

TAXATION

Diploma stage

11 December 2006

MARKING SCHEME



Question 1

(a)

	Pool	Jaguar	Audi	VW	Total	
y/e 31/3/06						
WDV b/f	153,430	22,190	14,270	10,960		
Addition	<u>9,200</u>					
	162,630					
Disposals (£9,450 + £15,500)	<u>(24,950)</u>		(12,500)			
	137,680					
Balancing allowance			<u>1,770</u>		1,770	1
Toyota						
Addition			18,340			
WDA 25%	34,420			2,740	37,160	3
WDA restricted	<u> </u>	3,000	3,000		6,000	1
	103,260					
Additions	102,400					
FYA 40%	<u>40,960</u>				40,960	1
	143,360					
Addition	9,200					
FYA 100%	<u>9,200</u>				9,200	1
	152,560					
WDV c/f	<u>164,700</u>	<u>19,190</u>	<u>15,340</u>	<u>8,220</u>		
Total allowances					<u>95,090</u>	

If the company had been large for financial reporting purposes, it would not have been able to claim the FYA of 40%. The additions of £102,400 would have been subject to a 25% WDA instead, reducing total capital allowances by £15,360.

1
(8)

(b)

	£	£	
Pre-tax profit per accounts		458,080	½
<i>Add:</i> Depreciation of delivery vans		26,110	½
Depreciation (£16,350 + £11,440 + £9,770)		37,560	½
Loss on disposal of motor car		3,510	½
Amortisation (£15,000 - (£140,400/12))		3,300	1
Expenses re rented property		39,130	½
Customer entertaining		5,960	½
Gifts of whisky		2,700	½
Gift Aid donations		2,000	½
Fees relating to tax appeal		12,500	½
Car hire (£3,420 - (£3,420 x 17.4/22.8))		810	2
Interest on overdue corporation tax		<u>670</u>	½
c/f		592,330	

b/f		592,330	
Less: Profit on disposal of delivery van	2,400		½
Profit on disposal of admin. equipment	1,390		½
Decrease in general provision	1,950		½
Other operating income	133,660		½
Interest receivable	4,430		½
Capital allowances	<u>95,090</u>	<u>238,920</u>	½
Schedule D Case I profit		<u>353,410</u>	
			(11)

(c)

		£	
Schedule D Case I	353,410		
Less: s393(1) relief	<u>133,900</u>	219,510	1
Schedule A:			
Rental income	173,660		½
Premium received (£60,000 x 92%)	55,200		1
Premium paid (£100,000 x 82% x 5/10)	(41,000)		1 ½
Expenses	<u>(39,130)</u>	148,730	½
Schedule D Case III (£4,430 - £670)		3,760	1
Gift Aid donations		(2,000)	½
Profits chargeable to corporation tax		<u>370,000</u>	

Capital losses c/f are £37,240. There are no trading losses to carry forward. 1
(7)

(d)

Corporation tax due:	£	
£370,000 @ 30%	111,000	
Less: Marginal relief:		
11/400 x (£1,500,000 - £370,000)	<u>31,075</u>	
	<u>79,925</u>	2

This tax is due for payment on 1 January 2007. The company is not required to pay by instalments since it is not a "large" company for this purpose (i.e. it is not paying tax at the full rate of 30%). 2
(4)

(e) The trading loss has been relieved at the marginal rate of 32.75%. If there had been no s393(1) relief, chargeable profit would have been £503,900, giving a tax liability of £123,777.25 (£503,900 @ 30%, less marginal relief of 11/400 x £996,100). The actual tax liability is £43,852.25 lower than this, which is 32.75% of £133,900. 2

This is the highest rate of tax relief available and therefore the company was wise to carry the loss forward. Relief under s393A(1)(a) would have saved tax at only 19% and there would have been no losses left to carry back under s393A(1)(b). 2

(4)

- (f) The CT600 tax return for the year to 31 March 2006 must be submitted by 31 March 2007 or within 3 months after the issue of a notice requiring a return (if later). A late return will attract penalties as follows: 1
- (i) If the return is up to three months late, there will be a fixed penalty of £100, rising to £500 for a third consecutive late return. 1
- (ii) If the return is over three months late, there will be a fixed penalty of £200, rising to £1,000 for a third consecutive late return. 1
- (iii) In addition to the above penalties, a further penalty will be charged if the return is submitted more than six months late. This penalty is expressed as a percentage of the amount of tax outstanding at the end of the six months, as follows:
- If the return is made between six and 12 months late, the penalty is 10% of the tax outstanding six months after the return was due.
 - If the return is made more than 12 months late, the penalty rises to 20% of the tax outstanding six months after the return was due. 2
- If the company fraudulently or negligently submits an incorrect return (or fails to rectify an error which it has detected in a return) a penalty may be charged of up to 100% of the amount of tax lost. 1
- (6)
- (40)**

Question 2

- (a) Terry's annual salary of £48,000 absorbs the whole of the income tax starting rate and basic rate bands. Therefore any further taxable income will be taxed at the higher rate of 40%. Similarly, his salary exceeds the NICs upper earnings limit and therefore any further income which is subject to primary Class 1 NICs will attract contributions at the 1% rate. 2

With an emission rating of 156 g/km, the car's appropriate percentage for tax purposes is 21% (15% + 3% + 3%). If Terry accepts the car, there will be a car benefit of £2,655 (21% of £15,500, less £600) and a fuel benefit of £3,024 (21% of £14,400). Total benefits will be £5,679. These are subject to income tax but not Class 1 NICs. The tax increase will be £2,271.60 (£5,679 @ 40%). The £100 per month paid to his employer bring the total cost to £3,471.60. 4

If Terry retains his own car, he will receive a mileage allowance of £2,500. £500 of this will be subject to income tax and primary Class 1 NICs at a combined rate of 41%, costing him £205. He will also have to pay his car's running costs of £6,000. The total cost to him is £3,705. 2

Therefore the more efficient option for him is to accept the company car.

(8)

- (b)

	£	£	
Salary		48,000	½
Car and fuel benefits		5,679	½
Lunches in staff dining room (available to all staff)		-	½
Relocation expenses (under £8,000)		-	½
PIEs (up to £5 per night)		-	½
Mobile phone (statutorily exempt)		-	½
Beneficial loan:			
Average method:			
(£50,000 + £30,000)/2 x 5%	2,000		1
Precise method:			
(£50,000 x 3/12) + (£30,000 x 9/12)			
= £35,000 x 5%	<u>1,750</u>	1,750	1
Employer's pension contributions (exempt)		-	½
Reimbursed travel and subsistence expenses		<u>7,150</u>	½
		62,579	
Less: Pension contributions £48,000 x 7%	3,360		½
Necessary travel and subsistence	7,150		½
Professional subscription	164		½
Payroll giving scheme donations	360		½
Customer entertaining	<u>-</u>	<u>11,034</u>	½
Employment income		51,545	
Rental of room in own home (under £4,250)		-	½
Dividends (£27,000 + £3,000)		<u>30,000</u>	½
		81,545	
Less: Personal allowance		<u>4,895</u>	½
Taxable income		<u><u>76,650</u></u>	

Income tax payable:		
£2,090 @ 10%	209.00	
£30,310 @ 22%	6,668.20	
£975 x 100/78 = £1,250 @ 22%	275.00	
£13,000 @ 40%	5,200.00	
£30,000 @ 32.5%	<u>9,750.00</u>	
	22,102.20	2
Less: Tax credits	<u>3,000.00</u>	½
	19,102.20	
Less: PAYE	<u>18,930.00</u>	½
Remaining income tax liability	<u>172.20</u>	

The remaining tax liability is small and will almost certainly be collected by means of an adjustment to Terry's 2006/07 tax code. However, the amount concerned could be collected by means of the Self Assessment system, in which case it would be payable on 31 January 2007.

1
(14)

(c)

	£	
Primary Class 1 NICs:		
(£32,760 - £4,895) = £27,865 @ 9.4%	2,619.31	
(£48,000 - £32,760) @ 1%	<u>152.40</u>	
	<u>2,771.71</u>	1
Secondary Class 1 NICs:		
(£32,760 - £4,895) = £27,865 @ 9.3%	2,591.45	
(£48,000 - £32,760) @ 12.8%	<u>1,950.72</u>	
	<u>4,542.17</u>	1
Class 1A NICs:		
(£5,679 + £1,750) @ 12.8%	<u>950.91</u>	1

(3)

(d) Taxation is a compulsory levy made by public authorities for which nothing is received directly in return. In theory, therefore, National Insurance contributions should not be seen as a form of taxation, since they are made in return for specific benefits (such as the state retirement pension). However, once a threshold number of contributions has been made, the benefits received are not directly related to the contributions made. Also, the National Insurance fund is supplemented by government expenditure financed from other sources. For these reasons, most commentators regard NICs as a tax and this view is borne out by their inclusion in the OECD classification of taxes.

(2)

(e) Transferring the preference shares to Terry's son would save no tax, since the investment income of an unmarried minor child is treated as the income of the parent if it is derived from the parent and exceeds £100 per annum.

1

However, transferring the preference shares to Terry's wife would have the desired effect. She is not (and would not become) a higher-rate taxpayer, so her tax liability on the dividends would be covered by the attached tax credit, saving income tax of £6,750 per annum. This would be a case of legal tax avoidance.

2

(3)

(30)

Question 3

- (a) The rollover claim was valid since land is on the list of eligible assets, both the old asset and the new asset were used for trade purposes and the new asset was acquired within the period starting one year before and ending three years after the date of disposal of the old asset. The computation of the amount of the rolled-over gain is as follows:

	£	
Disposal proceeds	50,000	
Less: Cost	<u>10,000</u>	
	40,000	
Less: Indexation allowance		
$(163.4 - 141.8)/141.8 = 0.152 \times \text{£}10,000$	<u>1,520</u>	
	38,480	
Less: Proceeds not re-invested	<u>8,000</u>	
Rolled-over gain	<u><u>30,480</u></u>	

(4)

- (b) The effect of the rebasing election is that costs incurred before 31 March 1982 are completely ignored for all purposes (including calculation of the indexation allowance) when computing the gain or loss arising on the disposal of an asset acquired before 31 March 1982. Such an asset is treated as if bought on 31 March 1982 for its market value on that date and indexation allowance is also based upon that market value, even if this is lower than cost.

2

This treatment reduces the amount of computation required on the disposal of a pre-31 March 1982 asset but increases chargeable gains in the case of assets with a cost in excess of their market value at 31 March 1982. For this reason, the (irrevocable) rebasing election should not be made lightly.

1

(3)

- (c) **Disposal of Bentley.** Motor cars are not chargeable assets so there is no chargeable gain. The company's capital allowances computation for the year to 31 March 2006 will show a balancing charge equal to the total capital allowances claimed in relation to the Bentley since it was acquired.

2

Disposal of office building

	£	£	
Disposal proceeds		470,000	½
Less: MV 31 March 1982	135,000		1
Enhancement expenditure	<u>40,000</u>	<u>175,000</u>	½
		295,000	
Less: Indexation allowance			
$(194.0 - 79.44)/79.44 = 1.442 \times \text{£}135,000$	194,670		½
$(194.0 - 108.4)/108.4 = 0.790 \times \text{£}40,000$	<u>31,600</u>	<u>226,270</u>	½
Chargeable gain		<u><u>68,730</u></u>	

Gift of used plant and machinery. Gifts to charity do not rank as chargeable disposals so there is no chargeable gain or allowable loss. The company's capital allowances computation for the year to 31 March 2006 will show a disposal of £1,000 and there will also be a £1,000 deduction from the company's Schedule D Case I trading profit.

2

Disposal of land

	£	
Disposal proceeds	120,000	
Less: Base cost (£42,000 - £30,480)	<u>11,520</u>	
	108,480	
Less: Indexation allowance (191.5 - 159.6)/159.6 = 0.200 x £11,520	<u>2,304</u>	
Chargeable gain	<u>106,176</u>	2

Disposal of plant and machinery. The plant and machinery disposed of in March 2006 was sold at a loss. This is not an allowable loss since it is relieved by means of the capital allowances system. The company's capital allowances computation for the year to 31 March 2006 will show a disposal of £9,000.

The plant and machinery sold in May 2005 was sold at a profit. The company's capital allowances computation for the year to 31 March 2006 will show a disposal of £19,500 and there will be a chargeable gain as follows:

	£	
Disposal proceeds	22,500	
Less: Cost	<u>19,500</u>	
	3,000	
Less: Indexation allowance (191.5 - 186.5)/186.5 = 0.027 x £19,500	<u>527</u>	
Chargeable gain	<u>2,473</u>	4

Disposal of gilt-edged stocks. The disposal of gilt-edged stocks by a company falls within the loan relationships regime and there will be a Schedule D Case III credit of £10,500. There is no chargeable gain or allowable loss. 2

Disposal of shares in Theta plc

S104 Holding

	<i>No. of shares</i>	<i>Cost £</i>	<i>Indexed cost £</i>
Bought June 1995	2,500	12,500	12,500
Indexation to January 2002 (173.3 - 149.8)/149.8 x £12,500			1,961
Bought January 2002	<u>3,000</u>	<u>18,000</u>	<u>18,000</u>
	5,500	30,500	32,461
Indexation to February 2006 (196.0 - 173.3)/173.3 x £32,461			<u>4,252</u>
			36,713
Sold February 2006	<u>500</u>	<u>2,773</u>	<u>3,338</u>
c/f	<u>5,000</u>	<u>27,727</u>	<u>33,375</u>

The shares were sold for £5,000 so the chargeable gain arising on the disposal of these shares is £1,662 (£5,000 - £3,338). 4

(19)

(d) Total gains are £179,041 (£68,730 + £106,176 + £2,473 + £1,662). There are no current-period allowable losses but there are capital losses brought forward of £156,200, reducing the chargeable gains figure to £22,841. (2)

(e) Prior to the introduction of the tax on chargeable gains, there was a strong incentive for companies to try to disguise trading profits (which were taxable) as capital gains (which were not). There were many such attempts at tax avoidance and this led to the development of the set of tests known as the "badges of trade" which could be used to determine whether or not a given activity should be construed as trading.

Since the introduction of the tax on chargeable gains, the incentive to attempt tax avoidance in this way has reduced considerably and this makes it rather more likely that trading profits will be properly charged to tax. (2)

(30)

Question 4

- (a) One consequence of failing to register is that the company would be held liable for the output tax that should have been charged to customers since the date on which registration should have occurred (and it would probably be impossible to recover this VAT in retrospect from customers). 1

A further consequence of failing to register is that the company would become liable to a penalty, calculated as a percentage of the amount of tax due between the date on which registration should have occurred and the date on which notification was eventually made. The percentage is 5% for a delay of up to nine months, 10% for a delay of between nine and 18 months and 15% for a longer delay. The minimum penalty is £50 in all cases. 2

(3)

- (b) Strictly speaking, VAT incurred before registration is not input tax. However, such VAT may be treated as input tax so long as certain conditions are satisfied. These conditions vary according to whether the VAT is incurred on a supply of goods or a supply of services:

- (i) **Goods.** VAT suffered on a pre-registration supply of goods may be treated as input tax so long as the goods were supplied to the taxable person for business purposes within the three years prior to the date of registration and were not sold or consumed before that date. 1

- (ii) **Services.** VAT suffered on a pre-registration supply of services may be treated as input tax so long as the services were supplied to the taxable person for business purposes no more than six months before the date of registration. 1

Toucan Ltd may recover the VAT incurred in relation to the stock of goods held on 1 September 2006 (£4,600) and on the services supplied to the company in the 6-month period from 1 March 2006 to 31 August 2006 (£6,800). The VAT incurred in relation to the expenditure on fixed assets (£34,000) may also be recovered, since these were not sold before the date of registration. The amount of pre-registration VAT which may be recovered is therefore £7,945 (£45,400 x 17.5%). 3

(5)

- (c)

	£	£	
<i>Output tax:</i>			
Standard-rated supplies £28,800 x 97.5% x 17.5%		4,914	1
Supply invoiced 15/11/06 £4,800 x 17.5%		840	1
Fuel scale charge		46	1
		<u>5,800</u>	
<i>Input tax:</i>			
Standard-rated goods £9,280 x 17.5%	1,624		½
Standard-rated services £5,200 x 17.5%	910		½
VAT on car (not wholly for business use)	0		1
Car maintenance £280 x 17.5%	49		½
Car fuel £520 x 17.5%	91		½
Fixed asset £14,100 x 17.5/117.5	<u>2,100</u>	<u>4,774</u>	1
		1,026	
Pre-registration VAT reclaimed		<u>7,945</u>	1
VAT refund due from HMRC		<u>(6,919)</u>	

If the company had been liable to make a payment of VAT to HMRC, this payment would have been due on 31 December 2006.

1

(9)

(d) As indicated above, the company is accountable for output VAT relating to the sale of £1,600, even though the customer never paid and the debt was then written off. However, a claim may be made for a refund of the VAT lost in relation to a bad debt so long as:

- goods or services have been supplied for a consideration in money and the related output tax has been accounted for to HMRC
- the debt has been written off in the books of account
- at least six months have elapsed since both the date of the supply and the date that payment was due
- the claim for bad debt relief is made within three years and six months from the later of the date of the supply and the date that payment was due.

2

Therefore Toucan Ltd must wait until the above-mentioned six months have elapsed and then claim a refund of the VAT lost ($£1,600 \times 17.5\% = £280$).

1

(3)

(e) Items that must be shown on a VAT invoice (other than those mentioned in the question) include:

- invoice number
- invoice date
- tax point
- VAT registration number of the supplier
- for each invoice item, the amount payable (excluding VAT) and the VAT rate applicable
- the total amount due (excluding VAT)
- the rate of any cash discount available
- the total amount of VAT chargeable.

1/2 mark for each valid point up to a maximum of (3)

(f) The flat-rate scheme for small businesses (FRS) is available to 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. Toucan Ltd appears likely to satisfy these requirements.

2

Membership of the scheme would allow Toucan Ltd to calculate its VAT liability as a flat-rate percentage of its total turnover and so avoid the need to keep detailed records of input tax and output tax. The FRS operates as follows:

- (i)** Output tax is charged to customers at the normal rate for the supply. Similarly, input tax is paid to suppliers at the normal rate. However, the output tax charged to customers is not paid over to HMRC and (in general) input tax is not recoverable.
- (ii)** In each tax period, a flat-rate percentage is applied to the VAT-inclusive turnover for the period. The result of this calculation is the amount of VAT payable to HMRC for the period.

1

1

(iii) Input tax on the purchase of fixed assets costing at least £2,000 (including VAT) can be reclaimed in the usual way. 1

If Toucan Ltd joined the FRS, its average monthly VAT liability would be £1,081 ($£11,500 \times 1.175 \times 8\%$). If the company did not join the scheme, the average liability would be £1,050 ($(£11,500 - £5,500) \times 17.5\%$). In both cases, input tax could be reclaimed on the expected fixed asset purchase of £5,000. 2

It would appear, therefore, that Toucan Ltd would not benefit from joining the FRS unless administrative savings exceeded £31 per month.

(7)

(30)