



Chartered  
Institute of  
Taxation  
Excellence in Taxation

# **The Chartered Tax Adviser Examination**

November 2017

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## **Taxation of Owner-Managed Businesses**

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Advisory Paper

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Suggested Solutions

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## Question 1

### 1) Profit allocations

#### *Profit adjustment*

	£	Notes
Net profit	153,000	Per accounts
Tax adjustments:		
Maintenance – capital expenditure	6,000	New shed is a capital asset
Vehicle expenses – high emission lease restriction	0	The vehicle is a van, so the high emission lease restriction does not apply
<i>Legal &amp; professional fees:</i>		
Creation of pension scheme	2,750	Capital expenditure (brings an asset into existence)
Purchase of farm land	5,000	Capital expenditure
Planning permission application	4,000	Capital expenditure (abortive expenditure)
Provision for possible future legal fees	5,000	General provision, not UK GAAP compliant
Profit on sale of assets	(2,500)	Accounting adjustment
Depreciation – other fixed assets	22,000	Capital cost. Depreciation on finance lease allowed
Capital allowances - WDA	<u>(25,000)</u>	See below
Adjusted taxable profit – CT	170,250	s.1259 CTA 2009
Income tax only adjustments:		
Private use of car	1,500	Private use adjustment applies only to IT partner, as companies cannot have private use of assets
Adjusted taxable profit - IT	<u><u>171,750</u></u>	s.849 ITTOIA 2005

#### *Capital allowances*

	£
TWDV b/f	60,889
Additions	95,000
Disposals	<u>(17,000)</u>
	138,889
WDA at 18% (see note)	<u>(25,000)</u>
TWDV c/f	<u><u>113,889</u></u>

Note: no AIA available due to corporate partner (s.38A(3)(b) CAA 2001)

*Partnership allocations*

	Alex (IT)	Barlow Ltd (CT)	Note
Interest on capital		40,000	From question
Adjusted taxable profit (50%)	65,875	65,125	1
	<u>65,875</u>	<u>105,125</u>	
Reallocation under mixed partnership rules	85,125	(85,125)	2
Profit allocation	<u>151,000</u>	<u>20,000</u>	

Notes:

1 -	Income tax	Corporation tax
Adjusted taxable profit (above)	171,750	170,250
Interest allocated to corporate partner	<u>(40,000)</u>	<u>(40,000)</u>
Remaining profit	131,750	130,250
50% share	<u>65,875</u>	<u>65,125</u>

s.850 ITTOIA 2005    s.1262 CTA 2009

2 - s.850C ITTOIA 2005 applies where an individual and a corporate partner are both allocated a profit for the year and:

- the corporate partner's profit share exceeds the "appropriate notional profit";
- the individual has the power to enjoy the corporate partner's profit share; and
- it is reasonable to suppose that some or all of the corporate partner's profit share is attributable to the individual's power to enjoy and the individual's profit share and tax liability are lower than they otherwise would be.

The appropriate notional profit of Barlow Ltd therefore includes the "appropriate notional return on capital" (interest at a commercial rate on capital) and the "appropriate notional consideration for services" (none).

The partnership capital is unsecured and therefore the 10% interest rate available on similar loans is appropriate to use. This results in an appropriate notional return on capital of £20,000. Barlow's allocation of £105,125 clearly exceeds this.

Alex is connected with Barlow Ltd, as it is owned by him and his family, and therefore has the power to enjoy Barlow Ltd's profit share. Therefore it is possible that profits could have been over-allocated to Barlow Ltd in order to reduce Alex's tax liability.

Therefore, Alex is allocated the profit which has been over-allocated to Barlow Ltd, for tax purposes. This results in an adjustment towards Alex of £85,125.

## 2) Alex – 2016/17

	£	Notes
Income:		
Farming profits (current year basis)	151,000	As above
Personal allowance	Nil	Reduced to nil due to level of income
Taxable income	<u>151,000</u>	
Income tax:		
32,000 at 20%	6,400	
118,000 at 40%	47,200	
1,000 at 45%	450	
Total income tax	<u>54,050</u>	
Class 4 NIC:		
34,940 at 9%	3,144	
108,000 at 2%	2,160	
Total Class 4 NIC	<u>5,304</u>	
Class 2 NIC:		
£2.80 x 52 weeks	<u>146</u>	
Total due for 2016/17	59,500	
Less: POA	<u>(55,000)</u>	
Balancing payment due	4,500	
First 2017/18 POA due	29,677	50% of income tax + C4 NIC due before POA
Total due 31 January 2018	<u>34,177</u>	

## 3) Barlow Ltd - Year ended 31 December 2016

Where the partnership's notional accounting period (treating the partnership as a company) differs from that of a corporate partner, the share of the profit or loss for the notional accounting period is apportioned between the accounting periods of the company which fall within that period, normally on a time basis (s.52 CTA 2009).

The partnership's notional accounting periods are each year ended 31 March (not the tax years).

Therefore, the year ended 31 December 2016 comprises three months of the year ended 31 March 2016 and nine months of year ended 31 March 2017.

$$3/12 \times £87,250 + 9/12 \times £20,000 = £36,812$$

## MARKING GUIDE

TOPIC	MARKS
<b>Part 1 – Profit allocation</b>	
Maintenance – adjustment	0.5
Maintenance – explanation	0.5
Vehicles – explanation	0.5
Pension – adjustment	0.5
Pension – explanation	0.5
Farmland purchase – adjustment	0.5
Farmland purchase – explanation	0.5
Planning permission – adjustment	0.5
Planning permission – explanation	0.5
General provision – adjustment	0.5
General provision – explanation	0.5
Profit on sale – adjustment	0.5
Depreciation – adjustment	0.5
Depreciation – explanation	1
Car adjustment for income tax	0.5
Capital allowances – additions and disposals	0.5
Capital allowances – application of rates	0.5
Capital allowances – deduction from profit	0.5
Interest on capital – inclusion in profit allocation	0.5
Division of remainder of profit – income tax	1
Division of remainder of profit – corporation tax	1
Mixed partnership rules – outline of legislation applying	1
Mixed partnership rules – calculation of “appropriate notional profit”	0.5
Mixed partnership rules – reallocation from Barlow Ltd to Alex	0.5
<b>Part 2 - Alex</b>	
Personal allowance restriction (with explanation)	0.5
Income tax rates and thresholds	1.5
Class 4 NIC rates and thresholds	1
Class 2 NIC	0.5
Payments on account	0.5
2017/18 payment on account	1
<b>Part 3 – Barlow Ltd</b>	
Explanation	0.5
Calculation	0.5
<b>TOTAL</b>	<b>20</b>

## Question 2

### SpillClean Ltd Year ended 31 March 2017 Capital Allowances computation

	Note	Main pool	Special rate pool	100% FYA	Non-qualifying
TWDV b/f at 1 April 2016		80,000	250,000		
Additions:					
<b>Fixtures and fittings</b>					
Purchase of building	1				499,998
SDLT	2				14,500
Legal fees	3				7,500
Replacement of roof	4				25,000
Formation of corridors etc.	5				85,000
Solar panels	6		30,000		
Plumbing/electrical systems	7		6,500		
Boiler	8			10,000	
Painting etc.	9				3,000
Site management etc.	10		214	59	3,727
s.198 allocation	11	1	1		
<b>Plant and machinery</b>					
Blow moulding machine	12	40,000			
Granulator	13	40,000			
Moulds	14	9,000			
Assembly line	15	60,000			
<b>Motor vehicles</b>					
BMW 320i	16		30,000		
Porsche	17			65,000	
		<u>229,001</u>	<u>316,715</u>	<u>75,059</u>	<u>638,725</u>
					Total allowances
100 % FYA				(75,059)	75,059
18% WDA		(41,220)			41,220
8% WDA			(25,337)		25,337
		<u>187,781</u>	<u>291,378</u>	<u>-</u>	<u>141,616</u>
TWDV c/f					

**Notes:**

- 1) Not qualifying – expenditure on buildings (s.21 CAA 2001)
- 2) Not qualifying – relates to building
- 3) Not qualifying – relates to building
- 4) Not qualifying – revenue expenditure on repairs (entire asset is the building, not the roof)
- 5) Not qualifying – List A – s.21 CAA 2001
- 6) Special rate – s.104A(1)(g) CAA 2001
- 7) Special rate – s.104A(1)(b) CAA 2001 and s.33A(5)(a) and (b) CAA 2001
- 8) 100% FYA – s.39 CAA 2001 and s.45A CAA 2001
- 9) Not qualifying – revenue expenditure on repairs
- 10) Preliminaries – can be apportioned across the categories of expenditure in line with *JD Wetherspoon v HMRC*. Apportioned pro-rata to total expenditure on the property of £681,500 which falls within each of the three relevant categories (£36,500 / £10,000 / £635,000 so £214 / £59 / ££3,727)
- 11) Agreed s.198 CAA 2001 allocations are added to the various capital allowances pools. The contractually agreed fixtures price is irrelevant for the purposes of capital allowances.
- 12) Expenditure on plant and machinery used in the trade – s.11 CAA 2001
- 13) Expenditure on plant and machinery used in the trade – s.11 CAA 2001, reduced by the amount of the grant received (s.532 CAA 2001)
- 14) Expenditure on plant and machinery used in the trade – s.11 CAA 2001
- 15) Machinery has not been delivered, so there is no unconditional obligation to pay (absent any contractual term to the contrary). Therefore the entire expenditure cannot be included in full (s.5 CAA 2001). However, as the deposit has been paid under a contract which provides that the company will own the asset upon performance of the contract, the deposit can be included as qualifying expenditure (s.67 CAA 2001)
- 16) Special rate – s.104A(1)(e) CAA 2001. Car's CO<sub>2</sub> emissions exceed 130 g/km (s.104AA CAA 2001)
- 17) 100% FYA – s.39 CAA 2001 and s.45D CAA 2001. Car's CO<sub>2</sub> emissions do not exceed 75 g/km

## MARKING GUIDE

TOPIC	MARKS
Building – explanation	0.5
SDLT – explanation	0.5
Legal fees – explanation	0.5
Replacement roof – explanation	0.5
Formation of rooms etc. – explanation	0.5
Solar panels – classification and amount	0.5
Solar panels – explanation	0.5
Electrical systems – classification and amount	0.5
Electrical systems – explanation	0.5
Boiler – classification and amount	0.5
Boiler – explanation	0.5
Painting etc. – classification	0.5
Preliminaries – apportionment	0.5
Preliminaries – explanation	0.5
s.198 election values – classification and amount	0.5
s.198 election values – explanation	0.5
Moulding machine and moulds – classification and amount	0.5
Moulding machine and moulds – explanation	0.5
Granulator – classification	0.5
Granulator – amount and explanation	0.5
Assembly line – classification and amount	0.5
Assembly line – explanation	1
BMW – classification and amount	0.5
BMW – explanation	0.5
Porsche – classification and amount	0.5
Porsche – explanation	0.5
100% FYA – application of rate	0.5
18% WDA – application of rate	0.5
8% WDA – application of rate	0.5
<b>TOTAL</b>	<b>15</b>



### Question 3

#### Corporation Tax computations

Retro Ltd is an investment company for the 6 months to 31 December 2016. A new Corporation Tax accounting period commences on 1 January 2017 at which point the company has dual status (i.e. investment and trading). A separate computation is required for each of the investment and trading business as the commencement of trade brings about a new Corporation Tax period.

Investment business	Note	6m to 31/12/16	6m to 30/06/17	Total to 30/06/17	Mark
		£	£	£	
Property income	1.	50,000	0	50,000	
Bank and other interest		1,000	0	1,000	
Chargeable gains on sale of investments		0	15,000	15,000	
Dividends received	2.	0	0	0	below
Management expenses – proportion of director's salary	3.	(1,500)	(1,500)	(3,000)	
		49,500	13,500	63,000	
Less: excess management expenses b/f		(12,000)	0	(12,000)	
<b>Profits subject to Corporation Tax</b>		<b>37,500</b>	<b>13,500</b>	<b>51,000</b>	

Notes:

1. Property income

		£	Mark
Rental income after expenses		25,000	
Balancing adjustment – cessation of qualifying activity	Below	25,000	
Total property income		50,000	

2. Dividends received by a UK resident small company are exempt (Part 9A CTA 2009).

3. £3,000 of salary relates to investment management activities and has been allocated as a management expense. The amount is not a deductible trade expense as at the time it was not spent wholly and exclusively for the purposes of the trade.

Trading business	Note		6m to 30/06/17	Mark
		£	£	
Trading profits per accounts			120,000	
Add Back:				
Depreciation	4.	10,000		
Director's salary	3.	3,000		
			13,000	
Less: Capital allowances	Below		(102,250)	
<b>Profits subject to Corporation Tax</b>			<b>30,750</b>	

4. Depreciation is disallowed by statute as this relates an accounting adjustment for capital items.

5. The costs relating to the arrangement of an overdraft for the trade including shareholder guarantee will be treated as a deductible trade debit under the loan relationship rules.

<b>Capital allowances</b>	£		£	£	<b>Mark</b>
Balancing charge– deemed proceeds cessation of a qualifying activity - 1 November 2016	<u>25,000</u>				Above
		AIA	@18% for 6 months	Tax WDV C/F	
Additions: deemed acquisition (above)	25,000		(2,250)	<u>22,750</u>	
New plant treated as acquired on commencement of trade	100,000	(100,000)	0	0	
Capital allowances		<u>(100,000)</u>	<u>(2,250)</u>		

**Corporation Tax liabilities and payment dates**

	Payable by	FY2016 @20%	FY 2016/ 2017 @19.5%*	Corporation Tax	
		£	£	£	<b>Mark</b>
Investment business 6 months to 31/12/2016	<u>1/10/17</u>	37,500		7,500	
Investment business 6 months to 30/06/17			13,500		
Trade			<u>30,750</u>		
	<u>1/04/18</u>		44,250	<u>8,629</u>	
Total Corporation tax at 20%/19.5%				<u>16,129</u>	

\*CT rate 3 months @ 20% and 3 months @ 19%

## MARKING GUIDE

TOPIC	MARKS
Recognition of dual status and two CT periods	2.0
• Property business net profit	0.5
• Bank interest received	0.5
• Chargeable gains	0.5
• Dividends – non-taxable	0.5
• Balancing charge – property business	1.0
• Director's remuneration	1.0
• Management expenses b/f	0.5
• Investment format	0.5
Trading computation format	0.5
• Depreciation	1.0
• Director's remuneration adjustment	0.5
• Bank fees	0.5
• Capital allowances adjustment	0.5
Capital allowances calculations	
• Acquisition of fixtures and calculation	1.0
• New plant inc. timing and calculation	1.0
• Due dates	1.0
• Corporation Tax liabilities	2.0
<b>TOTAL</b>	<b>15.0</b>

## Question 4

A Firm LLP  
110 List Street  
Cardiff  
CF3 7WP

Maria Rossi  
Director  
Bellissimo Ltd  
Cardiff  
CF1 2LX  
XX November 2017

Dear Maria

### Disposal of shares

Thank you for providing background details on the proposed sale of your shares in Bellissimo Ltd. I am writing to explain the Capital Gains Tax (CGT) implications for you and Alan Jones.

### Capital Gains Tax

The CGT liability on the disposal of your shares in Bellissimo Ltd will be computed by reference to the cash proceeds less the base cost of the shares. The base cost is the market value of the shares at the date of transfer to you in March 2014, reduced by the amount of your father's held-over capital gain. The effect of this is that the base cost will be equivalent to the original cost of the shares to your father.

The chargeable gain may be taxed at 10% by making a claim for Entrepreneurs' Relief (ER). ER is available if during the 12 months immediately preceding the disposal:

- you hold shares in a "personal company" i.e. where the shareholder owns 5% or more of the voting ordinary share capital;
- Bellissimo Ltd is a "trading company";
- you are an officer or employee of the company until the date of disposal; and
- the cumulative capital gains for previous disposals together with the gains arising on the proposed transactions do not exceed £10 million, the lifetime limit for ER claims.

HM Revenue & Customs (HMRC) has agreed that the company currently satisfies the conditions for "a trading company". This condition must continue to apply up to the date of sale.

Alan will not meet the conditions for ER as he is not an employee or officer of the company and has not currently held his shares for 12 months. Therefore, if Alan is a higher or additional rate taxpayer he will be subject to CGT at 20%. Alan cannot access a 10% CGT rate under the rules for Investors' Relief. This is available to individuals who are external investors of unlisted trading companies who subscribe for new ordinary shares on or after 17 March 2016 and dispose of the shares on or after 6 April 2019. Alan may wish to defer his disposal of shares (subject to negotiation with the purchaser).

### *Sale of factory*

Following the sale of the shares, a new lease will be granted to Bellissimo Ltd with an option for the purchaser to acquire the freehold property. The delay in the sale of the property may result in a higher CGT rate on eventual disposal. However if the factory is sold at the same time as you sell your shares then *part* of the expected gain of £1.5m, may qualify for the 10% ER rate under the “associated disposal” rules.

The conditions for an associated disposal are:

- the sale of the property is made in conjunction with a “material disposal” of the shares;
- as part of a withdrawal from the company which requires a sale of at least a 5% interest in the ordinary voting share capital;
- there are no arrangements for repurchase of the shares by you or a connected party; and
- throughout a period of one year up to the sale of the shares the property is used for trading purposes by the company.

Delaying the sale of the property may result in the loss of ER because the disposal is not associated with the sale of the shares.

The maximum permitted period between a sale of the shares and a disposal of the property is not defined. HMRC accept that if the property is sold within 3 years of the share sale then the property may also qualify for the 10% ER rate, if the property has only been used by the company in the intervening period.

It is proposed that the option for the sale of the freehold cannot be exercised until 5 years after the sale of the shares. You should explore whether the option period could be activated within a shorter period, say, 2 years.

If an ER claim can be made on the sale of the property then the capital gain eligible for the 10% rate will require a “just and reasonable” apportionment under the associated disposal rules. The gain qualifying for ER might be calculated as follows:

1. time apportioned for the period when the market rent was discounted by 50% (April 2013 – date of sale of the shares);
2. time apportioned to exclude the period of ownership before you held shares in the company (April 2013 - March 2014).

ER may then be claimed on 50% of the time apportioned gain; i.e. by reference to the discount on market rent.

Chargeable gains that do not qualify for ER will be taxed at your marginal CGT rate of 20%.

Please let me know if you require any further assistance.

Yours sincerely  
CT Adviser  
A Firm LLP

## MARKING GUIDE

<b>TOPIC</b>	<b>MARKS</b>
Presentation & higher skills	1.0
Basis for computing CGT – effect of previous hold-over	1.0
ER conditions	3.0
Trading status	1.0
Alan's CGT position/Investors' Relief	1.0
CGT implications in delaying sale of factory	1.0
Associated disposal rules	3.5
Associated disposal - Restriction of gain taxable at 10% rate	2.5
Earlier sale of property to access ER	1.0
<b>TOTAL</b>	<b>15</b>

## Question 5

A Firm LLP  
110 List Street  
Cardiff  
CF3 7WP

Mr Morse  
Builders R Us  
Potton Road  
Birmingham  
B74 5GR

Dear Mr Morse

### Discovery Assessment Tax Year 2013/14

Thank you for visiting the office and providing some further background to the assessment raised by HM Revenue & Customs (HMRC) under the "discovery" rules.

You have asked whether an assessment can be raised as the window for enquiring into your 2013/14 Self-Assessment return closed on 31 January 2016.

The Inspector has powers to raise a discovery assessment if they discover that an under-assessment has been made, no assessment has been made, or too much relief has been given provided that either:

- The loss of tax was the result of careless or deliberate behaviour by the taxpayer; or
- HMRC could not have reasonably been expected to have been aware that the assessment was insufficient on the basis of information presented by the taxpayer in the SA return or related information.

If the first condition above applied then a valid assessment may be raised within 6 years after the end of the tax year in question to recover the tax due, i.e. on or before 6 April 2020.

Careless behaviour is not defined but would include failure to take reasonable care when preparing and filing your tax return. On the information provided it seems that reasonable care was not taken to evaluate the proper tax treatment of the property sales reported in your 2013/14 return. If you have evidence to the contrary then I will prepare an appeal to vacate all or part of the assessment; this must be made within 30 days of the date of the issue of the assessment. An example of reasonable care would be if you received and followed advice from your previous accountant - based on all of the facts surrounding the property acquisitions and disposals.

#### *15 Station Road, Birmingham*

HMRC proposes to treat the sale of 15 Station Road as a trading transaction. There is no comprehensive definition of what constitutes a trade and case law has established a number of key indicators ("badges of trade") to identify a trading activity, including the following.

- *Profit motive*: i.e. the intention for re-selling the property at a profit, rather than holding it as an investment for letting.
- *Systematic and repeated transactions*: Repetition of transactions may indicate a trading activity. You have confirmed that no property purchases or sales have been undertaken before or since the tax year 2013/14.
- *The length of the period of ownership*: Taken in isolation the short period of ownership is not conclusive evidence of a trade. However, taken with other factors it may point towards a trade motive.

- *Changes to the asset:* Minor repairs were undertaken which alone is inconclusive in establishing a trading motive.
- *Connection with an existing trade:* "Builders R Us" is a builders' merchant and might be linked with property repairs and refurbishment but in the absence of other property transactions there is no clear connection with the existing trade.
- *Financing:* The purchase was funded by using the overdraft facility of the business, rather than applying for a mortgage or long-term finance. This may suggest a speculative motive to realise short term profit.

If the Inspector's view is correct then deductible expenses, including interest expenses should be assessed in computing the overall taxable profit, which may be lower than the reported gain of £70,000. However, profits on a trading transaction will be subject to Income Tax at your marginal rate and Class 4 NIC at 2% (based on your overall trading profits from Builders R Us being above the upper limit).

*214 Winston Road, Sutton Coldfield*

The sale of 214 Winston Road has been agreed as a capital transaction. However, taking stock from Builders R Us to carry out refurbishment will be treated as drawings. The deemed profit on items used for refurbishment will therefore be included as part of the taxable profits of Builders R Us and based on the value of the goods "sold on the open market" less the cost to the business.

The basis used to establish value is not clearly defined and is not necessarily the selling price to your customers. HMRC's view is that it is the price your business would sell a similar quantity of the used to a third party. The amount of the adjustment proposed by the Inspector should be reviewed.

The Capital Gains Tax (CGT) base cost of the property will be increased by the additional cost of the materials and a revised CGT computation should be submitted once the market value of the stock has been established. As the discovery assessment re-opens the 2013/14 tax year you will be within time to make this amendment, by making an appeal against the amount of the assessment within 30 days of issue.

The penalty notice has not yet been issued by HMRC. Your compliance record and the background surrounding the under-assessment to Income Tax will need to be considered in more detail. If the disclosure of the error was prompted by HMRC and was due to careless (rather than deliberate) behaviour, the tax geared penalty may be 15%-30% of the additional tax payable. Co-operation is advised in order to minimise penalties. If HMRC regards your behaviour as deliberate, then it may increase the penalty to 100% of the additional tax or 70% if there is no concealment. I will need to establish the facts surrounding the original disclosure of information at your meeting with HMRC.

Interest on overdue tax will accrue on underpayments of Income Tax and Class 4 National Insurance. I therefore recommend early settlement of the liabilities once the amounts are established.

Please telephone me when convenient to arrange another meeting to discuss the background in more detail in order that we can agree the best approach.

Yours sincerely

AO Adviser  
A Firm LLP



## MARKING GUIDE

TOPIC	MARKS
Presentation & higher skills	1
Conditions for raising a discovery assessment	2
Time limit to raise assessment	1
Careless behaviour	2
Badges of trade	7
Principles in computing income tax liability - interest	1
Withdrawal of trading stock	1
Establishing selling cost	1
Adjustment to CGT base cost and time limit	2
Penalties and interest	2
<b>TOTAL</b>	<b>20</b>

## Question 6

AN Accountant  
1 High Street  
Crieff  
PH7 2AB

Mrs S Barnes  
Lothian Engineering Ltd  
39 Castleton Road  
Auchterarder  
PH3 2ER

6 November 2017

Dear Sally

### **Management Incentive and Reward**

Further to our recent meeting, I have set out details below of how you could share the value of a future sale with the management team without awarding them shares in the company at this point.

#### **Cash Bonus**

The employees who remain with the company at sale could be paid a cash bonus in line with the increase in value of the company during the relevant period. This is a very straightforward option and would only require a simple agreement with the employees to reflect the terms under which the bonus would be calculated.

However, this is not a particularly tax efficient option, as the employees would suffer income tax and employee's National Insurance Contributions ("NIC") at their respective marginal rates – up to 47%. The company would also suffer employer's Class 1 NIC at 13.8% on the amount of the bonus. A corporation tax deduction would however be available for the amount of the bonus and employer's Class 1 NIC.

#### **Share Options**

The employees could instead be given options over shares in the company exercisable on (or immediately prior to) a sale of the company at specified price.

The option may require that the employees and the business meet performance and employment conditions.

Once exercised, the management shareholders would share in the proceeds of a sale without having to award actual shares at the current time.

There is no tax charge on the grant of an option. Tax charges may arise when the option is exercised and again when the shares themselves are sold.

#### *Non Tax Approved Share Options*

Share options can be granted without any beneficial tax arrangements and would consequently be non-tax approved share options.

However, the employees would suffer income tax on the difference between the market value at the time of exercise and the amount they pay for the options. Therefore, if these are to be exercised immediately prior to a sale, all of the "value" of the options will be subject to income tax which, as

above, is not likely to be tax efficient for the employees. If the options are exercised as part of the sale of the company's shares, the above amount will also be subject to both employee's and employer's Class 1 NIC.

#### *Company Share Option Plan ("CSOP")*

CSOP is an HMRC tax approved share option scheme which allows employers to issue options to an employee over shares up to a value of £30,000 at the time of issue. These options cannot be issued at a discount to the market value of the shares at that time, so the employees would only benefit from an increase in the company's value from the date of issue of the options.

However, a CSOP scheme is unlikely to be the most appropriate option scheme to implement, on account of the relatively small value of shares which can be issued relative to the current value of the company and the likely tax rate of 20%, due to the employees not qualifying for entrepreneurs' relief.

#### *EMI Share Options*

An EMI share option scheme would allow the company to issue tax-advantaged share options to selected members of staff, subject to certain conditions being met by the company and the employees being given the share options.

The company appears to meet all of the conditions relating to number of employees (less than 250), gross assets (less than £30m) etc. For the employee to be eligible, they must work for the company for at least an average of 25 hours per week, or 75% of their working time, if less. Each employee can be awarded options over shares with a market value at grant of £250,000 under this scheme. The total market value of shares under option under this scheme cannot exceed £3,000,000.

This grant of options needs to be notified to HMRC following the issue. The market value of the company's shares at the time of grant can be agreed with HMRC, in order to provide certainty.

If the option remains qualifying and is exercised within ten years, the increase in the value of the shares under option between grant and exercise is not charged to income tax, unless the exercise price agreed at grant was at a discount to the market value at the time. In this case, only any discount will be charged to income tax on exercise. If the options are exercised as part of a sale of the company, then PAYE and Class 1 National Insurance (for both the employee and the company) will be applied to any discount.

Based on the above, normally the employees will only pay capital gains tax on the increase in value of the shares from the date of grant of the option. If the EMI options were granted more than twelve months before the disposal of the shares, the employee should be able to benefit from a 10% rate of tax on the gain, under the entrepreneurs' relief rules.

If the options are exercised prior to a sale, or within 90 days of the takeover the company should also benefit from a corporation tax deduction for the difference between the market value of the shares at exercise and the amount paid by the employee, upon exercise of the shares.

I trust the above is clear, but if you have any questions please let me know.

Kind regards

AN Accountant

## MARKING GUIDE

TOPIC	MARKS
<b>Cash Bonus</b>	
Pay bonus to reflect company performance	0.5
Subject to income tax and Class 1 NIC	0.5
Subject to employer's Class 1 NIC	0.5
CT deduction available for bonus and employer's NIC	0.5
<b>Share Options - General</b>	
Description of options	0.5
Relation to performance criteria	0.5
Exercise prior to a sale taking place	0.5
No tax charge on grant of options	0.5
<b>Non Tax Approved Options</b>	
Value subject to income tax	0.5
Difference between MV at exercise and price paid	0.5
Subject to NIC if exercised as part of sale	0.5
<b>CSOP</b>	
Limit of £30,000	0.5
Cannot be issued at a discount	0.5
Reason for not being appropriate	1
<b>EMI</b>	
Employee condition	0.5
Gross assets condition	0.5
Working time condition	0.5
Limit of £250,000	0.5
Notification of grant to HMRC	0.5
Agree value in advance with HMRC	0.5
Exercise within ten year for favourable treatment	0.5
No income tax charge at exercise, if not at discount	0.5
Any discount subject to income tax	0.5
PAYE/NIC if part of arrangements for sale	0.5
CGT on sale of the option shares	0.5
ER if options/shares held for twelve months	0.5
CT deduction available if exercised prior to sale	0.5
PHS	1
<b>TOTAL</b>	<b>15</b>