The Chartered Tax Adviser Examination

November 2008

PAPER IIA

GENERAL PRACTICE

Suggested Answers (without marks)

Where candidates are required to comment on tax (and in particular CGT) which may apply in 2008/09 and subsequent years they will be given full credit whether they assume that 2007/08 rates (including taper relief) continue to apply or whether they answer using 2008/09 rates (including entrepreneurs relief).

Question 1

Dover and Sole LLP
246 Billingsgate
London EC4 7AP

Mr Cod
Fishface Distributors
17 Mackerel Place
Hull
Yorkshire

14 November 2008

Dear Mr Cod

VAT IMPLICATIONS OF RECENT ACQUISITION

Thank you for your letter of 31 October 2008 in which you requested advice on the VAT implications of your proposed acquisition of the trade and assets of Flounder Ltd.

Transfer of a going concern

As the business is to be acquired as a going concern the transaction is likely to be outside the scope of VAT and consequently no VAT would be charged by the vendor on the sale of the various assets. This is by virtue of the Transfer of Going Concern (TOGC) provisions, the conditions for which are:

- The assets are to be used by the transferee in the same kind of business
- The transferee is VAT registered, or becomes taxable as a result of the transfer
- Where part of a trade is transferred it is capable of separate operation
- There is no significant gap in trading

Thus there would be no VAT charged on the stock, plant and machinery and other assets acquired, and your business would therefore not have any input VAT to reclaim.

The only exception to this rule would be where the vendor transfers an “opted” property as part of the deal. An “opted” property is where the vendor has waived the normal VAT exemption in respect of the property. Once the option to tax has been made, it can only be revoked either within a 3 month cooling off period or after 20 years. If the property is then subsequently disposed of whilst the option is in place, standard rate VAT must be applied to the consideration for the sale of the property, unless the purchaser also opts to tax the property. Under those circumstances the transfer of the property would also be treated as a TOGC.

Partial Exemption

Where a business makes a mixture of taxable and exempt supplies the input VAT recovery by that business is restricted. Where input VAT is incurred on costs that are directly attributable to making exempt supplies none of that VAT may be recovered.

Where input VAT is incurred on costs that are directly attributable to making taxable supplies all of that VAT may be recovered.

Note that taxable supplies include both standard rated and zero rated supplies.

Where input VAT is incurred on costs that cannot be directly attributable to making either taxable or exempt supplies, the VAT that may be recovered in respect of these costs is reclaimed by using a method acceptable to HM Revenue and Customs. The standard method for apportioning this residual input VAT is to reclaim on the basis of the proportion of taxable supplies to exempt supplies. In your case this would be 90% taxable supplies to 10% exempt supplies and thus 90% of this residual VAT could be reclaimed.

Where the input tax relating to exempt supplies is no more than the de –minimis limits of £625 per month on average and no more than 50% of the total input tax, the full amount of input VAT may be recovered.

Capital Goods Scheme

As the premises to be acquired will cost at least £250,000 the capital goods scheme (CGS) rules will apply to the £400,000 property. These VAT rules seek to restrict the input VAT recovery in respect of the costs of acquiring that building to the proportion of the building used for making taxable supplies. This would not necessarily be the same proportion as the partial exemption formula outlined above, i.e. 10%.

If for example, 1 floor out of a 5 floor building was used for making exempt supplies and 4 floors for making taxable supplies the CGS restriction would be 20%. Thus if the VAT payable on the construction costs and legal costs of the acquisition of the new property were say £70,000 (17.5% of £400,000) then only 80% of the input VAT could be initially recovered, so £56,000.

The usage of the property would then need to be monitored over a 10 year adjustment period, and an annual adjustment may be necessary. Should the exempt usage fall to say 10% one year then additional input VAT could be recovered, being 90% less 80% x £70,000 x 1/10 = £700 additional input VAT recovery for that year. If the exempt usage were to increase during the 10 year adjustment period then additional VAT would be payable to HM Revenue & Customs.

(It is assumed that the Capital Goods scheme will not have applied to the old premises to be sold as the acquisition value is likely to have been less than £250,000.)

When the old premises are sold for approximately £200,000 each the disposals will be exempt from VAT, provided an option to tax was not made on these premises, and will be disregarded for the purpose of the partial exemption calculation.

I hope that the above answers your queries, if I can be of any further assistance please do not hesitate to contact me.

Yours sincerely

I M Fishy

Dover and Sole LLP

Question 2

MEMO

To: Tax Partner

Subject: Mr and Mrs Scraggy
Property Portfolio

1 In the ownership of an investment the owner is generally looking for an income stream or capital growth or both and the letting and retention of property provides both of these. As the properties were not acquired with the intention of resale at a profit it is unlikely to be regarded as a trading activity when considered in the context of the badges of trade. Certainly they have been held for a long period and no work has been done to the properties with a view to a sale.

The question is therefore whether the activity connected with the ownership of the investments is in such a manner as to amount to a business.

In American Leaf Blending 1978 STC 561 it was held that the mere receipt of rents from property raises no presumption that a business is being carried on.

Certainly Mr and Mrs Scraggy's activities suggest more than mere passive ownership. They have premises from which they advertise properties for let, indeed they have a website. Although Mrs Scraggy deals with the administration they engage a handyman to maintain the properties. The letting period is short term which would imply a turnover of lettings and the need for re-let. All these factors would point to a degree of activity and organisation in the manner of a business.

2 Incorporation can give rise to tax savings in the taxation of the rents but this will in turn depend on the level of drawings in the form of salaries and/ or dividends once incorporated. Drawings in the form of a salary once incorporated may also give rise to class 1 national insurance contributions for Mr & Mrs Scraggy and for the company.

As regards the properties themselves there are implications arising from the incorporation itself and looking forward, particularly when sale is in contemplation, which are as follows:

The transfer of the properties will be treated as a disposal to be valued at market value on the basis of Ss 17 and 18 TCGA 1992.

Given the property values this will give rise to significant capital gains.

Two reliefs from capital gains are usually available, one being s.165 TCGA 1992. However, this only applies where business assets are gifted and these assets are used in a trade, profession or vocation. As Scraggy Lets is not a trade, profession or vocation, s.165 will not be available.

The other relief is s.162 TCGA 1992 which would provide relief if all the assets of a business are transferred as a going concern to the company in return for shares issued by the company. In which case the capital gain is rolled over against the cost of the shares.

However, s.162 TCGA 1992 is only available on the transfer of a business. If Scraggy Lets is regarded merely in the holding of an investment then no such relief would be available and capital gains tax would be due. As indicated above, it does appear to be a business.

An election may be made to disapply the relief in which case the gain would be taxable.

The potential capital gain is:

Property	£
Market value	850,000
Cost	200,000
Capital gain	650,000

The post incorporation balance sheet would be:

	Balance Sheet	*Base Cost*
	£	£
Property	850,000	850,000
Debtors	50,000	
Cash	35,000	
	935,000	
Creditor	(70,000)	
Bank loan	(450,000)	
	415,000	
Share capital	415,000	0

Held over gain restricted as gains exceed the market value of the assets transferred

Share capital 415,000 – 650,000 = Nil

Capital gains arising £235,000 (£650,000 - £415,000)

Capital gains deferred £415,000

Note: ESC D32 whereby HMR&C are prepared not to treat liabilities as consideration.

As regards the future sale of the property:

As the capital gains base cost of the property transferred to the company is market value the subsequent sale is unlikely to give rise to a significant gain charged to corporation tax where this is shortly afterwards.

As the capital gain is held over against the cost of the shares this would provide for deferral of the gain otherwise arising on the sale of the property.

There would however be a stamp duty land tax charge on the transfer of the properties to the company. The consideration is taken to be the market value of the properties.

Question 3

1 **Components of payment:**

	£
Contractual	
October salary (£150,000 / 12)	12,500
2 weeks holiday pay (£150,000 / 52 x 2)	5,769
Bonus (£150,000 / 12 x 7 x 5%)	4,375
Payment in lieu of notice (£150,000 / 12 x 3)	37,500
	60,144
Non contractual (balance)	29,856
	90,000

Income Tax:

As the payment is made after the employment has ceased, assuming the P45 has been issued, the company is required to deduct at basic rate tax.

	£	£
Amounts arising from the contract, s.62 ITEPA 2003:	60,144	
Income tax at 22%		13,231
Payments within S401 ITEPA 2003:	29,856	
Less	(30,000)	
	0	
Income tax at 22%		0
Total		13,231

National Insurance:

	£
Earnings arising from the contract	60,144
Earnings threshold	435
Upper earnings limit	2,904
11% x (2,904 – 435)	272
1% x (60,144 – 2,904)	572
	844

No liability on non contractual element.

(2007/08 rates used)

2 (a) **Discretionary Clause**

If the payment in lieu of notice (£37,500) is discretionary then it is important to ascertain what the payment was for.

In the case of EMI v Coldicott it was held that a discretionary provision in the contract giving the employer the right to make a payment in lieu of notice (PILON) constituted a contractual entitlement and would be subject to income tax and national insurance.

A contractual PILON is one that has its source in the contractual arrangements between employer and employee. Such arrangements can take a variety of forms, including:

- the main contract document
- a side letter to the main contract document
- a staff handbook
- a letter of appointment
- a redundancy agreement
- an employer-union agreement.

Where the employer makes an automatic payment in lieu of notice then such a payment may fall within S62 ITEPA 2003 and be liable to national insurance.

(b) **No Clause**

If no such provision was present then providing such a clause could not be implied through such payments being customary, then a payment would be not subject to income tax or national insurance.

Question 4

HADDOCK GROUP

1 **Corporation Tax payable year ended 31 March 2008**

	Haddock	*Snapper*	*Turbot*	*Pilchard*
	£	£	£	£
Sch D case I	0	150,000	375,000	0
Sch A	120,000	0	0	0
Sch D case III	45,000	0	10,000	0
Capital gain (w)	0	0	0	237,000
Mangmnt Exp	(165,000)	0	0	0
S393A loss	0	0	0	(80,000)
Group relief	0	(100,000)	(335,000)	(107,000)
PCTCT	0	50,000	50,000	50,000
CT payable @ 20%	0	10,000	10,000	10,000

The liabilities of Mullet Ltd and Whiting Ltd would be NIL

Small companies lower limit = £300,000/ 6 = £50,000

(Note: No IBAs balancing charge on the sale of the factory)

Degrouping gain working

		£
Market value at transfer		500,000
Less cost to group		(200,000)
Indexation to June 2006	$200,000 \times 0.315$	(63,000)
Gain		237,000

Loss utilisation:

	Haddock	*Mullet*	*Whiting*	*Pilchard*
	£	£	£	£
Current trading loss	0	500,000	240,000	80,000
Mangmnt exps	200,000	0	0	0
Utilised by self	(165,000)	0	0	(80,000)
Group relief	(35,000)	(240,000)	(160,000)	0
Balance	0	260,000	80,000	0
Brought f/wd	0	0	700,000	370,000
Carried f/wd	0	260,000	780,000	370,000

Summary of Group relief claims:

	£
Surrender from H to T	35,000
Surrender from W to S (maximum 4/12 x £150,000)	50,000
Surrender from W to T (balance)	110,000
Maximum (4/6 x £240,000)	160,000
Surrender from M to T (to reduce to small company)	190,000
Surrender from M to S (to reduce to small company)	50,000
	240,000

(Give credit for other combinations that reduce profits chargeable to £50,000 but leave losses in Mullet Ltd to carry forward against profits in margin next year.)

Consider giving group relief to Pilchard Ltd as the profits are partially taxed at the marginal rate. Note that group relief would be restricted to the corresponding period i.e 1 April 2007 to 30 September 2007 (6 months Pilchard Ltd profits = £118,500, 6 months of Whiting Ltd loss = £120,000).

Utilising the group's loss against Pilchard Ltd profits (ie a company that has left the group) is not deemed to be the most efficient for the continuing group as a whole. It is assumed that the disposal proceeds reflect no loss utilisation.

Other relieving provisions utilised or considered

The disposal of the Pilchard Ltd shares by Haddock Ltd would appear to be an exempt disposal within the substantial shareholdings exemption as the company has held 10% or more of the shares in a trading company for 12 months and the group would appear to be a trading group.

The transfer of the factory from Haddock Ltd would have been at no gain/ no loss under s.171 TCGA 1992, being between members of a 75% gains group. However the disposal of Pilchard Ltd within 6 years whilst still owning the property would crystallise a s.179 TCGA 1992 degrouping charge on Pilchard Ltd.

The two companies could jointly elect for the gain to be transferred back to the vendor group rather than being charged on Pilchard Ltd. The gain on a qualifying asset could then be rolled over by group companies reinvesting the proceeds in a qualifying replacement asset within the period 1 April 2007 to 31 March 2011, being 12 months before to 36 months after the date of the deemed degrouping charge. This would have avoided using £150,000 trading losses but there are ample trading losses available within the group to eliminate the de grouping charge.

The elimination of the degrouping charge and consequent corporation tax liability would impact upon the value of Pilchard Ltd and would need to have been taken into consideration in negotiating the price paid by the management team.

2 **Treatment of losses of Pilchard Ltd and Whiting Ltd**

Pilchard Ltd losses

Pilchard Ltd has current year losses of £80,000 incurred in year ended 31 March 2008 and £370,000 of brought forward trading losses. As there were "arrangements" in place to dispose of Pilchard Ltd group relief would only be available for the losses incurred up to the date of the arrangements, 1 July 2007 (£20,000). However this restriction would not apply for the purposes of a s.393A ICTA 1988 loss claim and consequently a claim could be made for loss relief against the de grouping charge on the property transfer.

The remaining trading losses could then be carried forward against future trading profits subject to the anti-avoidance provisions of s.768 ICTA 1988. Clearly there will be a change of ownership when the company is sold to the management, and where there is also within a three year period a major change in the nature or conduct of the trade carried on by the company the carry forward of the trading losses would be denied.

Trading losses of Whiting Ltd

Whiting Ltd had brought forward trading losses of £700,000 at September 2007 and has incurred a further £240,000 of trading losses in the 6 months to 31 March 2008. Only the losses incurred in the 4 months since acquisition on 1 December 2007 (a maximum of £160,000) may be utilised by the Haddock group, the remaining £80,000 would be added to the £700,000 losses brought forward and would potentially be available to be carried forward against future trading profits of Whiting Ltd, subject to the same anti-avoidance provisions on change of ownership set out above for Pilchard Ltd.

Capital losses of Whiting Ltd

Whiting Ltd also had £450,000 of brought forward capital losses when acquired. These are regarded as "pre–entry" capital losses and may only be utilised by setting them against capital gains on disposals of Whiting Ltd's own assets, excluding gains on assets transferred from other Haddock group companies.

Additionally the pre-entry capital losses can be utilised against gains on disposal of assets acquired by Whiting Ltd AFTER it joined the group, but only to the extent that these assets are used by Whiting Ltd in the trade that it was carrying on when it joined the group and continued to carry on until the date of disposal of the asset.

Question 5

FILE NOTE

Client: Mr Smart
Smart Delicatessens Ltd

Subject: Purchase of own shares

1 **Tax Liabilities**

	£
Income distribution	
Consideration	700,000
Less subscribed on issue	700
Net distribution	699,300
Tax credit	77,700
Gross distribution	777,000
Income tax @ 32.5%	252,525
Less tax credit	(77,700)
	174,825
Capital distribution	
Consideration	700,000
Less March 1982 value	(70,000)
	630,000
Less indexation allowance	
1.047 x £70,000	(73,290)
	556,710
Less Taper Relief 75%	(417,533)
	139,177
Annual exemption	(9,200)
	129,977
Capital gains tax @ 40%	51,991

2 Conditions required for capital distribution

In order to be treated as a capital distribution the following conditions must be satisfied under s.219 ICTA 1988.

An application for advance clearance may be made and a return is required following any capital distribution.

2.1 Company

- The company must be an unquoted trading company or an unquoted holding company of a trading group.
- The purchase must be made wholly or mainly for the purposes of the trade.
- The purchase must not form part of a scheme or arrangement to enable the owner to participate in the profits of the company without a dividend or to avoid tax.

2.2 Vendor

- The vendor shareholder must be resident and ordinarily resident in the UK in the tax year of purchase.
- The shares must have been owned by the vendor for at least 5 years prior to the sale.
- The vendor shareholder must sell all their shares or substantially reduce their interest. Substantially is taken as holding not more than 75% of their percentage interest prior to the purchase.
- The vendor must not be connected with the company immediately after the purchase.

This is taken to mean if with their associates, which includes the shareholder's spouse and minor children, they possess or are entitled to acquire more than 30% of:

(a) the issued share capital, or
(b) the loan capital and issued share capital, or
(c) the voting power of the company , or
(d) the assets available to equity holders on a winding up

3 Financial Proposals

Loan back

It is likely that the loan back of the consideration would fall foul of the condition requiring that the vendor must not be connected immediately after the purchase, since Mr Smart would own more than 30% of the loan capital and issued share capital of the company.

If the company could obtain a loan from, say, the bank such that Mr Smart is not immediately connected then it may be possible for Mr Smart to make a loan back subsequently and use this to repay the bank.

Sale of shops

The sale of the shops should not in itself have any effect on the purchase qualifying as a capital distribution.

However, if the scale of the sale is such that it affects the trade then it may.

It is suggested in SP2/82 that HM Revenue & Customs would view the repurchase of shares from a retiring shareholder to make way for new management as being for the benefit of the trade. In Allum & Allum v March (2005) SSCD 191, however, it was held that where the funding of the buy back is prejudicial to the trade then it may not be regarded as meeting the condition of being made wholly or mainly for the purpose of the trade. In that case the purchase was funded by the sale of the company's trading premises and the company's operations were reduced considerably following the sale.

4 Income Distribution

Possible claim under s.574 ICTA 1988 may be made whereby any capital loss arising on the disposal of the shares may be set against total income.

The loss could only be used if incurred by way of a bargain at arms length for full consideration.

The extent of the loss under the buy back treated as a distribution would be:

	£
Consideration	700,000
Taxed as a distribution	(699,300)
	700
Less March 1982 value	70,000
	69,300

Question 6

Advise & Co
1 Chartered Lane
Pennyville

November 2008

Mr P Clark
Sunny View
51 Stoney Street
Carford

Dear Mr Clark

The Wells Family - Inheritance Tax Matters

Further to our recent meeting I provide a summary of my advice as follows:

1 **Appointment of the farm to Julian**

As regards the inheritance tax consequences of the appointment of the farm, given that the trust is a discretionary trust and falls within the relevant property regime, such an appointment gives rise to an immediately chargeable transfer (often referred to as an exit charge). The calculation of the liability is complicated but the rate of tax may be summarised as being 30% of the lifetime rate of inheritance tax with a maximum rate of 6%.

The charge to tax is found by first calculating the rate of tax on the initial value of the trust. The charge, however, is based on a 10 year charging period and with an appointment prior to the 10 years the charge is apportioned for the number of 3 monthly intervals that have elapsed prior to the appointment. In this case the effective rate of inheritance tax will be 3.3409% giving rise to a liability of £13,724 for Julian. (See working W1.)

2 **Farm remains in the trust**

If no such appointment is made then as explained above the trust will be subject to a charge to inheritance tax every 10 years. Assuming rates remain as currently the inheritance tax liability will be due in respect of the 10 year anniversary on 20 December 2011 of £28,140, payable by the trustees. (See working W2.)

3 **Vanessa's family trust**

Although the rules have changed such that all trusts since 22 March 2006 are now taxed as relevant property trusts in the same way as discretionary trusts, as the trust pre-exists that date the old rules continue to apply. This means that if Vanessa continues to be the life tenant then it will form part of her estate on death, although the tax will be payable by the trustees. If Vanessa during her lifetime no longer retains an interest in possession and it passes to another individual then it will be regarded as a potentially exempt transfer which with 7 years survival would not be subject to any inheritance tax liability.

If the assets remain within the settlement at the end of her interest then there would be an immediate chargeable transfer.

Given that Julian and Vanessa have valuable estates, the trustees, if given flexible powers, could consider an absolute appointment to, or continuing life interests for Vanessa's children with consideration of 7 years survival.

4 **Using trusts in the wills**

Julian and Vanessa could leave their estates absolutely to each other. No liability would arise on the first death being an exempt transfer between spouses. A double nil rate band would then be available to be claimed on the survivors death.

If a trust was used then funds could be set aside for the survivor and children.

If the trust is set up as an 'immediate post death interest' trust (ie an interest in possession trust) it will not be treated as a relevant property trust. Instead the treatment would be as for Vanessa's existing family trust. Any other trust being created would be within the relevant property regime and would, therefore, be a chargeable transfer. As a consequence, to the extent the nil rate band is utilised by a transfer of funds into the trust, only one nil rate band would be available on the survivor's death, although the value of the trust property would not be included within their estate.

Given they have children from their first marriage they may wish to consider an interest in possession trust for the survivor, with the trust then passing to the children. In this way there is no tax on the first death being intra-spouse and the trust value is then protected for their own children.

I trust this is helpful and should you have any further queries please contact me.

Yours sincerely

A C Adviser

WORKINGS

W1 Tax payable by trustees on set up

20.12.2001 (nil rate band £242,000)

		£	IHT £
Clock b/fwd		250,000	1,600
Discretionary trust	450,000		
Less APR (50%)	225,000		
	225,000		
Less AE 2001/02	3,000		
		222,000	44,400
		472,000	46,000

If appoint the farmland Nov 08, valued £800,000
(nil rate band £312,000)

	£	IHT £
Clock b/fwd	250,000	–
Initial value: (450,000 – 44,400)	405,600	68,720
	655,600	68,720

Initial rate $\frac{68,720}{405,600} \times 100 = 16.9428\%$

Complete quarters elapsed:
6 yrs + 3 quarters + 27
$\therefore$ rate of tax : 16.9428 x 27/40 x 30% = 3.4309%

	£
Taxable value of farmland	800,000
Less APR (50%)	(400,000)
	400,000

IHT payable by the beneficiary
3.4309% x 400,000 = £13,724

W2 Tax payable by trustees after 10 years

(assume nil rate band £312,000)
(assume valued £1m)

	£	£
Clock b/fwd	250,000	–
Trust property	1,000,000	187,600
	1,250,000	187,600

Effective rate $\frac{187{,}600}{1{,}000{,}000} \times 100 = 18.76$

Actual rate 8.76 x 30% = 5.628%

Taxable value of farmland	1,000,000
Less APR 50%	(500,000)
	500,000

Liability payable by trustees
5.628% x £500,000 = £28,140