

TAXATION

Diploma stage examination

12 June 2007

MARKING SCHEME



Question 1

(a) (i) Relief for trading losses:

s393(1) ICTA 1988 – carried forward and relieved against future trading profits	2
s393A(1)(a) ICTA 1988 – relieved against total profits of accounting period in which loss arises	2
s393A(1)(b) ICTA 1988 – relieved against the total profits of 12 months prior to the accounting period in which loss arises [with relief against current year in full before carryback]	2

Issues to consider:

Likelihood and expected amount of future trading profits	1
Cashflow situation	1
Past/future expected rates of corporation tax	1
Non-relief of trade and non-trade charges	1

(10)

(ii)

	12 months to 31 December 2006 £	3 months to 31 March 2007 £	
Schedule D Case I	524,850	114,759	5
Less: s393 (1) loss relief	(140,000)	-	1
	<u>384,850</u>	<u>114,759</u>	
Schedule A	24,200	8,000	5
Schedule D Case III	37,450	18,100	
Chargeable gain	2,500	4,000	2
Less capital loss	(2,500)	(1,250)	
	<u>-</u>	<u>2,750</u>	
	446,500	143,609	
Less: charges on income	(20,000)	(10,000)	2
	<u>426,500</u>	<u>133,609</u>	
Chargeable profits	£426,500	£133,609	<i>(see workings)</i>

(20)

Workings

1. Trading income is treated as Schedule D case I and is normally time apportioned. ½

	Year to 31 December 2006 £	3 months to 31 March 2007 £	
727,000 x 12/15	581,600		½
727,000 x 3/15		145,400	½
	581,600	145,400	
Less CAs (see below)	(56,750)	(30,641)	
	£524,850	£114,759	

Computation of capital allowances:

	£	Pool £	Allowances £	
Y/e 31/12/06				
WDV b/f		227,000		
WDA @ 25%		(56,750)	56,750	½
		170,250	56,750	
WDV c/f; allowances for period				
3 months to 31/03/07				
WDA @ 25% x 3/12		(10,641)	10,641	½
		159,609		
Additions qualifying for FYA @ 40%	50,000			
FYA @ 40%	(20,000)		20,000	½
	30,000		20,000	
WDV c/f; allowances for period		£189,609	£30,641	

As a medium sized business, Acme qualifies for 40% FYA (not time apportioned) on acquisitions between 1 April 2006 and 31 March 2007. 1

Total capital allowances for the period are £87,391. As it is a long period of account there are two chargeable periods for capital allowances purposes. 1

2. Property income is included under Schedule A, and is computed on an accruals basis and time apportioned for long periods of account. 1
The premium is taxable, less 2% for every year of the lease except the first one, and should be allocated to the accounting period in which it is paid. 1

See next page for calculations

	Year to 31 December 2006 £	3 months to 31 March 2007 £	
32,000 x 6/12	16,000		½
32,000 x 3/12		8,000	½
10,000 x (100% - (9 x 2%))	<u>8,200</u>	<u> </u>	1
Schedule A	<u>£24,200</u>	<u>£8,000</u>	1

3. Income from Government securities is received gross and included on the accruals basis as part of Schedule D case III. 1

	Year to 31 December 2006 £	3 months to 31 March 2007 £	
60,000 x 6/12	30,000		½
60,000 x 3/12		15,000	½
Bank interest	<u>7,450</u>	<u>3,100</u>	2
Schedule D Case III	<u>£37,450</u>	<u>£18,100</u>	1

4. Gift Aid donations made by a company are paid gross, and treated as a charge on income in the period in which they are paid. 2

5. Capital gains are allocated to the period in which disposals occur. Capital losses are relieved first against gains of the same period and then against subsequent periods. 1

3,750 b/f at 1 Jan 2006 – 2,500 used in year to 31 Dec 2006 = 1,250 loss c/f to 1 January 2007 1

6. Under s393 (1), a company's trading losses are carried forward and relieved against the first available profits of the same trade. 1

(b)

1982 holding	No of shares	Cost £	MV 31/3/82 £	
Acquired 23 March 1981	5,000	5,000	8,000	½
Sold 8 January 2007	<u>(5,000)</u>	<u>(5,000)</u>	<u>(8,000)</u>	½
1982 holding c/f	<u>-</u>	<u>£ -</u>	<u>£ -</u>	

S 104 holding – see next page

S104 holding	No of shares	Cost £	Indexed cost £	
Acquired 8 May 1984	45,000	67,500	67,500	½
Add: indexation to April 1985 (94.78-88.97)/88.97 = 0.065 x 67,500			4,388	1
	45,000	67,500	71,888	½
Add: indexation to January 2007 (199.0-94.78)/94.78 x 71,888			79,048	1
	45,000	67,500	150,936	½
Sold 8 January 2007	(45,000)	(67,500)	(150,936)	½
S104 holding c/f	-	£ -	£ -	

Gain arising on disposal of s104 holding	£	
Sales proceeds (45,000/50,000 x £310,000)	279,000	½
Less: cost	(67,500)	
Unindexed gain	211,500	
Less Indexation Allowance (£150,936 - £67,500)	(83,436)	½
Chargeable gain	£128,064	

Gain arising on disposal of the 1982 holding	Original cost £	Rebasing £	
Sales proceeds (5000/50000 x £310,000)	31,000	31,000	½
Less: original cost	(5,000)		½
Less: market value 31/3/82		(8,000)	½
	26,000	23,000	
Less: Indexation Allowance (199.0-79.44)/79.44 = 1.505 x £8,000	(12,040)	(12,040)	½
Chargeable gain	£13,960	£10,960	

Rebasing applies and the chargeable gain is therefore £10,960. 1

Total chargeable gain is £128,064 + £10,960 = **£139,024** 1

(10)

(40)

Question 2

(a) (i) Tax Code

	£	
Personal allowance for 2006/2007	5,035	½
Plus: Gross charge on income	150	½
Plus: Allowable expenses	120	
Plus: Claim for mileage expense (below)	250	
	£5,555	

Tax code will be 5,555 x 1/10 rounded down to nearest whole number = 555L (for Low indicating that William is only entitled to PA).

1

Discussion and explanations

Provision of a parking space at or near employee's place of work is exempt from income tax, as is provision of one mobile phone and free meals in a canteen available to all.

2

Mileage allowances:

A comparison between the actual mileage rate paid and the HMCE scale rates will produce an assessable benefit in kind charge where the total paid exceeds the scale rate amounts, or an additional expense of employment which may be claimed where the allowance paid is less than the scale rates.

	£	£	
Allowance paid: 25,000 x 35p		7,500	
Tax free allowance	10,000 x 40p	4,000	
	15,000 x 25p	3,750	
		(7,750)	
Expense claim		£(250)	2

In this case, William can make a claim for additional expenses. It has been assumed that as William's mileage has been consistent for two previous years, HMRC will have included an estimate in this year's code for his potential 2006/7 claim.

Loan benefit:

An assessable benefit arises where an advance by an employer to employee carries a rate of interest at less than the "official rate". The benefit may be calculated on the "average" method or the "precise" method and the lower amount will be assessable. However there is a "de minimis" level for the highest value of the outstanding loan in the tax year. If this is below £5,000 there will be no assessable benefit. This is the situation in William's case as the maximum is £4,000. No adjustment will be included in his code for the loan.

2

(8)

(ii) (1) P11D employees are those who earn at least £8,500 per annum and most company directors (except those are full-time, earn less than £8,500 and control no more than 5% of the OSC of their company). P11D employees are taxed on the cost to their employer of providing benefits in kind, whether or not they are convertible into cash. 2

Employers must submit a P11D form annually showing all benefit paid to such employees. When determining an employee's P11D status, all earnings including benefits valued on a P11D basis are taken into account, without any deductions for expenses 2

(ii) (2) Lower paid employees are all those not classed as P11D employees. They are taxed on only the second hand value of benefits in kind, and only on those which can be converted into money. 2

(6)

(iii) (1) As William is a P11D employee, he is assessed annually on 20% of a loaned asset's market value on date of the loan. For computer assets loaned before 6th April 2006, the first £500 of benefit is exempt. 2

2006/2007 (20% x £2,750) - £500 = £50 1

(iii) (2) If an employee purchases a previously loaned computer from an employer, the assessment will be based on the market value of the asset when sold to the employee, less any amount paid for the asset by the employee. 2

		£	
2007/8			
Annual charge	(20% x £2,750) – £500	50	
Additional benefit	£1,200 – £1,000	200	½
Total assessable benefit 2007/8		£250	½

(6)

- (b)** Contract of service vs contract for services
- Control
 - Financial Risk
 - Equipment
 - Work performance and correction
 - Holidays and sickness
 - Exclusivity
 - Mutuality of obligation

2 marks for each criterion well explained and applied to the scenario up to a maximum of (10)

(30)

Question 3

- (a) (i)** Zero-rated – certain supplies charged at 0%
 – 16 groups/example
 - person making only 0% rated supplies must register if taxable turnover exceeds threshold but can reclaim input tax
- 1 mark per relevant point made up to maximum 2 marks, plus 1 mark for example*
- Exempt – VAT not charged on 15 groups of supplies/example
 - person making exempt supplies only cannot register for VAT, charges no output tax, is not a taxable person and cannot reclaim input tax
- 1 mark per relevant point made up to maximum 2 marks, plus 1 mark for example*
- (6)**
- (ii)** VAT registration threshold £60,000 until 1 April 2006, £61,000 from 1 April 2006 1
 Include self-supply 1
 Exclude proceeds on disposal of assets previously used for the purposes of the trade
Alternative solutions accepted dependent upon whether students eliminated the self supply amount in October 2006
- | | Self Supply
ignored and
included | Self Supply
excluded | |
|-------------------------------------|--|-------------------------|---|
| Threshold exceeded: | April 2007 | May 2007 | 1 |
| Notify HMRC by: | 30 May 2007 | 30 June 2007 | 1 |
| Registration will take effect from: | 1 June 2007 | 1 July 2007 | 1 |
- (6)**
- (b) (i)** Mixed supply – a mixture of goods/services invoiced at a single price. ½
 If elements are chargeable at different rates, apportion price paid between elements of supply (plus example) 1½
- Composite supply – occurs when not possible to split a mixed supply into its component parts. Supply must be considered as a whole in order to calculate tax due (plus example). 2
- (4)**
- (ii)** Only part of the input tax suffered may be reclaimed – the amount attributable to taxable supplies. 1
 Input tax on goods and services used exclusively for making taxable supplies reclaimable in full. 1
 Input tax on goods and services used exclusively for making exempt supplies not reclaimable. 1
 Proportion of residual tax (input tax on supplies for making taxable and exempt supplies) may be reclaimed according to formula:
- $$\text{Residual input tax} \times \frac{\text{Value of taxable supplies}}{\text{Value of all supplies}}$$
- 1**

Self-supplies and proceeds from the disposal of capital assets used in the business are excluded from all elements of the calculation.

The fraction (taxable supplies over total supplies) used in the formula is rounded up to nearest whole percentage (ie 82.16% becomes 83%) unless the residual input tax exceeds £400,000 a month on average, when the percentage is rounded to two decimal places. 1

Omit self-supplies and supplies of capital assets from calculation.

If total unattributed input tax does not exceed *de minimis* of £625 a month on average and is not more than 50% of total input tax for period, it is reclaimed in full. 1

(6)

(iii) Input tax attributable to exempt supplies (£6,205) not reclaimable. 1

Calculation of the applicable ratio using the strict method excluding self supplies:

Unattributed tax reclaimable using ratio:

$$\frac{155,000 + 72,000 - 2,000}{155,000 + 72,000 - 2,000 + 47,000} = 82.72\% \Rightarrow 83\% \quad 2$$

Amended solution ignoring the self supplies : examiner's notice of 18th June:

$$\frac{155,000 + 72,000}{155,000 + 72,000 + 47,000} = 82.85\% \Rightarrow 83\% \quad 2$$

There is therefore no difference to the overall result of the calculation

VAT Payable:

	£	£	
Output tax:			
Standard rated supplies: £155,000 x 17.5%		27,125	1
Zero-rated supplies: £72,000 x 0%		-	
		27,125	1
Input tax:			
Attributed to taxable supplies:	9,750		1
Unattributed: £10,000 x 83%	8,300		
	(18,050)		1
Payable to HMRC		£9,075	

Input tax not attributed to taxable supplies is £1,700 (17% x £10,000) + £6,205 = £7,905 which exceeds de minimis level and cannot therefore be reclaimed. 1

(8)

(30)

Question 4

(a) Public goods

Non-excludable and non-depletable

“Free riders” problem understates demand

Taxation may be used to charge for these services

Examples of public goods might include defence and education.

1 mark per relevant point, plus 1 mark for example up to a maximum of 4

Externalities

Costs/benefits accrue to those other than the direct consumer/purchaser

Positive externalities under-produced/negative externalities over-produced as the sales price will not reflect the true cost

Taxation may be used as means of changing behaviour

Examples include training and pollution producing goods.

1 mark per relevant point, plus 1 mark for example up to a maximum of 3

Merit and demerit goods

Non-optimum quantities consumed without intervention

Merit goods under consumed eg education

Demerit goods over consumed eg tobacco

Taxation may be used to change behaviour

Potential conflict between varying purposes of taxation

1 mark per relevant point, plus 1 mark for example up to a maximum of 3

Monopoly

Exists where large barriers to entry limit number of providers eg utilities and railways

Taxation may be used to fund regulation to ensure price and quality in absence of competition

1 mark per relevant point, plus 1 mark for example up to a maximum of 2

(12)

- (b) Taxes may be distinguished from each other via their economic nature. For example:

Direct and indirect taxes

Direct taxes – formal and effective incidences are the same eg income tax and corporation tax

Indirect – formal and effective incidences differ eg VAT

1 mark per relevant point, plus 1 mark for example up to a maximum of 4

Tax bases

Entity/activity on which tax is levied eg:

- Income eg income tax, National Insurance
- Expenditure eg VAT and excise duties
- Capital gains
- Car ownership eg road fund licence

Not always easy to control eg illegal imports

1 mark per relevant point, plus 1 mark for example up to a maximum of 4

Rate structures

- Progressive – tax paid increases faster than rising income eg income tax
- Regressive – tax paid increases slower than the rise in income
- Proportional – tax paid is a constant proportion of income

1 mark per relevant point, plus 1 mark for example up to a maximum of 4

Specific/ad valorem taxes

Relationship to tax base eg 'specific' or 'unit' taxes - levied on the weight or size of tax base eg excise duties on bottle of whisky, or ad valorem – based on money value of tax base.

1 mark per relevant point, plus 1 mark for example up to a maximum of 4

Three categories to be given up to a maximum of (12)

- (c) **Equity**

Fairness in relation to both means (eg income tax) and benefits (eg community charge)
Vertical/horizontal equity

1 mark per relevant point, plus 1 mark for example up to a maximum of 3

Efficiency

Economic/administrative efficiency

Incentive/disincentive effect of tax

Tax is efficient – or fiscally neutral – to extent that it does not distort choices.

Not always desirable or possible – some taxes intended to be 'corrective'.

1 mark per relevant point, plus 1 mark for example up to a maximum of 3

(6)

(30)