Association of Taxation Technicians

Examination

May 2005

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. The Rhodes partnership normally prepares its accounts to 30 September, but the partners have decided that due to the seasonal nature of their trade, the period of account in 2004 should be shortened to end on 30 June 2004.

The partnership profit and loss account for the 9 months to 30 June 2004 is as follows:

	£
Turnover	1,678,506
Cost of sales	(952,561)
	725,945
Administrative expenses	(375,672)
Operating profit	350,273
Interest income	13,471
Interest payable	(27,893)
Profit before tax	335,851

Administrative expenses includes the following:

	£
Depreciation (including depreciation on assets held under finance lease of £5,750)	57,000
Profit on disposal of fixed assets (not held under finance leases)	(125,000)
Entertaining (including entertaining for 15 employees of £1,250)	3,760
Decrease in general stock provision	(5,000)
Hire of a hospitality box at a local football club (includes advertising space in the ground)	3,483
Legal fees on collecting debts	250
Legal fees to incorporate a company for one of the partners	1,250
Donations to local charities	100

The profit on disposal of the fixed assets arises from the sale of the partnership's freehold business property, which was acquired in September 1997 for £495,000. This was sold in May 2004 for £620,000.

The interest income has been received net of tax from funds put on deposit after the sale of the property. Although the accounts include interest of £13,471, the actual net interest received in the tax year to 5 April 2005 is £19,473.

The interest payable in the accounts arose on the mortgage on the property. This mortgage was repaid when the property was sold.

The capital allowances pool has a brought forward tax written down value of £137,560 at 1 October 2003. In the period, the partnership spent £15,000 on furniture, of this £8,000 was spent prior to 31 March 2004. The partnership also purchased £2,500 of computer equipment in May 2004.

The partnership has three partners, the business profits being shared equally between them and with no partner having any other sources of income. The partnership employs 15 members of staff and has gross assets of £1.2 million.

The partnership had Schedule D Case I profits for the financial year to 30 September 2003 of £175,680, and each partner has brought forward overlap relief of £34,200 at 1 October 2003.

Continued

1. *Continuation*

You are required to:

1) **Calculate the Schedule D Case I profits of the partnership for the period to 30 June 2004.** (7)

2) **Calculate the Schedule D Case I profit assessed on each partner in 2004/05 and show the impact of shortening the period of account on the overlap relief of each partner.** (2)

3) **Calculate the tax payable by each individual partner for 2004/05.** (7)

4) **Calculate each partner's Class 4 National Insurance liability for 2004/05.** (2)

5) **Identify the payments on account for 2005/06 and state the due dates for payment.** (2)

Total (20)

2. Joanna Pasher currently works for New World Interiors but is proposing to take voluntary redundancy offered by them and start her own interior design business on 1 August 2005 and would like some tax advice on this venture. She is likely to prepare her first business accounts for the period ended 30 June 2006 and annually thereafter.

Based on her business plan, she intends to employ two sewing machinists, a designer and a carpenter who will be based at her rented premises.

She also plans to sub-contract work to several other machinists who will work from their homes, one of which she expects to work full-time for the business. Joanna has been told by her friend who has his own hairdressing business that this may cause tax problems for some involved but she is unclear why.

Joanna is undecided whether to set the business up as an incorporated business or not and would like to understand the key tax considerations relating to this.

You can assume that the business can be expected to make annual profits in the region of £75,000 per year after Joanna has paid herself a salary of £35,000.

You can assume 2004/05 tax legislation and rates apply for later years.

You are required to write a letter to Joanna to:

1) **Outline the key differences in the taxation of her business venture as a company and as a sole trader, including the basis of assessment for both.** (9)

2) **Explain the considerations in determining whether the individuals Joanna will be sub contracting work to will be regarded as employees or self-employed and the implications of both for the business.** (7)

3) **Explain when the business will be required to register for VAT.** (4)

Total (20)

3. Your client, Mr Henno, owns 100% of the trading company, Garvie Ltd, which operates in the motor industry. He has been approached by a competitor, Dempsey Ltd, who wishes to acquire the business as Garvie Ltd has a number of valuable contracts with large automotive companies.

Dempsey Ltd are prepared to make an offer for either the shares in the company or for the business and assets of the company. The due diligence work undertaken by Dempsey Ltd has revealed potential claims against Garvie Ltd, and accordingly Dempsey Ltd is willing to offer more for the business and assets than for the shares.

Mr Henno has approached your firm to evaluate the respective offers and to advise him on the best course of action. In order to assist in this, he has advised you that he is a higher rate taxpayer and that he will not make any other capital disposals in 2005/06. He has also advised you that he plans to sell the business on 30 September 2005.

Offer for the shares in the company

Dempsey Ltd is willing to offer £1.4 million for the entire issued share capital of the company, which consists of 10,000 £1 ordinary shares which were acquired at incorporation at par. The company was incorporated in January 1997 and has traded since this date.

Offer for the business of the company

Dempsey Ltd is willing to offer £1.75 million for the assets and goodwill of the company. This consideration will be split as follows:

	£
Goodwill	1,250,000
Freehold property	300,000
Plant and machinery	200,000
	1,750,000

Under this offer, the purchaser wishes to treat the transfer of the property as a transfer of a going concern.

Having reviewed the company's records, you have ascertained the following information relevant to the sale of the business and assets:

1) The company has no associated companies.

2) The company has fixed assets with a net book value of £456,890, and a tax written down value as at 1 January 2005 of £225,750.

3) The freehold property was acquired in March 2000 and cost £215,000, and the company has opted to tax.

4) The goodwill has been generated by the business and therefore has no cost.

5) The company expects to make profits of £46,750 before tax in the 9 month period ending at the date of sale, at which point it will cease trading.

Continued

3. *Continuation*

6) The expected profits for the final 9 months before accounting for the disposal are after deduction of the following expenses:

	£
Depreciation	5,750
Christmas party for 20 staff	2,500
Interest on late payment of Corporation Tax	150
PAYE penalty	100
Interest on late payment of PAYE	135

The expected profit does not include the profit or loss on disposal of the goodwill and fixed assets, which it anticipates receiving.

7) Prior to receipt of the sale proceeds the company will have cash of £75,000 in the bank at 30 September 2005, no other assets and it's only liability being the Corporation Tax for the period to 30 September 2005.

Once the company has ceased trading it will be wound up immediately, it's Corporation Tax paid and all the remaining cash in the company's bank account including the sale proceeds will be paid out as a capital distribution.

Your tax partner has asked you to prepare a letter to the client that advises him on the relevant issues, assuming that the rates and allowances for 2005/06 are the same as 2004/05. This letter is to include the following:

1) An explanation of the tax treatment of the disposal of the shares by Mr Henno and calculation of the tax payable on the disposal. (5)

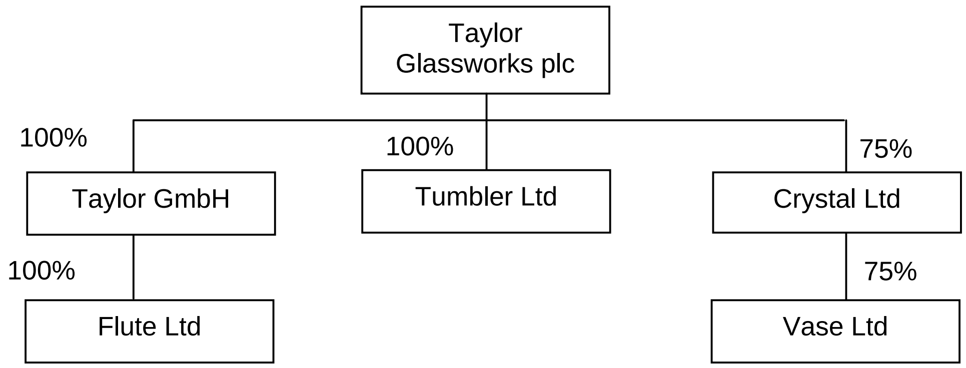
2) An explanation of the tax treatment of the disposal of the business and assets, together with a calculation of the tax payable by both Garvie Ltd and Mr Henno. (8)

3) Advice to Mr Henno on which of the two routes will result in the greatest amount of cash in his own hands. (3)

4) Advice on the conditions that need to be met in order for the transfer of the business and property to be treated as a transfer of a going concern. (4)

Total (20)

4. Taylor Glassworks plc is the parent company of the group which make various types of glassware products and is structured as follows;



All companies other than Taylor GmbH are tax resident in the UK and have a 31 December 2004 year end. Taylor GmbH and its subsidiary were acquired on 1 June 2004. There are no other associated companies and the minority interests of Vase Ltd and Crystal Ltd are owned by shareholders none of whom have more than a 5% holding in each company.

Your assistant has prepared draft tax computations for the UK companies for the year ended 31 December 2004. These are summarised as follows;

	Taylor Glassworks plc	Flute Ltd	Tumbler Ltd	Crystal Ltd	Vase Ltd
Schedule D Case I	320,000	140,000	(180,000)	145,000	(54,000)
Schedule A					36,000
Schedule D Case III					
Surplus	15,000		22,000		

However, your assistant has not been able to complete the computations before going on study leave and has left you with the following notes to enable them to be completed.

1) The following capital additions and disposals in the year ended 31 December 2004 for Crystal Ltd have not been taken into account;

		£	
Additions:	Ford Mondeo car	17,000	
	Glass blowing equipment	35,000	
	Computer	2,000	
Disposals:	Finishing machine	6,000	Note: Original cost was £5,000

The tax written down value brought forward at 1 January 2004 for the general pool was £72,000.

2) In March 2004, Tumbler Ltd sold some unused office premises to Vase Ltd for its market value of £140,000. The premises had originally cost Tumbler Ltd £62,000 in August 1995. Tumbler Ltd then purchased an additional workshop for £100,000. The capital allowances have already been included in the draft tax computations.

Continued

4. Continuation

3) Vase Ltd sold its existing offices in December 2004 to an unrelated party for £129,000 which it had originally acquired in January 2001 for £75,000.

You should assume Crystal Ltd is large for capital allowances purposes.

You are required to;

1) **Complete the Corporation Tax computations prior to any group relief for Crystal Ltd, Tumbler Ltd and Vase Ltd assuming any other reliefs are taken.** (7)

2) **Determine the profits of the companies after group relief assuming losses are relieved in the most beneficial way.** (8)

3) **Explain the requirements for the group to be eligible to establish a group VAT registration and the implications for the group if they obtain a group VAT registration.** (5)

Total (20)

5. You have recently met with Trevor Brown to discuss his tax affairs in relation to his website design business. Trevor Brown started the business on 1 September 2001 and has been very successful to date. Profits are growing and he has increased his number of employees to five and plans to increase this still further. Trevor regards one of these employees as key to the continued success of the business and would like to reward the employee, Sandra, for her commitment to the business.

The business is VAT registered.

Trevor has explained to you that he thinks the business is at a cross roads in terms of its structure as he is considering either introducing Sandra into the business as a partner or incorporating the business and making her a director. He understands that this will have tax implications and would like to understand these in terms of his income tax liability.

Sandra is currently paid a salary of £40,000. Trevor's view is that if Sandra joins as a partner, she will be remunerated with a fixed profit share of £50,000 per annum. Similarly, if she becomes a director she will be given an increase in salary to £50,000 per annum.

Trevor has explained that whichever route he goes he would like to make the change as of 31 December 2005 but will keep a 31 August accounting period end whether he incorporates or not.

Trevor provided the following results for the profits of the business since he started;

	£	
Accounting period ended 31 August 2002	55,000	
Accounting period ended 31 August 2003	85,000	
Accounting period ended 31 August 2004	105,000	
Accounting period ended 31 August 2005	130,000	Estimate
Period to 31 December 2005	45,000	Estimate

Trevor explained to you that he will be the sole shareholder in the company in the first instance and a director of the company for which he is intending to take a salary of £60,000 per annum.

Continued

5. Continuation

Based on his projections, before any deduction for Sandra's share, Trevor expects the profits for the period ended 31 August 2006 to be £180,000.

Trevor already understands that if he incorporates the business, the company will have to pay Corporation Tax on the profits of the company and he does not need any advice on the Corporation Tax position.

You should assume the tax legislation for 2005/06 is the same as for 2004/05.

You are required to write to Trevor to:

1) **Explain, with calculations, what his Schedule D Case I profits will be for the tax years 2001/02 to 2005/06 on the basis that Sandra joins as a partner and how his liability to tax will be determined after Sandra becomes a partner.** (6)

2) **Explain, with calculations, what his Schedule D Case I profits for 2005/06 will be if he incorporates the business on 31 December 2005.** (4)

3) **Explain the National Insurance Contributions implications for Sandra if she is a partner compared to a director of a newly incorporated business (calculations are not required).** (5)

4) **Explain what obligations Trevor has to notify HM Customs and Excise if he incorporates the business** (5)

Total (20)