THE CHARTERED INSTITUTE OF TAXATION

The Chartered Tax Adviser Examination

May 2009

Taxation of Individuals

Advisory Paper

TIME ALLOWED – 3 HOURS

- You should answer all of the questions.
- Start each answer on a new sheet of paper and write on one side only. Do not write in the left-hand margin.
- 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 the law elements in this paper in accordance with Scots law or Northern Ireland law should tick the appropriate box on the front of each answer folder.

1. Mr Dawson owns 5% of the ‘A’ ordinary share capital in Makeover Ltd, a retail company, which he acquired as part of a private equity backed management buy out in July 2005. He originally bought 4% of the shares for £50,000 at the time of the buy out and this was effectively increased to 5% in July 2007 as the result of a ratchet arrangement described below.

He and his fellow managers originally subscribed £150,000 for 120,000 ‘A’ ordinary shares (12%). The private equity investors subscribed £850,000 for 880,000 (88%) ‘B’ ordinary shares. A clause in the Articles of Association of the company required that 200,000 of the ‘B’ shares automatically convert into worthless deferred shares in the event the private equity fund’s investment returned more than a 25% return on their investment. After this conversion in July 2007, the division of the ordinary shares was 120,000 ‘A’ shares and 680,000 ‘B’ shares.

‘Bad leaver’ provisions are included in the managers’ contracts whereby the managers are required to sell their shares to the other investors if they cease to be employed in the business during the five years to July 2010. These ‘bad leaver’ provisions do not apply to the shares held by the private equity investors.

No elections have been made in respect of the managers’ shares.

A Stock Exchange listed competitor, Bigco plc, has made an offer to acquire all of the share capital of Makeover Ltd, with each shareholder in Makeover Ltd receiving 10 ordinary shares in Bigco plc for every one ordinary share in Makeover plc. The Bigco plc ordinary shares are currently trading at 80 pence and thus the offer is equivalent to £8 per share in Makeover plc. The private equity investors wish to accept the offer and as the result of “drag along” rights in the shareholders' agreement the managers are required to sell their shares as well.

Mr Dawson will therefore exchange his 40,000 ‘A’ shares in Makeover Ltd for 400,000 ordinary shares in Bigco plc, currently valued at £320,000. He will also be retained as marketing manager by the acquiring group, which has a diverse portfolio of retail businesses.

You are required to write a letter to Mr Dawson outlining the tax implications for him personally of the takeover by Bigco plc. (15)

2. One of your clients, Mr Pattersen, is a South African domiciled individual who has been resident in the United Kingdom since 2002/03. He has significant overseas investments in addition to his UK income and has asked for advice on how he will be taxed if he remains in the UK for three further years before returning to South Africa.

You establish that he has the following overseas investments and approximate annual net income arising therefrom:

Investment	Current value	Approximate annual income	Approximate foreign tax suffered
	£	£	£
Guernsey bank account	300,000	12,000	Nil
House in Cape Town	250,000	3,000	Nil
Shares in Rand Mining Inc (a South African company)	50,000	2,500	500
New Zealand bank account	200,000	8,000	2,000

Mr Pattersen took out a mortgage of £300,000 from a bank in Guernsey in 2003 at a fixed rate of 6% to help him purchase his UK house. The interest and capital repayments are made from his bank accounts in Guernsey and New Zealand. He is considering remortgaging the property with a Jersey Bank to obtain a more favourable base rate tracker deal.

The New Zealand bank account was opened in 2004 with the proceeds from the sale of commercial property in New Zealand which had resulted in a capital gain of £50,000. No Capital Gains Tax was paid in New Zealand.

In addition, Mr Pattersen earns a salary of £80,000 in the UK and receives bank interest each year of approximately £1,000.

Mr Pattersen tells you that he has not remitted any income or gains to the UK during the period that he has lived here as his UK salary has been sufficient to support his lifestyle.

You are required to write a letter to Mr Pattersen explaining how he will be taxed in the UK on his UK and overseas income and gains from 2008/09 onwards and the UK tax consequences of remortgaging the UK house by taking out a mortgage with a Jersey bank. (15)

3. Your clients Mr and Mrs Trescothin, who have recently retired from their full time jobs, own four holiday rental properties in Cornwall, which they have been running as a rental business as 50:50 owners for a number of years. They meet and greet their customers and also pick them up from the station or airport if they are travelling by train or aeroplane. Mr Trescothin undertakes most of the maintenance and Mrs Trescothin deals with the bookings and day to day accounting from an office at their home in Penzance.

On 1 June 2008, the couple acquired a villa in Estepona, Spain, which they have also been renting to holidaymakers. On the advice of a Spanish lawyer, the villa is owned by a Spanish company which itself is wholly owned by Mr and Mrs Trescothin. The villa was rented to holidaymakers on a series of short-term furnished lets from 1 June 2008 until 31 January 2009. Mr and Mrs Trescothin then stayed there during February 2009 carrying out repairs and redecoration before re-letting the villa to holidaymakers from 1 March 2009.

The details of income, expenditure and lettings for the five properties for 2008/09 are as follows:

	Fishermans Cottage, Looe	Anchors, Polperro	Surfs Up, Newquay	Lighthouse View, Coverack	Villa Banga Estepona
	£	£	£	£	£
Rental income	10,500	11,000	18,000	2,400	8,000
Mortgage interest	0	0	4,800	6,000	5,000
Repairs and redecoration (see below)	2,275	930	1,635	3,575	2,300
Insurance	700	800	900	600	500
Letting Agents commission	0	0	0	0	1,500
Light and heat	1,200	1,500	1,800	1,000	1,000
Travelling to and from the property	840	750	1,200	400	600
Other deductible expenses	600	800	900	500	400
Available for letting (weeks)	52	52	52	36	40
Actually let (weeks)	21	22	30	6	20

The repairs and redecoration expenses include the following items:

Mr Trescothin replaced the bathroom in Anchors, Polperro at a cost of £750, and installed a new en-suite bathroom in the main bedroom in Surfs Up, Newquay at a cost of £800. The Newquay cottage now has two bathrooms instead of one and the rent was increased by £50 a week as a result of this improvement.

The old wooden windows at Fishermans Cottage were replaced with new double glazed windows, at a cost of £2,000, included within the £2,275 repairs.

Lighthouse View, Coverack was acquired in March 2008 in a dilapidated state and £3,000 of the £3,575 repairs expenditure was incurred to make the property habitable. The property was only let for six weeks in 2008/09, although it was available for letting from 1 August 2008 onwards.

Continued

3. *Continuation*

The travelling expenses to and from the properties are for the purposes of meeting and greeting customers and undertaking maintenance. A rate of 40 pence per mile has been claimed for UK journeys and four return airfares and car hire for visiting the Spanish property.

You are required to:

1) **Discuss the tax treatment of the repairs expenditure and travelling expenses to and from the properties.** (7)

2) **Discuss the UK tax consequences of owning the Spanish villa through a Spanish company.** (3)

3) **Compute the taxable property income for Mr and Mrs Trescothin for 2008/09.** (5)

Total (15)

4. A new client Mr Green has just visited your office to hand over the information to complete his 2008/09 self assessment return. He provided you with his P60 from Widget Ltd, a trading company of which he is the managing director, showing gross salary of £89,000 with tax deducted of £31,920.

He told you that he could not find his form P11D at the moment. As he would like an estimate of his tax liability he asked if he can give you details of the benefits he has received and if you can use this information while he tries to locate the original P11D form. The benefits he has received from his employment were as follows:

Mr Green has a company car. The list price of the car was £45,000 when new in September 2006. It is a petrol driven car with a CO2 emissions figure of 165g. The engine capacity of the car is 2001cc. Private fuel was provided by the company until 6 November 2008. As a condition of having the car, Mr Green pays £1,000 per annum personally towards the insurance for the car so his daughter can drive it and he paid £7,500 towards upgrading the vehicle when it was purchased. The company also provides a parking space in a nearby car park at an annual cost of £750.

During the year the company paid £2,000 for some emergency dental work for Mr Green which was not covered by the company medical insurance policy, for which the premium paid by the company was £500.

Mr Green attended two company parties during the year, the staff Christmas party and the annual summer ball. The cost of the Christmas party was £100 per head and the summer ball was £65 per head. Mrs Green attended the Christmas party but not the summer one which was for employees only. Additionally, a Christmas lunch was provided for directors and senior staff only. This cost £30 per person.

Mr Green has two interest free loans from the company, the first for £20,000 which was advanced in 2004 to purchase a holiday cottage in Devon. A second loan of £15,000 was taken on 6 June 2008 to pay off Mrs Green's credit card bill and was still outstanding at 5 April 2009.

On 10 July 2008 the company set up an unapproved pension fund on behalf of the directors of the company. A total contribution of £100,000 was made into the fund whose beneficiaries are the four company directors who each have an equal interest.

He has a P60 from another company NewCo Ltd showing directors' fees of £9,485 from which PAYE of £3,792 has been deducted. Mr Green told you that at Christmas 2007 NewCo installed the latest plasma screen TV at Mr Green's house for him to use. The retail cost of the television is £2,500. He felt sure he should have a P11D giving the details of this benefit as well and he will forward it to you when he finds it.

Mr Green also tells you that he has received income of £6,500 from letting his holiday cottage in Devon. The only expenses incurred in connection with this were a gas safety check of £100, letting agent fees of £310 and insurance of £100. Mr Green has used the cottage for his two week summer holiday and for a week at Christmas. The cottage was let or available for letting for the remainder of the year.

Mr Green handed you his bank statements covering the 2008/09 tax year from which you can see he received net bank interest of £32,530 and quoted company dividends were credited to his account totalling £956.

Continued

4. *Continuation*

With the bank statements is a certificate from Pensionco showing a net pension contribution made by Mr Green of £32,000 in the 2008/09 year. He told you that he received a cash gift from his grandfather which he decided to invest in the pension fund. There is also a statement from HM Revenue & Customs confirming payments on account of his 2008/09 liability made by Mr Green on 31 January 2009 and 31 July 2009 of £6,000 per instalment.

During the course of your meeting Mr Green advised you that his wife will shortly give birth to their first child. She will be returning to work after six months at which point the baby will be put into a nursery the cost of which Mr Green believes will be in the region of £500 per month.

Widget Ltd is prepared to help with the costs of the child care and will pay him £100 per week towards the costs of the childcare. This being the case, Mr Green would like to know what tax implications there would be of receiving the payment and whether there is any way that nursery costs could be met in a more tax efficient way.

You are required to:

1) Calculate Mr Green's balancing payment for 2008/09 together with any payments on account due for 2009/10. (15)

2) Explain the tax implications of the payment of the allowance towards nursery costs and how this can be paid in the most tax efficient way. (5)

Total (20)

5. You have been asked to give a 20 minute presentation to six managers of a technology company, iRobotics plc, who are being awarded options under the Enterprise Management Incentives (EMI) share option scheme. The presentation will include the tax consequences of the managers exercising their options and a subsequent sale of their shares.

The managers are being awarded options over between 2% and 5% of the company's ordinary shares (currently between 20,000 and 50,000 shares each) depending upon their seniority.

The options may be exercised on the earliest of the following conditions being satisfied:

1) The company obtaining a full listing on the London Stock Exchange; or
2) An agreed sale for the company or its trade.

The restricted value of a minority shareholding of 5% or below has been agreed with HM Revenue & Customs as being £2.00 per share, and the unrestricted market value has been agreed as £2.20. The directors of iRobotics plc have decided that the option price will be £1.50 per share. The directors' plans anticipate that the company will float on the full London Stock Exchange in two years time when the shares will be worth £10.00 each.

You are required to prepare notes for the presentation to the managers on the tax consequences of the EMI share option scheme.

You should also outline disqualifying events and their consequences, and the tax implications of the subsequent sale of their shares. (15)

6. Your client Harry has recently telephoned you to say he has just turned 60 and wishes to reduce his working commitments and spend more time at the coast in a new yacht which he would like to buy.

Harry is a director of Trader Ltd, a UK trading company in which he also owns 15% of the ordinary share capital, 150 £1 ordinary shares, which he subscribed for at par on formation of the company in 1996. His son, Charles, is the only other shareholder in Trader Ltd.

As part of his retirement plans he has passed his shareholding in Trader Ltd onto Charles. Mindful of his plans for his yacht he didn't feel he wanted to gift the shares outright but he wanted to make it easier for Charles to take over his shareholding by selling them to him at reduced value. Charles had an inheritance of £30,000 which he was happy to use to buy the shares from Harry and Harry was happy to accept this amount.

The shares were transferred on 1 April 2009. Harry's shareholding was valued at £60,000 at that date.

Harry also owned the property from which the business is operated. He purchased it on 5 April 1996 for £50,000 and rented the property to the company from the date of purchase at a market rent. As the business grew, he extended the property in 1998 at a cost of £25,000. On 5 April 2009 contracts were exchanged for the sale of the property to a third party for £250,000 and completion is due to take place on 5 June 2009.

He explained to you that a smaller unit on the same business park is currently on the market for £130,000. He is considering purchasing this smaller unit with part of the proceeds so that he can retain an income stream.

In order to release further capital for his yacht he also made the following disposals.

1) A Venture Capital Trust investment in ABC Ltd which he subscribed for in June 2006 at a cost of £160,000. Income Tax relief was claimed on the investment. The shares were sold on 1 December 2008 for £175,000.

2) A Venture Capital Trust investment in CDE Ltd which he subscribed for in September 2006 at a cost of £60,000. Again, Income Tax relief was claimed on this investment and the shares were also sold on 1 December 2008, for £40,000.

3) A watercolour picture bought for £2,000 from a local artist in June 2006 was sold on 1 March 2009 for £7,500.

The funds released from these sales are currently on deposit with the bank. Harry would like to set aside sufficient funds to purchase the small business unit and to meet all taxes arising from the above transactions.

You are required to calculate how much will be available to Harry from the above transactions to put towards the purchase of his yacht assuming that he sets aside sufficient to cover any tax liabilities arising and that the smaller unit will be purchased. (20)