The Chartered Tax Adviser Examination

May 2018

Taxation of Owner-Managed Businesses

Advisory Paper

TIME ALLOWED – 3 ¼ HOURS

- The first 15 minutes is designated as reading time. During this time you may read your question paper and legislation, annotate your question paper and use your calculator. You are not permitted to write in the answer booklet. The Presiding Officer will inform you when you can start writing.
- You should answer all **SIX** questions.
- Start each answer on a fresh page and do not write in the margins.
- All workings should be shown and made to the nearest month and pound unless the question specifies otherwise.
- Marks are specifically allocated for presentation.
- Candidates who answer any law elements in this paper in accordance with Scots law or Northern Ireland law should tick the appropriate box on the front of each answer booklet.
- Unless otherwise indicated by the provision of additional table information, you may assume that 2017/18 rates and allowances continue to apply for 2018/19 and future years. Candidates referring to actual or pending rates and allowances for 2018/19 and future years will not be penalised.

1. John, Becky and Aiden are the partners in KCS LLP, a long-established and very successful trading partnership specialising in the provision of web design services. John will be retiring from the partnership on 30 June 2018.

Both income and capital profits have always been allocated 50% to John and 25% to each of Becky and Aiden. All three partners have been members of the partnership since it was formed in 2005. Once John retires from the partnership, income and capital profits will be shared equally between Becky and Aiden.

The balance sheet of KCS LLP at 31 March 2018 is shown below:

	£	£	£
Fixed assets			
Land and buildings			260,000
Goodwill			100,000
Listed investments			150,000
			510,000
Current assets			
Debtors		300,000	
Stock		50,000	
Cash		225,000	575,000
			1,085,000
Current liabilities			
Creditors		(20,000)	
Accruals		(25,000)	(45,000)
Net assets			£1,040,000

Capital accounts	Capital	Current	Total
John	125,000	395,000	520,000
Becky	62,500	197,500	260,000
Aiden	62,500	197,500	260,000
	£250,000	£790,000	£1,040,000

All assets are shown in the balance sheet at their original cost, except for the goodwill, which originally cost £65,000 but was revalued to its market value of £100,000 at 31 March 2018.

The land and buildings owned by the partnership consists of the office from which the business trades and which has a current market value of £500,000. The investments have a market value of £130,000.

On his retirement, John will become the sole owner of the office and will also withdraw any amounts remaining on his capital and current accounts. He will then rent the office back to the partnership.

Aiden also has a small sole-trade business repairing and selling racing bikes. In November 2017 he acquired a small warehouse unit for £100,000 to hold his stock. Neither John nor Becky has any other business interests.

None of the partners have made any significant capital disposals in the past, however Becky has capital losses of £7,500 carried forward at 5 April 2018.

All of the partners will be higher rate taxpayers in 2018/19 and none will make any other disposals in the tax year. The partners are not connected outside the partnership.

Continued

1. Continuation

You are required to:

1) Explain the Capital Gains Tax implications of John's retirement, assuming that all beneficial claims are made. (16)

2) Explain the effect of retiring from the partnership on John's Inheritance Tax position. Calculations are NOT required. (4)

Total (20)

2. Mr and Mrs Edwards are long-standing clients of your firm. They each own 50% of the shares in Warrington Wholesalers Ltd, which operates a number of 'trade-only' cash and carry warehouses in the North West of England.

Mr and Mrs Edwards have also recently acquired the entire issued share capital of Quik-Stores Ltd, which owns a retail convenience store, from a third party. Again, they each own 50% of the shares.

Both companies have a 30 June year end.

As the two businesses operate in a similar geographical area, Mr and Mrs Edwards would like to merge the retail business into Warrington Wholesalers Ltd on 30 June 2018 and will therefore transfer the trade and certain trading assets of Quik-Stores Ltd into Warrington Wholesalers Ltd. The building will be transferred at its market value and other assets will be transferred at their net book value. The relevant values are set out below:

	Net book value	Market value	Cost
	£	£	£
Land and buildings	150,000	300,000	200,000
Plant and machinery	30,000	25,000	60,000
Stock	25,000	40,000	25,000

The tax written down value of the plant and machinery at 30 June 2018 will be £45,000. Indexation on the cost of the building to 30 June 2018 will be £50,000.

The expected debtors of £20,000, bank overdraft of £40,000 and other creditors of £365,000 of Quik-Stores Ltd will not be transferred to Warrington Wholesalers Ltd.

Quik-Stores Ltd was previously a profitable business, but has incurred losses in the years ended 30 June 2017 and 30 June 2018 (forecast). Trading losses carried forward at 30 June 2018 are therefore expected to be £75,000.

Quik-Stores Ltd will also have capital losses at 30 June 2018 of £60,000, prior to the transfer.

Mr Edwards is also considering the future direction of the acquired Quik-Stores location, and may convert this into a cash and carry in future, in order to align it with the rest of the business.

Your partner has had a preliminary discussion with Mr and Mrs Edwards and agreed to send them a memo explaining the tax implications of the above proposed merger of the businesses. You have been asked to prepare paragraphs for this memo dealing with the Corporation Tax treatment of the proposals.

You are required to draft paragraphs for inclusion in a memo to Mr and Mrs Edwards, explaining the Corporation Tax treatment of the above proposals for both Warrington Wholesalers Ltd and Quik-Stores Ltd. (15)

3. You are a tax manager working for a firm of Chartered Accountants. Your firm acts for a Prospect Developments Ltd, a house builder, and its shareholders. The partner responsible for the client is Joe Mills. The company and its shareholders are all UK resident.

The Managing Director and major shareholder, Steve Bishop (age 65), recently suffered a stroke. He is recovering, but is unable to carry out all of his former duties and has decided to retire from the company. In the past Steve has been the main driving force behind the company while his wife has concentrated on administration. His children are in their twenties and are keen to take over the business.

Steve acquired his shares on formation of the company in October 2006. The shares in the company are held as follows:

	£1 Ord
Steve Bishop	45
Laura Bishop (Steve's wife)	15
Michael Bishop (their son)	20
Leia Bishop (their daughter)	20
	100

The company's balance sheet at 31 October 2017 was as follows:

	£	£
Fixed assets		
Leasehold property (the company's premises)		200,000
Plant & machinery at net book value		150,000
Investment rental property		700,000
		1,050,000
Current assets		
Stock and work in progress	350,000	
Trade debtors	200,000	
Cash at bank	350,000	
Director's loan account (Steve)	100,000	
S.455 tax paid (Steve's loan)	25,000	1,025,000
		2,075,000
Current liabilities		
Trade creditors	325,000	
Bank overdraft	125,000	
Corporation Tax	60,000	(510,000)
Net current assets		1,565,000
Amounts falling due after more than one year (bank loan)		(550,000)
Net assets less liabilities		£1,015,000
Capital and reserves		
Called up share capital		100
Profit and loss account		1,014,900
Shareholders' funds		£1,015,000

Continued

3. Continuation

The company's Total Taxable Profit consisted of £255,000 trading profit and £45,000 profit from a UK property business.

Steve has discussed his withdrawal from the business with Joe Mills. He proposes that the company purchase his shares for £500,000, which is considered to be an arm's length price. The company does not have the cash available to purchase all Steve's shares so it has been suggested that the company buy back half his shares now for £250,000, which will be paid in cash on completion of the buy-back. Steve is a higher rate taxpayer.

Given Steve's knowledge of the business he would like to remain as a director or consultant to the company and the intention is that after six months the company will purchase the remaining half of his shares under a separate contract for £250,000. If necessary, funds would be raised by selling the investment property.

The conditions for Entrepreneurs' Relief to be available are met but Joe is uncertain as to whether capital treatment would be available. Steve is quite flexible over the timing of his retirement and the sale of his shares and would like your firm's suggestions as to what steps would be required to achieve the optimum tax treatment.

Steve could repay his director's loan as soon as he receives the cash for his shares but has asked whether he would be better to do that or whether it would be preferable for the company to formally write-off the loan and for him to accept £400,000 for his shares.

You are required to write a memo to Joe Mills advising on the tax implications of Steve's proposals and on optimising the tax position for Steve and the company.

(15)

4. You are a tax senior at a firm of Chartered Tax Advisers. Your client, Marlowe Ltd, builds refrigerated cabinets for the catering trade. It started trading in 2001, operating from commercial premises ("Red Site"). It transferred some operations to a new industrial unit ("Yellow Site") in 2014. However, to rationalise the business it was decided to sell Red Site and transfer its remaining operations to Yellow Site. Marlowe Ltd's accounting date is 31 December.

Red Site was sold on 1 June 2017 for £750,000, which is apportioned as follows in a schedule to the sale and purchase agreement:

	£
Building (including fixtures)	680,000
Plant	70,000
Total	£750,000

This apportionment is considered to be just and reasonable.

An election under s.198 CAA 2001 was made jointly with the purchaser of Red Site, as follows:

	£
Heating system	30,000
Electrical system and lighting	25,000
Built-in storage cupboards, racking and worktops	20,000
Security alarm system	15,000
Lift and installation costs	100,000
Sprinkler system	30,000
Sanitary ware - toilets, washbasins etc.	15,000
Total	£235,000

The sale and purchase agreement includes a commitment that Marlowe Ltd will pool any un-pooled expenditure on fixtures in its Corporation Tax computations for the year to 31 December 2017. A capital allowances specialist has identified further costs incurred in 2012 of £40,000 in respect of building work required for the lift installation, which was capitalised within land and buildings.

The additions and disposals of fixed assets in the year ended 31 December 2017 in addition to the above are as follows:

	Additions	Disposal proceeds
	£	£
Red Site:		
Central heating	35,000	
Yellow Site:		
Floodlights and supports	12,000	
Thermal insulation	25,000	
Fire doors	10,000	
Fire extinguishers and blankets	8,000	
Hoist	50,000	
Building alterations re installation of hoist	5,000	
Fixed mezzanine storage platform	27,000	
Air conditioning	90,000	
General:		
Ford transit vans x 2	40,000	
Nissan Leaf electric cars x 2	35,000	
Mercedes E350 (CO_2 emissions 144g/km)	45,000	
BMW M4 (CO_2 emissions 195g/km)		20,000
BMW 525d (CO_2 emissions 129g/km)		9,000
Totals	£382,000	£29,000

Continued

4. Continuation

The payment for the air conditioning at Yellow Site was staged with £15,000 payable on the signing of the contract (1 October 2017) and the balance payable in 10 equal instalments of £7,500 on the first day of each following month.

The historical cost of all assets sold was greater than the values achieved on disposal.

The company's capital allowances computation for the year ended 31 December 2016 showed the following qualifying expenditure carried forward:

	£
Main rate pool	250,000
Special rate pool	200,000

You are required to prepare a capital allowances computation, with appropriate explanations, for Marlowe Ltd for the year ended 31 December 2017. (20)

5. Allegra Garuti is a client of your accountancy practice. She has been running “Hi-Fash”, a small fashion import business, as a sole trader since 1 March 2013. She ceased to trade on 30 June 2017 when she commenced employment as a senior buyer for a large retail company. Her total taxable salary and employment benefits for 2017/18 was £130,000.

The tax adjusted profits for Hi-Fash since inception have been:

	£
1 March 2013 to 30 April 2014	14,000
1 May 2014 to 30 April 2015	30,000
1 May 2015 to 30 April 2016	32,000

The profit and loss account for the 14 month period to 30 June 2017 is:

	£	£
Turnover		118,400
Opening stock	18,000	
Purchases	56,000	
Closing stock	(9,000)	
Cost of sales		(65,000)
Gross profit		53,400
Salaries and statutory redundancy costs	35,500	
Light and heat	5,500	
Staff party	1,500	
Client entertaining	500	
Depreciation	1,000	
Legal fees	3,500	
Other allowable business expenses	10,000	
		(57,500)
Trading loss		£(4,100)

Legal fees were incurred on the sale of the business premises.

The staff party expenditure related to an event attended by Allegra and her two office managers to mark the closure of the business.

In September 2016, Allegra attended her sister’s wedding and took a dress from the stock of Hi-Fash. The original cost was £750 and the retail value was £1,600.

At 1 May 2016 the tax written down value of the business assets was:

Assets	Tax written down value
	£
Fixtures and fittings	2,000
Van	nil

Business use of the van was 80% and the market value at 30 June 2017 was £2,500. The vehicle was retained by Allegra.

Continued

5. Continuation

Allegra disposed of the remaining assets of her business as a going concern on 21 July 2017 to an unconnected third party at open market value. The original cost and sale consideration for each asset was as follows

	Cost	Sale proceeds
	£	£
Goodwill	30,000	10,000
Freehold premises	260,000	413,500
Loose plant and equipment	18,000	3,000
Stock	9,000	11,000

Allegra also made capital gains on the sale of quoted shares in the year totalling £7,600.

You are required to:

1) **Calculate, with appropriate explanations, the tax adjusted profits or losses for the period to 30 June 2017 and state the basis periods and profits of the business from inception.** (11)

2) **Calculate Allegra Garuti's Income Tax and Capital Gains Tax liability for 2017/18.** (4)

Total (15)

6. You are a tax senior in a firm of Chartered Tax Advisers. A new client, Frans Ltd, which is a large privately owned company, has asked your firm to assist with the preparation of the company's P11Ds for 2017/18. Your initial review has identified the following benefits, which have been provided by the company. All salary sacrifice arrangements are negotiated annually and commence from 6 April.

   1) A mobile phone is provided to all senior employees. Two of the directors are provided with a second mobile phone for the use of their spouses. More junior staff are offered a mobile phone in exchange for a salary sacrifice of £25 per month. The phone packages provided with each phone would cost £35 per month if purchased direct from the provider, however the company has negotiated a charge of £20 per month.

   2) The company pays for private medical insurance for senior employees. As businesses have been acquired in the past, there are still a variety of mechanisms by which this benefit is provided. In most cases the company arranges and pays the premiums direct. In some circumstances the cover is arranged by the employee but Frans Ltd pays the premiums direct to the provider and in other cases the company simply reimburses the premiums of insurances arranged by the employees.

   3) All managers and directors are provided with a company car through a car ownership scheme. Frans Ltd contracts with a large dealership and is able to negotiate a substantial discount on leased vehicles. These individuals must make a contribution for the private use of the car and so employees are required to make a payment from their net pay equivalent to the full vehicle costs. As such there is no net cost to the company.

   4) All staff who use their own vehicles on company business are reimbursed at 20p per mile for business mileage.

   5) Loans of up to £6,000 are offered to all employees exclusively for the purchase of railway season tickets. The loans are reimbursed by the employees through a monthly deduction from net pay.

   6) The only other loan is a sum of £15,000 lent to the finance director of the company on 30 January 2017, to cover the Income Tax and employee NIC arising when she acquired shares in Frans Ltd under an Enterprise Management Incentive scheme. She did not receive a season ticket loan.

   7) At Christmas, the company provided all employees with a non-cash voucher to the value of £250. The company has agreed a PAYE Settlement Arrangement in respect of this benefit with HM Revenue & Customs.

   8) In June 2017 the company sent a bouquet of flowers costing £35 to one of their employees on the birth of her baby. In September 2017 a box of wine at a cost of £100 was given to each of the three members of the company's finance team on the successful passing of their professional exams.

Continued

6. Continuation

Frans Ltd would like advice on the possibility of payrolling some or all of the above benefits in kind.

You are required to write a briefing note for your manager explaining:

1) **The reporting obligations and National Insurance implications of the above for the company.** (12)

2) **The operation and implications of payrolling of the above benefits.** (3)

Total (15)