Chartered Institute of Taxation
Excellence in Taxation

The Chartered Tax Adviser Examination

May 2017

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 and annotate your question paper. You are not permitted to write in the answer booklet. The Presiding Officer will inform you when you can start writing. Calculators may not be used during this time.
- 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 2016/17 rates and allowances continue to apply for 2017/18 and future years. Candidates referring to actual or pending rates and allowances for 2017/18 and future years will not be penalised.

1. Your firm has recently been appointed as tax advisers to LM Ltd, a company specialising in the development of medical equipment.

The company employs 100 people and had a turnover for the year ended 30 June 2016 of £10 million, increased from £8 million for the year ended 30 June 2015.

Development of one of the company's recent products included advancements in technology which qualify for enhanced tax relief for expenditure on Research & Development (R&D).

The company's Finance Director has provided the following information in relation to the project costs that have arisen through the development period which started on 1 December 2014 and ended with the completion of the prototype product on 31 October 2015.

Staff member	Project role	Salary (incl. Employer's National Insurance)	Company pension contribution	Private medical benefit
		£	£	£
Alan Hart	Product development	28,000	2,000	1,800
Janice Stanley	Product development	25,000	0	1,000
Rachel Jones	Market research	20,000	0	1,000
Harry Marshall	Production Director	30,000	0	0

The salary and benefit costs were incurred evenly throughout the development period.

Except for Harry Marshall, who spent one sixth of his time on the new product development, all individuals worked full time on the project.

On 31 October 2015 the company made a statutory redundancy payment of £2,200 to Janice Stanley on the completion of the project.

Over the period of the project LM Ltd also paid Test Cage Ltd, an unconnected company, £50,000 to provide testing of the prototype. You have established that the expenditure incurred by Test Cage Ltd on the project amounted to £42,000.

Other related revenue expenditure, which was incurred evenly throughout the product development, was:

	£
Telephone	500
Rent	1,000
Water, fuel and power	750

In September and October 2014, LM Ltd incurred capital expenditure of £60,000 in total on the construction of a new R&D workshop.

In addition to its own R&D work, LM Ltd has also been subcontracted by a large UK pharmaceutical company to undertake early stage R&D for a new medical scanner. Over the period September to November 2015 LM Ltd incurred total payroll costs of £18,000 on this project. The company has chosen not to make an election under the Research and Development Expenditure Credit regime.

Continued

1. Continuation

From a review of the submitted Corporation Tax return for the year ended 30 June 2015, you note that the company's taxable profit after the expenditure shown above but before enhanced deductions for R&D is £150,000. The comparable taxable profit for the year ended 30 June 2016 is £200,000.

You are required to:

1) Explain how much of the above expenditure will qualify for enhanced R&D relief and prepare amended Corporation Tax computations for the years ended 30 June 2015 and 30 June 2016. (12)

2) State the time limits for claims and elections for the expenditure. (3)

Total (15)

2. Your firm has recently been appointed to act as tax advisers to Plex Ltd, a successful sports equipment retailer.

Plex Ltd is in the process of engaging three IT consultants in order to set up the company's on-line retail presence. The consultants are all UK resident and currently operate as self-employed individuals. The project is likely to take between 9 and 12 months and both Plex Ltd and the consultants would prefer the engagement to be one of self-employment. The negotiations are at an early stage and Plex Ltd would like to know how the engagement can be structured in a manner that will support self-employed status.

The Human Resources Director of Plex Ltd has asked you to advise him.

You are required to prepare the briefing note for the Human Resources Director advising on tax issues relating to the status of the IT consultants. (15)

3. You are a Tax Manager in a medium-sized accountancy firm.

Your client Bill Meecham purchased a large, empty Victorian property on 1 July 2005 for £500,000, which he then furnished and let as student accommodation until 1 September 2008.

He then converted the property into a hotel, incurring £150,000 on building costs; £100,000 on fixtures qualifying for capital allowances and £150,000 on furniture, equipment and decorative items. The hotel opened for business on 1 January 2009 and was operated by Bill as a sole trader until 1 January 2017 when it was sold for £1,350,000 and his hotelier business ceased.

The sale price was allocated under the sale agreement as follows and is a 'just and reasonable' apportionment:

	£
Property	1,200,000
Fixtures	50,000
Furniture, equipment and decorative items at net book value	100,000
Total	£1,350,000

On 1 March 2016 Bill purchased a second-hand car sales business, which he also operates as a sole trader, paying £600,000 for the trading premises and forecourt including fixtures.

By converting a storage area into a workshop Bill now also offers motor repairs and servicing. On 1 March 2017 he incurred expenditure of £100,000 on vehicle lifting equipment which is bolted to the floor of the workshop.

Within the next two years Bill expects to spend £200,000 on building an extension to the garage workshop.

Bill is a higher rate taxpayer and has made no prior asset disposals.

You are required to write to Bill advising him of the Capital Gains Tax payable in respect of the sale of the hotel and explaining any claims for relief which are available. (15)

4. You are a newly qualified Tax Adviser working for a firm of accountants.

You client, Ivan Skelhorne aged 55, recently retired from a senior position with a national company which provides services and products related to damp-proofing.

He intends to start up his own business providing similar services in his local area and is considering whether he should operate as a sole trader or form a company. He has engaged your firm to provide accountancy and taxation services. You have briefly discussed both alternatives with him and he has now asked you for further advice.

Ivan is entitled to draw his pension from his former employer, but would prefer to defer drawing it for the time being. That being the case, he will have no income other than from the business. He estimates that he needs net income of approximately £40,000 per annum to cover living expenses.

A colleague in your audit and accounts department has assisted Ivan in drawing up a business plan and his tax-adjusted profit for the first year of trading is projected to be £75,000, before considering any remuneration or profit extraction for Ivan.

You are required to write to Ivan, with calculations, advising him of the most tax efficient way to operate his business and to draw his profits. (15)

You are NOT required to consider the choice of accounting date, capital allowances or benefits in kind.

5. You work for a firm of Chartered Tax Advisers which provides tax technical support to other professional firms. One of your clients, Chris Fipps Chartered Accountant, has sent you the following letter:

A T Mann	Mr C Fipps
Account LLP	Chris Fipps Chartered Accountant
1 Station Road	West Park
Westland	Westland
Wessex	Wessex
WE1 7AX	WE1 2ED

30 April 2017

Dear Mr Mann

One of my clients, Salvo Ltd, has operated as a successful IT consultancy and software engineering company for over 10 years. Unfortunately, trading has declined over the last two years as a result of a combination of the loss of two of its major clients to overseas competitors and the serious ill-health of the sole director and main shareholder, Paul Simms.

The company has a 30 September year end and the shares are held 75% by Paul Simms and 25% by his nephew Steve Western. Paul subscribed at par for his shares on incorporation in June 2005. Steve is a freelance IT consultant who runs his own business and has never held any formal role within Salvo Ltd, principally because several of his largest clients require that he does not hold any office or employment with any company in the IT sector. Steve purchased his shares from Paul in May 2010 for £175,000.

My clients have been attempting to sell Salvo Ltd for over a year but are unable to find a buyer. The company ceased trading on 31 December 2016 and the shareholders would both like to realise the value of their interests in the company as tax efficiently as possible. Paul has suffered serious long term health issues and intends to retire to Wales and have no further involvement in the business. Steve has no interest in the activities of the company as he wishes to focus on his own IT consultancy business.

I have summarised below the balance sheet of Salvo Ltd at 31 December 2016.

	£	£
Fixed assets		
Plant and equipment		65,000
Current Assets		
Trade debtors	265,000	
Cash at bank	739,000	
		1,004,000
Creditors		
Trade creditors	17,000	
Directors loans (owed to Paul Simms)	40,000	
Taxes and social security	12,000	
		(69,000)
		1,000,000
Capital and reserves		
Called up share capital		100,000
Profit and loss		900,000
		1,000,000

The tax written down value of the fixtures and fittings at 30 September 2016 was £12,000 and the market value on 31 December 2016 was £2,000.

Continued

5. Continuation

The cash deposits represent accumulated profits. Your firm has already obtained clearance from HM Revenue & Customs that the company meets the trading criteria of s.165A TCGA 1992.

The tax adjusted trading profits and losses have been as follows:

	£
30 September 2016	(120,000)
30 September 2015	(1,000)
30 September 2014	30,000
30 September 2013	110,000

The trading loss, before capital allowances, for the final three months to 31 December 2016 was £36,000.

The shareholders have accepted that the goodwill of the company is of negligible value. The lease for the current operating premises comes to an end in 2019 but the lease includes the right for the company to terminate on 30 June 2017.

I should be grateful if you would explain the implications of the company's cessation of trade and also what options are available to allow the owners to realise their value as tax efficiently as possible. I understand that there is a specific "disincorporation relief" available and I was wondering if this would be relevant?

Yours sincerely

Chris Fipps

You are required to write a letter to Mr Fipps advising on the tax implications for the company of the cessation of trade and the options available to the shareholders to realise the value of their shareholdings. (20)

6. You work in the tax department of a medium-sized accountancy firm.

One of your firm's clients, Alan Davey, is a recording engineer and music producer. He makes up his accounts as a sole trader to 31 December each year. Accounts for the year to 31 December 2016 have been produced by your firm's accounts department showing a profit of £75,000 after deducting depreciation and amortisation of £11,000. You have been asked to complete the tax review and computation for a colleague who is off sick, but who had previously made a detailed list of points for review which she thought might be relevant.

1) Alan's former studio was leased under a tenant repairing lease which terminated on 31 July 2016. Immediately after termination the landlord served a schedule of dilapidations comprising the items listed below and in respect of which Alan made a payment of £4,500 to the landlord.

	£
Repairs to windows	500
Repairs to guttering and repointing	2,500
Demolition of sound-proof recording booth	1,500
Total	£4,500

This payment is included in repairs and maintenance.

2) Alan leased his current studio on a 10-year lease from 1 August 2016 paying a premium of £20,000, which has been capitalised as leasehold additions. Legal and professional costs include solicitor's fees in respect of the new lease of £750.

3) Alan runs two cars through the business. One car is an Audi A4 held on a five-year lease taken out in October 2014, under which all costs apart from fuel are covered by the leasing company. Lease rental payments in the year were £6,000 and CO_2 emissions are 145 g/km. Alan also purchased a Mercedes for £2,000 on 1 January 2016, which was first registered in 2005. CO_2 emissions are 165 g/km.

4) Motor expenses include:

	£
Fuel – Audi	2,500
Fuel – Mercedes	2,000
Car tax, insurance, repairs and maintenance for Mercedes	500

Alan's mileage logs record:

	Mileage	
	Business	Private
Audi	20,000	5,000
Mercedes	12,000	3,000

ITEPA mileage rates have not been claimed in respect of the Audi.

Alan has a small studio at home where he mixes and masters artists' 'demo' recordings on computer, but does not record artists there. When a recording session has been booked at his main studio he drives from home to this studio and back using the Mercedes. Approximately 5,000 of his 12,000 business miles was for those journeys.

5) Alan travels throughout the UK recording live bands and stays in a hotel for the night after a gig, where he will normally take an evening meal and he will also take lunch on the way to the venue.

Travel and subsistence costs include £3,500 for hotels and £1,500 for meals.

Continued

6. Continuation

6) Alan was engaged by a record company as a sound engineer and co-producer for work on an album for a major artist, over a period of three months. He rented a one bedroom holiday apartment near to their studio as it was a long way from home from 1 March 2016 to 31 May 2016 at a cost of £750 per month. The project overran by two months and the record company arranged and paid for hotel accommodation from 1 June 2016 to 31 July 2016 at a cost of £6,000 which includes £1,000 for evening meals and refreshments. For two weeks of that period his wife joined him at the hotel.

7) Alan incurred £5,000 in the year on music production software which has been written off to computer expenses in the accounts. He expects to use the software for several years but each year a new version is released and existing users are invited to upgrade to the latest version for a lower cost than new subscribers.

8) Sundry expenses include £500 for water dispenser refills, tea, coffee and other soft drinks provided to artists during recording sessions.

9) Alan is learning to play keyboards so that he can accompany solo musicians in the studio. The cost of the lessons of £800 is also included in sundry expenses.

You also have the following information on file:

1) The balance on the capital allowances main pool at 31 December 2015 was £20,000.

2) The plant and machinery fixed assets note for the year ended 31 December 2016 was as follows:

	Plant & machinery	Computers	Motor vehicles	Total
	£	£	£	£
Cost	40,000	10,000		50,000
Depreciation	(20,000)	(3,000)		(23,000)
Net book value at 1 January 2016	20,000	7,000		27,000
Additions	10,000[1]	3,000[2]	2,000	15,000
Depreciation for year	(6,000)	(2,500)	(500)	(9,000)
Net book value at 31 December 2016	24,000	7,500	1,500	33,000

1) Recording equipment
2) Computer hardware

You are required to calculate Alan's adjusted trading profit for the year ended 31 December 2016, annotating how the points listed by your colleague have been dealt with. (20)