THE CHARTERED INSTITUTE OF TAXATION

APPLICATION AND PROFESSIONAL SKILLS

Human Capital Taxes

November 2023

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 in the question, you may assume that 2022/23 legislation (including rates and allowances) continues to apply for 2023/24 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 senior associate at a firm of Chartered Tax Advisers and your client is Eagle Kitchens Ltd. You and your tax partner, Mary Stone, recently met with the Managing Director, Richard Hutch.

Richard has explained that following the external investment from Fitch and Squirrel LLP, Eagle Kitchens Ltd has an ambitious growth plan with the aim of listing the shares on a stock exchange or selling privately in 2029. Richard realises that this requires a new team to implement changes to his family business. Accordingly, he and his son Charles are to stand down from the day-to-day management of the company. A potential new Managing Director, Andrew Tag, has been identified.

Andrew already has a team of people he has worked with before who will join him at Eagle Kitchens Ltd.

Negotiations with the new management team are ongoing and two new remuneration packages have been proposed.

The following exhibits are provided to assist you:

EXHIBIT A: Email from Richard

EXHIBIT B: Extract from five-year business plan

EXHIBIT C: Email to Andrew

EXHIBIT D: Email from Andrew

EXHIBIT E: Pre-seen information

Requirement:

Draft a report to Richard, for Mary Stone's review, advising on the two remuneration packages proposed and recommending how to proceed.

Continued

EXHIBIT A

Email from Richard

To: Mary Stone
From: Richard Hutch
Date: 1 November 2023
Subject: New management team negotiations

Dear Mary

Thank you for coming to see me to discuss our plan to hire a new management team to replace my son Charles and me. As you know, our five-year business plan is ambitious and I agree with Fitch and Squirrel LLP that this needs a new team to implement the radical changes necessary.

Working with Fitch and Squirrel LLP, I have designed a management incentive package that we think is competitive and will incentivise the new team to work hard and deliver our plan. I have relied heavily on Fitch and Squirrel LLP's experience in developing management incentive packages. I attach our proposal to the new management team (**EXHIBIT C**). The new management team have reviewed our proposal and responded with comments (**EXHIBIT D**). Please focus on the Management Incentive Plan and pension contributions because the other items are now agreed.

I approach their counter-offer with an open mind. If you think that their counter-offer is less expensive for the existing shareholders, or it is cost neutral but more tax efficient for the new management team, then I am happy to accept their proposals.

It would be helpful if you could estimate the overall cost of both approaches. The new management team's counter-proposal assumes that the growth shares have a no value, which we are happy with.

I would also like to understand whether there are any practical advantages or otherwise of their proposal as I would have reservations about implementing something too complicated.

To provide you with some further background I attach our five-year business plan (**EXHIBIT B**) agreed by everyone.

Thanks for your help.

Richard

Continued

EXHIBIT B

Extract from five-year business plan

4 September 2023

Summary

1) Eagle Kitchens Ltd will seek to expand rapidly over the next five years by capitalising on the increased spending by consumers on the home post-pandemic.

2) The injection of equity finance by Fitch and Squirrel LLP will be used to refit showrooms, renew product lines and market products more actively.

3) A new management team will be brought in to make changes to production costs and facilities.

Executive team

A new enlarged management team will be hired to replace the current founder and Managing Director Richard Hutch and the Finance Director Charles Hutch. The new team will have experience of transforming existing and mature medium-sized manufacturing and retail businesses. They will also have recent experience bringing businesses to market. Richard will remain as a director.

Growth

Management will target an annual profit of £20 million by 31 December 2028. This should make the company worth somewhere in the region of £100 million to £200 million.

Exit

The goal is for the business to either be listed on a stock exchange or sold privately in 2029.

Continued

EXHIBIT C

Email to Andrew

To: Andrew Tag
From: Richard Hutch
Date: 15 September 2023
Subject: Summary of management package for consideration

Dear Andrew

Further to our discussions, I am writing to you with our proposal for a remuneration package for you and your team. I should be grateful if you would consider this offer and discuss it with your team.

Salary

Andrew Tag, Managing Director	£350,000 per annum
Clare Betty, Finance Director	£240,000 per annum
Nigel Crab and Enid Felines, Senior Managers	£100,000 each per annum

Benefits

Private medical cover. Life insurance of four times base salary.

Management Incentive Plan

We will offer you, Clare and the two senior managers share options (see the table below). They will have the following terms:

1) The share options will have an exercise price of £150 per share. The current market value reflecting the minority discount is £150 per share.

2) The options can only be exercised after five years and one day of employment. This means if you leave employment before that time, other than as a good leaver, your options will lapse.

3) If the business plan targets are met by 2028 but there is no sale or listing in 2029, the current shareholders will put in place arrangements to buy any shares held by you for their fair value.

4) Some of these share options will be granted under a Company Share Option Plan (CSOP) up to the maximum allowed. Your CSOP shares will be subject to the same conditions described above.

This is our estimate of what those options are worth if you deliver on the business plan.

	Number of shares subject to CSOP	Number of shares subject to unapproved share options	Share option gain assuming growth plan in 2028 is achieved
			£
Managing Director	200	200	1,260,000
Finance Director	200	100	945,000
Senior Manager (total for both roles)	200	0	630,000

Illustration for Managing Director

Options	Exercise price (£150 per option)	Value in 2028	Profit
	£	£	£
CSOP	30,000	660,000	630,000
Unapproved option	30,000	660,000	630,000
			1,260,000

Pension

An employer pension contribution of 15% of base salary is made to the Eagle Kitchens Ltd registered occupational (defined contribution) pension scheme.

To avoid annual allowance charges for you and Clare we propose that the excess contributions above your Annual Allowance are made to a ‘Top-Up’ employer financed retirement scheme. This Top-Up plan would pay you a lump sum when you reach 55 years of age.

Holiday

20 days per year.

If you agree to our proposal in principle, I will have our advisers draft a more detailed term sheet for your consideration.

Kind regards

Richard

Continued

EXHIBIT D

Email from Andrew

To: Richard Hutch
Cc: Jimmy Hanken (Fitch and Squirrel LLP), Clare Betty
From: Andrew Tag
Date: 25 September 2023

Dear Richard

Thank you for your offer letter. Having discussed this with Clare, we would like to provide some comments and suggestions for consideration.

Salary and benefits

We agree to your proposal.

Management Incentive Plan

As you know my team and I have considerable experience transforming manufacturing and retail businesses. In our previous role our incentive package involved taking equity in the business that acquired value if we grew the company value by delivering on the business plan.

We therefore propose that instead of share options, Eagle Kitchen Ltd award a new class of 'growth' shares which are different from the existing ordinary shares.

Growth shares would have a no value at present because they would only share in any share price growth that exceeds the current value of £150 per share. For example if the company was sold for £200 per share then the growth shares would only have rights to the £50 per share excess over the current £150 per share. As these growth shares should have no current value, we would pay the nominal value of £0.01 per share only.

To illustrate:

	Growth shares	Value of shares if business plan achieved
		£
Managing Director	400	1,260,000
Finance Director	300	945,000
Senior Manager (total for both roles)	200	630,000

We had this at our previous company, and it was more tax efficient for us. We are happy for these shares to have forfeiture provisions mirroring your share option proposal (in other words we forfeit the shares if we leave employment within five years of joining).

Pension

In the last three years Clare and I each made contributions above our annual allowance. We would prefer something simple and ask that you consider paying us additional salary instead of a pension contribution of £36,000 for Clare and £52,500 for me.

Holiday

This is also acceptable.

I look forward to receiving your comments on our suggestions.

Kind regards

Andrew

Continued

EXHIBIT E

Pre-seen information

Client

Eagle Kitchens Ltd

Eagle Kitchens Ltd is a medium-sized privately owned family business incorporated in the UK in 1997.

Ownership

Until 30 December 2022 the company was entirely owned by the Hutch family and a small number of private individuals. On 30 December 2022 Fitch and Squirrel LLP subscribed for 35,000 new ordinary shares for £15 million. Fitch and Squirrel LLP is a US-based venture capital investor.

	Ordinary Shares of £0.01 each
Richard Hutch	40,000
Charles Hutch	20,000
Fitch and Squirrel LLP	35,000
Other individuals	5,000
	100,000

Business

Eagle Kitchens Ltd has a business manufacturing, selling and installing domestic kitchens. It has three manufacturing facilities and 15 retail sites across England and Wales. It specialises in producing high quality kitchens. Sales are largely domestic but with some exports to Europe. Eagle Kitchens Ltd has been trading since 1997.

Employees and Directors

Eagle Kitchens Ltd has 410 full time and 24 part-time employees across all manufacturing, office and retail sites. There are two directors: Richard Hutch who is the Managing Director and his son Charles Hutch, who is the Finance Director.

Summary accounts for Eagle Kitchens Ltd for the year ended 31 December 2022

	Year ended 31 December 2022	Year ended 31 December 2021
	£	£
Turnover	22,500,000	21,250,000
Cost of sales	(12,350,000)	(11,800,000)
Gross profit	10,150,000	9,450,000
Expenditure		
Directors remuneration	(890,500)	(870,500)
Employment costs	(7,900,000)	(7,550,000)
Other administrative costs	(325,500)	(315,450)
	(9,116,000)	(8,735,950)
Bank interest	2,150	2,005
Profit before Tax	1,036,150	716,055
Tax	(205,000)	(120,000)
Profit after Tax	£831,150	£596,055

Balance Sheet at 31 December 2022

	2022	2021
	£	£
Fixed Assets		
Freehold Property	4,795,000	4,725,000
Plant and Machinery	3,530,000	3,700,000
	8,325,000	8,425,000
Current Assets		
Stock and Work in Progress	800,000	750,000
Debtors	700,000	650,000
Cash	15,977,500	150,000
	17,477,500	1,550,000
Creditors	(325,000)	(329,000)
	£25,477,500	9,646,000
Share Capital	1,000	650
Share Capital premium	15,000,000	-
Retained Earnings	10,476,500	9,645,350
	£25,477,500	9,646,000