The Chartered Tax Adviser Examination

May 2008

PAPER IIC – COMPANIES

Suggested Answers

QUESTION 1

Mr D Merryweather
Merryweather Services Limited
1 New Office Square
Poplar Way
Cranford
Borsetshire

Dear Mr Merryweather

Thank you for your query regarding VAT.

Prior to 1 April 2007, all supplies made by the company were subject to VAT at the standard rate of 17.5%. Since 1 April 2007 you have additionally been making exempt supplies as an insurance broker. This means that your recovery of input tax incurred in the course of your business will be restricted. This restriction may extend to a claw-back of input tax recovered in relation to the purchase of your new office.

Input tax can only be recovered by a business to the extent that it is incurred for the purpose of making taxable supplies. A company that makes both standard rated and exempt supplies is therefore required to identify supplies of goods and services made to it and attribute this to the onward supplies made, i.e. taxable or exempt.

Input tax on goods and services received for the purposes of making taxable supplies is wholly recoverable while input tax on goods and services received for the purposes of making exempt supplies may not be recovered. A proportion of input tax on goods and services used for making both taxable and exempt supplies ("residual input tax") can be recovered. The standard method of calculating the recoverable proportion is calculated by taking the proportion of taxable supplies as a percentage of total (taxable and exempt) supplies and applying it to the residual input tax. If the amount of residual input tax is less than £400,000 per month on average then the percentage proportion is rounded up to the next whole percentage, for example 67.32% is rounded up to 68%. If the average exceeds £400,000 then the percentage is rounded up to two decimal places.

Whilst the standard method for calculating partial exemption adjustments is based on the proportion of taxable supplies to total supplies, it is possible to agree with HM Revenue & Customs that an alternative ("special") method may be used. Special methods could be based for example on the value of inputs or on the floor area used by offices making taxable and exempt supplies.

Any special method must be agreed in advance with HM Revenue & Customs in writing and can only be used if the taxpayer has made a declaration stating that the method is a fair representation of the extent to which goods and services are used for making taxable supplies.

If it is later discovered that the taxpayer was aware that the method chosen does not fairly represent the use of goods and services for making taxable supplies and the taxpayer has recovered input tax in excess of what would have been recovered under the normal method, the approval to use the special method may be withdrawn with retrospective effect, and the taxpayer will be liable for the difference between the VAT recovered and the true VAT recoverable, based on the principle of how the VAT incurred has been used.

Both the standard and special methods are subject to an annual adjustment which averages out the VAT recovery during the tax year (i.e. the year to 31 March in your case) and applies an overall percentage recovery to this. There will then be an adjustment (either up or down) to the recovery made during the course of the year and this is accounted for on the next return after the year end (i.e. June). Also, each of the methods can be "over-ridden" in certain situations.

Capital items

The partial exemption rules are extended to cover input tax incurred on certain capital items that are used over a period of years to make taxable and exempt supplies. This Capital Goods Scheme applies to computer equipment costing more than £50,000 and certain land, buildings and civil engineering works costing more than £250,000 (both amounts being exclusive of VAT). In the case of computer equipment, this adjustment is made over five years. In respect of land and buildings the adjustment is

generally made over ten years, with the exception of leases that have less than 10 years to run, in which case the adjustment is five years.

Input tax in relation to these items is initially recovered in the period in which the tax is incurred based on the proportion of taxable supplies made in that first period. If the proportion of taxable supplies, as a percentage of total supplies, changes in subsequent years then an adjustment will be made each year (either up or down) in order to take into account the degree of use for taxable purposes in different periods.

This adjustment is calculated by dividing the total input tax by the number of years in the total adjustment period (5 or 10 years as set out above). The result of this calculation is multiplied by the difference between the initial recovery percentage and the percentage of taxable supplies for the period under consideration. If the proportion of taxable supplies has increased then the result of the calculation is an additional amount of input tax recoverable. If the proportion of taxable supplies has fallen then the result is an amount payable to HMRC. In your case of course, since you initially recovered 100% of the VAT on the basis of making 100% taxable supplies, you can only have an amount due to HMRC.

The adjustment is made on the second return following the year end (i.e. September in your case). In appendix 1, I have included calculations of how this adjustment would apply to the company in the years to 31 March 2008 and 31 March 2009.

Sale of the building

So long as a capital item is owned by a business and used for making supplies, the above calculations will be necessary each year. If the building itself is sold within the adjustment period then it is necessary to consider the VAT treatment of that sale. A final adjustment will be necessary following the sale of the building based on the assumption that it would have been used for either wholly taxable or wholly exempt supplies, depending on whether the sale was itself taxable or exempt.

As the sale of most commercial buildings is exempt from VAT in the absence of an election to waive exemption, this can result in a claw back of VAT recovered in respect of each year remaining in the capital goods scheme adjustment period.

If the building were sold whilst still less than three years old, i.e. before 1 April 2009, it would be a standard rated supply and therefore no claw back of VAT would be made.

If the building is to be sold after 1 April 2009 but before the end of the ten year adjustment period it may be wise to consider making an election to waive exemption in order that the sale can be standard rated. Failure to do so could result in a significant proportion of the VAT recovered in the first year being repayable to HMRC, as illustrated in the attached appendix.

I hope this is of assistance.

Yours sincerely

Anne Adviser

Appendix 1

Initial VAT recovery 100% taxable supplies, therefore, £750,000 @ 17.5% = £131,250.

Percentage of taxable supplies in the year to 31 March 2008.

$$\frac{2,637,931}{3,210,763} = 82.159\%$$

Rounded up to 83%

Adjustment percentage (83%-100%) = 17%

Calculation of adjustment

$$\frac{£131,250}{10} \times 17\%$$

£2,231.25 additional payment due to HMRC

Percentage of taxable supplies in the year to 31 March 2009.

$$\frac{3,143,426}{3,937,182} = 79.84\%$$

Rounded up to 80%

Adjustment percentage (80%-100%) = 20%

Calculation of adjustment

$$\frac{£131,250}{10} \times - 20\%$$

£2,625.00 additional payment due to HMRC

Sale of Building

If the building were sold on say 31 March 2012 and the option to tax had not been exercised, the adjustment would be:

Adjustment Percentage (0% -100%)

Calculation of adjustment

$$\frac{£131,250}{10} = 13,125 = 100\% \times 4 = £52,500$$ additional payment due to HMRC

QUESTION 2

A.N. Accountant
Address

Finance Director
Browning Ltd
Address

Our ref
Your ref

Date

Dear Sir

Research and Development ("R&D") relief

I refer to our recent telephone conversation about the R&D relief that may be available to Browning Ltd. I said I would write to you to provide further details.

Qualifying expenditure

You mentioned that Browning Ltd incurred various expenditure in the year ended 31 December 2007. I set out below my comments on what would be qualifying expenditure for the purposes of the R&D tax relief SME scheme.

In order for any expenditure to qualify for R&D tax relief Browning Ltd must spend at least £10,000 per annum on qualifying expenditure.

A Water, fuel, power

Water, fuel and power are specifically included in statute as "consumable or transformable materials". Revenue expenditure on consumable items directly employed in R&D is qualifying expenditure. However consumables used in the provision of administrative services are not qualifying. Here a reasonable apportionment based, for example, on floor area could be used.

B Computer software

Expenditure on software used by the R&D team to record the results of the R&D would be a direct part of the R&D and therefore be included as qualifying expenditure. However, software used by the human resources staff would not. Again an appropriate apportionment of the expenditure should be made, for example, based on staff numbers if a particular software product is used by both R&D and non R&D staff.

C Staffing costs

Staffing costs for directors or employees directly and actively involved in relevant R&D are qualifying but not in respect of HR or administrative staff. Salaries and pension fund contributions would qualify. Redundancy payments are not emoluments and therefore do not qualify. Non-cash taxable benefits such as a car and living accommodation benefit are also excluded.

D Payment to one self-employed consultant directly engaged in R&D work

If there is no contractual arrangement between the consultant and a third party staff provider then this would not be expenditure on 'externally provided workers'. Instead it may be expenditure on subcontracted R&D which still falls within qualifying expenditure. For connected subcontractors, the company can claim the lower of the payment that it makes to the subcontractor and the relevant expenditure of the subcontractor.

E Expenditure that has been capitalised on the balance sheet.

Capital expenditure is not eligible to be qualifying R&D expenditure but may qualify for R&D allowances. However it is possible for expenditure to be revenue expenditure for tax purposes but capitalised for accounting purposes. In which case, the expenditure is allowed to be deducted in computing the profit when it is incurred irrespective of whether it appears as a deduction in the financial statements provided the expenditure is either:

- recognised as a deduction in computing the profit for tax purposes; or
- is an intangible asset which is not prevented from being an allowable deduction in calculation of profit for that period (for example because it is capital expenditure for tax purposes) and the expenditure is incurred during the accounting period.

Amount of payable tax credit

You asked for further information on the amount of payable tax credit that Browning Ltd might be able to claim.

The amount of payable tax credit that a company is entitled to for an accounting period is the lesser of:

- 16% of the surrenderable loss for that period;
- the company's PAYE and NIC liabilities for payment periods ending in that accounting period.

The surrenderable loss is the lesser of:

- the amount of the unrelieved trading loss sustained in that period;
- 150% of the related qualifying R&D expenditure.

The unrelieved loss is the actual trading loss less:

- any possible current year claims which could be made; and
- any actual prior year claims or group relief surrenders which have been made.

Trading losses brought forward or back from other years are ignored.

A payment period is a period that ends on the 5th of the month and for which the company is liable to account for income tax and NIC to HMRC.

The total of the company's PAYE and NIC liabilities for a payment period is the total of:

- gross amount of income tax that the company is required to account to HMRC for that period ignoring deductions the company is authorised to make for working tax and child tax credit;
- gross Class 1 NICs paid for that payment period ignoring any deductions the company is authorised to make for statutory sick pay, statutory maternity pay, working tax credit or child tax credit.

However the amount of tax credit payable may be withheld by HMRC where:

- the company has outstanding CT liabilities in which case the R&D tax credit may be used to discharge them;
- there is an enquiry into the company's return for the accounting period for which the R&D tax relief is claimed in which case the payment may be withheld until the enquiry is completed; or
- the company has outstanding PAYE or Class I NIC liabilities for payment periods ending in the accounting period.

Please let me know if you require assistance in calculating the actual amount of R&D tax credit that Browning Ltd would be entitled to claim.

Pre-trading expenditure

You also asked for details of the election that can be made in respect of the expenditure incurred in the year to 31 December 2006.

Instead of treating the pre-trading expenditure as incurred on the first day that trading begins, Browning Ltd can elect to deem 150% of the qualifying R&D pre-trading expenditure as a trading loss for that accounting period. The election must be made by notice in writing to HMRC within 2 years of the end of the accounting period to which it relates, ie by 31 December 2008.

The deemed loss can be relieved by:

- Set off against any other profits Browning Ltd may have for that accounting period;

- Set off against any other profits for the previous 12 months provided that it was entitled to a pre-trading R&D tax relief for that earlier accounting period;
- Surrender as group relief;
- Surrender for a payable tax credit; or
- Carry forward as a loss for the future trade to be derived from the R&D.

Large company scheme

Finally you mentioned that Browning Ltd was planning to grow substantially. I set out below the key differences between the SME scheme and large company scheme that may be relevant for Browning Ltd in the future:

SME scheme	Large company scheme
150% rate of enhanced deduction	125% rate of enhanced deduction
Payable credit of up to £24 for every £100 of qualifying expenditure on R&D	No payable credit
If sub-contract R&D to others, can still claim for expenditure on that R&D	Unless sub-contracts to certain qualifying persons can only claim for expenditure on R&D it carries out itself
If R&D project is subsidised or a grant is received, claim can be reduced	No reduction for grant or subsidy
Must own the intellectual property arising out of the R&D	Need not own the intellectual property arising out of the R&D

If you have further queries, please contact me.

Yours faithfully

A.N. Accountant

QUESTION 3

The primary issue concerning the first three of the issues raised in the due diligence process concerns the operations of the United Kingdom's controlled foreign companies legislation. This applies to companies resident outside the United Kingdom, controlled by persons resident in the United Kingdom and subject to a lower level of taxation in their territory of residence, generally less than three-quarters of the United Kingdom's standard corporation tax rate.

If a company is a CFC and none of the various exemptions applies and the profit exceeds £50,000 for the year, the profits will be apportioned to the United Kingdom corporate shareholders with interests of at least 25% of the total profit. As all of these subsidiaries are 100% owned by Couch Park Ltd, the whole of the profit will be attributed under the CFC legislation unless any of the statutory exemptions applies.

The exemptions available include a motive test whereby the UK company must demonstrate both that:

- the foreign company was not carrying out transactions which achieved a reduction in United Kingdom tax (the transaction leg); or
- such a reduction was not the main purpose of these transactions and that the main or one of the main reasons for the foreign company's existence was not the achievement of a reduction in United Kingdom tax by diverting profits away from the United Kingdom (the diversion of profits leg).

As it will often be the case that a foreign branch could have been set up to carry on the activity, HMRC is reluctant to allow the second defence under the motive test.

Exemption is also available if the foreign company can be shown to be carrying on exempt activities. Generally the carrying on of a trading activity in the foreign country which can be shown to be fully managed in that country by persons engaged for that purpose. This extends to holding companies which hold investments in companies carrying on exempt trading activities.

The Isle of Man insurance company is, at first sight, paying tax in excess of 75% of the United Kingdom rate and would, therefore, not fall within the CFC regime. It is, however, within the designer rate rules which apply to named territories, of which the Isle of Man is one, where the taxpayer has the right to elect for a certain rate of tax to apply. The profit would, therefore, be attributable to the United Kingdom parent with credit given for the Isle of Man tax under the double taxation relief provisions.

Couch Park BV is a holding and trading company. A holding company only meets the exempt activities test if at least 90% of its income is derived from companies which it controls and which are themselves carrying on exempt activities. Strictly, Couch Park BV fails this test and it would be better to have its investment activity split from its trading activity to ensure exemption. In practice it looks well placed to pass the motive test since it can show that its individual activities would both have achieved exemption in their own right had they been set up in separate companies so no United Kingdom tax advantage is being obtained.

Couch Park Engineers Pte Ltd is a service business. Assuming that it has sufficient management in Singapore to run the business, it would appear well placed to qualify under the exempt activities rules. However, the fact that it undertakes work for other group companies creates a potential problem as, if more than 50% of its trading receipts are from connected persons, as other group companies automatically will be, it will fail the exempt activities test. It is less likely to pass the diversion of profits leg of the motive test as HMRC would contend that there would have been nothing to stop the United Kingdom company setting up a branch in Singapore. The CFC apportionment rules, however, do not extend to capital gains and, therefore, the capital gain from the sale of the surplus trading property will be excluded from the apportionment.

Even if the companies fail to meet the various exemptions, however, the apportionment of the whole of the taxable profit to the United Kingdom corporate shareholders may be avoided. This would be achieved by making an acceptable distribution of profits back to the United Kingdom. An acceptable distribution is 90% of the taxable profit as calculated on a United Kingdom taxable profit basis provided that such a distribution is made within eighteen months of the end of the chargeable period.

In both the first and third issues raised by the due diligence team, transfer pricing should also be noted as a concern. As there are transactions between group companies, these require to be conducted on the basis of prices set on an arm's length calculation. This will apply both in respect of deductibility for payments made by United Kingdom companies by way of insurance premiums and any payments for services. It will also apply in respect of the calculation of the profits for CFC purposes so that, for example, the Singapore company's charges to other group companies for overhaul services require to be computed on an arm's length basis.

The other issue raised is that of the calculation of tax in a foreign currency. If the company prepares its accounts in US dollars, it is required by Section 92C Finance Act 1993 to compute its taxable profit in that currency and then convert the profit to sterling by reference to the average exchange rate for the accounting period. If the company prepares its accounts in sterling but identifies the US dollar as its functional currency, the provisions of Section 92B apply and it is that functional currency which is used to compute the profits, again translated into sterling at the average rate for the period.

QUESTION 4

1 (a) The exchange loss of £12,000 is treated as a loan relationship debit for the year. Regarding the interest, the amount receivable was £4,945 (US$ 9,000/ 1.82) but the amount received was only £4,639 (US$ 9,000 / 1.94). The difference of £306 is an exchange loss so there is a loan relationship debit for the year of this amount.

(b) The shares in Sadler (Italy) SpA are not a loan relationship and therefore the gain of £160,000 is ignored for tax purposes. The £160,000 loss on the matched portion of the bank loan, which is taken to reserves, is not relieved (s84A FA 1996). The £160,000 loss on the unmatched portion, which is taken to the profit and loss account, is relieved as a non-trading loan relationship debit.

(c) Again the exchange loss on the shares is ignored for tax purposes. The US$700,000 long-term loan is a loan relationship but because the exchange loss of £50,000 on the

investment is taken to reserves in accordance with UK GAAP, it is ignored for tax purposes. The gain on the US dollar currency swap that is matched with the dollar shareholding and loan and taken to reserves is not taxed.

(d) **If the shareholding qualifies as a substantial shareholding on disposal**

The exchange gains of £5,000 going through the profit and loss account will be brought into account as a loan relationship credit. The disposal of shares will not give rise to any chargeable gain or allowable loss. None of the exchange gains or losses on the liability, which have been taken to reserves are brought back into charge.

If the substantial shareholding exemption does not apply

As before there will be a loan relationship credit of £5,000. The disposal of shares is a chargeable event. In sterling terms the shares cost £1,017,442 (1,750,000 / 1.72) and were sold for £1,428,571 (2,100,000 / 1.47). There is a chargeable gain of £411,129 less any indexation allowance.

Part of the exchange losses and gains that have arisen on the bank loan are brought back into charge. There has been an aggregate exchange loss of £120,000 on the bank loan (loss of £160,000 in 2006 and gain of £40,000 in 2007). 1.75m Euros of the total 2m Euros or 87.5% has been matched with the asset throughout. So 87.5% of £120,000, being £105,000, is allowed as a capital loss in the APE 31 May 2007, partially offsetting the gain on the shares.

2 "Loan relationships for Unallowable Purposes" at para 13 Sch 9 FA 1996 is an anti-avoidance provision. An "unallowable purpose" is one which is not amongst the business or other commercial purposes of the company.

One such purpose is where any part of the company's activities is not chargeable to corporation tax (para 13(3)). For example, where a UK branch of a non-UK resident company pays interest on a loan being used to fund activities of the company not connected with the UK branch, the related debits would be disallowed.

Another unallowable purpose is where the main or one of the main purposes for which the company is party to the relationship or has entered into a related transaction by reference to it, is a tax avoidance purpose. This is defined in para 13(5) as any purpose that consists of securing a tax advantage (whether for the company or any other person). "Tax advantage" is defined under s840ZA ICTA 1988. Where a tax avoidance purpose does not qualify as being a business or other commercial purpose of the company the related debits are disallowed.

Note that the test is the purpose of the loan relationship in the accounting period so a loan relationship may have a business purpose when a company enters into it in an earlier accounting period but have an unallowable purpose in a later accounting period.

FA 2002 brought exchange differences on loan relationships into the provisions of para 13 so both the debits arising from exchange losses and credits arising from exchange gains are disallowable. A company lending or borrowing foreign currency for an unallowable purpose is still likely to have a genuine exposure to both exchange gains and losses so it would be inequitable to tax the gains while disallowing the losses.

QUESTION 5

1 **Proposal 1**

In principle the provision of free shares is subject to income tax in the hands of the employee. It is irrelevant that they are placed in trust and the employees are not able to be registered as the owners. They are still treated as having acquired the shares and this is further exemplified by the fact that they will receive the dividends during the period that the shares are held in trust. However, the shares which it is proposed be given to the key employees are restricted securities because they are subject to forfeiture. As such, there would be an exemption from the normal tax charge on acquisition but this is only the case if the restriction will cease within five years of the date of acquisition. If the company wishes to avert the possibility of a tax charge on acquisition, therefore, they should ensure that the forfeiture on leaving employment is terminated before the five years from grant have elapsed. The possibility of the restriction being raised earlier because of the flotation of the company does not affect this.

If there is a charge to tax on acquisition because of the five year forfeiture period, this will be based on the market value of the shares at that time, taking into account the risk of forfeiture, and this value would require to be agreed with HMRC. There will then also be an income tax charge at the time that the forfeiture conditions lapse. This will be determined by reference to the market value of the shares after that lapse less any amount brought into charge at the time of the acquisition.

There is, however, an election available to the employee and the employer which must be made within fourteen days of the acquisition whereby income tax is determined only on the date of acquisition of the shares but calculated on the basis that there are no restrictions adversely affecting the market value. Any subsequent increase in value is subject to the capital gains regime with the possibility of annual exemption and taper relief reducing the tax charged on the gain [candidates may refer to the 2008 proposed changes]. The risk in making the election is that the shares may become forfeit and there would be no relief for the tax already paid. In the context of a possible flotation of this company, some employees may be willing to take that risk on the basis that the current market value of the shares is likely to be quite low in comparison to the value which might be realised on or after flotation.

Income tax in respect of these free shares will be collected under the PAYE mechanism. In practice, the amounts involved can be quite substantial and may exceed the employee's income for the month of exercise. The employer is still obliged to remit the PAYE and requires to put in place a mechanism for recovering the excess from the employee. If the employee does not pay this back to the employer within 90 days of the date on which the income arose, the amount of PAYE not recovered will be treated as additional income of the employee and subsequent recovery will not be credited against this.

Proposal 2

The second circumstance is the provision of a share option scheme for a select group of senior employees. There are two tax-effective schemes for consideration. The Enterprise Management Initiative (EMI) is the most suitable arrangement for the selected senior executives. This constitutes a form of share option scheme but with relatively few conditions and aimed specifically at small high-risk companies. The company must satisfy certain conditions. It must not be under the control of another company, its gross assets must at the time of the grant of options not exceed £30 million and it must carry on a qualifying trade (which is the case here).

The employee to whom the EMI grant is made must work at least either 25 hours per week or 75% of his total working time for the company. There is also a limit of £100,000 upon the value (at the time of grant) of the unexercised options that an employee may hold at any time and there is an overall aggregate limit of £3,000,000 on the initial market values of unexercised options granted by the company.

The alternative possibility for these executives is the company share option plan (CSOP) but that is subject to a £30,000 limit on the value of unexercised options held by an employee at any time and it is also less attractive from the business asset taper relief point of view [note - candidates

may also refer to the new rules]. It would, therefore, only really be required if the EMI arrangement is not possible because of a breach of the qualifying limits.

There is no income tax on the exercise of the option unless the option was granted at a discount to market value in which case that discount is subject to income tax at the time of exercise. There is a particular benefit for EMI options in relation to capital gains tax as the qualifying period for business asset taper relief starts when the grant is made rather than when the option is exercised.

Proposal 3

A CSOP is a possible option for the all-employee arrangement as the awards are likely to be well within the £30,000 limit for each employee.

However, the more appropriate solution is the share incentive plan (SIP). Under this scheme employees may obtain an interest in shares in four ways:

1. Free shares up to £3,000 each year may be appropriated to each participant in any tax year.
2. The employee may authorise deductions from gross salary or bonus of up to £1,500 per year to be invested in partnership shares.
3. These partnership shares may be matched by the employer via an appropriation of further free shares on a basis of up to two free shares for each partnership share purchased.
4. The plan may provide for the dividends on a participant's plan shares to be reinvested, free of tax, in additional plan shares up to a limit of £1,500 in each tax year.

The plan has to be operated by trustees who may only dispose of a participant's free and partnership shares upon a direction given by that participant but that is subject to a minimum holding period set by the company of between three years and five years unless certain events occur. The minimum period applies to all grants under a single award.

The income tax benefit is maximised by keeping the shares within the plan. If the shares are withdrawn before three years have elapsed, income tax is charged on the market value at the time of the withdrawal. If the shares are kept in the plan for five years, there is no income tax charge on their subsequent withdrawal. If they are withdrawn between the third and fifth anniversary, the charge is based on the lower of the value on the date of the award or the date of withdrawal from the plan.

This is more tax-efficient for the employees than the simple issue of shares with no (or par) consideration, that being less than market value as the benefit of that discount would be subject to income tax in full. Similarly, a share option scheme (other than the approved option scheme explained below) would give rise to an income tax charge on the benefit, ie the value at the time of exercise less the price paid for the shares. Additionally, as far as the company is concerned, the employee does not get the shares until the exercise period, so this acts as a retention mechanism as opposed to giving employees shares at the outset.

This is an all-employee scheme and all employees must be eligible to participate on similar terms but the level of participation may be varied by reference to objective factors which are remuneration, length of service and hours worked. The free shares may also be subject to certain objective performance criteria.

The company can also benefit from a deduction in computing its profits in respect of the amount of income received by the employees. This is the case regardless of whether this income is assessable on the employees or is covered by exemptions from tax. This relief is restricted in the case of the SIP arrangements so far as the free and matching shares are concerned to the market value of the shares at the time that they are placed into the trust.

2. The rules and practices governing periods of overseas employment have been explained by HM Revenue & Customs in its Tax Bulletin 76. As a general principle, if the employee was not resident in the United Kingdom when the option was granted, there will be no charge to income tax on the exercise. If he was resident in the United Kingdom when it was granted but is non-resident at the time of exercise, there is a liability to United Kingdom income tax and the

employer at the time of grant is required to apply PAYE. However, HMRC practice is to give relief if the employee is non-resident at the time of exercise and the country of residence will also tax the gain. The relief is given by reference to the proportion of the holding period spent exercising the employment outside the United Kingdom.

QUESTION 6

Profit before tax				1,115,620	
Adjustments					
	Depreciation	250,000			
	Profit on disposal of fixed assets	(3,250)			
	Entertaining	6,000			(W6)
	Repairs	14,500			(W7)
	Legal fees	125,000			(W8)
	Pension Contributions	343,493			(W5)
	Interest deduction	(117,370)			(W3)
	Interest on cash deposits	(5,000)			(W3)
	Gain on sale of asset	(900,000)			(W2)
	Rental income	(100,000)	Note 1		(W4)
	Dividends form quoted shares	(25,000)			(W4)
	IBAs	(22,500)			(W11)
	Capital Allowances	(286,631)			(W12)
				(720,758)	
Schedule DI Profit				394,862	
Capital Gain				99,000	(W9)
Schedule A				92,500	(W10)
Schedule D III				5,000	(W3)
PCTCT				**591,362**	

Upper relevant maximum amount (W1)	1,130,137	
"Profits" for purposes of s13	619,140	
Basic profits for the purposes of s13	591,362	
The company qualifies for marginal relief		
PCTCT		591,362
Tax at 30%		177,409
Marginal relief (see B below)		(12,202)
Corporation Tax		**165,207**

W1 (a) Upper relevant maximum amount £1,500,000 $\times \frac{275}{365} =$ 1,130,137

(b) Marginal relief $\frac{1}{40} \times £(1,130,137 - 607,890) \times \frac{591,362}{619,140} = 12,202$

Note 1: For Corporation Tax purposes, all rental income is assessable under Schedule A. By concession, the letting of surplus business accommodation may be taxed under Schedule DI. The rents from the recruitment company may be included in Schedule DI if preferred.

W2 Exceptional Items

	£	*Disallow*
Gain on sale of buildings	900,000	900,000
Statutory redundancy pay	(350,000)	
	550,000	900,000

W3 Interest

	£
Interest payable on bank borrowing	460,000
Interest on three year loan	2,630
Bank charges	1,000
Interest on cash deposits	(5,000)
	458,630

Three year loan interest

Under para 2(1B) and para 2(2) Schedule 9 FA 1996 the interest will be allowable, in part, in the period in which it is paid. If the interest is not paid within 12 months of the end of the AP and the recipient is linked to the payer and is not subject to UK corporation tax, relief is delayed until actual payment

	£		*Allowed in 31 December 2007*
31 March 2005	57,370	57,370	
31 March 2006	60,000	60,000	
31 March 2007	60,000	0	(Paid within twelve months of the year end)
31 December 2007	2,630	2,630	
	180,000	120,000	
Total allowable interest	120,000		
Less interest per P&L	(2,630)		
Net allowable deduction	**117,370**		

Interest on cash deposits

Interest on cash deposits are not trading receipts

hence they are deducted from Schedule DI profits (s80(2) & (3) FA 1996)

Deduction from Schedule DI profit (5,000)

W4 Other Income

	£	*Deduct from Schedule DI*
Rent received	100,000	100,000
Quoted dividends	25,000	25,000
	125,000	125,000

W5 Pension Contributions

Prior Year Contributions			800,000
CPCP (s197(9) FA 2004)			
	Days in current chargeable period (DCCP)	275	
	Days in previous chargeable period (DPCP)	365	
	PY Contributions x	$\frac{DCCP}{DPCP}$	602,740
210% of CPCP			**1,265,754**
Current Period Contributions (CCCP)			**1,400,000**

Therefore, CCCP exceeds 210% of CPCP and spreading applies under s197 FA 2004

Allowed in 31 December 2007

Amount allowed in 31 December 2007 is:

* 110% of CPCP, plus		663,014
* A proportion of the excess in accordance with s197(4) and (5) FA 2004.		
The "relevant excess" is CCCP - 110% CPCP	736,986	
This exceeds £500,000 but is less than £1,000,000		
Therefore, under s197(5) FA 2004, half of the excess is allowed in 31 December 2007		368,493
Allowable amount		**1,031,507**
Net Adjustment		
Profit and loss deduction (disallowed)		1,375,000
Allowable deduction as above		(1,031,507)
Net disallowance		**343,493**

[Note - candidates working to the month rather than the day will receive full credit]

W6 Entertaining

	£	*Disallow*
Client entertaining	6,000	6,000
Staff Christmas party	2,000	
Other staff entertaining	1,000	
	9,000	6,000

W7 Repairs

	£	*Disallow*
New secuirity building	11,500	11,500
Redecorate reception area	2,000	
Repair damage to perimeter fence	3,500	
New security cameras, screens and intercom for security building	3,000	3,000
	20,000	14,500

W8 Legal Fees

	£	*Disallow*
Sale of factory 1	30,000	30,000
Border dispute on factory 1	45,000	45,000
Planning permission for security building	7,500	7,500
Aborted negotiations for new factory acquisition	35,000	35,000
New six month rental agreement for excess office space	7,500	7,500
Redundancy negotiations	25,000	
	150,000	125,000

W9 Factory Gain

			£
Proceeds of sale			1,500,000
Original cost of factory 01 April 1997		1,000,000	
Incidental costs of sale			
Legal fees on sale		30,000	
Border dispute		45,000	
			(1,075,000)
Indexation			
01 April 1997	156.3		
29 August 2007	207.3		
$\frac{R(d) - R(a)}{R(a)}$		0.326×1,000,000	(326,000)
Capital Gain			99,000

W10 Rent

	£	Deduct £
Recruitment company	15,000	15,000
Telesales company	85,000	85,000
Less legal fees on grant of lease		(7,500)
Total	100,000	92,500

W11 IBAs

	Factory 1	Factory 2	Factory 3	
Date constructed	01 April 1992	01 April 1982	01 April 2000	
Date acquired	01 April 1997	01 November 1997	N/A	
	£	£	£	
Cost of acquisition/construction	1,000,000	1,500,000	750,000	
Residue after sale (on acquisition)	300,000	200,000		
WDV at 1 April 2007	150,000	0	540,000	
Writing Down Allowance	0	0	22,500	**22,500**

W12 Capital Allowances

Capital Allowances			£	Allowances
WDV at 1 April 2007			1,500,000	
Additions				
General P&M		25,250		
Cameras etc for security building		3,000		
			28,250	
Disposals			(6,500)	
			1,521,750	
WDA 25% x	275		(286,631)	286,631
WDV c/fwd			1,235,119	
Allowances				286,631