

THE CHARTERED INSTITUTE OF TAXATION

APPLICATION AND PROFESSIONAL SKILLS

Taxation of Owner-Managed Businesses

May 2022

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 2021/22 legislation (including rates and allowances) continues to apply for 2022/23 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 employed by Tillia Taxation, a firm of Chartered Tax Advisers, where you work primarily for Julia Tillia.

Julia has recently met with Anne and Robert Simpson (**EXHIBIT A**), the shareholders of Simpson Engineering Ltd, a successful company which manufactures joinery equipment. The Simpsons and their company have recently become clients of Tillia Taxation.

Anne is unwell so the couple have decided to retire as soon as possible. The couple require advice regarding passing ownership of their company to their son, Simon, together with other connected matters.

It was agreed that Julia would draft a report to the Simpsons addressing the issues discussed at the meeting.

EXHIBIT A: Notes of meeting between Julia Tillia and Anne and Robert Simpson

EXHIBIT B: Notes of a telephone conversation between Julia Tillia and Robert Simpson

EXHIBIT C: Extract from share valuation report prepared by ZYX Valuation Services Ltd

EXHIBIT D: Pre-seen information

Requirement:

Prepare a draft report to Anne and Robert Simpson, for review by Julia, providing advice and recommendations on the issues discussed at the meeting.

Continued

EXHIBIT A

Notes of meeting between Julia Tilia and Anne and Robert Simpson

Meeting Date: 22 April 2022

Present: Julia Tilia, Anne and Robert Simpson

Subject: Transfer of shareholdings in Simpson Engineering Ltd and ancillary issues

Anne explained that six months ago, she was diagnosed with a serious life-limiting disease. With treatment she currently feels fine and is still working for the company, although this is expected to continue for only another six months or so. She has been informed that her life expectancy is only a further three years. Robert, who was working part-time, is in good health. To help Anne run the company, he is now working full-time again.

It has always been intended that ownership of the company would eventually transfer to their son, Simon, and the time has now come to fully consider how this might be achieved. Simon has been working for the company as its production manager since leaving school and knows the business extremely well.

They intend to gift all their shares to Simon, who will become the Managing Director. Robert said that Simon has no plans to sell the shares once they are transferred to him. Ideally, they would like to make the gifts soon but are prepared to wait if it is advisable to do so. The couple require advice on the tax implications of these proposed gifts, including when the transfers should occur.

With the exception of Robert's gift of Simpson Engineering Ltd shares to Anne in June 1985 the only previous gift made by either of them was to Simon on 30 June 2019, when they gifted their former jointly owned main residence to him. The house was valued at £675,000 at that time. No chargeable gain arose on the gift of this house and Simon has continued to live in it since then.

Robert mentioned that the company currently has a healthy bank balance. Based upon the most recent cashflow projections he estimated that approximately £75,000 of this was in excess of the company's trading requirements, a situation that has prevailed for several years. Robert said that he would provide further information regarding the company's fixed assets, including capital expenditure for the year ended 30 September 2022, and investments over the next few days (**EXHIBIT B**).

Whilst discussing the company's investments Julia confirmed that WR Woodturning Ltd is not a joint venture company for the purposes of the Taxes Acts.

In anticipation of our meeting, Andrew Crouch of ZYX Valuation Services Ltd was appointed to value the couple's shareholdings. An extract from his report is attached to this memo summarising his conclusions (**EXHIBIT C**). The company has been growing in a fairly steady way under Anne's stewardship. It is anticipated that this will continue into the foreseeable future such that the shares will have increased in value by 15% after a further three years and 40% after a further seven years. It was agreed that these increases in value can be used in our analysis.

Robert also mentioned that he wants to sell the warehouse that he personally owns to the company to raise some additional cash for the couple's retirement. The warehouse would be sold for its full market value of £100,000. Robert explained that he has never charged any rent for this warehouse. Robert therefore also wants some advice regarding the tax implications for him of selling his warehouse to the company and when this should occur.

It was agreed that a report would be prepared to address the above issues and detail our advice and any recommendations. With regards to Inheritance Tax advice, it was further agreed that only the Inheritance Tax implications arising from the gifts of the shareholdings would be looked at in the report, and not any wider implications. The meeting then ended.

J Tilia

Continued

EXHIBIT B

Notes of a telephone conversation between Julia Tilia and Robert Simpson

Robert Simpson phoned on 24 April 2022 and provided the following information.

Investments held by Simpson Engineering Ltd

Robert explained that the company held the following investments:

- 1) 1,000 ordinary £1 shares in WR Woodturning Ltd, acquired for investment purposes on 1 January 2010 for £5,000. The company is run by William Rudd, a friend of Robert. It used the funds to help fund some equipment it needed. This holding represents 10% of the issued share capital of WR Woodturning Ltd. Neither Anne nor Robert are directors of this company, nor are they involved in its management. Annual dividends of £5,000 have been paid on these shares for the last few years. This investment has increased in value over time as the company has been able to win some good contracts. Based on the valuation report of A B Crouch (**EXHIBIT C**) these shares are currently worth £50,000.
- 2) A unit on a local industrial estate let to unconnected commercial tenants at an annual rent of £8,000. This building was acquired on 1 January 2018 at a total acquisition cost of £115,000. Based on the valuation report of A B Crouch (**EXHIBIT C**) this property is currently worth £160,000.

Fixed assets

Robert mentioned that the company will purchase the following fixed assets in the year ended 30 September 2022:

- 1) Commercial vehicle costing £15,000 (excluding VAT) in May 2022. This will replace a commercial vehicle sold for £5,000 excluding VAT in March 2022.
- 2) Lathe equipment costing £25,000 (excluding VAT) in August 2022.

Robert also confirmed that the company's tangible fixed assets comprise a freehold factory building (purchased in April 1982 for £20,000), and equipment used to make their products. Robert confirmed that no individual item of equipment is worth more than its cost.

Continued

EXHIBIT C

Extract from share valuation report prepared by ZYX Valuation Services Ltd

We have been asked to report to you with our opinion of the value of Simpson Holdings Ltd and of your shareholdings in it.

Based on our analysis and subject to the assumptions explained in this report we have arrived at the following open market value for the assets and liabilities of Simpson Engineering Ltd as at 20 April 2022.

	£
Freehold property	220,000
Other tangible fixed assets	140,000
Investments	
Shares in WR Woodturning Ltd	50,000
Industrial unit	160,000
Stock	20,000
Trade debtors	40,000
Cash & bank balances	120,000
Goodwill	250,000
Liabilities	<u>(30,000)</u>
	<u>970,000</u>

If all of the shares of the company were sold together on the open market we would expect they would realise £970,000 (£485,000 for each of your holdings).

Smaller shareholdings would be discounted to reflect the level of control in the company. Therefore, the open market value of your individual 50% shareholdings would be discounted by 25% and would be worth £362,500 each.

Andrew Crouch

For and on behalf of ZYX Valuation Services Ltd
20 April 2022

Continued

EXHIBIT D

Pre-seen information

Client Names

Anne and Robert Simpson
Simpson Engineering Ltd

Personal Background

Anne was born on 1 May 1958 and Robert was born on 3 February 1955. They married on 7 July 1981.

They have one child, Simon Simpson, who was born on 15 April 1993. Simon is not married and has no children.

Their annual income is as follows:

	<u>Anne</u>	<u>Robert</u>
	£	£
Salary from Simpson Engineering Ltd	30,000	15,000
Dividend from Simpson Engineering Ltd	50,000	50,000
State Retirement Pension	-	9,100

Robert bought the warehouse used rent-free by Simpson Engineering Ltd on 31 October 2016 for £78,000.

Neither Anne nor Robert have used any of their lifetime limit for the purposes of Business Asset Disposal Relief.

The couple have personal pension schemes currently worth approximately £500,000 each. Annual company contributions of £10,000 each have been made into these schemes since 1 May 2001. Neither Anne nor Robert currently draw from their personal pensions.

Anne and Robert Simpson's wills are reciprocal in nature, leaving all assets to the surviving spouse, and then to Simon.

Company Background

The company was incorporated on 3 January 1948 by Reginald Simpson, Robert's father, who subscribed for 1,000 fully paid-up ordinary £1 shares. The company has always manufactured equipment for the joinery industry.

Reginald died on 3 June 1985, leaving all of his shares to Robert. The probate value of the shares at that time was £20,000. Robert was appointed a director of the company on 28 June 1985.

Robert gave 500 of his ordinary £1 shares to Anne on 28 June 1985 when she also became a director.

Robert moved from working full-time for the company to working part-time on 2 February 2016 so that he could spend more time renovating and maintaining the couple's house and gardens. He remained a company director and retained ownership of 500 ordinary £1 shares.

Simon has worked for the company as its production manager since 1 June 2011.

The company operates from freehold premises which it owns and also a warehouse owned personally by Robert Simpson. No rent is charged for the company's use of Robert's warehouse.

The company's accounts are made up to 30 September each year.

Continued

Company Tax Information

The Corporation Tax Return for the year ended 30 September 2021 shows

	£
Trading income	118,701
Property income	8,000
Interest from non-trading loan relationships	<u>148</u>
Total profits	<u>126,849</u>
Corporation Tax at 19%	<u>24,101</u>

Simpson Engineering Ltd has a capital loss brought forward of £24,500 following the disposal of some dilapidated storage facilities on 25 January 2017.

Simpson Engineering Ltd has been VAT registered since 1 April 1973. All of its supplies are standard rated.

Accounts for Simpson Engineering LtdProfit and Loss Account

	<u>30/09/2021</u>	<u>30/09/2020</u>
	£	£
Turnover	1,320,853	1,282,290
Cost of sales	<u>(805,060)</u>	<u>(774,540)</u>
Gross profit	515,793	507,750
Administrative expenses	<u>(396,848)</u>	<u>(401,800)</u>
Operating profit	118,945	105,950
Income from other fixed asset investments	13,000	13,000
Other interest receivable	<u>148</u>	<u>188</u>
Profit before taxation	132,093	119,138
Tax on profit	<u>(24,101)</u>	<u>(21,980)</u>
Profit after taxation	<u>107,992</u>	<u>97,158</u>

Balance Sheet

	<u>30/09/2021</u>		<u>30/09/2020</u>	
	£	£	£	£
<u>Fixed Assets</u>				
Tangible assets		141,505		129,572
Investments		<u>120,000</u>		<u>120,000</u>
		261,505		249,572
<u>Current Assets</u>				
Stock	20,527		19,035	
Debtors	36,431		45,724	
Cash at Bank and in hand	<u>113,507</u>		<u>114,756</u>	
	170,465		179,515	
<u>Creditors: Amounts falling due within one year</u>	(31,970)		(37,079)	
<u>Net current assets</u>		<u>138,495</u>		<u>142,436</u>
<u>Total assets less current liabilities</u>		<u>400,000</u>		<u>392,008</u>
<u>Capital and Reserves</u>				
Called up Share Capital		1,000		1,000
Profit and Loss Account		<u>399,000</u>		<u>391,008</u>
		<u>400,000</u>		<u>392,008</u>