TAXATION

Diploma stage
June 2005

MARKING SCHEME

Question 1

(a) Capital allowances on plant and machinery:

		Pool	Ford	Total	
		£	£	£	
6 months to 31/3/04					
Additions		8,800	12,400		*1*
WDA 25% x 6/12		1,100		1,100	*1*
WDA £3,000 x 6/12			1,500	1,500	*1*
		7,700			
Additions	32,500				
FYA 40%	13,000	19,500		13,000	*1*
WDV c/f		27,200	10,900		
Total allowances				15,600	

(Capital allowances are not restricted because of private use by an employee).

Industrial buildings allowances:

The building acquired in October 2003 cost £205,000 excluding land. The cost of the general offices (£55,000) exceeds 25% of £205,000, so the qualifying expenditure is £150,000. WDA for the period is £3,000 (£150,000 x 4% x 6/12). *3*

Corporation tax computation:

Since the company is making no claim with regard to its trading loss, the loss is carried forward under s393(1). The amount of this loss is £20,000 (£1,400 + £15,600 + £3,000). *1*

Chargeable profits for the six months to 31 March 2004 consist solely of the chargeable gain of £22,600. This is between the scaled-down limits (for a six-month period) of £5,000 and £25,000 so tax is due at 19% less marginal relief. *1*

The corporation tax liability is £4,180 (£22,600 @ 19%, less marginal relief 19/400 x (£25,000 - £22,600)). This is due for payment on 1 January 2005. *1*

(10)

(b) Capital allowances on plant and machinery:

		Pool	Ford	Total	
		£	**£**	**£**	
year to 31/3/05					
WDV b/f		27,200	10,900		
Disposals		2,100			½
		25,100			
WDA @ 25%		6,275	2,725	9,000	½
		18,825			
Additions	59,400				
FYA 50%	29,700	29,700		29,700	1
Additions	10,300				
FYA 100%	10,300	0		10,300	1
WDV c/f		48,525	8,175		
Total allowances				49,000	

Industrial buildings allowances:

An IBA of £6,000 (£150,000 x 4%) is available in relation to the building bought in October 2003. *1*

The building bought in November 2004 has 20 years of its tax life remaining. Beta plc would have claimed an IBA of £6,400 (£160,000 x 4%) in each of the four years to 31 December 1999, 2000, 2002 and 2003. A notional allowance of £6,400 would have been deducted for the year to 31 December 2001. Therefore the written down value of the building prior to the sale was £128,000 (£160,000 - 5 x £6,400). *3*

Beta plc used the building for 60 months, including 10 months of non-industrial use. Net cost is £36,000 (£160,000 - £124,000). Adjusted net cost is £30,000 (£36,000 x 50/60). Therefore a balancing allowance of £4,400 (£30,000 - £25,600) would have been given when the building was sold. This gives a residue of expenditure of £123,600 (£128,000 - £4,400). *3*

An IBA of £6,180 (£123,600 ÷ 20) is available for the year to 31 March 2005. Total IBAs for the year are therefore £12,180. *1*

Corporation tax computation:

	£	
Schedule D Case I	161,180	½
Less: Capital allowances (£49,000 + £12,180)	61,180	½
	100,000	
Less: Section 393(1) relief	20,000	1
	80,000	
Schedule A:		
Rent £8,000 x 3/12	2,000	1
Premium £10,000 - (£10,000 x 9 x 2%)	8,200	1 ½
Schedule D Case III (£880 + £220)	1,100	1
	91,300	
Less: Charges	500	½
PCTCT	90,800	

The tax liability is £17,252 (£90,800 @ 19%). This is due to be paid on 1 January 2006. *1*

(18)

(c) As from 1 April 2004, companies which pay dividends to individual shareholders must pay at least a minimum amount of corporation tax on the profits which are used to pay those dividends. This minimum amount is calculated at the "non-corporate distribution rate" which is currently 19%. *1*

This rule does not apply to the company's first accounting period since it ended before 1 April 2004. The rule does apply to the year to 31 March 2005 but profits are already taxed at 19% in that year. Therefore the company could have paid a dividend in either period without any tax consequences. *2*

(3)

(d) The company could have made a claim under s393A(1)(a) to set the trading loss against its profits for the six months to 31 March 2004. This would have reduced the chargeable profits for that period to £2,600 (£22,600 - £20,000) and so reduced the corporation tax liability to zero. *1*

This would have saved tax of £4,180 (which can also be calculated as £17,600 @ 23.75% + £2,400 @ 0%). The company's decision to relieve the loss under s393(1) has saved tax of only £3,800 (£20,000 @ 19%) so a s393A(1)(a) claim would have been advisable. *2*

(3)

(e) The CT600 return must be submitted by 31 March 2006. There is a £100 fine if the return is up to three months late and a £200 fine if it is over three months late. A further penalty may be charged if the return is more than six months late. This penalty is a percentage of the corporation tax outstanding (if any) at the end of those six months. The percentage is 10% if the return is between six and 12 months late and 20% if the return is more than 12 months late. *(3)*

(f) Companies are required to pay tax by instalments if they pay corporation tax at the full rate (30%) without deduction of marginal relief. This requires profits of at least £1.5 million. However, a company is not required to pay by instalments for an accounting period if profits are no more than £10 million for that period and the company did not pay tax at the full rate in the previous 12 months.

The effect of these rules is that High Peak Trading Ltd will not be required to pay by instalments in the first accounting year in which profits exceed £1.5 million but will be required to pay by instalments thereafter (so long as profits do not fall beneath £1.5 million).

For an accounting year to 31 March, instalments will be due on 14 October and 14 January in the year and on 14 April and 14 July following the end of the year. Each instalment is equal to one-quarter of the corporation tax liability for the year. The company will be required to estimate its tax liability and base its instalment payments on this estimate. Interest is charged (or paid) on underpaid (or overpaid) instalments. *(3)*

(40)

Question 2

(a) The purpose of a form P11D is to state the benefits in kind provided to an employee in a tax year and to record any expense allowances (or reimbursements of expenses) paid to the employee during the year. *1*

A P11D must be completed for each employee who earned at least £8,500 in the tax year and for most company directors. The only exceptions are full-time working directors who earned less than £8,500 in the year and who control no more than 5% of their company's ordinary share capital. *1*

P11Ds must be submitted to the Inland Revenue by 6 July following the end of the tax year to which they relate. The employees concerned must be provided with copies by the same date. *1*

(3)

(b) **Jean's income tax computation 2004/05**

	£	**£**	
Salary		42,000	
Less: Pension contributions (£42,000 x 10%)		4,200	
		37,800	*½*
Car benefit (Car 1)			
15% + 8% = 23% x £11,200 x 3/12	644		*1*
Car benefit (Car 2)			
15% + 6% + 3% = 24% x £12,700 x 9/12	2,286		*1*
	2,930		
Less: Contribution for private use	1,200	1,730	*½*
Fuel benefit (Car 1)			
23% x £14,400 x 3/12	828		*1*
Fuel benefit (Car 2)			
24% x £14,400 x 9/12	2,592	3,420	*1*
(partial fuel contribution not deducted)			
Loaned asset:			
20% x £1,000 x 9/12	150		*1*
Greater of:			
£400 - £100 = £300			
£1,000 - £100 - £200 - £150 - £100 = £450	450	600	*2*
Long-service award (non-cash, less than £50 pa)		0	*½*
Total employment income		43,550	
UK dividends £3,015 + £335		3,350	*½*
ISA interest (exempt)		0	*½*
		46,900	
Personal allowance		4,745	*½*
Taxable income		42,155	

	£	£	
Income tax due:			
Non-savings income (£42,155 - £3,350)			
£2,020 @ 10%	202		
£29,380 @ 22%	6,464		
Gift Aid £195 x 100/78 = £250 @ 22%	55		
£7,155 @ 40%	2,862	9,583	
Dividend income			
£3,350 @ 32.5%		1,089	
		10,672	*2*
Less: Tax credits on dividends		335	½
		10,337	
Less: Tax deducted via PAYE		9,410	½
Income tax liability		927	
			(13)

(c) John's income tax computation 2004/05

	£	£	
Salary - this employment		27,500	
- previous employment		1,920	
		29,420	½
Mileage allowance:			
12,000 @ 30p	3,600		
Less: 10,000 @ 40p + 2,000 @ 25p	4,500	(900)	*1*
Relocation expenses (under £8,000)		0	½
Beneficial loan:			
Lower of:			
(£50,000 + £40,000)/2 x (5% - 2%) x 10/12	1,125		
£50,000 x 3% x 3/12 + £40,000 x 3% x 7/12	1,075	1,075	*1*
Mobile phone (exempt)		0	½
Note: Suit of clothes fails the "wholly, exclusively and necessarily" test)			
Total employment income		29,595	
Premium bond prize (exempt)		0	½
BSI £1,680 x 100/80		2,100	½
		31,695	
Personal allowance		4,745	½
Taxable income		26,950	
Income tax due:			
Non-savings income (£26,950 - £2,100)			
£2,020 @ 10%	202		
£22,830 @ 22%	5,023	5,225	
Savings income			
£2,100 @ 20%		420	
		5,645	*1*
Less: Tax deducted at source from BSI		420	½
		5,225	
Less: Tax deducted via PAYE (£4,871 + £315)		5,186	½
Income tax liability		39	
			(7)

(d) In general, it is difficult to anticipate the precise amount of an employee's benefits in kind and expenses at the start of a tax year (when tax codes are issued) and therefore the amount of tax deducted from a P11D employee by the PAYE system will not always be exact. In John's case, it is likely that his tax code was not adjusted to reflect his beneficial loan and mileage allowance, so that at the end of the year he owes income tax of 22% x (£1,075 - £900). *1*

A further reason for owing tax at the end of the year is that the employee might be required to pay higher-rate tax on interest or dividends. This probably accounts for the majority of Jean's underpayment. *1*

If the amount of income tax owing at the end of the year does not exceed £2,000 it may be collected by adjusting the employee's tax code for the following year. Alternatively, the underpaid tax could be collected by means of the self assessment system. For tax year 2004/05, this would mean making a payment to the Inland Revenue on 31 January 2006. *1*

(3)

(e) **Jean's NICs**

	£	
Primary Class 1 NICs:		
(£31,720 - £4,745) = £26,975 @ 9.4%	2,536	
(£42,000 - £31,720) @ 1%	103	
	2,639	*1*
Secondary Class 1 NICs:		
(£31,720 - £4,745) = £26,975 @ 9.3%	2,509	
(£42,000 - £31,720) @ 12.8%	1,316	
	3,825	*1*
Class 1A NICs:		
(£43,550 - £37,800) @ 12.8%	736	*½*

John's NICs

	£	
Primary Class 1 NICs:		
(£29,420 - £4,745) = £24,675 @ 11%	2,714	*½*
Secondary Class 1 NICs:		
(£29,420 - £4,745) = £24,675 @ 12.8%	3,158	*½*
Class 1A NICs:		
£1,075 @ 12.8%	138	*½*

(4)

(30)

Question 3

(a) Shares in Epsilon plc

S104 Holding (7,000 shares sold):

	No. of shares	*Cost*	*Indexed cost*	
		£	**£**	
Bought June 1991	3,000	15,000	15,000	½
Indexation to March 2001				
(172.2 – 134.1)/134.1 x £15,000			4,262	½
Bought March 2001	4,000	28,000	28,000	½
	7,000	43,000	47,262	
Indexation to September 2004				
(187.0 – 172.2)/172.2 x £47,262			4,062	½
			51,324	
Sold September 2004	7,000	43,000	51,324	½
c/f	0	0	0	

The shares were sold for £45,500 (7,000 x £6.50) so the unindexed gain on the disposal is £2,500 (£45,500 - £43,000). The available indexation allowance is £8,324 (£51,324 - £43,000) but indexation allowance cannot be used to convert a gain into a loss so the allowance is restricted to £2,500, reducing the chargeable gain to zero. *1*

1982 Holding (500 shares sold):

	No. of shares	*Cost*	*MV 31/3/82*	
		£	**£**	
Bought January 1981	2,000	4,000	5,000	½
Sold September 2004 (500/2,000)	500	1,000	1,250	½
c/f	1,500	3,000	3,750	

	Original cost	*Rebasing*	
	£	**£**	
Disposal proceeds (500 x £6.50)	3,250	3,250	½
Less: Acquisition cost	1,000		½
Market value 31/3/82		1,250	½
	2,250	2,000	
Less: Indexation allowance			
(187.0 – 79.44)/79.44 = 1.354 x £1,250	1,693	1,693	½
	557	307	

The lower gain is £307.

Watercolour paintings

The gross disposal proceeds of the two paintings are £5,750 (£5,175 x 100/90) and £6,450 (£5,805 x 100/90) respectively. The first painting is disposed of for less than £6,000 and is therefore exempt. The gain arising on the second painting is as follows: *½*

	£	
Disposal proceeds	6,450	
Less: Auctioneer's fee	645	
	5,805	*½*
Less: Cost	2,000	*½*
	3,805	
Less: Indexation allowance		
(187.4 – 149.6)/149.6 = 0.253 x £2,000	506	*½*
Chargeable gain	3,299	

This gain is restricted to £450 x 5/3 = £750. *1*

Assignment of short lease

When it was assigned, the lease had 5 years and 7 months left to run. The relevant Schedule 8 percentage is 29.331 (26.722 + 7/12 x 4.473) and so the allowable loss is computed as follows: *1*

	£	
Disposal proceeds	7,000	*½*
Less: Cost		
(29.331/72.770) x £20,000	8,061	*½*
Allowable loss	(1,061)	

Indexation allowance is not available since indexation allowance cannot be used to increase an unindexed loss. *½*

Freehold property

The building was sold for £115,000 and £100,000 was invested in fixed plant within the period starting one year before the disposal and ending three years after it. Presumably both assets are used for business purposes. Rollover relief is not available since the plant is a depreciating asset but all save £15,000 of the gain can be held over. The computation is as follows: *1*

	£	
Disposal proceeds	115,000	*½*
Less: Cost	50,000	*½*
	65,000	
Less: Indexation allowance		
(187.8 – 158.5)/158.5 = 0.185 x £50,000	9,250	*½*
	55,750	
Less: Held-over gain	40,750	*½*
Chargeable gain	15,000	

Net chargeable gains

Total gains are £16,057 (£307 + £750 + £15,000). Allowable losses are £1,061 so net gains are £14,996. These are reduced by the losses brought forward of £6,646 to £8,350. *1*

(16)

(b) The rebasing election (if made) is irrevocable and applies to all subsequent disposals of assets acquired before 31 March 1982. The effect of the election is to compute gains and losses on disposals of assets held at 31 March 1982 by reference to their market value at that date. Costs incurred before 31 March 1982 are completely ignored for all purposes, including calculation of the indexation allowance.

This election simplifies the calculations required on the disposal of a pre-31 March 1982 asset but would have a detrimental effect if the company's portfolio of assets held at 31 March 1982 contained assets with a cost exceeding their market value at that date. Therefore the company's decision not to make the election should have been based on the balance between ease of calculation and the likelihood of incurring unnecessarily high chargeable gains. *1*

If the election had been in force during the year to 31 December 2004, the company's chargeable gains would have been unaltered, since the only disposal of a pre-31 March 1982 involved an asset with a market value at 31 March 1982 in excess of cost. *1*

The election must be made within two years of the end of the accounting period in which the first disposal of a pre-31 March 1982 asset occurs after on or after 6 April 1988. It may, therefore, be too late to make the election. However, if the disposal of the shares in Epsilon plc happens to be the first such disposal since 6 April 1988, the company may make the rebasing election at any time up to 31 December 2006. *1*

(3)

(c) £15,000 of this gain is chargeable during the year to 31 December 2004, as explained above. The remaining £40,750 is held over against the fixed plant but becomes chargeable (or "crystallises") on the earliest of the following dates:

- the date on which the plant is disposed of
- the date on which the plant ceases to be used for business purposes
- the 10th anniversary of the plant's acquisition (ie February 2014). *2*

However, if a suitable non-depreciating asset is acquired before crystallisation occurs, the temporarily held-over gain may be transferred to this new asset and become a permanently rolled-over gain. *1*

(3)

(d) The badges of trade are:

- the subject matter of the transaction
- the length of the period of ownership
- the frequency of transactions
- supplementary work
- the reason for the sale
- motive for acquiring the asset.

(½ mark per badge + further ½ mark for explanation) 6

Trading profits and chargeable gains are both assessed to corporation tax but it is still very important to distinguish between them. The main reasons for this are as follows:

(i) The rules of computation for trading profits and for chargeable gains are different from each other. In particular, the rules on allowable deductions differ and chargeable gains attract indexation allowance. *1*

(ii) Trading profits can be used to relieve trading losses brought forward but not capital losses brought forward. Similarly, chargeable gains can be used to relieve capital losses brought forward but not trading losses brought forward. *1*

(8)

(30)

Question 4

(a) Registration is compulsory when taxable turnover for the previous 12 months exceeds the registration threshold (currently £58,000). Registration is also compulsory if there are grounds for believing that taxable turnover in the next 30 days alone will exceed the threshold. *1*

In the case of Parkside Products Ltd, it is probable that registration was required because the company's taxable turnover for the 12 months to 30 November 2004 exceeded the threshold. The company would have been required to notify HM Customs and Excise within 30 days (by 30 December 2004) and registration would then take effect as from 1 January 2005. *1*

(2)

(b) The tax point of a supply is the date on which the supply is deemed to have occurred for VAT purposes. For a supply of goods, the basic tax point is the date on which the goods are removed or made available to the customer. For a supply of services, the basic tax point is the date on which the services are completed. However, the tax point of a supply may differ from the basic tax point in the following circumstances: *1*

(i) If a tax invoice is issued or payment is received on a date which is earlier than the basic tax point, then that date becomes the tax point. *½*

(ii) Otherwise, if a tax invoice is issued within 14 days after the basic tax point, then the invoice date becomes the tax point. *½*

If VAT rates change, the tax point of a supply determines the rate of tax which is applicable to that supply. The tax point of a supply also determines the VAT period in which output tax relating to the supply must be accounted for or the VAT period in which input tax relating to the supply may be reclaimed. *1*

(3)

(c)

	£	£	
Output tax:			
Standard-rated supplies £12,000 x 97% x 17.5%		2,037	*1*
Zero-rated supplies		0	*½*
Payment received in advance £2,400 x 17.5%		420	*1*
Fuel scale charge		32	*1*
		2,489	
Input tax:			
Standard-rated goods £3,200 x 17.5%	560		*½*
Pre-registration goods acquired within last 3 years and still in stock £1,400 x 17.5%	245		*1*
Staff wages (not VATable)	0		*½*
VAT on car (not wholly for business use)	0		*½*
Car repairs £320 x 17.5%	56		*½*
Overhead expenses £2,800 x 17.5%	490		*½*
Pre-registration services acquired within last 6 months 6 x £60 x 17.5%	63		*1*
Computer £1,880 x 17.5/117.5	280	1,694	*1*
Payable to HM Customs and Excise by 30 April 2005		795	*1*

(10)

(d) 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 HM Customs and Excise, 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 £660,000 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. This may well apply to Parkside Products Ltd. *1*

The flat-rate scheme (FRS) for small businesses allows a business to calculate its VAT liability as a fixed percentage of total turnover and so avoids the need to keep detailed records of input tax and output tax. The main features of the FRS are as follows: *1*

(i) Output tax is charged to customers at the usual rate (eg 17.5%) and input tax is paid to suppliers at the usual rate. However, the output tax is not paid to HM Customs and Excise and the input tax is not recoverable. *1*

(ii) At the end of each tax period, the amount of VAT payable to HM Customs and Excise is calculated as a flat-rate percentage of VAT-inclusive turnover for the period. The percentage used ranges from 2% to 13.5%, depending on the trade sector in which the business operates. *1*

The FRS is available to businesses with a taxable turnover which is not expected to exceed £150,000 in the next 12 months. This scheme can be used in conjunction with the annual accounting scheme. *1*

(7)

(e) A *regressive* tax is one where the proportion of income or wealth paid in tax decreases as the amount of the taxpayer's income or wealth increases. *1*

It can be argued that VAT is regressive since a person with a low income will pay the same amount of VAT on a given purchase as will a person on a high income. For instance, VAT of £100 paid in connection with the purchase of an item represents 1% of the annual income of someone who earns £10,000 per annum but only 0.1% of the annual income of someone who earns £100,000 per annum. *1*

On the other hand, it could be argued that wealthier individuals buy more goods and services than those who are less wealthy, so that the total VAT paid in connection with the purchase of goods and services might be fairly constant. If this were the case, VAT might be seen as proportional rather than regressive. For instance, an individual on £10,000 per annum might pay total VAT of £500 per year, whilst someone on £100,000 per annum (who can afford to buy a greater amount of goods and services) might pay total VAT of £5,000 per year. In each case, the VAT paid represents 5% of income. *1*

Another point which mitigates against the regressive nature of VAT is that many of the basics of life are either zero-rated (food, water) or exempt (rent). This means that lower-paid individuals (who may spend a large proportion of their income on the basics) will pay VAT on proportionately less of their expenditure than wealthier people. For instance, someone earning and spending £10,000 per annum might pay VAT at the standard rate on only £1,000 of their total expenditure (£175 or 1.75% of income). Someone earning and spending £100,000 per annum might pay VAT at the standard rate on (say) 80% of their expenditure (£14,000 or 14% of income). This point applies to a lesser degree to individuals who save part of their income and so have lower total expenditure. *1*

(4)

(f) 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 takes a dim view of complex and highly artificial tax avoidance schemes which are devised by tax advisors to exploit "loopholes" in the tax law. In an attempt to curb the use of such schemes, Finance Act 2004 introduced new rules imposing disclosure requirements on those who sell or use such schemes. In the case of VAT, businesses are required to notify HM Customs and Excise if they make use of certain VAT avoidance schemes which are listed on a statutory register or if they make use of schemes which bear certain hallmarks of VAT avoidance. *1*

Presumably, the idea of these disclosure requirements is that the tax authorities will be better able to detect the use of VAT avoidance schemes and (in the case of abusive schemes) will then be able to recommend appropriate anti-avoidance legislation to the Government. *1*

(4)

(30)