



# The Chartered Tax Adviser Examination

November 2008

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## PAPER IIB

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TAXATION OF INDIVIDUALS, TRUSTS AND ESTATES

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TIME ALLOWED – 3 HOURS

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- You should answer all of the questions.
- Start each answer on a new sheet of paper and write on one side of the paper only.
- All workings should be shown and made to the nearest month and pound unless the question specifies otherwise.
- Marks are specifically allocated for presentation.
- Candidates who answer any relevant legal aspects in this paper in accordance with Scots law or Northern Ireland law should tick the appropriate box on the front of the answer folder.

1. Klaus Hofmann, his wife Katrina and their two sons moved to the UK from Germany on 15 October 1992 and started employment on that date. They also purchased a home in Surrey. Klaus studied in the UK in 1991 and it is not clear whether he was UK resident or not for 1991/92 as he was splitting his time between the UK and Germany almost equally. Prior to this he had always lived in Germany.

Klaus was still living in the UK when he died on 13 December 2007, although it remained his intention to move back to Germany when his children finished school. Klaus' parents, who were both born in Germany and lived there all their lives, still live in the same house where Klaus grew up. Klaus visited his parents and extended family in Germany at least four times a year and maintained very close links with the country during the time he was in the UK.

Klaus did not have a Will and his estate on the date of his death comprised the following:

	£
Residential house in Surrey, as joint tenant with his wife (value of his share)	1,100,000
Savings account balance (Bank in Jersey)	25,500
Savings account balance (Bank in London)	13,500
Shares in Deutsche Telekom AG, a German registered company	123,950
House in the outskirts of Dusseldorf	950,000 Euros
Villa in Spain	750,000 Euros
A judgement debt (obtained in a German Court) owed to Klaus by a Belgium Company	35,000 Euros

**Assume an exchange rate of 1.30 Euros to £1.**

**You are required to set out in a letter to Mrs Hofmann the scope of Inheritance Tax on her late husband's estate. You should ignore any Double Tax Agreement between the UK and Germany and any non-UK taxes.** (10)

2. Samuel and Rebecca live in a large country house, Priory Manor, with extensive grounds and outbuildings. They have lived in this property for some years and have redeveloped a number of outbuildings during that time. They jointly own a private limited company (Priory PR Ltd) which provides marketing and public relations advice and trades from one of the redeveloped outbuildings. The business is expanding and they are currently exploring the possibility of extending the office premises and recruiting more staff.

Rebecca's father, Joshua Smyth, is a widower. Joshua is approaching 80 years of age and is in reasonable health for his age. His wife died about eight years ago and the nil rate band on her death was utilised by a transfer of assets into a discretionary trust for Rebecca and her sister, Ruth, who lives abroad.

He wishes to move to live with his daughter and son-in-law at Priory Manor. A proposal has been discussed amongst the family that Joshua would pay £150,000 towards the conversion of a disused barn into a small two-bedroomed cottage (to be called New Cottage). The family estimate that the value of the existing disused barn with planning permission is £100,000 and that the value after conversion will be approximately £250,000. A letting agent has suggested that the rental value of New Cottage would be £750 per month.

Joshua intends to sell his current home which is worth £500,000. In addition he has investments and money on deposit of another £100,000. Joshua receives £70,000 per annum from an occupational pension as well as a state pension of £7,000 per annum.

*Continued*

2. *Continuation*

At the same time that Joshua pays £150,000 to convert the disused barn at Priory Manor, he also intends to make a cash gift of £150,000 to Ruth. He believes that he will live for at least another seven years and so as a result of these lifetime gifts he will have reduced his remaining estate to a level at which no Inheritance Tax liability arises.

Rebecca and Ruth are concerned that Joshua is properly advised and have encouraged him to seek tax advice on these proposals. He has now contacted you to obtain your advice.

**You are required to write a letter to Joshua:**

- 1) **Explaining the tax implications of his proposed course of action, based on the information available.** (11)
- 2) **Commenting on other tax planning approaches that might be available and the limitations of any such approaches.** (4)

Total (15)

3. You have been telephoned by Mark Dempsey, a manager in the audit department, who needs advice on a gift of shares in Profitable Ventures Ltd which took place last week. Alan Davies and Simon Jones each gifted 25 ordinary shares of £1 each to each of Roy and Sheila Heathson. Roy is the managing director of Profitable Ventures Ltd and Sheila is Roy's wife. The articles of association of the company adopt Table A and include pre-emption rights on any transfer of shares.

The shareholdings in the company before and after the gift are as follows:

	<u>No. of shares held before gift</u>	<u>No. of shares held after gift</u>
Alan Davies	100	50
Roxie Davies (Alan's wife)	50	50
Simon Jones	100	50
Sian Jones (Simon's wife)	50	50
Roy Heathson	-	50
Sheila Heathson (Roy's wife)	-	<u>50</u>
	<u>300</u>	<u>300</u>

Alan and Simon are experienced entrepreneurs and believe that there are no tax issues as long as a Capital Gains Tax hold-over election is entered into. Both Roy and Sheila have agreed to do this. Alan and Simon think that this is a good way to reward and motivate Roy who has been very successful in building up the company. Alan and Simon do not want to increase Roy's salary to more than the £50,000 he currently receives. Roy is keen to increase Sheila's income if possible as she is only a basic rate taxpayer.

Mark Dempsey suggests that a one third shareholding in the company is probably worth around £100,000 after allowing for an appropriate discount for the minority interest. Mark further suggests this value is about 90% of the value if there were no pre-emption right restrictions in the articles of association.

**You are required to draft a memo to Mark Dempsey:**

- 1) **Explaining the tax issues arising from the share transfers.** (9)
- 2) **Explaining the returns, if any, which may need to be made to HM Revenue & Customs by the various persons concerned.** (3)
- 3) **Advising on specific actions which the parties concerned may wish to take now in order to mitigate immediate or future tax liabilities.** (3)

Total (15)

4. Graham Terrence was born on 5 August 1931 and has been married to Henrietta for over 50 years. You complete his tax return each year and you have just received the following information for the year ended 5 April 2008:
- 1) P60 from his directorship with Traumelia Ltd showing a gross income of £5,000. No PAYE was deducted.
  - 2) Interest received from a Swiss bank account of £3,575 after deduction of 35% Swiss tax at source.
  - 3) UK interest received gross of £875.
  - 4) UK Bank interest received net of £6,082.
  - 5) State retirement pension £3,830.
  - 6) Pension from Just Retirement Ltd of £47,408. Tax of £10,428 was withheld.
  - 7) Enterprise Investment Scheme certificate from Starbrook.com Ltd, showing that £20,000 was subscribed for ordinary shares on 16 March 2008.
  - 8) Dividends on 400 ordinary 25p shares in Large plc of £161 on 3 May 2007 and of £74 on 12 September 2007.
  - 9) Various donations to UK registered charities amounting to £4,651.
  - 10) Disposal of 25,000 shares in Piccadilly Photo Framers Ltd, an unquoted trading company, for £38,750 on 31 December 2007. These were acquired on 5 July 1998 for £6,250. Graham never worked for the company and his shareholding had always been lower than 25%.
  - 11) Disposal of a 1935 Bentley for £61,250 on 31 January 2008. This was a legacy left by Graham's father who died on 21 September 1996. The probate value was £35,000.
  - 12) Disposal of shares held in an Individual Savings Account on 4 December 2007 for £15,000. The shares were acquired on 8 December 2006 for £3,000.

**You are required to prepare an annotated Income Tax and Capital Gains Tax Calculation for the year.** (20)

5. Doug and Tony are partners in a boat repair yard and servicing business at Newbay Docks. They bought the business in 1999 having previously lived and worked in and around the docks at Newbay for most of their lives. Initially the business was very profitable but in 2004 and 2005 it made very substantial losses as a result of the loss of a large contract and a reduction in the level of activity at the docks. Consequently, the partners scaled back the level of activities and so stabilized the trading position. However, the partners remain confident that there is a good future for the business when trading conditions improve.

Between 1999 and 2004 the partners reinvested the profits made in buying residential property in and around Newbay Docks for letting. The residential properties are 1-4 Dockers' Cottages and Millbay Flats. These properties provide a good rental stream which has supported the business in recent years.

Doug and Tony are now both in their sixties. At 6 April 2007 Doug and Tony had carried forward trading losses of £223,571 each. They are both divorced and have no other income or expenses that are not reflected in the partnership accounts. Neither of them had an Income or Capital Gains Tax liability for 2006/07.

The accounts to 31 March 2008 have now been prepared and show the following:

Profit and Loss Account – Year Ended 31 March 2008

	£
Trading Income	4,267,333
Cost of sales	<u>(3,862,213)</u>
	405,120
Rental income	78,000
Overheads	(442,801)
Depreciation	<u>(16,733)</u>
	<u>£23,586</u>

The property letting expenditure has been agreed as 10% of the overheads.

Balance Sheet at 31 March 2008

	£	£
Newbay repair yard premises at cost		488,300
Residential properties at cost		772,800
Plant and machinery at cost		<u>66,935</u>
		1,328,035
Work in progress	105,693	
Debtors	743,821	
Cash	8,000	
Creditors	(763,891)	
Bank overdraft	(220,723)	
		<u>(127,100)</u>
		<u>£1,200,935</u>
Partners' Current and Capital Accounts		
Brought forward		1,177,349
Profit for the year		<u>23,586</u>
		<u>£1,200,935</u>

*Continued*

5. *Continuation*

The current market values of the properties are as follows:

	£
Newbay repair yard	700,000
Numbers 1-4 Dockers' Cottages	960,000
Millbay Flats	<u>425,000</u>
	<u>£2,085,000</u>

There were no plant and machinery additions in the year. The tax written down value of the pool at 6 April 2007 was £95,683. The plant and machinery has been independently valued at £60,000.

Doug and Tony do not believe that the business currently has any saleable goodwill.

Doug and Tony have both previously resisted incorporating the business but now believe that there is no alternative because of the substantial trading risks concerned. They are also concerned about their trading reputation and wish to disclose a strong balance sheet. After incorporation Doug and Tony have suggested a share capital of £2 million. They want to understand the tax implications of incorporating the business and have asked you to produce various calculations.

**You are required to:**

- 1) Calculate Doug and Tony's income tax position for 2007/08 and explain whether there would have been any difference if the business had been incorporated on 31 March 2008. (7)**
- 2) Comment on whether s.162 TCGA 1992 or s.165 TCGA 1992 can apply to the transfer of the partnership properties into a company on incorporation and to determine the base cost of the shares in the new company on the assumption that s.162 TCGA 1992 applies to the incorporation. (8)**
- 3) Comment on the potential downsides from a tax perspective if the business had been incorporated on 31 March 2008 and share capital of £2 million had been issued. (5)**

Total (20)

6. John Smith, who was domiciled within the UK, died on 13 March 2008. He had undertaken the following transactions:
- 1) He set up a discretionary trust on 1 May 1998 for the benefit of his grandchildren. John and his wife are excluded from the trust. The funds transferred from his Cayman Islands account amounted to £300,000. The trust is resident and administered in the UK and any tax due on the set up of the trust was paid by the trust.
  - 2) He gifted £250,000 to his son Mark to help buy his house on 12 February 2002.
  - 3) On 13 February 2002, he also gifted a house, 43 Pear Tree Avenue, to his other son Peter. The house was valued at £250,000 at the time of the gift and at £210,000 at the time of his death.
  - 4) On 15 August 2002, John gifted £15,000 as a wedding present to his daughter Amélie.
  - 5) He owned a set of four paintings. As they were quite valuable as a set, he decided to gift them to his daughter individually in May of 2003, 2004, 2005 and 2006 in order to lower the value of the gift.

The relevant values were:

	<u>2003</u>	<u>2004</u>	<u>2005</u>	<u>2006</u>
No. of paintings	£	£	£	£
Four	10,000	11,000	12,000	13,150
Three	7,500	8,250	9,150	10,000
Two	4,375	4,850	5,250	5,550
One	1,550	1,750	1,870	2,065

John's Will determined that the house he had inherited on his father's death in the mid-1990s should be given to his daughter Amélie. He felt that the other sons had already benefited during his lifetime. The house was valued at £450,000 and was rented out on a short-term basis at the date of death. Amélie currently rents shared accommodation and plans to move into the house. She works as a primary school teacher and is therefore on a modest salary.

His total estate was valued at £1,250,000 and, other than the legacy to his daughter, everything has been left to his wife Judith, who is resident, ordinarily resident and domiciled in the UK.

**You are required to explain and calculate the Inheritance Tax implications of the above transactions and advise when the tax is payable.** (20)