Association of Taxation Technicians

Examination

November 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. Jim Thompson has been employed for many years.

In August 2005, he started to run a confectionery stall at local markets on a casual basis in his spare time. He has been offered a lucrative purchase contract from a confectionery wholesaler and, as a consequence, he is considering leaving his current employment to devote his time fully to the market stall.

Jim has contacted your accountancy firm to gain further information on tax issues related to his planned change in work. A summary of his letter of enquiry is provided below:

"I have not registered my business with HM Revenue & Customs but understand that I should have done so. Can you let me know the implications of not registering?

To help me decide on what date I did start to trade, please can you explain the definitions of trading for tax purposes?

When I am self-employed will I get tax relief for the equipment that I own and have introduced into the business? I estimate that it cost £4,000 some years ago and is worth in the region of £1,000 currently.

Will I need to pay self-employed National Insurance for the 2005/06 tax year?

When will I need to register for VAT?"

You are required to prepare a response letter to Jim explaining the following:

1) **The requirement to register self-employment with HM Revenue & Customs and the penalties, if any, for not doing so.** (2)

2) **The indicators or "Badges of Trade" that are used to define trading for tax purposes.** (6)

3) **How Jim can gain tax relief against the cost of the equipment he has introduced into the business.** (4)

4) **Treatment of his self-employed income for National Insurance purposes in the first tax year of trading.** (5)

5) **The requirements to register for VAT.** (3)

Total (20)

You should assume that the tax rates for the tax year 2006/07 are the same as those for the tax year 2005/06.

2. You are a tax assistant at a firm of accountants. A client of the firm, Janet Hacker, has been trading as a hairdresser for many years from a large city-based salon. She is VAT registered and accounts for VAT on an invoice basis.

Janet owns the premises and lets a large part (about 60% of the floor space) of the premises to other businesses. For VAT purposes, she has not elected to waive exemption on the building.

For the quarter ended 31 March 2006, her records show the following:

Income	£
Total hairdressing takings	48,500
Rent invoiced in the quarter	10,000
Expenditure	
Gross purchase invoices for hair products (including VAT at 17.5%)	7,900
Wages paid to staff	20,500

Due to the age and condition of the premises, significant repair work needs to be undertaken. It is expected the repairs will cost £30,000 net of VAT and take about two months to complete.

Janet prepares her accounts to a year end of 31 January. She has the following recent and expected results:

Year ended 31 January	Trading income as adjusted for tax purposes
	£
2006 (actual)	72,500
2007 (expected)	85,000
2008 (expected)	100,000

Assume the profits arise evenly throughout each year.

Janet has recently sent the VAT records to your office for completion of the VAT return for the quarter ended 31 March 2006.

In addition, she attended a meeting with your tax partner to discuss both the VAT implications of the expenditure on repairs to the premises and a possible change to the accounting date for the business.

You are required to:

1) Calculate the VAT return entries for the quarter ended 31 March 2006 as follows:

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

2) Prepare a letter to Janet Hacker setting out the following:

- **(a) How an election to waive exemption on the property may allow greater reclaim of the VAT on the repair expenditure.** (3)
- **(b) How such an election will alter the VAT status of future supplies in connection with the property.** (3)
- **(c) The effect of the election on the tenants at the property.** (3)
- **(d) How changing her accounting year end to prepare a 15 month set of accounts to 30 April 2007 could improve her cash flow.** (5)

Total (20)

3. You have been approached by Mr Dart, a potential new client, who needs your advice in the purchase of a business to add to his existing portfolio of businesses. He has provided you with the following details:

Company to be purchased: South West Brick Company Ltd (a brick making company)

Price to be paid for shares wholly-owned by Mr Jones for many years: £1million

Accounting date of company: 31 December

Current balance sheet at 31 December 2005:

	£
Freehold property (constructed and brought into use January 2000):	400,000
Other plant and machinery (with tax written down value £40,000)	100,000
Stock	50,000
Debtors	50,000
Bank loan	(250,000)
Net assets	£350,000

The property is currently valued at £800,000 and the plant at £50,000. No value is included for goodwill but this is currently valued at £300,000.

Mr Dart is considering whether it is more tax efficient to acquire shares in the company or to acquire its business, and has requested your advice. To assist you in considering the two routes, he has advised that the assets to purchase would be:

	£
Property at value	800,000
Goodwill at value	300,000
Stock at cost	50,000
Plant and machinery at value	50,000
	£1,200,000

Mr Dart currently owns the entire share capital of Dart Development Ltd, a property development company, which has one wholly-owned trading subsidiary Dart Builders Ltd.

You are required to prepare a memorandum summarising:

1) **The tax implications of this share purchase, including both current and potential tax issues for the future. This should include considerations as regards how to structure the purchase.** (6)

2) **The tax implications of undertaking an asset purchase, again considering the structure to use.** (8)

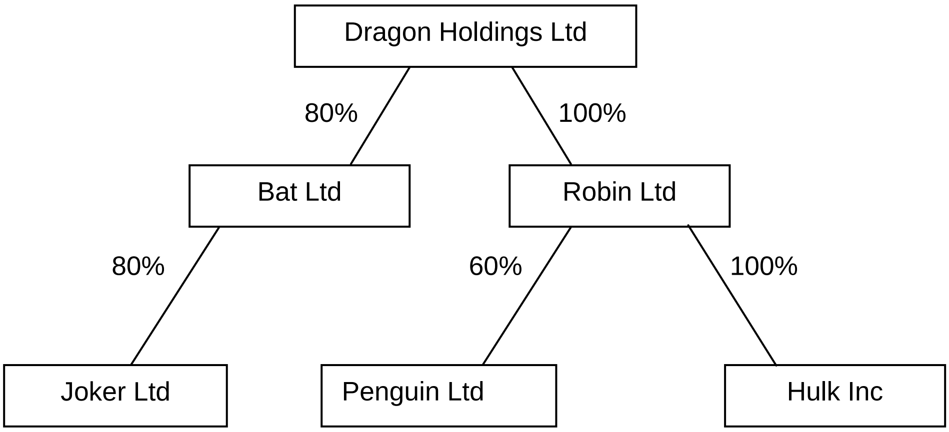
3) **The differences, in tax terms, between an asset purchase and a share purchase for the vendor, and the impact on net cash received by the vendor.** (6)

You are NOT required to comment on the legal differences between an asset purchase and a share purchase.

Total (20)

4. The Dragon group of companies has the following group and ownership structure, with all shares in Dragon Holdings Ltd owned by Derek Johnson and his wife in equal shares (there are no other shareholdings over 50% in the group).

All companies are resident in the UK except for Hulk Inc a company resident in the African state of Benya.



All companies have prepared accounts for the year ended 31 March 2006 except for Joker Ltd, the share capital of which was acquired on 1 July 2005, which has prepared annual accounts for the year to 31 December 2005.

The results for these accounting periods were as follows:

	<u>Dragon</u>	<u>Bat</u>	<u>Robin</u>	<u>Joker</u>	<u>Penguin</u>	<u>Hulk</u>
	£	£	£	£	£	£
Trading profit/(loss)	4,000	(90,000)	205,000	-	260,000	(72,000)
Schedule A rental income	-	-	20,000	9,000	-	-
Interest received	2,000	-	-	10,000	30,000	-
Interest paid	-	-	-	(70,000)		
Capital loss	-	(30,000)	-	-	(20,000)	-
Dividends received in year	8,000	-	100,000	-	-	-
Dividends paid in year	-	10,000	-	-	100,000	

In addition you are advised that Robin Ltd has Schedule A losses brought forward of £30,000 and has trading losses brought forward of £20,000.

Mr and Mrs Johnson have been told by a man they met in their local pub that the more companies they own the greater the potential Corporation Tax liabilities of each company. They have even been told that shares owned by other people can affect the position. They are of course sure that this does not affect them as they only own shares in one company and if they did decide to form another company Mr Johnson would own all the shares.

You are required to:

1) **Calculate the Corporation Tax liabilities of each company for the relevant accounting periods on the basis that the most beneficial tax claims and elections are made, clearly stating any losses to carry forward.** (12)

2) **State the tax implications for the company if Dragon Holdings Ltd had paid a dividend of £30,000 out of its distributable reserves during the accounting period ended 31 March 2006.** (3)

3) **Prepare a memorandum for the partner clarifying the tax position for Mr and Mrs Johnson as regards the comments on the ownership of companies affecting their Corporation Tax liabilities, and addressing their understanding of the comments.** (5)

Total (20)

5. Mr Hopkirk commenced trading on 1 May 2005 as a wholesaler of soap and detergent products.

The first year of trading for the business to 30 April 2006 had the following results:

	£
Sales	625,000
Cost of Sales	535,000
Gross Profit	90,000
Expenses	123,750
Net Loss for the year	£(33,750)

The expenses of £123,750 included the following:

		£
1)	Depreciation	6,250

Includes £535 relating to a laptop computer acquired under a finance lease.

2)	Bad debts	
	Specific bad debts written off	825
	General bad debt provision	625
		1,450
3)	Legal fees	
	Negotiation of a short term lease	200
	Employment contracts preparation	325
	Debt collection	500
		1,025

In addition, the following capital expenditure was made in the period:

		£
6 May 2005	Laptop computer acquired on finance lease	1,250
12 July 2005	Shelving and fixtures	15,850

Additional information:

1) Mr Hopkirk was in employment in 2004/05 with an annual salary of £50,000. His annual salary in earlier tax years had been £20,000. He has no other sources of income.

2) The business uses the VAT cash accounting scheme.

3) Mr Hopkirk expects the net turnover in the second year of trading to reach £900,000.

4) Mr Hopkirk has requested advice from his accountant regarding the VAT annual accounting scheme.

(continued)

5. (continuation)

You are required to prepare a letter to Mr Hopkirk to include the following:

1) **A schedule setting out the tax adjustments needed to the first year's accounts.** (5)

2) **The options available for utilisation of the first year's trading loss and your recommended option.** (5)

3) **A schedule setting out Mr Hopkirk's assessable income for 2003/04 to 2006/07 based upon your recommendation.** (2)

4) **The effect of the increase in turnover in the second year on the ability to use the VAT cash accounting scheme and how any resulting demands on cash flow can be minimised.** (4)

5) **A brief summary of the rules, features, advantages and disadvantages of the VAT annual accounting scheme.** (4)

Total (20)

You should assume that the tax rates for the tax year 2006/07 are the same as those for the tax year 2005/06.