Association of Taxation Technicians

Examination

November 2004

PAPER 2 – PART II

BUSINESS TAXATION

TIME ALLOWED - 3 HOURS
(for Part I and Part II)

You are required to answer **all** questions in Part I (printed separately) and any **three** out of five questions in Part II.

The maximum number of marks for each question in Part II is shown in brackets.
For Part II, start each answer on a fresh sheet.
All workings should be shown and made to the nearest month and pound unless the question requires otherwise.
Marks are specifically allocated for good presentation.

1. John and Margaret Redwood, husband and wife, have run Redwoods & Co, an estate agency, as a partnership for several years. Due to commercial reasons they are considering incorporating the business from 1 January 2005 and have set up a company, Redwood & Co Ltd, for this purpose. John and Margaret will be directors of the company.

The partnership profit sharing arrangement gives John a salary of £10,000 per annum and the remaining profit is shared equally between the two partners.

Previously, they have prepared partnership accounts annually to 31 December and have overlap profits brought forward at 1 January 2004 of:

John Redwood	£5,250
Margaret Redwood	£4,875

Management accounts indicate the following results for the year ended 31 December 2004:

Schedule D Case I profit	£38,250

The balance sheet at 31 December 2004 is expected to be:

	Original cost/purchase date		Current value
	£		£
Goodwill	-		100,000
Property, 12 High Street	28,000	June 1986	178,750
Office equipment	2,000		
Debtors	16,500		
Cash at bank	13,475		
Trade creditors	(8,650)		
	£51,325		
Capital accounts			
John Redwood	25,750		
Margaret Redwood	25,575		
	£51,325		

If the incorporation goes ahead, John and Margaret will each take a gross salary of £1,000 per month from the business.

Redwood and Co Ltd will have an accounting date of 31 December and is expected to have a profit chargeable to Corporation Tax for the year ended 31 December 2005 of £13,500.

You are required to prepare a letter to John and Margaret dealing with the following:

1) **Explain the options available to them to incorporate their business and the capital gains implications. Your answer should include the calculation of any capital gains arising on the incorporation of the business.** (8)

2) **Calculate their expected Schedule D Case I income for 2004/05 and the use of their overlap profits.** (4)

3) **Calculate the National Insurance liabilities relating to John's 2004/05 income.** (4)

4) **Calculate the Corporation Tax liability for the company for its first accounting period and state the due date for payment of the tax.** (4)

You should assume that the tax rates for the tax year 2004/05 and the financial year beginning on 1 April 2004 are the same as those for the tax year 2003/04 and the financial year beginning 1 April 2003.

Total (20)

2. You are a tax senior at a firm of accountants.

A client, Alan Walters, has traded as "A. Walters - Sign Writer" since June 1983. Alan decided to retire from the business in March 2004 and passed the business on to his son, James, on 31 March 2004. At this date, the balance sheet of the business included the following assets:

	Market value	Original Cost
Goodwill	£256,765	£10,500
Freehold property; Unit 2, Harper Industrial Estate	£146,845	£74,575

The goodwill had been acquired on the start up of the business and the property in February 1999.

For the year ended 31 March 2004, the business had the following profit and loss account:

	£	£
Gross profit		128,725
Other income – bank interest	(1,156)	
Office expenses (see comments below)	10,125	
Motor expenses	15,852	
Profit on disposal	(2,015)	
Depreciation	10,584	33,390
Net profit		£95,335

Office expenses include the following expenses:

Gifts to customers (100 £8 whisky tumblers, engraved "A. Walters")	800
Bad debts (including a £400 increase in the general bad debt provision)	1,213
Retirement planning advice for A. Walters	875

25% of the motor expenses relates to Alan's private motoring.

Capital allowances for the year ended 31 March 2004 are £9,257.

During the year ended 31 March 2004, the following assets and equipment of the business were sold:

1) An antique sign used in the business as an advertising prop – sold in June 2003 for £9,000 (which was net of the auctioneer's 10% commission). It was purchased in October 1998 for £1,200.

2) A vintage car used in the business for sign-writing display. The car was sold for £12,500 in January 2004 and had cost £2,500 in May 1984.

It is expected that in James's first year of trading to 31 March 2005 there will be a trading loss in the region of £10,000.

You are required to prepare a memorandum for use by the tax partner at a meeting with Alan setting out:

1) **The capital gains calculations for Alan's retirement and transfer of the business to James.** (5)

2) **A summary of how both Alan's and James's capital gains position will be effected by claiming gift relief on the transfer of the business.** (2)

3) **The capital gains calculations for the assets sold in the year ended 31 March 2004.** (5)

4) **The Schedule D Case I profit of the business for the year ended 31 March 2004.** (4)

5) **The types of loss relief potentially available to James for the trading loss for the year ended 31 March 2005 and their effectiveness in giving loss relief as soon as possible.** (4)

Total (20)

3. Wilkinson Ltd, a member of a small group, is involved in the manufacture of sporting goods and has a nine month accounting period to 31 March 2004.

Your firm has been approached to prepare the company's financial statements for this period and to prepare the associated Corporation Tax computations.

The accounts department has now completed the financial statements for the company and its parent company, Robinson Ltd. Robinson Ltd has a Schedule D Case I loss of £41,350 for the year to 31 March 2004.

The profit and loss account for Wilkinson Ltd for the period is as follows:

	£	£
Turnover		3,157,001
Cost of sales		(2,068,110)
		1,088,891
Administrative expenses		
Directors remuneration	320,000	
Staff salaries	378,475	
Employers National Insurance	86,404	
Rent and rates	54,625	
Repairs and renewals	15,723	
Light and heat	9,074	
Travel and subsistence	12,324	
Motor expenses	3,628	
Entertaining	8,754	
Sundry expenses	12,324	
Legal and professional	14,300	
Depreciation	65,624	
Profit on disposal of fixed assets	(33,750)	
Bad debts	53,072	
		(1,000,577)
Interest expense		(3,500)
Rental income		55,000
Interest received		19,325
Net profit on ordinary activities before taxation		£159,139

You note from the accounts department working papers the following:

1) Included within repairs and renewals is £2,500 for the redecoration of the company's premises, £2,100 for a new computer, and £2,250 to replace the motor for one of the machining tools.

2) Included within motor expenses is an operating lease for a Jaguar car with a retail price of £26,250. The lease costs for the period are £4,350, which consists of a maintenance element of £450 and a finance cost of £3,900.

3) Entertaining includes a Christmas party for the company's 20 staff, which cost £1,000. The balance of the expense relates to client entertaining.

(Continued)

3. *(Continuation)*

4) Sundry expenses include; a gift aid donation of £250 to Asthma Research, a national charity; £100 penalty for late filing of accounts at Companies House; and £6,000 for cleaning.

5) Bad debts consist of specific bad debts of £45,023 and a general provision of £8,049.

6) The loan interest expense relates to a loan taken out to finance the acquisition of the company's rental properties.

7) Legal and professional includes the following costs:

	£
Chasing bad debts	1,800
Negotiating a long lease over the company's premises	3,000
Renewing a short lease over one of the company's retail premises	1,750
Acquiring a new short lease	1,500
Legal fees on disposal of property	2,200
Trademark applications	1,500
Accountancy fees	2,550
	£14,300

8) Included within wages and salaries above is £100,000, which is in respect of a bonus for the staff. Having reviewed the company's cashflow projections the directors have declared that this will be paid in January 2005.

The company also had some movements in its fixed asset register for the year and these are set out below:

1) A freehold rental property was disposed of for £100,000. The property had a net book value of £66,250 at the date of disposal in January and no depreciation had been charged on the property since its acquisition in March 1995.

2) Computer equipment was acquired for £2,500 in the period.

The documentation received from the company's previous tax advisers shows a tax written down value brought forward of £175,600 for the general pool.

You are required to:

1) Calculate the Schedule D Case I profits of Wilkinson Ltd for the period to 31 March 2004. (11)

2) Calculate the total profits chargeable to Corporation Tax for the period assuming all available reliefs are claimed. (5)

3) Calculate the Corporation Tax payable and state when the tax is payable. (4)

Total (20)

4. Sharpe Ltd, a VAT registered company, has traded for several years as a manufacturer of surgical equipment and also as manufacturers of ball bearings for use in the aviation industry. In the current period, the directors decided that the company should extend its accounting period end to 31 March from 30 September in order to compensate for the seasonal trends affecting the business.

Consequently, accounts were prepared for the 18 month period to 31 March 2004 and the finance director has asked you to determine the capital allowances available to the company.

The change in the company's year end has resulted in an improved turnover for the 18 month period to 31 March of £2,250,000, compared to the previous year's turnover of £1,300,000.

The company acquired the following fixed assets during the period:

	£	Date of acquisition
Computer and accessories	1,494	1 December 2003
Air conditioning units	32,480	15 March 2003
Furniture for the company's office	3,500	10 December 2003
Lathe machine	15,000	21 October 2002
Drilling machine	21,000	21 February 2004
New van	18,000	30 September 2003
Boring machine	55,000	see comments below
BMW 328i	28,995	10 June 2003
Renault Clio	8,995	1 May 2003

The company has a very good relationship with one of its suppliers and as a result has been granted a six month credit period for the boring machine. Therefore, although it received the machine on 25 February 2004 and received an invoice dated 7 March 2004, the company will not need to pay the £55,000 for the machine until 7 September 2004.

The company disposed of the following two assets in the period;

1) an old van which cost £12,000 was scrapped on 1 September, and

2) an old lathe was disposed of on 31 January 2004 for £1,250.

The company had a brought forward tax written down value of £157,250 for the general pool.

As a result of the increase in its fixed assets, the company has gross assets in the current period of £2,400,000, compared with £1,100,000 in the prior period. The company currently employs 25 individuals.

The company has outgrown its manufacturing premises and on 1 February 2004 sold the property for £800,000. The property was originally acquired new for £1,000,000 on 1 October 1993, and has used these premises throughout its ownership.

The company purchased a second hand building for £1,575,000 on 1 January 2004 from Harper Ltd. This property was originally acquired by Harper Ltd on 1 July 1989 for £2,000,000.

The company submits its VAT returns in February, May, August and November.

(Continued)

4. *(Continuation)*

You are required to:

1) **Calculate the allowances available to the company for the 18 month period.** (10)

2) **Calculate the impact of the disposal of the manufacturing property for Sharpe Ltd.** (3)

3) **Calculate the annual allowances that will be available to the company for the new property.** (3)

4) **Explain the rules for determining the tax point for the acquisition of the boring machine and identify which VAT quarter the input tax can be reclaimed in.** (4)

Total (20)

5. As a tax senior in a firm of accountants, you are required to deal with the following matters on behalf of a client, Hurley & Co.

Hurley & Co is a partnership of chartered surveyors. The partnership operates from large city offices that it owns. For several years, the business has only occupied 40% of the premises with the remaining 60% let out to other businesses. The standard method of calculating input tax for partial exemption is used.

No election to waive exemption (option to tax) has ever been made for the building. Your firm prepares the quarterly VAT returns for the partnership which is partially exempt due to the rental income and uses the cash accounting scheme.

For the quarter ended 30 November 2004, the business records show the following:

<u>Income</u>

Surveying fees received	£35,350
Rents received	£12,500

The surveying fees are a standard rated supply:

<u>Outgoings</u>

Payment for subcontracted services	£5,675 (VAT element - £845)
Payment for repairs to the property roofing	£6,750 (VAT element - £1,005)
Other non-attributable supplies paid in the quarter	£2,350 (VAT element - £350)

The building is in need of some major repairs and the senior partner of Hurley & Co, Jim Bowyer, would like some advice regarding the tax effects of the election to waive exemption on the property, the advantages of VAT annual accounting for the business and the VAT and self assessment implications of a partner leaving the practice.

You are required to:

1) Calculate the following VAT return entries for Hurley & Co for the quarter ended 30 November 2004:

- **(a) Ouput tax.**
- **(b) Input tax.**
- **(c) VAT payable/reclaimable.**
- **(d) Net outputs.**
- **(e) Net inputs.** (6)

2) Prepare a letter to Jim Bowyer setting out the following:

- **(a) How an election to waive exemption on the property will alter the VAT status of future supplies in connection with the property.** (2)

- **(b) The possibility of recovering the input tax on any property related expenditure before and after the election is made.** (3)

- **(c) The effect of the election on the tenants.** (2)

- **(d) A summary of the advantages of VAT annual accounting for Hurley & Co.** (3)

- **(e) The VAT and self assessment implications of a partner leaving the practice.** (4)

Total (20)