TAXATION

Diploma stage examination

11 December 2006

From 2.00pm to 4.00pm
plus ten minutes reading time from 1.50pm to 2.00pm

Instructions to candidates

*Answer **three** questions in total:*
One** compulsory question from **Section A
Two** of the three questions from **Section B

The question in Section A carries, in total, 40 marks
The questions in Section B each carry a total of 30 marks

All workings should be shown. Where calculations are required using formulae, calculators may be used but steps in the workings must be shown. Calculations with no evidence of this (for example, using the scientific functions of calculators) will receive no credit. Programmable calculators are not permitted in the examination room.

Where a question asks for a specific format or style, such as a letter or report, marks will be awarded for presentation and written communication.

Calculations may be performed to the nearest £ and any necessary apportionments may be made to the nearest month. There is a summary of useful tax data at the end of the examination paper.

AT THE HEART OF YOUR CAREER

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SECTION A (Compulsory)

1 Trent Trading Ltd has always prepared accounts to 31 March each year. It has no associated companies and is small for financial reporting purposes. An extract from the company's profit and loss account for the year to 31 March 2006 is shown below:

	£	£	*Note*
Turnover		2,270,340	
Cost of sales		1,306,150	1
Gross profit		964,190	
Distribution costs	307,330		2
Administrative expenses	332,760	640,090	3
		324,100	
Other operating income		133,660	4
Operating profit		457,760	
Interest receivable		4,430	5
Interest payable		(4,110)	6
Profit before taxation		458,080	

Notes:

1 All of the expenses included in the cost of sales figure are allowable trading expenses under the rules of Schedule D Case I.

2 Distribution costs are as follows:

	£
Depreciation of delivery vans	26,110
Profit on disposal of delivery van	(2,400)
General distribution costs (all allowable)	283,620
	307,330

3 Administrative expenses are as follows:

	£
Depreciation:	
Administrative equipment	16,350
Directors' motor cars (i)	11,440
Other motor cars	9,770
Profit on disposal of administrative equipment	(1,390)
Loss on disposal of director's motor car (i)	3,510
Amortisation of lease premium (ii)	15,000
Expenses relating to rented property (see Note 4)	39,130
Bad and doubtful debts:	
Trade debts written off	28,220
Trade debt recovered	(3,000)
Decrease in general provision for doubtful debts	(1,950)
Entertaining and gifts:	
Customer entertaining	5,960
Staff entertaining	3,750
Gifts of whisky to customers at Christmas	2,700
Gift Aid donations paid in the year	2,000
c/f	131,490

b/f	131,490
Legal and professional fees:	
Relating to tax appeal	12,500
Audit and accountancy fees	35,000
Motor expenses:	
Running costs of directors' motor cars (i)	9,640
Running costs of other motor cars	17,390
Car rental costs (iii)	3,420
General administrative expenses (all allowable)	123,320
	332,760

(i) There is 25% private use of the directors' motor cars.

(ii) On 1 October 2003, a premium of £180,000 was paid to acquire a 12 year lease on a property to be used for trade purposes. This premium is being written off to administrative expenses over the period of the lease.

(iii) A motor car was rented during the year which would have cost £22,800 to buy. This car was used entirely for trade purposes.

4 Other operating income is as follows:

	£
Rental income re properties let unfurnished:	
Prepaid at 31 March 2005	23,500
Received during the year to 31 March 2006	181,800
Prepaid at 31 March 2006	(31,640)
Premium received 1 January 2006 (i)	60,000
Premium paid 1 April 2005 (i)	(100,000)
	133,660

(i) On 1 April 2005, the company paid a premium of £100,000 to acquire a 10-year lease on a commercial property. This property remained empty until 1 January 2006, when it was sublet to a tenant. The tenant paid a premium of £60,000 on the grant of a 5-year lease.

(ii) Expenses incurred during the year in connection with rented properties were £39,130. These expenses are included in administrative expenses.

5 Interest receivable is as follows:

	£
Accrued at 31 March 2005	(1,370)
Received during the year	4,290
Accrued at 31 March 2006	1,510
	4,430

6 Interest payable consists of bank overdraft interest of £3,440 (incurred for trade purposes) and interest of £670 on overdue corporation tax.

7 After deducting capital allowances for the year to 31 March 2005, the tax written down values of the company's plant and machinery were:

	£
General pool	153,430
Jaguar motor car	22,190
Audi motor car	14,270
VW motor car	10,960

Transactions in plant and machinery during the year to 31 March 2006 were as follows:

(i) A delivery van which had originally been bought for £14,900 was sold for £9,450. A new van was acquired at a cost of £15,200.

(ii) The Audi motor car was sold for £12,500 and replaced by a new Toyota (not a low-emission car) costing £18,340. There is 25% private use of the Jaguar, Audi, VW and Toyota motor cars.

(iii) Two motor cars were bought for £9,200 each. One of these was a low-emission car. There was no private use of either of these cars.

(iv) Equipment was sold for £15,600. Most of this equipment was sold for less than original cost, but one item was sold for £100 more than original cost. New equipment was bought for £87,200.

The company claims maximum capital allowances on plant and machinery but claims no industrial buildings allowances.

8 There were no chargeable disposals during the year to 31 March 2006. Capital losses brought forward at 1 April 2005 were £37,240.

9 A trading loss of £133,900 was incurred in the year to 31 March 2005. The whole of this loss was carried forward.

10 The company's chargeable profits for the year to 31 March 2005 were £247,700. The equivalent figure for the year to 31 March 2004 was £1,729,460.

11 There was no franked investment income in any year.

- **Requirement for question 1**

(a) Prepare a capital allowances computation for the year to 31 March 2006. What difference would it have made if the company had been large for financial reporting purposes? *8*

(b) Compute the Schedule D Case I trading profit for the year to 31 March 2006 (your computation should start with the pre-tax profit of £458,080). *11*

(c) Compute the chargeable profit for the year to 31 March 2006, stating the amount of any losses carried forward. *7*

(d) Compute the corporation tax liability for the year to 31 March 2006, stating the date on which this tax is due for payment. Explain why the company is not required to pay corporation tax by instalments for this year. *4*

(e) Compute the effective rate of tax relief that has been obtained on the trading loss incurred in the year to 31 March 2005 and comment on whether the company was wise to carry this loss forward. *4*

(f) State the date by which the company must submit its tax return for the year to 31 March 2006 and explain the consequences of submitting a late or an incorrect return. *6*

(40)

SECTION B (Answer two questions from this section)

2

Terry is a director of Turner Ltd. He is married and has a 10-year-old son. Both Terry and his wife were born in 1958. Terry's basic salary in tax year 2005/06 was £4,000 per month and PAYE of £18,930 was deducted during the year. The information given below relates to the benefits in kind which he received from his employer during the year and the expenses he incurred.

1. Until 2005/06, Terry had used his own car on business trips and was paid a mileage allowance of 50p per mile. As from 6 April 2005, he was offered a company car instead. However, he could decline the company car and continue to use his own car, if he preferred. The details of these arrangements would be as follows:
   - The company car would have a list price of £15,500 and an emission rating of 156 g/km. It would be diesel powered. The company would pay all running costs, but Terry would be required to pay £50 per month for private use of the car and a further £50 per month towards the cost of fuel used for private motoring. This contribution would not fully reimburse the company for the cost of private fuel. Terry would be able to dispose of his own car, which would save him £6,000 per annum in running costs (including depreciation).
   - If Terry chose to retain his own car rather than taking the company car, he would receive a mileage allowance of 50p per mile for 5,000 business miles driven during 2005/06.

2. Throughout 2005/06, Terry (in common with all staff working for Turner Ltd) was entitled to free lunches in the staff dining room. These meals would cost the company a total of £1,000 during the year. However, if he preferred, Terry could take his lunches in a local restaurant and the company would pay him a lunch allowance of £1,000.

3. In July 2005, the company required Terry to relocate to a different part of the country. This required a house move and the company paid his removal costs of £7,320.

4. Terry spent 32 nights away from home on company business during 2005/06 and he was paid £5 per night to cover his personal incidental expenses. He was also provided with a mobile telephone. The company paid the full cost of all calls made on this telephone during 2005/06, of which £390 related to private calls.

5. On 1 April 2005, the company granted Terry an interest-free loan of £50,000. In June 2005 he won a £20,000 Premium Bond prize and he used this to repay £20,000 of the loan on 6 July 2005.

6. Terry pays 7% of his salary into the company's occupational pension scheme each year and the company contributes a further 13%. Other expenses during 2005/06 were as follows:
   (i) £7,150 of travelling and subsistence expenses incurred in connection with necessary business travel, all reimbursed by the company
   (ii) a professional subscription of £164
   (iii) payroll giving scheme donations of £30 per month
   (iv) customer entertaining expenses (not reimbursed) of £220.

Throughout 2005/06, Terry rented out a spare room in his house and received rents of £80 per week. His only other income in 2005/06 consisted of preference dividends of £27,000. He made Gift Aid donations totalling £975 during the year.

Terry would like to reduce his tax burden and for this reason he is thinking of transferring the preference shares to either his son or his wife (neither of whom have any significant income for tax purposes).

- **Requirement for question 2**

(a) Determine whether Terry should accept the company car or whether he should continue to use his own car, taking into account the income tax and National Insurance consequences of each course of action. *8*

(b) Assuming that Terry chooses the most efficient options with regard to the car and the lunches, calculate the amount of his income tax liability remaining to be paid at the end of 2005/06 and explain how this would be collected. If any of his income is not taxable (or if any of his expenses are not deductible) explain why this is the case. *14*

(c) Assuming that Terry is contracted-out of the State Second Pension, calculate the National Insurance contributions payable by Terry and by his employer for 2005/06. *3*

(d) Give reasons for and against the belief that National Insurance contributions are a form of taxation. *2*

(e) Comment on whether Terry's proposed transfer of the preference shares would succeed in reducing his tax liability. If so, would this be a case of tax avoidance or tax evasion? *3*

(30)

3

Timberlake Ltd prepares accounts to 31 March each year. The company made the following disposals of chargeable assets in the year to 31 March 2006:

1 In February 2006, a rare Bentley motor car used by the company's Managing Director was sold for £55,000. This car had cost £30,000 in November 1997.

2 In October 2005, an office building was sold for £470,000. The building had been acquired in January 1978 for £100,000 and was extended in July 1980 at a cost of £10,000 and again in September 1988 at a cost of £40,000. The market value of the building on 31 March 1982 was £135,000.

3 In March 2006, used plant and machinery was given to a local charity. This plant and machinery had cost £10,000 in June 1995 and was worth £1,000 in March 2006. Capital allowances had been claimed.

4 In May 2005, a plot of land was sold for £120,000. This land had cost £42,000 in November 1997 and had been used for trade purposes.

In June 1998, the company had sold land for £50,000 and had made a claim for rollover relief in relation to this disposal. This land had cost £10,000 in October 1993 and had been used for trade purposes.

5 In May 2005, plant and machinery bought for £19,500 in May 2004 was sold for £22,500. In March 2006, plant and machinery bought for £16,000 in March 1995 was sold for £9,000. Capital allowances had been claimed in relation to both of these items.

6 In August 2005, gilt-edged stocks bought for £100,000 in August 2003 were sold for £110,500.

7 In February 2006, 500 ordinary shares in Theta plc were sold for £10 per share. Timberlake Ltd had bought ordinary shares in Theta plc as follows:

		£
June 1995	Bought 2,500 shares	12,500
January 2002	Bought 3,000 shares	18,000

Timberlake Ltd has made an irrevocable "re-basing" election to the effect that assets acquired before 31 March 1982 should be treated as if acquired on 31 March 1982 at a cost equal to their market value on that date.

On 1 April 2005, the company had capital losses brought forward of £156,200.

- **Requirement for question 3**

(a) Explain why the claim for rollover relief made in connection with the June 1998 disposal was valid and compute the amount of the rolled-over gain. *4*

(b) Explain the consequences of the rebasing election made by the company. *3*

(c) Compute the chargeable gain or allowable loss arising on each of the disposals made during the year to 31 March 2006. If any of these disposals do not rank as chargeable disposals, explain why this is the case. Also explain any other tax consequences of each disposal. Assume Retail Price Indices as follows: *19*

March 1982	79.44	August 2003	181.6
September 1988	108.4	May 2004	186.5
October 1993	141.8	May 2005	191.5
March 1995	147.5	August 2005	193.0
June 1995	149.8	October 2005	194.0
November 1997	159.6	February 2006	196.0
June 1998	163.4	March 2006	196.5
January 2002	173.3		

(d) Compute the chargeable gains figure which should be included in the company's chargeable profits for the year to 31 March 2006. *2*

(e) Explain why the introduction of the tax on chargeable gains in 1965 helped to ensure that trading profits are properly charged to tax. *2*

(30)

4

Toucan Ltd began trading on 1 January 2006. Taxable turnover for the seven months to 31 July 2006 exceeded the VAT registration threshold and therefore the company notified HM Revenue and Customs of this fact in August 2006 and applied for VAT registration. Registration took effect as from 1 September 2006. Prior to registration, the company had bought goods (for resale or consumption) and services as follows:

	Goods	*Services*
	£	**£**
January 2006	2,200	800
February 2006	2,300	1,100
March 2006	1,700	1,300
April 2006	2,100	700
May 2006	1,900	1,400
June 2006	2,300	1,200
July 2006	2,700	1,500
August 2006	3,200	700

Toucan Ltd was charged VAT on all of these items, but the figures shown above are VAT-exclusive. The cost of the goods not sold or consumed at 1 September 2006 was £4,600 (excluding VAT). In January 2006, the company acquired fixed assets at a cost of £34,000 (excluding VAT) and none of these fixed assets had been disposed of before 1 September 2006.

The following information relates to the company's first VAT return, which covered the three-month period to 30 November 2006. All figures are exclusive of VAT unless stated otherwise.

1 Standard-rated supplies made to customers were £28,800. A cash discount of 2.5% was offered to customers who paid within 28 days and this discount was taken advantage of by customers who bought 50% of the supplies made during the quarter.

   The above figure of £28,800 includes a £1,600 sale made to a customer in September 2006. This customer went bankrupt in November 2006 and a bad debt of £1,600 was written off in the company's books on 30 November 2006.

   On 15 November 2006, a customer was invoiced for £4,800 in relation to a sale of standard-rated goods. The customer paid for these goods on 4 December 2006 and the goods were made available to the customer on 10 December 2006. This sale is NOT included in the above figure of £28,800 and was NOT eligible for the 2.5% cash discount.

2 Standard-rated goods bought for resale or consumption cost £9,280. Standard-rated services cost £5,200.

3 On 1 September 2006, the company was charged VAT of £1,960 on the purchase of a 1,999cc petrol-engined motor car. Private use of this car by one of the company's employees accounts for 50% of its mileage. Maintenance charges in relation to the car were £280 for the quarter and fuel costs were £520. The company wishes to reclaim VAT on fuel as far as possible.

4 In October 2006, the company bought a new fixed asset for a VAT-inclusive price of £14,100.

The company is now considering an application to join the flat-rate scheme for small businesses. Standard-rated sales are expected to run at £11,500 per month from now on and purchases of standard-rated items (other than fixed assets) on which VAT may be reclaimed are expected to be £5,500 per month. The company also anticipates the acquisition of a single fixed asset at a cost of £5,000 during 2007. All of these figures exclude VAT. The flat-rate percentage applicable to the business of Toucan Ltd is 8%.

- **Requirement for question 4**

(a) Explain the consequences which would have ensued if the company had failed to register for VAT when its taxable turnover reached the registration threshold. *3*

(b) State the conditions which must be satisfied in order that pre-registration input tax should be recovered and compute the amount of pre-registration tax which may be recovered by Toucan Ltd. *5*

(c) Compute the amount of VAT payable to (or repayable by) HM Revenue and Customs for the three months to 30 November 2006 and state the date on which any amount payable would be due for payment. *9*

(d) Explain the VAT relief available in relation to the bad debt written off on 30 November 2006. *3*

(e) List SIX items that the company must show on the VAT invoices issued to customers, other than the company's own name and address, the customer's name and address and a description of the goods or services supplied. *3*

(f) Explain the main features of the flat-rate scheme for small businesses. Would Toucan Ltd be eligible to join this scheme? If so, would it be beneficial for the company to join the scheme? *7*

(30)

SUMMARY OF TAX DATA

Corporation Tax

	Financial Year 2005	*Financial Year 2004*	*Financial Year 2003*
Full rate	30%	30%	30%
Small company rate	19%	19%	19%
Lower limit	£300,000	£300,000	£300,000
Upper limit	£1,500,000	£1,500,000	£1,500,000
Marginal relief fraction	11/400	11/400	11/400
Starting rate	0%	0%	0%
Lower limit	£10,000	£10,000	£10,000
Upper limit	£50,000	£50,000	£50,000
Marginal relief fraction	19/400	19/400	19/400
Non-corporate distribution rate	19%	19%	-

Marginal relief formula: fraction x (M-P) x I/P

Capital Allowances

Writing down allowance (per annum):	
Plant and machinery	25%
Industrial buildings	4%
First year allowance on acquisitions of qualifying plant and machinery by qualifying companies:	
Acquired on or after 2 July 1998	40%
Acquired 1 April 2004 to 31 March 2005	50%

Income Tax

			2005/06	*2004/05*
Starting rate	10%	first	2,090	£2,020
Basic rate	22%	next	30,310	£29,380
Higher rate	40%	over	32,400	£31,400

Personal allowance:		
Age 0 to 64	4,895	£4,745
Age 65 to 74	7,090	£6,830
Age 75 or over	7,220	£6,950
Married couple's allowance:		
Age under 75 and born before 6 April 1935	5,905	£5,725
Age 75 or over	5,975	£5,795
Minimum amount	2,280	£2,210
Income limit for age-related allowances	19,500	£18,900

Car benefit

Emission rating	*Taxable percentage of list price*
Up to 140 g/km	15%
Each additional 5g/km	+ 1%
Diesel engine	+ 3%
Maximum charge	35%

Car fuel benefit

Figure to which appropriate percentage is applied so as to calculate car fuel benefit	£14,400

Official Rate of Interest
5%

Authorised mileage rates	*first 10,000 miles per year*	*miles in excess of 10,000*
Motor cars and vans	40p	25p
Motor cycles	24p	24p
Bicycles	20p	20p

Class 1 National Insurance Contributions

	2005/06	*2004/05*
Primary threshold (annual)	£4,895	£4,745
Secondary threshold (annual)	£4,895	£4,745
Upper earnings limit (annual)	£32,760	£31,720
Employee contribution rates:		
On earnings up to primary threshold	0%	0%
On remainder up to UEL (Not contracted out)	11%	11%
On remainder up to UEL (Contracted out)	9.4%	9.4%
On earnings above the UEL	1%	1%
Employer contribution rates:		
On earnings up to secondary threshold	0%	0%
On remainder up to UEL (Not contracted out)	12.8%	12.8%
On remainder up to UEL (Contracted out)	9.3%	9.3%
On earnings beyond UEL	12.8%	12.8%

Class 1A National Insurance Contributions

	2005/06	*2004/05*
Employer contribution rate	12.8%	12.8%

Value Added Tax

Standard rate (from 1 April 1991)		17.5%
Registration threshold (from 1 April 2005)		£60,000
Deregistration threshold (from 1 April 2005)		£58,000
Fuel quarterly scale charges (from 1 May 2005):		
VAT due per car:		
Petrol engines:	up to 1,400cc	£36.64
	up to 2,000cc	£46.32
	2,001cc or more	£68.06
Diesel engines:	up to 1,400cc	£35.15
	up to 2,000cc	£35.15
	2,001cc or more	£44.68