

THE CHARTERED INSTITUTE OF TAXATION

APPLICATION AND PROFESSIONAL SKILLS

Taxation of Owner-Managed Businesses

TIME ALLOWED
3 HOURS 30 MINUTES

- In order to secure a pass in this exam, you will be required to demonstrate competence in each of three skills.

You will be assessed across your answer as a whole for Structure. A pass or fail grade will be awarded.

You will be assessed for competence in a number of broad topics for the following skills:

- Identification and Application
- Relevant Advice and Substantiated Conclusions

For each topic for each of these two skills, a grade will be awarded. The grades for those topics will be weighted and averaged to produce a final grade for each skill of 0, 1, 2, 3 or 4. A grade of 3 or 4 is required to demonstrate competence.

- All workings should be shown and made to the nearest month and pound unless the question specifies otherwise.
- Candidates who answer any law elements in this paper in accordance with Scots law or Northern Ireland law should indicate this where relevant.
- Scots Law candidates may provide answers referring to Land and Buildings Transaction Tax rather than Stamp Duty Land Tax.
- Unless otherwise indicated by the provision of additional information, you may assume that 2019/20 legislation (including rates and allowances) continues to apply for 2020/21 and future years. Candidates answering by reference to more recently enacted legislation or tax cases will not be penalised.
- You must type your answer in the space on the screen as indicated by the Exam4 guidance.

You are a tax senior in a firm of Chartered Tax Advisers reporting to the tax partner, Alice Broom. Alice has recently received a letter (**EXHIBIT A**) from one of her clients, Colin Dust, who is a shareholder in Dust & Flow Products Ltd.

Colin has an idea for a new product that he wants to develop. Whilst Colin believes that this product could be highly profitable, his fellow directors are not keen on the idea. They are however prepared to allow the company to contribute towards the funding of the venture.

Colin has therefore asked Alice for her advice on two possible structures that he has proposed as a basis to develop the new product and with a view to a future business sale.

Alice has asked you to review the letter from Colin and to prepare a draft report for him considering the implications of the two structures proposed and recommending the most appropriate one for the new product.

The following exhibits are provided to assist you:

EXHIBIT A: Letter from Colin Dust to Alice Broom

EXHIBIT B: Income and expenditure forecast

EXHIBIT C: Pre-seen information

Requirement:

Prepare a draft report to Colin Dust considering the implications of the two structures proposed and recommending which one is most appropriate for the new product and any future sale.

Continued

Continuation

EXHIBIT A

Letter from Colin Dust to Alice Broom

Alice Broom
Broom & Broom Chartered Tax Advisers
1, East Street
North Town
NT1 4CD

Colin Dust
2 West Lane
Central Trading Estate
North Town
NT2 3AB

26 October 2020

Dear Alice

I am writing to you regarding an idea I have for a new product that I would like to develop. It is a special pipe for the water industry that will substantially reduce underground water leaks. I think there is great potential for this product, but it will be expensive to develop and does therefore carry some risk.

The company makes excellent profits selling our current range of products and has a healthy bank balance. Unfortunately, my fellow directors are far more risk averse than I am and do not want the pipe to be developed by our company. They are however happy for me to develop the product independently.

I enclose an income and expenditure forecast for the first five years (**EXHIBIT B**), which shows the business will start to make profits in year five. I have arranged an interest only loan secured against my house to provide funds for the project, but I have not been able to raise enough to fully fund it. As I don't want to sell any assets, I will need to raise £100,000 from elsewhere.

Whilst the other directors don't want the company to take on the project, they have agreed that the company can make an interest free loan of £100,000 provided that it receives 25% of any proceeds on sale.

Technical support to develop the product will be critical to its success and therefore I have discussed my idea with Gary Lake, Dust & Flow Products Ltd's Design Director. He would like to be involved providing this will not significantly affect his existing position with the company. My fellow shareholder in Dust & Flow, Edgar, is happy with this and we have therefore agreed that Gary can help me for two days a week.

I have identified the following structures for this project which I think would work from a commercial perspective: can you advise me which would be better?

Develop the product in a partnership

Gary would continue to be employed by Dust & Flow Products Ltd and they would pay his salary. He would work on the project for two days a week and the partnership would be recharged two fifths of his salary.

Dust & Flow Products Ltd would make an interest free loan to the partnership of £100,000 and I would make an interest free loan to the partnership for the balance of money needed to fund the development.

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Continuation

Both Dust & Flow Products Ltd and Gary would be partners. Profits would be shared as follows:

	<u>Income Profits</u>	<u>Capital Profits</u>
Colin Dust	80%	60%
Gary Lake	20%	15%
Dust & Flow Products Ltd	0%	25%

All profits before sale would be distributed. I have agreed with Gary that if the business fails he won't bear any loss. In the event of a sale of the business under this structure, the proceeds after settling all partnership liabilities including the loans would be distributed in line with the above capital profit percentages.

Develop the product in a new company

In this case, Gary would be employed by this company for two days a week and by Dust & Flow Products Ltd for three days a week. Dust & Flow Products Ltd would make an interest free loan to the company of £100,000 and I would make an interest free loan to the company for the balance of the money needed to fund the development. The shares in the company would be held:

	<u>A Shares</u>	<u>B Shares</u>
Colin Dust	60	0
Gary Lake	15	0
Dust & Flow Products Ltd	0	25

All shares rank equally on a sale or winding up, but the B shares would have no voting or dividend rights. Any profits before sale would be extracted by way of dividend. In the event of a sale of the business under this structure we would only consider a share sale with the purchaser settling all company liabilities.

I am very confident that the product will succeed and that the business will be sold for a substantial amount of money although of course, there is always a risk of failure. I think if it succeeds the business could have a sale value of around £5 million in 10 years.

My final thought is whether it would be worth my wife Estelle having any ownership of this business?

I would like to arrange a meeting with you for as soon as possible to advise on the above and to discuss the best structure for this development. In advance of a meeting, it would be extremely useful if you could please prepare a report detailing your advice and recommendations.

I look forward to hearing from you and thank you in advance for your help.

Kind regards

Colin Dust

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EXHIBIT B

Income and expenditure forecast

	<u>Notes</u>	<u>Year 1</u> £	<u>Year 2</u> £	<u>Year 3</u> £	<u>Year 4</u> £	<u>Year 5</u> £
<u>Income</u>						
Sales	1)	Nil	Nil	40,000	110,000	610,000
<u>Expenditure</u>						
Plastic and materials for pipe	2)	(20,000)	(10,000)	(20,000)	(25,000)	(125,000)
Materials for machine	3)	(20,000)	(30,000)	(20,000)	0	0
Sub-Contract Labour	4)	(40,000)	(40,000)	(30,000)	(10,000)	(5,000)
Gary's Pay	5)	(20,000)	(21,000)	(21,000)	(22,000)	(25,000)
Employee Costs	6)	(25,000)	(27,000)	(27,000)	(28,000)	(28,000)
Rent of Warehouse		(12,000)	(12,000)	(12,000)	(15,000)	(15,000)
Other Overhead Costs		(13,000)	(10,000)	(10,000)	(10,000)	(12,000)
<u>Net (Deficit)/Surplus</u>		<u>£(150,000)</u>	<u>£(150,000)</u>	<u>£(100,000)</u>	<u>£0</u>	<u>£400,000</u>

- 1) Sales are expected to commence at the beginning of year three on a small scale but it will not be until the end of year four when it is clear whether or not the business will succeed. I hope however that it will be a success although minor teething problems are expected and there will be continuing testing/development in future periods.
- 2) The costs represent the raw materials for production of the pipe. It is assumed that the costs in years one and two will be for development purposes which will not generate any saleable stock. In years three to five it is assumed this is the cost of the goods sold.
- 3) These represent the cost of building a machine to mass produce the pipe.
- 4) A specialist consultant will be required to help with the design of the pipe.
- 5) This represents the amount payable for Gary's services.
- 6) I will also need to recruit an admin assistant and this cost figure includes all associated liabilities.

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EXHIBIT C

Pre-seen information

Client Name

Colin Dust

Client Background

Colin was born on 20 July 1969. He is married to Estelle who was born on 30 July 1966. Both are UK resident and domiciled and are not Scottish taxpayers.

They have no children.

Other than their shareholdings in Dust & Flow Products Ltd (see below), their only other assets are their private residence, valued at £500,000 and a holiday home in Portugal valued at £350,000. The holiday home in Portugal was purchased for £340,000 in November 2019. Both properties are mortgage free and have no borrowings against them and are owned jointly.

Colin's only sources of income is from Dust & Flow Products Ltd. Estelle has income of £20,000 per annum from a property portfolio which is jointly held with her brother.

Dust & Flow Products Ltd

Dust & Flow Products Ltd is registered in England & Wales and was incorporated on 25 May 1995. The company commenced trading on 1 June 1995 and makes up its accounts to 31 May each year. No previous business was acquired.

The company is engaged in the manufacture and sale of products to the water industry.

The £1 ordinary shares in the company, which were subscribed for on incorporation, are held as follows:

Colin Dust	375
Estelle Dust	125
Edgar Flow	250
Sally Flow (Edgar's wife)	<u>250</u>
	<u>1,000</u>

The company has three directors: Colin Dust, Edgar Flow and Gary Lake (who is not a shareholder).

Dust & Flow Products Ltd Balance Sheet as at 31 May 2020

	£
Freehold property	240,150
Plant and Machinery	95,120
Cash at Bank	145,260
Stock	83,050
Debtors	75,400
Creditors	<u>(230,220)</u>
Net Assets	<u>£408,760</u>

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Continuation

Represented by:

Share Capital – Ordinary £1 shares	1,000
Profit & Loss b/fwd	303,220
Retained profit for the year	<u>104,540</u>
Net Assets	<u>£408,760</u>

The retained profit for the year is after payment of:

- 1) A salary of £75,000 for Gary, and salaries of £8,000 to each of Colin, Edgar and Sally.
- 2) Total dividends paid of £112,000 on 31 March 2020.

The company is registered for VAT with registration number 123 4567 89. The company was registered for VAT on 1 June 1995 and all company supplies are standard rated. No option to tax has been made.