TAXATION

Diploma stage examination

9 June 2008

MARKING SCHEME

AT THE HEART OF
YOUR CAREER

Question 1

(a) The previous owner acquired the building in the year to 31 December 2002. An annual WDA of 4% of £160,000 = £6,400 would have been deducted from the building's cost in each of the five years to 31 December 2006, leaving a written down value of £128,000. (Only a notional WDA would be calculated for the year to 31 December 2003, since the building was in non-industrial use on that date). *3*

When the building was sold (for more than original cost) a balancing charge would be made equal to the allowances given up until the date of sale. This charge would be £25,600 (4 x £6,400) giving a residue of expenditure of £128,000 + £25,600 = £153,600. This is less than the acquisition cost of £200,000 excluding the cost of the land (which is excluded from qualifying expenditure) and so becomes the qualifying cost for Liver Trading Ltd. There are 20 years left of the building's tax life so Liver Trading Ltd may claim an annual WDA of £7,680 (£153,600 divided by 20). *2*

The company's final adjusted trading profit for the year to 31 December 2007 becomes £1,450,000 (£1,457,680 - £7,680). *1*

(6)

(b)

Disposal of lease

	£	
Disposal proceeds	10,000	*1*
Less: Cost:		
(16.959/46.695) x £25,000	9,080	*1*
	920	
Less: Indexation allowance		
(203.1-167.5)/167.5 = 0.213		
0.213 x £9,080	(920)	*1*
	nil	

The indexation allowance is restricted as it cannot create or increase a loss. *1*

Disposal of office

	Cost	**March 1982**	
	£	**£**	
Disposal proceeds	350,000	350,000	*1*
Less: Cost / Market value	(70,000)	(120,000)	*1*
	280,000	230,000	
Less: Indexation allowance:			
(203.1-79.44)/79.44 = 1.557			
1.557 x £120,000	(186,840)	(186,840)	*1*
	93,160	43,160	

The lower of the two gains is taken, so the company will use the 1982 market value, resulting in a gain of £43,160. *1*

(8)

(c) The deferral of gains is possible using rollover relief. This is available subject to the following conditions:

- Both the asset disposed of and the asset acquired must be used in the trade(s) of the company;
- Both the asset disposed of and the asset acquired must belong to a qualifying class of asset
- The new asset must be brought into use by the trade immediately; and
- The new asset must be acquired up to one year before, and three years after, the disposal of the asset giving rise to the gain.

(one mark for each condition)
(4)

If these conditions are met, then the gain can be deferred against the base cost of the new asset. If the proceeds are not fully reinvested, then part of the gain becomes immediately chargeable. This is the lower of

- the gain, and
- the proceeds not reinvested.

If these conditions are met, then the gain can be deferred against the base cost of the new asset.

3

In the case of Liver Trading Ltd, the proceeds have not been fully reinvested, and so the lower of the gain (£43,160) and the proceeds not fully reinvested (£30,000) is taxable in the year ended 31 December 2007, i.e. £30,000. *1*

(8)

(d)

	Year ended 31/12/07 £	
Schedule D Case I	1,450,000	*1*
Schedule D Case III	16,680	*1*
Chargeable gains (£30,000 - £6,000)	24,000	*1*
	1,490,680	
Less: Charges	1,000	*1*
PCTCT	1,489,680	
FII	10,000	*1*
Profits	1,499,680	

	y/e 31/12/07 £	
Corporation tax @ 30% (1,489,680 x 30%)	446,904	*1*
Less: Marginal relief		
1/40 x (£1,500,000 - £1,499,680) x (1,489,680 / 1,499,680)	(8)	*2*
Corporation tax liability	446,896	

NOTE: Dividends received from other UK companies are not taxable. *1*

(9)

(e) As the company was not large in the year, corporation tax will be payable by 1st October 2008 – 9 months and one day after the year end. *(1)*

(f) If the gain was not deferred, the profits chargeable to corporation tax (PCTCT) would be £13,160 (£43,160 – 30,000) higher in the year ended 31 December 2007, giving a total PCTCT of £1,502,840 (£1,489,680 + £13,160). This would mean that the company was large for corporation tax purposes. *1*

As it was also large in 2006, corporation tax would be payable in quarterly instalments as follows:

14 July 2007
14 October 2007
14 January 2008
14 April 2008. *4*

In addition, the corporation tax payable for the year ended 31 December 2008 will also be affected. Although the company is forecast to be large for the 2008 year end (as its taxable profits exceed £1,500,000) it would not have been required to make quarterly payments due to the fact that the original profits in 2007 meant that it was not large in the preceding year. However, the increase in 2007 taxable profits has changed matters. As Liver Trading Ltd is large in both 2007 and 2008, quarterly payments will thus be required for 2008. 3

(8)

(40)

Question 2

(a) Claire's Income Tax computation 2007/08

	£	£	
Salary		43,000	½
Mileage allowance:			
15,000 @ 30p	4,500		
Less: 10,000 @ 40p + 5,000 @ 25p	5,250	(750)	1
Long-service award (non-cash, less than £50 pa)		0	½
Total employment income		42,250	
UK dividends £3,078 + £342		3,420	½
ISA interest (exempt)		0	½
		45,670	
Personal allowance		5,225	½
Taxable income		40,445	
Income tax due:			
Non-savings income (£40,445 - £3,420)			
£2,230 @ 10%	223		
£32,370 @ 22%	7,121		
Gift Aid £100 x 100/78 = £128 @ 22%	28		
£2,297 @ 40%	919	8,291	2
Dividend income			
£3,420 @ 32.5%		1,112	½
		9,403	
Less: Tax credits on dividends		342	½
		9,061	
Less: Tax deducted via PAYE		8,934	½
Income tax liability		127	

(7)

(b) Claire's NICs

	£	
Primary Class 1 NICs:		
(£34,840 - £5,225) = £29,615 @ 11%	3,257	1
(£43,000 - £34,840) @ 1%	82	1
	3,339	
Secondary Class 1 NICs:		
(£42,250 - £5,225) = £37,025 @ 12.8%	4,739	1

(3)

(c) Alan's income tax computation 2007/08

	£	£	
Salary - this employment		27,500	
- previous employment		1,920	
		29,420	½
Car benefit (Car 1)			
15% + 6% + 3% = 24% x 15,400 x 2/12	616		*1*
Car benefit (Car 2)			
15% + 4% = 19% x £18,800 x 9/12	2,679		*1*
Less: contribution for private use (120 x 11)	1,320	1,975	½
Fuel benefit			
19% x £14,400 x 9/12	2,052	2,052	*1*
Relocation expenses (under £8,000)		0	½
Beneficial loan: *lower of:*			½
(£50,000 + £30,000)/2 x (5% - 2%) x 9/12	900		½
£50,000 x 3% x 6/12 + £30,000 x 3% x 3/12	975	900	½
Mobile phone (exempt)		0	½
Total employment income		34,347	
BSI £2,520 x 100/80		3,150	½
		37,497	
Personal allowance		5,225	½
Taxable income		32,272	
Income tax due:			
Non-savings income (£32,272 - £3,150)			
£2,230 @ 10%	223		
£26,892 @ 22%	5,916	6,139	
Savings income			
£3,150 @ 20%		630	
		6,769	*1½*
Less: Tax deducted at source from BSI		630	½
		6,139	
Less: Tax deducted via PAYE (£4,696 + £395)		5,091	½
Income tax liability / (repayment)		1,048	
			(10)

(d) The main features of the PAYE system are as follows:

- Employers deduct income tax and NICs from employees when paying their wages and salaries. The sums deducted in a tax month (together with the employer's secondary NICs) must be paid over to HMRC within 14 days of the end of that tax month.
- The PAYE system applies to all payments assessable as employment income, including "payments" taking the form of assets which are readily convertible into cash.
- Each employee is issued with a tax code by HMRC. This code reflects the employee's entitlement to allowances and reliefs. The tax code may be

adjusted to collect tax due on benefits-in-kind or to account for tax under-paid or over-paid in previous years.

- The system is cumulative in nature. With the aid of tax tables provided by HMRC, the employer uses the tax code to determine the amount of tax-free pay to which an employee is entitled for the tax year to date. This amount is then subtracted from the employee's gross pay to date, giving the taxable pay to date. A further table look-up then determines the amount of tax due for the year to date. The tax already paid for the year (if any) is then subtracted, giving the tax due for the current week or month.

- The aim is that, at any time of year, the tax paid so far during the year should accord with the amount due so far for that year. At the end of the year, the system should have automatically collected the correct amount of tax and it should not be necessary to issue the employee with a further tax demand or make a tax repayment.

- At the end of each tax year, employers are required to submit an end-of-year return to HMRC, summarising all employees' gross pay and tax paid for the year. A certificate of gross pay and tax deducted must also be provided to each employee at the end of the tax year on form P60.

- The system as originally designed revolves around the use of printed tax tables and forms. However, many employers now run computer-based payroll systems in which disk files have replaced the printed tables. Similarly, there is an increasing trend for end-of-year PAYE returns to be submitted to HMRC by electronic means.

1 mark for each valid point (including a description of the various forms) up to a maximum of *(6)*

(e)

	£	£	
Disposal proceeds		7,800	
Less: commission			½
		(780)	
		7,020	
Less: cost		(3,200)	½
		3,820	
Less: Indexation allowance:			
(201.1-162.6)/162.6 = 0.237			
0.237 x £3,200		(758)	*1*
		3,062	
The maximum gain is 5/3 x (£7,800 – 6,000)		3,000	*1*

The chargeable gain is the lower of £3,062 and £3,000 i.e. £3,000. 1

(4)

(30)

Question 3

(a) The answer should make reference to the following points:

Registration

VAT registration is compulsory once taxable supplies exceed £64,000.
½

This turnover figure is based on the value of the cumulative taxable supplies in the previous 12 months.
½

Julie has an obligation to inform HMRC within 30 days of the end of the month in which the annual limit is exceeded. ½

Registration will become effective on the first day of the following month. ½

Julie is also required to register for VAT if there are reasonable grounds for believing that her taxable supplies in the following 30 days will exceed £64,000. In such cases, notification is required by the end of that 30 day period with registration being effective from the start of that period. ½

Based on her estimates of taxable supplies, Julie will exceed the annual limit in September 2008 when her cumulative turnover will be £65,000. She will therefore have to inform HMRC by the end of October. Her registration will be effective as of 1 November 2008.
½

Julie can also register voluntarily prior to then in which case she will normally become registered from the date she applied. This is useful where sales are to VAT registered customers for whom the extra VAT would not be a cost.
½

Recovery of pre-registration VAT

It is possible to claim the recovery of VAT incurred prior to registering for VAT. There are some conditions, however.

The costs of goods or services must have been incurred for the purpose of the business

½

Julie has three years from the effective date of registration to recover the VAT on fixed assets (such as the computer). ½

However, Julie has only 6 months in the case of purchased services (such as the consultancy fees).

½

As a result, Julie should apply for voluntary registration as soon as possible, as registering after 1 July 2008 will mean that she will be unable to reclaim the VAT on her consultancy fees.

½

Marks for presentation and format
2

(7) max

(b) There are two VAT accounting schemes that Julie could consider. These are the Flat Rate Scheme and the Annual Accounting scheme.

The Flat Rate Scheme (FRS) exists for small businesses. It enables a small business to calculate its VAT liability as a "flat rate" percentage of total turnover. This percentage varies from 2% to 13.5% depending on the trade sector in which the business operates. *1*
The scheme operates as follows:

Output tax is charged to customers at the normal rate for the supply in question. Input tax is also paid to suppliers, again at the prevailing rate. However, the output tax is not paid over to HMRC, and the input tax is not reclaimed. *½*

Instead, a flat rate percentage is applied to the VAT-inclusive turnover for the period. This includes the value of any exempt supplies. The result of this calculation represents the amount of VAT due to HMRC in that period. *½*

The FRS is available to small businesses with a taxable turnover which is not expected to exceed £150,000 in the next 12 months, and with a total turnover (including exempt and non business income) which is not expected to exceed £187,500 in the next 12 months. *½*

If total turnover in a year exceeds £225,000, the business must leave the scheme unless total turnover for the next 12 months is not expected to exceed £187,500. *½*

The FRS can be used in conjunction with the annual accounting scheme. *½*

The annual accounting scheme allows businesses to make only one VAT return per year, so reducing administrative costs. The main features of the scheme are as follows: *½*

(i) During the year the business makes nine interim payments to HMRC, each calculated as 10% of the VAT liability for the previous year. These payments must be made by direct debit or electronically and begin in the fourth month of the year. *½*

(ii) Alternatively, the business may opt to make three interim payments (in the fourth, seventh and tenth months of the year) rather than the nine payments referred to above. In this case, each payment is equal to 25% of the VAT liability for the previous year. *½*

(iii) At the end of the year, the annual VAT return is submitted together with a final balancing payment. The return must be submitted within two months of the end of the year. *½*

The scheme is generally available only to businesses which have been registered for at least 12 months and which have a taxable turnover which is not expected to exceed £1.35m in the next 12 months. However, a business which has a taxable turnover which is not expected to exceed £150,000 per annum may join the annual accounting scheme without having to wait for 12 months after registration. *1*

Based on the information given, both schemes appear to apply to Julie's business. ½

Answers referring to cash accounting can only score 2 marks for that topic
(7)

(c) VAT invoices should contain the following information

- The invoice number, date and tax point;
- The name, address and VAT registration number of the supplier
- The name and address of the customer
- For each item on the invoice, a description of the goods or service supplied
- For each description, the quantity of the goods or the extent of the services, the unit price, the amount payable (before VAT) and the rate of VAT applicable.
- The total amount due before VAT
- The total amount of VAT chargeable.

One mark for each description up to a maximum of *(6)*

(d)

The formal incidence relates to the person or individual who formally pays the tax. An example would be a shop that pays over the VAT to HMRC on the sale of a computer to an individual. ½

The effective incidence relates to the individual or entity which in reality bears the cost of the tax. Using the above example, while the shop pays over the VAT, it charges this to the individual who pays the VAT charged to the shop. Thus, it is the individual in reality who bears the cost of the VAT charged. ½

Direct taxes are taxes which are assessed on and collected from the individuals or organisations who are intended to bear them. They are taxes whose formal and effective incidences are intended to be the same. Examples of direct taxes are income tax and corporation tax. *1*

Indirect taxes are where the formal and effective incidences of a tax are designed to be different from each other. VAT is an example of an indirect tax. *1*

(3)

(e) The answer to this question should contain references to the following categories:

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

One mark for each description up to a maximum of *(7)*

(30)

Question 4

(a) The following items need to be adjusted.

- **Bad debt general provision**: while specific provisions are allowable, this is a general provision. The increase in provision will be disallowed. The disallowance will only be removed when the provision is used, or credited back to the income statement.

- **Donation to Green Party**: donations to political parties are (in general) not allowable for tax, and so this donation will be disallowed.

- **Customer Entertaining**: While staff entertaining is allowable, customer entertaining is specifically not allowed by legislation. Thus, the amount will have to be added back in the computation.

- **Gifts of wine**: While certain gifts are allowable, these do not include, *inter alia*, gifts of alcohol. This item is disallowable.

- **Interest: loan to buy investment asset**: Such a loan is not trade related, and thus interest on such loans is a non-trade debit. This is added back in the Schedule D Case I computation and offset against non trade credits before being deductible against income of the accounting period to which it relates.

- **Fine: late tax return**: Fines for late submission of items such as accounts or tax returns are not allowable. The amount needs to be added back.

- **Non-employee costs**: Only amounts that are incurred wholly and exclusively for the trade are allowable for tax. Paying costs for a non-employee fail this test and are not allowable.

- **Pension contributions**: A deduction is available for pension contributions in the year in which they are paid. As the contribution was made after the year end, there is no deduction available for the year ended 31 March 2008, and the amount will have to be added back. A deduction will be available in the following year.

A half mark for identifying the item; one mark for explaining the reason for disallowance (12)

(b) While capital expenditure is disallowed as a revenue expense in ITTOA 2005, there is no guidance in statute as to what constitutes capital. The usual reference is the case *Atherton v British Insulated & Helsby Cables* (1926). From this, it was held that an item which provided an "enduring benefit" to the business was deemed to be capital. In reality, this is usually taken to be an asset with a useful economic life of three years or more, although there are exceptions. *1*

Capital items that can be found in income statements include the following:
- costs relating to capital items such as legal fees in acquiring capital assets,
- gains / losses from the sale of capital items e.g. gain/loss on the sale of a motor vehicle, and
- items of a capital nature that have been expensed e.g. IT equipment. *2*

From a tax perspective, capital items are disallowed in the Schedule D Case I calculation. Instead, capital allowances (where appropriate) are claimed on the expenditure. In this manner, (qualifying) assets still obtain a tax deduction, but over a longer period. *1*

Two cases provide additional help in defining what is (and is not) capital in nature. These are as follows:

Law Shipping Co Ltd v CIR (1923) – where repairs were required following the purchase of a ship. Without these repairs, the ship was unable to operate, and the purchase price reflected this. The repairs were held to be capital in nature.

Odeon Associated Theatres Ltd v Jones (1971) – a company acquired theatres in a state of disrepair. However, the theatres were usable, and the purchase price was not affected by their state of repair. It was held that sums spent on repairing and decorating the theatres were revenue in nature.

The tax treatment of capital items depends on whether or not the asset is treated a plant & machinery. Several tax cases have helped determine what is, and is not, plant. The main cases are as follows:

Yarmouth v France (1887) – the original definition of plant
Jarrold v John Good & Sons Ltd (1963) – moveable office partitioning allowed as plant
CIR v Barclay Curle & Co (1969) – a dry dock was held to be plant
Wimpey International Ltd v Warland (1988) – a mezzanine floor represented the setting, and not plant
Brown v Burnley Football & Athletic Co Ltd (1980) – a football stand is the setting, not plant
CIR v Scottish & Newcastle (1982) – decorative assets used in the trade qualified as plant

Half mark for each case (including relevant cases not listed above), plus half a mark for its relevance, up to a maximum of *4*

(8)

(c) Tax avoidance (which is legal) involves arranging a taxpayer's financial affairs in such a way so as to minimise the amount of tax payable. For example, income tax would be legally avoided by a taxpayer who moved funds from a savings account paying taxable interest to an ISA which pays tax-free interest. *1*

Tax evasion (which is illegal) involves reducing tax payments by means of dishonest conduct. For example, income tax could be evaded by claiming tax relief on an expense which has not actually been incurred. *1*

Although tax avoidance is legal, the Government is opposed to complex and highly artificial tax avoidance schemes devised by tax advisors to exploit "loopholes" in the tax law. In an attempt to curb the use of such schemes, the 2004 Finance Act introduced new rules imposing disclosure requirements on those who promote or use such schemes. As a consequence the tax authorities can detect the use of tax avoidance schemes and can then recommend appropriate anti-avoidance legislation to the Government. *1*

(3)

(d) Stephen will be required to file his income tax return by October 31 2008 if the return is submitted manually or if he wishes HMRC to calculate the tax liability. If the return is electronic (which includes a tax calculation), the deadline is 31 January 2009 (the annual filing date). *1*

If the return is filed after this date, a £100 penalty will apply. *½*

HMRC has the right to amend ("repair") a taxpayer's self-assessment return within nine months of the date on which the return is filed. *½*

Stephen has the right to amend his return within 12 months of the annual filing date (i.e. 31 January 2010). *½*

Enquiries

If HMRC wish to raise an enquiry into Stephen's tax return, the enquiry must begin within 12 months of the annual filing date for the year into which the enquiry relates. However, HMRC may make a "discovery" assessment outside this period if it is discovered that full disclosure has not been made. *1*

There are two time limits for discovery assessments:

- If there is no negligence or fraud, 31 January in the sixth tax year following the year to which the assessment related. For Stephen, this would be 31 January 2014. *½*

- If there *is* negligence or fraud, 31 January in the twenty-first tax year following the year to which the assessment related. This would be 31 January 2029. *½*

Appeals

Appeals can be against a number of items, such as the imposition of penalties and surcharges, or an appeal against amendments. The general approach to making an appeal, however, is as follows:

- The appeal must be made in writing to HMRC with 30 days of the relevant decision. ½

- Most appeals are settled by an exchange of information, usually by correspondence. ½

- If an issue cannot be settled, either the taxpayer or HMRC can take the issue to the Commissioners. There are two types.
    - General Commissioners can hear appeals locally. Appeals to the General Commissioners are usually on straightforward matters. *½*
    - Special Commissioners hear appeals involving complex points of law. *½*
- The matter may be taken further, but only on a point of law. *½*

(7)

(30)