

# THE CHARTERED INSTITUTE OF TAXATION

## APPLICATION AND PROFESSIONAL SKILLS

### Taxation of Owner-Managed Businesses

**May 2026**

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TIME ALLOWED

3 HOURS 30 MINUTES

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- 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 required by the question, candidates may answer the question using Scottish Income Tax rates or Income Tax rates applying elsewhere in the UK.
- Unless otherwise indicated by the provision of additional information in the question, you may assume that 2025/26 legislation (including rates and allowances) continues to apply for 2026/27 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 manager at Morgan & Mitchell, a firm of Chartered Accountants and Tax Advisers. You have been assigned to work with one of the partners, Charlotte Mitchell, to provide advice to a long-standing client.

James Blackwood is a VAT-registered sole trader. His business, Blackwood Trading, is about to undergo a significant expansion requiring new equipment and larger premises. A recent meeting with Charlotte concluded with James making the decision to incorporate the business as Blackwood Trading Ltd.

The meeting focused on the long-term tax advantages of incorporating the business, given James's objectives. However, a number of decisions still need to be made, including the Capital Gains Tax issues on the incorporation and potential reliefs, the timing of some key capital expenditure, and how to bring James' daughter Danielle into the business to provide her with some income.

It was agreed that Charlotte would send a follow up report to James covering these issues.

The following exhibits are provided to assist you:

**EXHIBIT A:** Notes of a meeting between Charlotte Mitchell and James Blackwood

**EXHIBIT B:** Charlotte's illustrative calculations

**EXHIBIT C:** Email from James Blackwood to Charlotte Mitchell

**EXHIBIT D:** Pre-seen information

**Requirement:**

**Prepare a report for Charlotte to send to James, making recommendations on the most suitable incorporation method and how best to meet James' objectives for the business going forward.**

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## **EXHIBIT A**

### Notes of the meeting between Charlotte Mitchell and James Blackwood

Meeting date: 18 April 2026

Present: Charlotte Mitchell (Tax Partner), James Blackwood (owner, Blackwood Trading)

Subject: Discussion about forthcoming expansion and proposed incorporation of the sole trade

Charlotte arranged the meeting following a call from James. In recent years, Blackwood Trading has enjoyed steady profits of between £80,000 and £90,000. Due to winning two new contracts, this will significantly increase from May 2027. This will require additional machinery and additional workshop space.

#### Proposed incorporation

James believes the profits for the first 12 months after commencing the new work will be at least £180,000, even after financing costs for the new machinery are factored in. Beyond that, they are likely to continue to increase.

James does not require all of this income. Charlotte explained that in such circumstances, using a limited company as the trading vehicle would allow him to benefit from lower Corporation Tax rates and restrict the Income Tax and National Insurance payable to the income he takes from the company. James would aim to keep his total income below £100,000 in order to avoid the withdrawal of his Personal Allowance. This would give him enough after-tax income to meet his needs.

Charlotte covered a number of options for the undrawn profits; but James was most interested in using some of them to provide his daughter Danielle with a modest income.

Charlotte also explained that incorporating will lead to a chargeable disposal for Capital Gains Tax purposes. This would be calculated based on the assets' current market values. Based on the current working valuation, the chargeable gain will be approximately £335,000, with £40,000 of this attributable to the business premises.

#### Illustrative savings

To highlight the potential savings from the incorporation, and adopting a strategy in line with the above, Charlotte shared some calculations, comparing a sole trader with the forecast profits, a company with James as the sole director and shareholder where all profits are extracted as dividends, and a company where the extraction is restricted to £100,000 to avoid the loss of James' Personal Allowance.

#### Decision

James agreed that incorporating the business makes sense and asked if this should be done immediately. Charlotte advised that James should wait until the end of the 2026/27 tax year, as at the current profit levels it is more efficient to be taxed as a sole trader. The actual date should be after 31 March 2027, but before the date that the new contracts commence. Charlotte suggested that, unless there are reasons not to do so, it makes sense that the incorporation should be on 1 April 2027 to coincide with the end of the accounting period.

#### Method of incorporating

James asked how the incorporation actually happens. Charlotte said that there are a couple of ways to transfer the business to the company but is to provide more detail in a follow up report, subject to any further questions from James.

#### Closing

The meeting ended with the conclusion that James is committed to incorporating the business and, barring any benefits being identified for an alternative date, it should be from 1 April 2027. However, Charlotte stressed that James should consider anything that might mean this is revised. James will do this and email Charlotte with any further information and/or questions, and a follow up report will be prepared.

Continued

**EXHIBIT B****Charlotte's illustrative calculations****Sole trader**

	£
Taxable Profits	180,000
Personal Allowance	<u>-</u>
Taxable income	<u>180,000</u>

**Income Tax and Class 4 National Insurance**

Income Tax	67,203
Class 4 National Insurance	<u>4,856</u>
Total	<u>72,059</u>

Retained amount	<u>107,941</u>
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**Company 100% extracted**

	£
Taxable Profits	180,000
Corporation Tax	<u>(43,950)</u>
After-tax profit	<u>136,050</u>

**James' personal position**

Salary	0
Dividend income	<u>136,050</u>
Total income	136,050
Personal Allowance	<u>0</u>
Taxable income	<u>136,050</u>

Tax on dividends	37,059
Corporation Tax	<u>43,950</u>
Total tax	<u>81,009</u>

Retained amount	<u>98,991</u>
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**Company restricted extraction**

	£
Taxable Profits	180,000
James' salary	(12,570)
Employer's Class 1 National Insurance	(1,136)
PCTCT	<u>166,294</u>

Corporation Tax	<u>(40,317)</u>
After-tax profit	<u>125,977</u>

**James' tax**

	£
Salary	12,570
Dividend income	<u>87,430</u>
Total income	100,000
Personal Allowance	<u>(12,570)</u>
Taxable income	<u>87,430</u>

Tax on dividends	20,038
Corporation Tax	<u>40,317</u>
Total tax	<u>60,355</u>

Retained by James	79,962
Retained by company	<u>38,547</u>
Overall retained	<u>118,509</u>

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## EXHIBIT C

### Email from James Blackwood to Charlotte Mitchell

From: James@blackwoodparts.co.uk  
To: Charlotte@MorganMitchell.co.uk  
Date: 23 April 2026

Hi Charlotte

Thanks again for your time last week. I'm glad we were able to come to a firm decision to incorporate from next tax year.

I know you are going to send me a follow up report about the mechanics and tax considerations of this and wanted me to contact you with any other information or queries before you do this. A couple of things did come to mind over the last few days that might be relevant.

#### Business premises (ownership)

I have started to think about Inheritance Tax. While I don't want to do anything just yet, I have it in mind that I could make a gift of the business premises to Danielle at some point in the future. We don't need to discuss this in detail now, but I have decided that this would be easier if I keep the building outside the company as I won't have to extract the property again later on.

#### Business premises (expansion)

I mentioned briefly last week that the new contracts will require increased capacity. I need to buy two new machines that won't fit into the existing workshop. I've had a quote for extending the current workshop to allow enough floor space. Work is due to start next week, and will be completed in six months, in plenty of time for the new contracts' commencement next May.

#### New machines

Initially, the plan was to wait until just before the new contracts start in May to have the new machines delivered, in part to push back the cash outflow. However, would there be any issues if I purchase them immediately after the extension work is complete i.e. in October or November this year, before the incorporation? My thinking is that we may be able to attract new contracts if we have the capacity already in place, but I should stress that this is very unlikely, so I wouldn't want to do it if it would cause problems. Your guidance here would be greatly appreciated. The machines will cost £150,000 and £200,000 respectively and will be partly financed by a loan (agreement in principle already given).

The balance will be paid by me personally from accumulated savings. This will deplete my savings almost completely, but I am unable to convince the bank to increase the agreed amount. I am not overly concerned, as I can build up my savings again over the next few years, but in the meantime, I obviously want to avoid any unexpected large outgoings.

#### Danielle's role in the business

When we spoke about different uses for the undrawn profits from Blackwood Trading Ltd going forward, one thing you mentioned was using some to provide an income for Danielle. I would like to do this, as she is currently at university and I am paying her rent, book costs, etc, out of post-tax income, as I am keen for her not to need to work while studying.

Danielle has indicated that she wants to become more involved with the business after graduating, but for now would be happy to help out over the summer and other holidays. She is studying accountancy, so I thought she could help with the bookkeeping and similar tasks in those months. I would also like to bring her to some client meetings, and networking events as she becomes more familiar with things. In the medium term, I would like to put her in charge of the financial side of the business but also attend networking events, business fairs, etc to help attract new clients.

Ideally, if we could find a way to get her around £10,000-£12,000 each year, I think I can justify the amount with the work I can get her to do.

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Continuation

I would strongly prefer not to give up any voting rights at the moment. However, I believe dividends are more tax-efficient? If there is a potential saving, we should have a further discussion. What do you recommend?

I know there will be some housekeeping, e.g. auto-enrolment, registering as an employer or filing forms with Companies House whatever option we go with, but please just focus on the tax/NI for now – we can think about the administrative matters later on.

That's all that came to mind, but please do cover anything I've missed.

Best wishes

James

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**EXHIBIT D**Pre-seen informationClient profile

James Blackwood is 48 and UK resident. He lives in North West England. His wife died in March 2021. James has been trading as Blackwood Trading since 2014, when he bought a machine to manufacture components, which are then used in appliances. Initially he ran this in his spare time but in March 2022, he purchased a second machine and it became a full-time activity. Since then, it has produced steady profits of between £80,000 and £90,000 per annum. He makes up his accounts to 31 March each year and elects for the accruals basis of accounting. James owns the trading premises, and there are no outstanding loans secured on it.

The results for the most recent three tax years, and the Income Tax and National Insurance paid are as follows:

<u>Tax year</u>	<u>Profit reported on tax return</u>	<u>Income Tax and Class 4 National Insurance paid</u>
	£	£
2025/26	87,254	25,334
2024/25	89,770	26,392
2023/24	83,098	24,720

The profit for the current year is expected to increase to approximately £90,000.

The business has no employees and was registered for VAT (number 9871234560) from 1 April 2017. James has no brought forward trading or capital losses and has made no previous capital disposals or transfers.

James has a daughter Danielle aged 19. She has just finished the first year of a four-year accountancy course at university and has no income of her own.

Capital Allowances information

There are a number of items of plant and machinery, various tools, a computer and fixtures. The Tax Written Down Values at 5 April 2026 were as follows:

- 1) Main pool – £68,880
- 2) Special rate pool – £27,260

There are no single asset pools.

Estimated value of business assets at 31 March 2027

<u>Description</u>	<u>Market value</u>	<u>Cost</u>
	£	£
Business premises	320,000	280,000
Goodwill	295,000	Nil
Machinery	* 92,000	200,000
Current assets (cash, debtors, etc)	5,000	
Liabilities (loans & trade creditors)	** (252,000)	
Value	460,000	

\* Capital Allowances have been claimed.

\*\* loans are unsecured and were used to purchase machinery, equipment and for working capital.