Association of Taxation Technicians

Examination

May 2006

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 new sheet of paper.
- 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 Amanda have been trading for many years as a partnership, sharing profits on an equal basis. The partnership's principal activity is the manufacture of glue.

On 1 March 2005, Ivor was introduced as a partner with the profit sharing arrangement from that date changed to:

	Share of profits,%
John	40
Amanda	40
Ivor	20

In the year ended 31 December 2005, the partnership undertook research and development work relating to the development of new glue products. The expenditure incurred in the year on research and development consisted of:

	£
Research undertaken by a local university on behalf of the company	10,000
Rent paid (including for laboratory space)	12,500
Research manager's and assistants' salaries	58,750
Promotion of the research in scientific journals	5,850
General administrative costs apportioned to the research cost centre	10,000
Research software	11,750
	£108,850

On 1 May 2005, the partnership purchased a factory unit for £310,000. It was intended the unit be used as a site for the production of the new glue product. The factory was originally constructed in 1987 and brought into industrial use on 1 May 1988. The factory has had a continuous industrial use ever since. The original cost of the building was:

	£
Purchase of land	50,000
Construction costs	65,000
	£115,000

The partnership purchased the following equipment in the year ended 31 December 2005:

	£
Motor car (25% private use by a partner)	12,500
Motor car (30% private use by an employee)	8,750
Laptop computers (acquired 31 May 2005)	5,300

The plant and machinery general pool written down value brought forward at 1 January 2005 was £123,857.

For the year ended 31 December 2005, the partnership had the following income (adjusted for tax purposes):

Trading income (before capital allowances) £125,000

The trading income of £125,000 is after deduction of the £108,850 of research and development expenditure described above.

You have been advised that the partners are considering incorporation of the partnership in the near future.

(Continued)

1. *(Continuation)*

As the partnership's tax adviser, you are required to write a letter to the partners:

1) Stating, after incorporation into a small limited company:

(a) What type of expenditure qualifies for research and development tax credits.

(b) The basic requirements to meet to qualify for the tax credits. (6)

2) Showing calculations of the industrial buildings and capital allowance claims for the year ended 31 December 2005. (8)

3) Showing a calculation of the profit apportionment for each partner for the year ended 31 December 2005 and stating in which tax years the income will be assessed. (6)

Total (20)

2. You are a tax assistant for the firm of tax advisers, Redwood and Co, and are involved in advising one of its corporate clients, the Conor Group.

Conor Group Ltd is a company based in the UK with one wholly owned UK subsidiary, Conor (Retail) Ltd. The group's principal activity is wholesale and retail sale of gift products.

The companies' profits chargeable to Corporation Tax (PCTCT) for the accounting periods ending in 2004 and 2005 are shown below:

	PCTCT, £
Conor Group Ltd	
Year ended 31 March 2004	783,000
Year ended 31 March 2005	741,000
Conor (Retail) Ltd	
Year ended 31 August 2004	823,000
Period ended 31 March 2005	451,000

From a meeting with the managing director of the Conor Group Ltd, the senior partner has gained the following information:

1) Conor Group Ltd plans to make the following new payments in the year ended 31 March 2006:

Annual royalty payment	£15,000 gross
Charitable payment under gift-aid	£2,500 gross
Loan to Conor (Retail) Ltd	£100,000

2) The loan to Conor (Retail) Ltd will bear interest at 8% payable quarterly in arrears.

3) Conor Group Ltd owns land adjoining its head-office building and the board of directors are considering developing the site by building and selling five houses.

You are required to prepare a memo to the senior partner:

1) Calculating the tax payable by both companies for the period ended 31 March 2005 and stating the due dates for payment. (9)

2) Stating when the companies need to file Corporation Tax returns for the periods ending in 2005. (2)

3) Setting out who can qualify for a group payment arrangement for Corporation Tax and the advantages to the group of such an arrangement. (3)

4) Advising whether each of the new payments in 2006 will require inclusion on form CT61. (3)

5) Stating the VAT treatment of the sales income and expenditure relating to the proposed building work. (3)

Total (20)

3. Harry and Doreen Usher have run Usher & Co, a shoe shop, as a partnership for several years. They are considering incorporating the business from 1 January 2006 and have set up a company, Usher & Co Ltd, for this purpose. Harry and Doreen will be directors of the company.

The partnership profit sharing arrangement gives Harry a salary of £8,500 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 2005 of:

Harry	£4,300
Doreen	£5,010

Management accounts indicate the trading profits for tax purposes for the year ended 31 December 2005 are £42,325.

The balance sheet at 31 December 2005 is expected to be:

	Original cost/ purchase date		Current value
	£		£
Goodwill	-		110,000
Property, 82 South Street	25,000	April 1985	192,500
Office equipment	2,500		
Debtors	3,250		
Cash at bank	9,852		
Loans	(10,562)		
	30,040		
Capital Accounts			
Harry	15,020		
Doreen	15,020		
	30,040		

Assuming that the business is incorporated, they will both receive a gross salary of £1,000 per month from the company.

Usher & 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 2006 of £12,000.

You are required to prepare a letter to Harry and Doreen dealing with the following.

1) **Explain the options available to them to incorporate their business and the capital gains implications.** (6)

2) **Show calculation of the capital gains arising from the above options, and identify any planning opportunities.** (5)

3) **Calculate their expected trading profits for 2005/06 and the use of their overlap profits.** (3)

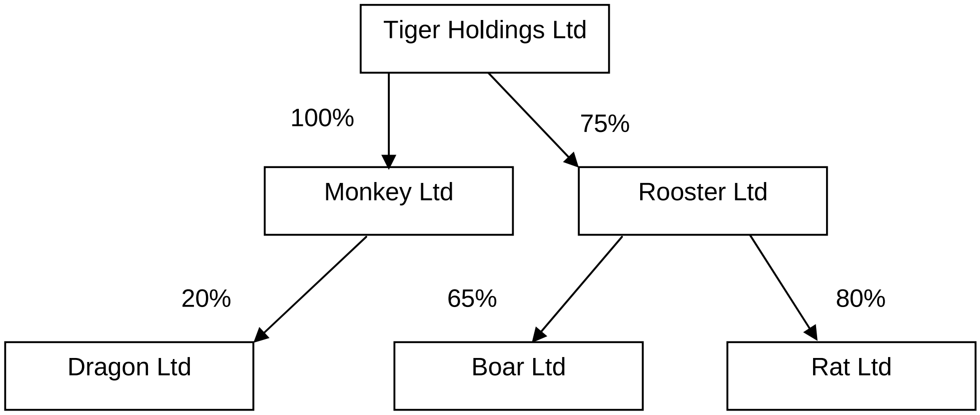
4) **Calculate the National Insurance liabilities relating to Doreen's 2005/06 income.** (4)

5) **Calculate the Corporation Tax liability for the company for its first accounting period and state the due date for payment of the tax.** (2)

Total (20)

You should assume that the tax rates for the tax year 2006/07 and the financial year beginning on 1 April 2006 are the same as those for the tax year 2005/06 and the financial year beginning 1 April 2005.

4. The Tiger Holdings group has the following group structure and ownership. All companies are resident in the UK and are trading companies.



The companies have the following details in respect of capital transactions during the year ended 31 March 2006:

1) Rooster Ltd disposed of its freehold business premises on 31 January 2006 for £400,000. The premises had been acquired on 31 October 1996 for £100,000 and a new extension had been constructed on 31 December 1998 for £40,000.

2) Boar Ltd disposed of its freehold business premises on 31 January 2006 for £200,000. The premises had been acquired on 31 January 2000 for £80,000.

3) On 1 June 2005 Tiger Holdings Ltd purchased new freehold premises for £300,000 to be used by all group companies.

4) Monkey Ltd has capital losses brought forward at 1 April 2005 of £80,000.

5) On 30 September 2005 Rat Ltd had transferred its freehold business premises to Monkey Ltd. The premises had originally cost £120,000 on 31 March 1998 and at 30 September 2005 they were valued at £240,000.

Monkey Ltd, Boar Ltd, Rat Ltd and Rooster Ltd had taxable profits, excluding the above, for the year ended 31 March 2006 of £20,000, £80,000, £90,000 and £100,000 respectively.

You are required to prepare:

1) A calculation of the chargeable gains arising in respect of all capital disposals, assuming that all available claims and elections are made, and state any tax implications of such claims for future disposals. (10)

2) A calculation of the Corporation Tax liabilities of Monkey Ltd and Boar Ltd. (4)

3) The directors of Tiger Holdings Ltd are also considering the purchase of additional leasehold premises for £80,000. The lease of the premises will have 20 years to run on acquisition. State the effect of this acquisition on the above capital gains calculations and the future tax implications. (3)

4) The directors of Monkey Ltd are considering a sale of the shares in Dragon Ltd for £300,000. Summarise under what circumstances this gain could be exempt from tax. (3)

Total (20)

5. You are a tax senior in the firm of Timothy & Co and one of the partners, who has only a very limited knowledge of taxation, has received the following letter from a potential new client.

Mr A Timothy
Timothy & Co
Accountants
34 High Street
Newtown
Cornish
CO1 2RN

10 March 2006

Dear Alan,

<u>Company and Personal Tax Issues</u>

Further to our telephone conversation on Friday I now write to give further background to my business affairs and to summarise the areas on which I would like you to give my wife, Sheila, and I specific tax advice.

<u>Town Builders Ltd</u>

This company commenced to trade on 1 April 2004 and prepares accounts to 31 March each year. The shares in the company are owned 25% by Sheila and 75% by myself. The management accounts for the year ended 31 March 2006 estimate profits before tax and provision for salaries or pension contributions will be £15,000. The company trades from premises owned personally by Sheila and I. Rent has never been charged although I am told that a market rent would be in the region of £10,000. During the year I borrowed £20,000 from the company to purchase a car for my son. This loan remains outstanding. In the previous year the company made taxable profits of £50,000. Neither dividends nor salaries have ever been paid by the company even though my wife works full-time in the business.

<u>City Demolition Ltd</u>

This is a long established company in which the shares are owned 75% by Sheila and 25% by myself. The management accounts for the year ended 31 March 2006 estimate profits before tax and provision for salaries or pension contributions will be £190,000. The company does have a small self-administered pension scheme. The company is currently in the process of purchasing new business premises for, in the region of, £160,000. This purchase is partly to be funded out of company cash resources but approximately 70% will need to be borrowed either by the company or by Sheila and I. During the year to 31 March 2006 Sheila loaned the company £40,000 out of her personal resources.

<u>Personal Tax status of Sheila and myself</u>

My wife has other taxable income of approximately £5,000 and has never extracted any monies from either company. I am a partner in a totally separate business with an annual profit share in the region of £45,000. None of the other partners in this business nor their spouses hold shares in any other companies.

<u>Advice required.</u>

We are looking for advice on the potential tax liabilities of each company for the year ended 31 March 2006 and the various methods by which we can extract monies from each company in a tax efficient manner. We also need specific advice on the loan I owe Town Builders Ltd and the purchase of the new premises for City Demolition Ltd.

(Continued)

5. *(Continuation)*

We look forward to hearing from you as soon as possible, particularly if any action is required before 31 March 2006.

Kind regards.

Yours sincerely,

John Truro

On the assumption that you are dealing with this matter prior to 31 March 2006, you are required to prepare a memorandum for the partner, with supporting calculations, detailing:

1) **Calculations of each company's Corporation Tax liability for the year ended 31 March 2006 based on the management accounts and before adjustments, commenting on how such liabilities could be mitigated in future periods.** (5)

2) **Comments on all possible ways of extracting monies from the companies based on the information given and the tax implications of each. This should advise if any method could reduce the tax liability for the year ended 31 March 2006.** (10)

3) **The tax implications of the overdrawn loan account in Town Builders Ltd.** (3)

4) **The tax implications of the various options with regard to the funding of the purchase of the new premises.** (2)

Total (20)