina have made any lifetime gifts.
- In his will, Ernest has left the whole of his estate to Georgina.
- In her will, Georgina has left the whole of her estate to Eileen.
- Ernest and Georgina wish to minimise their total inheritance tax liability.
- They are willing to make lifetime gifts to each other but not to Eileen or any other person or organisation.

Current market values of assets owned:

	Ernest £	Georgina £
Family home	620,000	–
Antiques and works of art	400,000	60,000
Investment property	380,000	–
Shares in Neutron Ltd	127,875	–

Required:

- (a) Prepare calculations of the after tax sales proceeds that would be realised on the proposed sale of the painting and on the proposed sale of the shares on 1 February 2009.

Note: you should assume that Ernest will make any necessary beneficial claims or elections. (7 marks)

- (b) Prepare brief notes explaining the inheritance tax liabilities that will arise on the deaths of Ernest and Georgina if no action is taken to reduce such liabilities; identify any actions that could be taken in order to reduce these liabilities and explain the inheritance tax and capital gains tax implications of these actions.

Note: you are not required to prepare calculations for part (b) of this question. (12 marks)

(19 marks)

- 4 James is about to be made redundant by Quark Ltd. He is seeking advice on the taxation of his redundancy payment and on the sale of shares acquired via an approved share incentive plan. He intends to form Proton Ltd, which is expected to be treated as a personal service company, and wants to know how much better or worse off he will be as compared to the job he is about to lose.

The following information has been obtained from a meeting with James.

James – Income, national insurance and capital gains tax position:

- James is paid a salary of £70,000 per year by Quark Ltd.
- He is not contracted out of the State Second Pension.
- He has no income other than that from Quark Ltd and Proton Ltd in the tax year 2008/09.
- He withdrew shares from the Quark Ltd approved share incentive plan on 1 September 2008.
- His disposal of the shares in Quark Ltd is his only disposal for the purposes of capital gains tax in the tax year 2008/09.

Withdrawal and sale of shares from the Quark Ltd approved share incentive plan:

- James has been awarded free shares on 1 June every year since 2004.
- James withdrew all of the shares in the plan on 1 September 2008 and immediately sold them.

Redundancy and future plans:

- Quark Ltd will make James redundant on 31 January 2009.
- The company will make a redundancy payment to James of £38,500.
- In accordance with its usual policy, the company will also pay James £17,500 in lieu of notice.
- James will form a new company, Proton Ltd.

Proton Ltd – Activities:

- Proton Ltd will provide services to Quark Ltd and to other companies.
- The services will be carried out by James personally.
- All of Proton Ltd's income will be in respect of relevant engagements and therefore subject to the personal service company (IR 35) legislation.

Proton Ltd – Estimated income and outgoings for a full year:

	£
Gross fee income	80,000
Salary paid to James	48,000
Administrative expenses	3,000
Travel expenses reimbursed to James	1,500
Dividends paid to James	18,000

Notes:

1. Where applicable, the above amounts are stated excluding value added tax (VAT).
2. The travel expenses are those which will be necessarily incurred by James in performing the work for Quark Ltd and the other customers of Proton Ltd.

Required:

- (a) **Identify the income tax, national insurance contribution and capital gains tax implications, if any, of the withdrawal and subsequent sale of the shares in Quark Ltd, the redundancy payment and the payment in lieu of notice.** (6 marks)
- (b) (i) **Prepare calculations to determine the effect on James's annual income, after deduction of all taxes, of working for Proton Ltd rather than Quark Ltd.** (8 marks)
- (ii) **Calculate the effect on James's annual income, after deduction of all taxes, if the income of Proton Ltd were not regarded as being in respect of relevant engagements.** (2 marks)
- (c) **Give three examples of specific contractual arrangements that would assist in arguing that the relationships between Proton Ltd and its customers do not amount to relevant engagements such that they would no longer be covered by the personal service company (IR 35) legislation.** (3 marks)

(19 marks)

- 5 Boson has been living overseas and is about to return to the UK. He requires advice on his capital gains tax position and on whether to retain an overseas investment property or to sell it and invest the funds in the UK.

The following information has been obtained from telephone conversations with Boson.

Boson's current position:

- He is UK domiciled.
- He had lived in the UK all of his life until he moved to the country of Higgsia on 1 January 2004.
- He sold shares in Meson plc whilst living in Higgsia.
- He purchased a house in Higgsia but retained his principal private residence in the UK.

Boson's future:

- Boson plans to return permanently to his home in the UK on 20 January 2009.
- He has signed an employment contract with Graviton Ltd, which commences on 15 April 2009.
- He is considering selling the house in Higgsia and investing the after tax proceeds in a portfolio of quoted shares in UK companies or, alternatively, retaining the house and renting it out.

Sales of shares in Meson plc:

- Meson plc is a UK resident quoted company.
- Boson inherited 19,500 shares on 1 August 1997 when they were worth £2 each.
- Boson sold 10,000 shares on 1 May 2004 for £11 each.
- Boson sold the remaining shares on 1 November 2008 for £15 each.

House in the country of Higgsia:

- Purchased by Boson on 1 May 2004 for £105,000.
- Could be rented out for £11,000 per year after deduction of allowable expenses.
- Is currently worth and could be sold for £200,000.

The tax system in the country of Higgsia:

- Non-residents of Higgsia are charged income tax at 30% on income arising in the country of Higgsia.
- No capital gains tax.
- No double tax treaty with the UK.

Employment contract with Graviton Ltd:

- Boson will be paid an annual salary of £32,550.

Portfolio of quoted shares:

- The portfolio would be expected to generate annual dividends at the rate of approximately 4.3% of the capital invested.

Required:

- (a) Advise Boson, by reference to his residence and ordinary residence position, as to whether or not the sales of the shares in Meson plc on 1 May 2004 and 1 November 2008 and the possible sale of the house in the country of Higgsia will be subject to capital gains tax. State what he should do in order to ensure that any gains arising are not subject to capital gains tax.

Note: you are not required to prepare calculations for part (a) of this question. (9 marks)

- (b) (i) Calculate Boson's annual rental income after deduction of all taxes in respect of the house in Higgsia. (4 marks)
- (ii) On the assumption that the house in Higgsia is sold for £200,000, with no capital gains tax payable, calculate the annual after tax income generated if the whole amount is invested in the portfolio of quoted shares. (3 marks)
- (iii) Calculate the maximum by which the rate of return on the portfolio of quoted shares could fall before the after tax income generated would cease to exceed the return from renting out the house in Higgsia. (3 marks)

(19 marks)

End of Question Paper