The Chartered Tax Adviser Examination

May 2017

Suggested solutions

Taxation of Owner-Managed Businesses

Advisory Paper

QUESTION 1

1) R&D expenditure

Qualifying expenditure

	£	£	
Staff costs			
Alan Hart	28,000		(direct expenditure)
Alan Hart pension contribution	2,000		(direct expenditure)
		30,000	
Janice Stanley		25,000	(direct expenditure)
Harry Marshall		5,000	(qualifying indirect expenditure)
		60,000	**Note 1**
Sub-contracted costs			
Test Cage Ltd		42,000	(per) **Note 2**
Consumables			
Water, fuel and power		750	(allowed by) **Note 3**
Total qualifying expenditure		**£102,750**	

Impact on tax computations

	30 June 15 (7m/11m)	**30 June 16 (4m/11m)**	**Note 4**
Staff costs	38,182	21,818	
Sub-contracted costs	26,727	15,273	
Consumables	477	273	
Total	£65,386	£37,364	
Additional deduction for qualifying R&D			
Four months to 31 March 2015 - 125%	46,704		
Three months to 30 June 2015 - 130%	36,429		
	£83,133		
Four months to 31 October 2015 - 130%		£48,573	**Note 5**
Relief for subcontracted work			
Subcontracted work		£18,000	**Note 6**
Additional deduction - 30%		£5,400	

Tax liabilities

	30 June 15	30 June 16	
Initial taxable profits	150,000	200,000	
100% R&D capital allowances	(60,000)		**Note 7**
Additional deduction (above)			
SME R&D	(83,133)	(48,573)	
Large company R&D		(5,400)	
Taxable profits	£6,867	£146,027	
Corporation tax at 20%	**£1,373**	**£29,205**	

Notes:

1) Alan Hart and Janice Stanley qualify as direct expenditure
   Rachel Jones's time does not qualify, as it is not spent resolving a technological uncertainty in the project.
   Company pension contributions will count as qualifying expenditure
   Benefit in kind will not qualify
   Statutory redundancy costs are non-qualifying expenditure for R&D
   Harry Marshall's costs (£30,000 x 1/6) are qualifying indirect expenditure
2) Usually the enhanced subcontracted R&D expenditure is limited to 65% of the total cost but LM Ltd may jointly elect with Test Cage Ltd under s.1135 CTA 2009 to base the claim on the actual expenditure incurred by the subcontracted company
3) Water, fuel and power costs are specifically included as qualifying for enhanced R&D relief.
   Telephone and rent costs do not qualify, as these are not within any of the heads of qualifying expenditure; i.e. they are not "consumed or transformed" in the R&D process (s.1125(2) CTA 2009).
4) The expenditure will qualify for relief as it is charged to the relevant profit and loss account.
5) The rate of enhancement changed from 125% to 130% from 1 April 2015
6) Expenditure to provide sub-contracted R&D services to a large company will qualify for enhanced relief. The relief is given at 30% of eligible costs incurred by the SME
7) The construction of the R&D workshop does not qualify for enhanced R&D relief as it is capital expenditure. However, although it is a building, it can qualify for 100% R&D capital allowances, as it is used for qualifying R&D purposes

2) Time limits for claims and elections

- R&D claim and amended 30 June 2015 tax return due by 30 June 2017.
- Joint election for subcontracted expenditure election to be made by 30 June 2018 under s.1135 CTA 2009
- Claim for R&D capital allowances under s.441 CAA 2001 to be made by 30 June 2017 under para 82 schedule 18 FA 1998

MARKING GUIDE

TOPIC	MARKS
Hart and Stanley qualifying expenditure	0.5
Jones non-qualifying	1
Pension contribution qualifies	0.5
Benefits in kind do not	0.5
Redundancy payments do not qualify	1
Marshal qualifying indirect expenditure	0.5
Subcontracted expenditure elect for actual cost incurred if greater than 65% of total charge	1
Water, fuel power qualifies	1
Telephone and rent will not qualify	1
Expenses subject to R&D as charged to p&L	1
Rate increase from 125% to 130%	1
Subcontracted expenditure incurred on behalf of third party qualifies	1
Relief limited to large company rate	1
100% R&D capital allowance on building	1
2015 amended tax return and claim due 30 June 2017	1
Joint election for subcontracted expenditure due 30 June 2018	1
Revised capital allowances claim due 30 June 2017	1
TOTAL	**15**

QUESTION 2

Briefing note to Plex Ltd HR Director: Self-employment status of new IT consultants

Employment/self-employment is not a choice nor is it defined in the tax legislation. HM Revenue & Customs (HMRC) provide an on-line "status test" that may be used as a guide but this is only indicative. Over the last 70 years Court and Tribunal decisions have articulated a number of tests that are accepted as indicative of one status or the other. It is unlikely that one test in isolation will be conclusive, it is therefore necessary to consider the relevance of each test as part of the whole engagement.

Control

The greater the degree of control exercised over the day to day work of the consultant, the closer this is to employment. Where possible, the engagement should define key objectives and timescales. The implementation of how, when and where these objectives are achieved should be left to the consultant.

Substitution

An employee must provide their services personally. In a self-employed relationship, it is likely that that the contractor may legitimately provide a suitably qualified substitute if appropriate.

Mutuality of obligation

Under an employment relationship the employer is required to provide work and the worker is obliged to accept it. A self-employed contractor would have no certainty that further work would be offered and would be under no obligation to accept it if it were.

Financial risk and opportunity for profit

Other than the ultimate risk of losing their job, an employee would not expect to have any personal financial risk. Similarly, they would have limited opportunity for significant profit. On the other hand, a self-employed individual would expect to increase their overall profit through the efficient implementation of their engagement or suffer financial risk if they fail to deliver. Where possible the consultants should be asked to tender for each engagement. Ideally staged payments on the completion of agreed milestones would be advisable rather than a fixed day rate for an unspecified period.

Own equipment

Although not particularly relevant in the context of an IT consultancy, the consultants should be required to provide their own equipment such as laptops, telephones etc.

Integration into the organisation

Subject of course to the efficient implementation of the project, the consultants should not be overtly integrated into Plex Ltd. For example, an employee of the company would normally expect a range of benefits such as company pension contributions, private medical insurance, paid holiday and sick leave together with other typical employment "perks" such as their own desk or office, business cards, dedicated email address and entry on the company's intra-net. Where possible, the consultants should be excluded from these.

Number of other engagements

Provided there are no competitive conflicts, the consultants should be at liberty to undertake other contracts with third parties.

Business operation

The consultants should demonstrate that they operate as a legitimate self-employed business. This should be supported by third party evidence such as sight of accounts and written confirmation from the individual's accountant. The consultant should raise VAT invoices where appropriate and demonstrate that suitable professional indemnity insurance is in place.

What happens if incorrectly treated?

An individual's employment status must be decided on a case by case basis. It is essential that this is addressed correctly as the primary responsibility to operate PAYE rests with the employer. In the majority of cases any sanctions for failing to do so will be applied to the employer.

If HMRC do establish that PAYE should have been operated, then they will seek to collect both income tax and employee's and employer's National Insurance Contributions (NICs) from Plex Ltd. It is recommended that the contractual arrangement with the consultants should allow Plex Ltd to seek recompense where appropriate.

HMRC are normally able to go back up to four years. In the event that they can demonstrate that due care was not taken then this is extended to six years.

Following the case of Demibourne Ltd v HMRC, where the consultant is able to demonstrate that they have declared their income and paid the appropriate amount of tax then HMRC will usually allow credit for these payments against the PAYE obligation.

A similar position applies in the case of class 2 and 4 NIC paid. HMRC have the power to offset such payments against class 1 NIC found to be due.

Any PAYE/NIC found to be paid late will be subject to an interest charge calculated from the normal due date of the liability in question.

In addition, Plex Ltd will be potentially liable for penalties for the failure to operate PAYE. Where HMRC are able to demonstrate "carelessness" then the penalty may range between 0% and 30% of the under-declared tax. As such it is essential that due care is applied when engaging each consultant.

MARKING GUIDE

TOPIC	MARKS
No one test conclusive, need to consider as a whole	1
Control	0.5
Explanation	1
Substitution	0.5
Explanation	1
Mutuality of obligation	0.5
Explanation	1
Financial risk and reward	0.5
Explanation	1
Own equipment and explanation	0.5
Integration	0.5
Explanation	1
Number of engagements and explanation	0.5
Business operation	0.5
Explanation	1
Primary responsibility of employer	0.5
Ensure some form of contractual recompense	0.5
Look back up to 6 years for carelessness	0.5
HMRC will usually allow offset	0.5
Subject to interest charge	0.5
Potential penalties	0.5
Range of penalties for carelessness	0.5
PHS	0.5
TOTAL	**15**

QUESTION 3

Mr B Meecham 8 The Windings Canterbury CT2 8UY	AN Accountant 1 High Street Maintown LX1 2BN

3 May 2017

Dear Bill

Capital Gains Tax

Further to our recent discussion, I write to explain the Capital Gains Tax (CGT) consequences of the sale of your hotel business and property on 1 January 2017 and what reliefs are available to mitigate or defer the liability.

Your CGT liability for 2016/17 on disposal of the hotel is calculated as follows:

	£	£
Sale proceeds of property and fixtures		1,250,000
Less:		
Purchase price	500,000	
Conversion costs	250,000	
		(750,000)
Gain		500,000
Less: Annual Exempt Amount		(11,100)
Taxable		£488,900
CGT @ 10%		£48,890

Furniture, equipment and decorative items were all sold below cost and so no capital gain arises in respect of those items, the proceeds of which are adjusted through your capital allowances computation for the period to cessation of the hotel business. You qualify for CGT Entrepreneurs' Relief (ER) and would pay CGT at 10%, rather than the normal rate of 20%. ER is available for a "material disposal" of business assets consisting of the whole or part of a business which is owned by the individual throughout a period of at least one year ending with the date of disposal.

The CGT will be payable on 31 January 2018 as part of your self-assessment tax liability. However, the CGT rules provide for "rollover relief", which may be claimed where a business asset is sold and the proceeds reinvested in the purchase of a further qualifying business asset or assets within a time-frame of one year before and three years after the date of disposal of the "old"' asset.

You owned the hotel for 11.5 years, but for the first 3.5 years the property was not used for the purposes of the hotel trade, as this did not commence until 1 January 2009. Where an asset has not been used for the purposes of the trade for the whole period of ownership, the part of the asset representing the period for which the asset was used for trade purposes is treated as a separate asset. This means that 8/11.5 of the gain i.e. £347,826 can qualify for rollover relief while £152,174 remains taxable, the tax on which of £14,107 ((152,174- 11,100) x 10%) is payable on 31 January 2018.

The proceeds of the deemed separate asset for which rollover relief is potentially available are £1,250,000 x 8/11.5 = £869,565. Where the proceeds of sale of the "old" asset are not wholly used for the purchase of the "new" asset(s), some of the gain not reinvested remains taxable.

You purchased the car sales business on 1 March 2016 for £600,000. As 1 March 2016 is less than one year before the disposal of the hotel then rollover relief may be claimed. As the cost of the garage was £600,000, this leaves £269,565 of the proceeds not reinvested.

Expenditure qualifying for rollover relief must fall within certain classes of assets, one of which is "fixed" plant and machinery. "Fixed" in this sense refers to equipment which is intended to be fixed in one particular location, but which does not become part of a building. You purchased garage equipment for £100,000 on 1 March 2017 which is within the period of three years from the date of sale of the hotel. Where the "new" assets have a useful expected life of less than 60 years, however, the relief is temporary. Instead of being rolled over against the cost of the new asset, the gain is held over and falls into charge when the new asset is sold, ceases to be used for the purposes of the trade or when ten years have expired. If a non-depreciating asset is acquired in the meantime a claim may be made to roll over the gain against the cost of that asset.

You told me that you expect to spend £200,000 within the next two years on extending the garage workshop. Where expenditure is anticipated that will qualify for relief, a provisional claim may be made by making a declaration in the tax return for the year in which the disposal takes place. The relevant return is your 2016/17 tax return, which is due to be filed by 31 January 2018. The declaration ceases to have effect three years after that date unless superseded by a valid claim for relief when the expenditure is incurred. Provided the cost of the extension is incurred on or before 1 January 2020 then rollover relief may be available.

Therefore, if this expenditure is incurred within the required timescale, you will have reinvested £800,000 in qualifying assets with a useful life of more than 60 years and £100,000 on qualifying assets with a useful life of less than 60 years.

Rollover relief claims may therefore be made for the whole of the gain on the disposal of the hotel, apart from the £152,174 which does not qualify for rollover relief.

If you have any queries, please do not hesitate to contact me.

Kind regards

A N Accountant

MARKING GUIDE

TOPIC	**MARKS**
Calculation of gain on property	1
No CG re furniture & equip – deal with through Cas comp	1
Date for payment of tax	0.5
Application for ER: material disposal, in use on cessation, 12 month period of ownership	1.5
Rollover relief general description & time limits	1
Application of time limits	1
Effect of s.152(7) and calculation of gain qualifying	1.5
CGT payable re non-qualifying gain	1
Calculation of proceeds re separate asset	1
Matching proceeds against amounts reinvested & gain chargeable	1
RR available against cost of garage	0.5
Classes of assets – fixed plant & machinery	0.5
Explanation & claim for RR re depreciating assets s.154, effect of 3.154 (2)	1.5
Claim for relief re extension	1
Presentation	1
TOTAL	**15**

QUESTION 4

Mr Ivan Skelhorne
192 Park Avenue
Chester
CH6 8TG

B N Accountant
3 Carbridge Way
Manchester
MN3 7TF

3 May 2017

Dear Ivan

Proposed Damp-Proofing Business

We have briefly discussed whether you should operate your new business as a sole trader or a limited company. You have now requested my advice on which of the alternatives is most appropriate in your circumstances with a view to minimising your exposure to tax and National Insurance Contributions (NICs), and taking account of your requirements in terms of profit extraction.

A sole trader pays Income Tax (IT) and Class 4 NICs on his profits whereas a company pays Corporation Tax (CT). As a sole trader you are taxable on the full amount of your profits as adjusted for tax purposes, irrespective of how much you draw from the business, through completion of the self-employment pages of your tax return. A company, however, is able to "shelter" funds retained in the company in the sense that IT and, if applicable, NICs are only payable when income is paid or credited.

In terms of profit extraction, a company must account for PAYE and employers' and employees' Class 1 NICs in respect of payments of remuneration. The gross remuneration, along with the employers' NICs, is allowable for CT purposes. Alternatively, a company may pay dividends to its shareholders provided it has the reserves, i.e. basically retained profits, to do so, but since these are distributions of profit they are not deductible for CT purposes.

Many private company owner-managers draw only a small director's fee from the company which does not exceed the 'primary threshold' for Class 1 NICs of £155 per week, and draw further amounts in the form of dividends. Despite increases in the rates of dividend tax from 6 April 2016, this remains the most tax-efficient strategy in your circumstances as illustrated below.

My calculation of the IT and NIC payable by you as a sole trader is as follows:

	Workings £	IT/NIC £
Profit	75,000	
Personal allowance	(11,000)	
Taxable	64,000	
IT:		
@ 20%	32,000	6,400
@ 40%	32,000	12,800
Class 4 NIC:		
@ 9% on 43,000 – 8,060	34,940	3,144
@ 2% on 75,000 – 43,000	32,000	640
Class 2 NIC 52 x 2.80		145
Total IT/NIC		£23,129

Based on a profit of £75,000 you would be left with net funds of £51,871.

My calculation of the IT and NIC payable by you operating as a company is as follows if you opt to draw a small director's fee and top up with dividends.

	Workings	IT
	£	£
Company		
Profit	75,000	
Less: Salary	(8,060)	
CT profit	66,940	
CT @ 20%	(13,388)	
	53,552	
Dividend	(53,552)	
Funds retained in company	nil	
Individual		
Director's fee	8,060	
Dividend	53,552	
Total income	61,612	
Personal allowance	(11,000)	
Taxable	50,612	
Dividend tax:		
@ 0%	5,000	0
@ 7.5%	27,000	2,025
@ 32.5%	18,612	6,049
Total IT		£8,074

Based on a small director's fee and drawing the remaining profit after corporation tax as dividends you would be left with net funds of £53,538. This is a small saving of £1,667 when compared with operating as a sole trader but the additional compliance costs of running your business as a company may outweigh the saving.

However, you mentioned that to cover your living expenses you require net income of £40,000 per year. By running your business as a company, you can choose the level of profits to draw and therefore delay any tax on the undrawn profits until either it is drawn or the company is eventually wound up.

The following illustration demonstrates the position if you draw only sufficient income from the company to meet your profit extraction requirement of £40,000 per year.

	Workings	IT
	£	£
Company		
Profit	75,000	
Less: Salary	(8,060)	
CT profit	66,940	
CT @ 20%	(13,388)	
	53,552	
Dividend	(33,886)	
Funds retained in company	19,666	
Individual		
Director's fee	8,060	
Dividend	33,886	
Total income	41,946	
Personal allowance	(11,000)	
Taxable	30,946	

Dividend tax:		
@ 0%	5,000	0
@ 7.5%	25,946	1,946
@ 32.5%	0	
Total IT		£1,946

By drawing £8,060 as director's fees and a dividend of £33,886 you would achieve net income of £40,000 (£41,946 - £1,946). However, if the funds retained in the company are paid out as dividends, the amount by which your income exceeds £32,000 would be taxable at the dividend upper rate 32.5%.

Conclusion

As you will see from my calculations, by trading through a company you may save a small amount of tax £1,667, by comparison with a sole trader, however I do not consider that this is a sufficient saving to make the company route worthwhile unless limited liability were required for commercial reasons. Operation as a company entails additional administration e.g. Companies House requirements and accountancy costs which could easily exceed the modest tax saving. While further tax may be deferred based on your expected income requirements, those requirements may change for a variety of reasons. On balance, I would therefore recommend operating as a sole trader based on current profit projections.

Yours sincerely

B N Accountant

MARKING GUIDE

TOPIC	**MARKS**
Sole trader profits not dependent on drawings	1
Suggesting typical profit extraction strategy	1
Div v salary re CT deduction & application of NIC	2
Tax payable only on withdrawals from company/possible retention of funds	1
Sole trader comp	2
CT comp with remuneration £8k/£11k & all profits distributed	3
Calculation to provide drawings of £40k	2
Comparison of funds retained	1
Conclusion	1
Presentation	1
TOTAL	**15**

QUESTION 5

Mr C Fipps
Chris Fipps Chartered Accountant
West Park
Westland
Wessex
WE1 2ED

A T Mann
Account LLP
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Westland
Wessex
WE1 7AX

3 May 2017

Dear Mr Fipps

Thank you for your letter of 30 April. I have set out below the tax implications of the company's cessation of trade together with the options available to enable the shareholders to realise the value of their holdings in the company as tax efficiently as possible.

Company cessation of trade and final period losses

The cessation of trade will be a deemed disposal of the fixtures and fittings of the business at their market value. This will result in a balancing allowance of £10,000, being the difference between the tax written down value of £12,000 and the market value of £2,000. The allowance will be added to the final period's loss of £36,000 to give an adjusted loss of £46,000.

As the trade has ceased then the company may make a terminal loss relief claim under s.39 CTA 2010. This is made up of the losses of the final twelve months being:

3 months to 31 December 2016	£46,000
9/12 of the year to 30 September 2016	£90,000

Relief for the two elements of the loss are treated separately with the loss of the earlier period relieved in priority to the later period.

The optimum use of the losses can be summarised as:

	Year ended 30 September 2013	Year ended 30 September 2014	Year ended 30 September 2015	Year ended 30 September 2016	3 months to 31 December 2016
	£	£	£	£	£
Profits	110,000	30,000	Nil	Nil	Nil
Note 1		(1,000)			
Note 2	(61,000)	(29,000)			
Taxable profits	49,000	Nil	Nil	Nil	Nil

Loss Memo:

		£
Trading loss year ended 30 September 2015		1,000
s.37 CTA 2010 c/b 30/9/14		(1,000)
Trading loss year ended 30 September 2016		120,000
s.39 CTA 2010 terminal loss maximum 9/12		
30/9/15		Nil
30/9/14		(29,000)
30/9/13		(61,000)
Unrelieved		30,000

Trading loss year ended 31 December 2016		46,000
s.39 CTA 2010 terminal loss		
30/9/16		Nil
30/9/15		Nil
30/9/14		Nil
Unrelieved		46,000

Notes

1) The loss for the year ended 30 September 2015 would be carried back for one year under s.37 CTA 2010
2) Nine twelfths of the loss to 30 September 2016 (total £90,000) will be carried back under s.39 CTA 2010 and set against the available profits of the three previous years on a LIFO basis.
3) Terminal loss relief for the final three months, these losses are unrelieved as there are no remaining profits available to set against these losses in the three years to 30 September 2016.

Extraction of Value

Disincorporation Relief

Your letter makes reference to “disincorporation relief”. I am afraid that this would not be applicable in this case as it is only offers limited relief for gains arising on “qualifying business assets” which are defined as land and goodwill which are not relevant in the case of Salvo Ltd.

Dividend

The directors may choose to distribute the profit and loss reserves of the company by way of dividends. It is unlikely that a dividend would be attractive as this would result in a substantial personal income tax liability. The majority of the funds received would be taxed at a marginal rate of 38.1%. As such it is likely that the shareholders would wish to avoid an income distribution if possible.

Liquidation

Alternatively the directors may consider placing the company into a member’s voluntary liquidation.

The liquidator will distribute the asset of the company to the shareholders. Based on the information provided the tax position of each of the shareholders will need to be considered separately.

Paul Simms

As Paul will have no further involvement with the business or any related activity then any appointments by the liquidator will be treated as a capital gain in his hands. Each appointment is taxed as a separate part disposal of his shares. Assuming Paul has no other gains, it may be worth making two distributions spread over two tax years in order to utilise Paul’s capital gains tax (CGT) annual exemptions.

Provided the distributions are made within three years of the cessation of trade then any gains arising to Paul would qualify for entrepreneurs’ relief.

Steve Western

The tax treatment for Steve may be very different. As he wishes to continue to act as an IT consultant then there is a risk that he will be caught by the Targeted Ant-Avoidance Rules (TAAR) introduced in Finance Act 2016, s.396B ITTOIA 2005.

The effect of these provisions is to treat a distribution out of a liquidation not as a gain subject to CGT but as a dividend subject to income tax. The amount subject to income tax would be the excess of the monies received over the base cost of the shares for CGT purposes.

The anti-avoidance provisions will apply if, within a period of two years from the date of a capital distribution, Steve "carries on a trade or activity which is the same as, or similar to," that undertaken by Salvo Ltd.

Fortunately the legislation also provides that the TAAR will only be applied where "it is reasonable to assume that the main purpose, or a main purpose, of the winding up, or arrangements which include the winding up, is the avoidance or reduction of a charge to income tax." Unfortunately HM Revenue & Customs (HMRC) have not provided a formal clearance procedure and hence it is necessary to consider the key relevant facts.

I believe that the principal reasons for the winding up can be summarised as:

a) The loss of key clients and a corresponding fall in turnover and resultant trading losses
b) The serious ill health of the director
c) The imminent termination of the premises lease
d) The planned retirement of the only director

After considering the above and the fact that Steve has operated as an independent consultant for many years and will simply be continuing this role then it is unlikely that HMRC would seek to invoke the TAAR. As this is a self-assessment matter then it is recommended that full disclosure be made on the "white space" of Steve's self-assessment tax return.

On the assumption that the TAAR did not apply then Steve will be subject to CGT. Because he holds no position with the company then he would not benefit from entrepreneurs' relief and would be taxed at 20% on the taxable gain in excess of his annual exemption, assuming he has fully used his basic rate band.

I hope that the above is clear.

Yours sincerely

A T Mann

MARKING GUIDE

TOPIC	**MARKS**
Cessation is deemed disposal of fixed assets	0.5
Balancing allowance of £10,000	0.5
Added to final period loss to give £46,000	0.5
Terminal loss made up of final 12 months	1
Loss of the nine months to 31 December carried back first	1
Loss of the final three months cannot be utilised	1
Disincorporation relief not applicable	1
Distribution in the absence of liquidation will be subject to income tax	0.5
Consider formal liquidation	1
Paul Simms receipts as capital gains	0.5
Each payment is a part disposal	0.5
Consider spreading over two tax years	1
Entrepreneurs' Relief will apply provided distributed within three years of cessation	1
TAAR may apply	1
Impact is to tax the receipt as a dividend	1
Only the amount in excess of the base cost would be taxed as income	1
TAAR applies if similar activity within 24 months	1
Exception where no tax motive	1
Outline reasoning why TAAR may not apply	1
Subject to self-assessment and recommend full disclosure	1
Entrepreneurs' Relief will not apply	1
Presentation & higher skills	2
TOTAL	**20**

QUESTION 6

A Davey
Adjusted trading profit computation
Year ended 31 December 2016

	£	£
Profit per accounts		75,000
Add:		
Depreciation & amortisation	11,000	
Lease dilapidations – demolition costs[1]	1,500	
Legal fees re new lease[2]	750	
Car lease payments re Audi[3]	1,920	
Private fuel re Audi[4]	500	
Fuel, repairs & maintenance re Mercedes[5]	2,500	
Travel and subsistence[6]	-	
Software[7]	5,000	
Keyboard lessons[9]	800	
		23,970
		98,970
Less:		
Allowance for lease premium on taxed lease[2]	683	
Mileage allowance re Mercedes[5]	3,150	
Capital allowances (W1)	21,870	
		(25,703)
Adjusted profit		£73,267

W1 – Capital allowances

	£	£ Main pool	£ Allowances
TWDV at 1 January 2016		20,000	
AIA qualifying expenditure:			
Additions per FA note	13,000		
Software disallowed[7]	5,000		
	18,000		
AIA	(18,000)		18,000
Demolition costs[1]		1,500	
		21,500	
WDA 18%		(3,870)	3,870
TWDV at 31 December 2016		£17,630	
Total allowances			£21,870

Notes to computation

1) Demolition costs are capital expenditure so disallowed but as the sound booth would have qualified for capital allowances (CAs) costs are added to the main pool.

2) Lease premium £20,000 for ten years. Taxed receipt (s.277 ITTOIA 2005) - £20,000 x ((50-9)/50) = £16,400. Deduction under s.61 ITTOIA 2005 £16,400/10 = £1,640 x 5/12 = £683. Legal fees for renewal of short lease allowed by concession but costs of new lease are capital as creating an ‘enduring benefit’ and are not allowable.

3) CO_2 emissions for Audi exceed 130g/km therefore lease payments are restricted by 15%. Further restriction for private use of 20% (5,000/(5,000+20,000). Total restriction (£6,000 x 15%) + (£6,000 x 85% x 20%) = £1,920.

4) Private fuel for Audi £2,500 x 20% = £500 disallowed.

5) Since Alan's business base would appear to be his studio it is likely that the costs of travel from home to the studio of approximately 5,000 miles would be disallowed on the basis of the decision in *Samadian v CRC* [2014] STC 763. Dr Samadian had an office at home but the FTT did not find that this was his business base, only that he had a number of places of business, one of which was his home. The costs of travel from home to two private hospitals where he held regular sessions to see patients were disallowed.

   Business use deduction for the Mercedes would therefore be £1,167 ((£500 + £2,000) x 7,000/15,000). A fixed rate deduction using ITEPA mileage rates would be £3,150 (7,000 x 45p) and therefore more beneficial.

   No CAs therefore available and all motor expenses for Mercedes added back.

6) Reasonable subsistence costs are allowable where travel costs are allowable or journey is not part of normal travel – s.57A ITTOIA 2005. No disallowance.

   Since Alan's purpose in renting the flat appears to have been solely for business reasons, the accommodation costs would not appear to be affected by the decision in *Tim Healy v HMRC* [2015] TC04425 and the costs should be allowable as 'wholly and exclusively' incurred for the purposes of the trade. The hotel accommodation arranged and paid for by the client, including subsistence and irrespective of his wife joining him for two weeks is not taxable. A trader is taxable only on receipts of money or money's worth and as the provision of hotel accommodation represents neither it is not taxable.

7) Expenditure on purchase of software is considered to be capital expenditure if this gives rise to an 'enduring benefit'. In practice HMRC will allow as revenue if expected economic life is less than two years. As the software is expected to be in use for several years, albeit that updating may be needed each year, this would be regarded as capital and disallowable but CAs may be claimed.

8) The costs of refreshments for recording sessions may be disallowable as entertaining but it seems reasonable to suppose that while such refreshments are not provided as part of the trade they are part of the service which customers expect.

9) It is likely that HMRC would argue that while Alan's immediate purpose in taking keyboard lessons is a business one there is also a conscious or unconscious motive of personal enjoyment and that there is therefore a dual purpose in line with the decision in *Mallalieu v Drummond*, 57 TC 330 and that the costs are disallowable. Even if that were not the case the cost of training to learn a new skill is considered to be capital expenditure on the basis that the skill is of an enduring benefit to the trade.

MARKING GUIDE

TOPIC	**MARKS**
Disallowance of depreciation/amortisation	0.5
Allowance for dilapidations	0.5
Disallowance of demolition costs	0.5
Allowance for lease premium	1.5
Legal costs/distinction between new lease & renewal	0.5
Restriction of lease payments Audi re CO2 emissions & private use	1.5
Costs re Merc, mileage allowance claim, no CAs	2
Private fuel re Audi	0.5
Subsistence costs allowable if part of normal travel	1
Travel & hotel costs allowable	0.5
Software w/off disallowed & CAs claim	1
Disallowance of travel to studio	1
Occupation of holiday apartment:	
Wholly and exclusively for business/ ref to T Healy case	1
Treatment of meals	0.5
Wife's stay not relevant	1
No adjustment re hotel costs paid by customer	1
Entertaining – normal course of trade	1
Disallowance of keyboard lessons	1
Adjusted profit	1
Capital allowances comp	1
Demolition costs added to main pool/WDA claim instead of AIA	0.5
Presentation (re written part)	1
TOTAL	**20**