Answers

1 Flame plc group

(a) Report to the Group Finance Director of Flame plc

(i) Flame plc – sale of Inferno Ltd

Sale by Flame plc of the whole of the ordinary share capital of Inferno Ltd for £1 million

A sale of the share capital will result in a liability to corporation tax calculated as follows:

	£	£
Proceeds		1,000,000
Degrouping charge:		
Market value of the premises as at 1 March 2008	300,000	
Less: cost	(240,000)	
indexation allowance (IA) (£240,000 x 0·158)	(37,920)	
		22,080
		1,022,080
Less: cost		(600,000)
IA (£600,000 x 0·155)		(93,000)
Chargeable gain		329,080
Corporation tax (£329,080 x 26%)		85,561

Due to the unavailability of the substantial shareholding exemption, the sale of Inferno Ltd will result in a gain chargeable to corporation tax.

A degrouping charge will arise in respect of the building because it was transferred at no gain, no loss (Flame plc and Inferno Ltd are members of a capital gains group) within the six years prior to the sale of Inferno Ltd. Inferno Ltd will be regarded as having sold the building at the time of the no gain, no loss transfer for its market value at that time. Inferno Ltd's base cost in the building, resulting from the no gain, no loss transfer, is the original cost to Flame plc plus indexation allowance up to 15 March 2008, the date Inferno Ltd purchased the building. The degrouping charge will increase the sales proceeds on the disposal of Inferno Ltd.

The corporation tax limits of Flame plc for the year ending 31 March 2013 will be divided by nine (Flame plc and eight subsidiaries), such that the upper limit will be £166,667 (£1,500,000 ÷ 9). Accordingly, because the annual taxable profits of Flame plc exceed £200,000, the chargeable gain will be taxed at the main rate of corporation tax.

Sale by Inferno Ltd of its trade and assets for their market value

A sale of the trade and assets will result in a liability to corporation tax calculated as follows:

	£	£	£
Balancing charge on the sale of equipment and milling machine			
((£60,000 + £80,000) – £0)			140,000
Profit on the sale of goodwill			530,000
Additional trading profits			670,000
Crystallisation of gain deferred on the purchase of milling machine			8,500
Chargeable gain on the sale of the premises			
Proceeds		490,000	
Cost	240,000		
IA up to March 2008 (£240,000 x 0·158)	37,920		
		(277,920)	
IA up to January 2013 (£277,920 x 0·155)		(43,078)	
			169,002
Taxable profits			847,502
Corporation tax (£847,502 x 26%)			220,351

The excess of the sales proceeds (market value) of the equipment and the milling machine over the balance on the main pool will result in a taxable balancing charge.

The goodwill is a trading asset such that the profit on its sale will be additional trading income.

When a rollover relief claim has been made in respect of the purchase of a depreciating asset, as in the case of the milling machine, the deferred gain crystallises on the sale of that replacement asset.

The equipment and the milling machine are to be sold for less than cost. However, no capital loss will arise because capital allowances have been claimed.

As noted above, Inferno Ltd's base cost in the building is the original price paid by Flame plc plus indexation allowance up to March 2008.

Inferno Ltd will cease trading when it sells its business on 1 January 2013. This will bring about the end of an accounting period. The corporation tax limits will be divided by nine (in respect of the number of associates) and multiplied by 9/12 in respect of the nine-month accounting period, such that the upper limit will be £125,000 (£1,500,000 ÷ 9 x 9/12). Accordingly, because the taxable profits of Inferno Ltd for the nine-month period are expected to be £160,000, the trading income and chargeable gains arising on the sale of the business will be taxed at the main rate of corporation tax.

(ii) Flame plc – employee share scheme

The tax advantages of an approved company share option plan (CSOP) over an unapproved scheme

1. With a CSOP, there would be no income tax or national insurance contributions liability on the grant or exercise of the option, provided it is exercised between three and ten years after it is granted. Whereas with an unapproved scheme, there would be a liability when the option is exercised.
2. With a CSOP, the whole of the employee's profit on the shares will be subject to capital gains tax when the shares are sold. Whereas with an unapproved scheme, the excess of the market value of the shares at the time the option is exercised over the amount paid by the employee for the shares will be subject to income tax and national insurance contributions in the year the option is exercised; any subsequent increase in the value of the shares will be subject to capital gains tax when the shares are sold.

   The advantages of capital gains tax over income tax and national insurance contributions are the availability of the annual exempt amount and the lower tax rates.

Suitability of a CSOP

Gordon wants to use the scheme to reward the company's senior managers as opposed to all of the company's staff. Accordingly, he needs to use a scheme that allows him to choose which employees are able to join. The two approved schemes that allow this are the CSOP and the enterprise management incentive scheme.

Restrictions

- The value of shares in respect of which an employee holds options cannot exceed £30,000.
- The exercise price of the shares must not be manifestly less than the value of the shares at the time of the grant of the option.

(iii) Bon Ltd – the grant of a lease

If Bon Ltd were to opt to tax the building, the proposed granting of the lease would be a standard rated supply rather than an exempt supply, such that Bon Ltd would have to charge value added tax (VAT) on the rent. A lessee that was registered for VAT and making wholly taxable supplies would be able to recover all of the VAT charged. However, some or all of the VAT would be a cost for a lessee that was not registered or one that was partially exempt and not within the *de minimis* limits.

(b) Refund of corporation tax

We should review the tax affairs of Bon Ltd in order to identify the reason for the tax refund.

If, as would appear likely, it is an error on the part of HM Revenue and Customs (HMRC), we should inform Bon Ltd that it should be repaid immediately. Failure to return the money in these circumstances may well be a civil and/or a criminal offence.

We should advise Bon Ltd to disclose the matter to HMRC immediately in order to minimise any interest and penalties that may otherwise become payable.

In addition, unless the money is returned, we would have to consider ceasing to act as advisers to Bon Ltd. In these circumstances, we are required to notify the tax authorities that we no longer act for the company, although we would not provide them with any reason for our action. We should also consider whether or not we are required to make a report under the money laundering rules.

2 Dana

(a) Relief available in respect of trading loss

A trading loss for tax purposes of £22,500 (W2) has arisen in the tax year 2012/13.

It can be relieved against Dana's total general income of 2012/13, the year of the loss, and/or 2011/12.

Alternatively, because the loss has arisen in one of the first four tax years of trading, it can be relieved against Dana's total general income of the three years prior to the year of the loss starting with the earliest year, i.e. 2009/10.

The income taxable at the higher rate in each of the tax years is set out below.

	2009/10	2010/11	2011/12	2012/13
	£	£	£	£
Employment income (W1)	32,000	–	–	–
Trading income (W2)	–	4,500	6,000	–
Rental income	15,175	26,475	33,475	44,075
Less: personal allowance	(7,475)	(7,475)	(7,475)	(7,475)
	39,700	23,500	32,000	36,600
Less: basic rate band	(35,000)	(35,000)	(35,000)	(35,000)
Income taxable at the higher rate	4,700	–	(3,000)	1,600
Taxable gains:				
((£310,000 – £250,000) – £10,600)			49,400	
Gains taxable at the higher rate			46,400	

The claims against general income are all or nothing claims such that the trading loss will be offset in full in one of 2009/10 or 2011/12 or 2012/13, depending on which relief is claimed. Because an opening year's claim would relieve the loss in full in 2009/10, it is not possible to relieve the loss in 2010/11.

The year with the most income taxable at the higher rate is 2009/10. Relieving the loss of £22,500 in that year would save income tax as follows:

	£
£4,700 x 40%	1,880
(£22,500 – £4,700) x 20%	3,560
	5,440

Relieving the loss in 2012/13 would clearly save less tax, as there is less income taxable at the higher rate in that year than there is in 2009/10.

There is no income taxable at the higher rate in 2011/12 but there are capital gains. Relieving the loss against the general income in the basic rate band would allow an equivalent amount of capital gains to be taxed in the basic rate band rather than the higher rate band.

Accordingly, relieving the loss in 2011/12 would save tax as follows:

	£
Income tax	
£22,500 x 20%	4,500
Capital gains tax	
(£22,500 x (28% – 18%))	2,250
	6,750

The most beneficial claim is to relieve the loss in 2011/12 in order to save tax of £6,750.

Notes in respect of the additional information provided by Dana:

– The bonus is in respect of work carried out by Dana for her employer. Accordingly, it is taxable in full in the year of receipt.

– The cost of travelling around the UK in 2010 would have been allowable had it been incurred after Dana began to trade. Accordingly, because it was incurred in the seven years prior to commencing to trade, it is treated as if it had been incurred on the first day of trading.

Workings

1. Employment income in 2009/10

	£
Salary for nine months (£40,000 x 9/12)	30,000
Bonus	2,000
	32,000

2. **Trading income**

	£
2010/11 (1 January 2011 to 5 April 2011)	
£13,500 (W3) x 3/9	4,500
2011/12 (1 January 2011 to 31 December 2011)	
£13,500 – £7,500 (£30,000 x 3/12)	6,000
2012/13 (Year ended 30 September 2012)	
Loss (£30,000 – £7,500)	(22,500)

The trading loss of £7,500 deducted in arriving at the taxable profit for the tax year 2011/12 is excluded from the loss available for relief in respect of the tax year 2012/13.

3. **Trading profit for the nine months ended 30 September 2011**

	£
Original figure	14,900
Pre-trading expenditure	(1,400)
	13,500

(b) Transfer of the rental property to the trust on 1 September 2012

(i) Capital gains tax

Dana can claim gift relief in respect of the transfer of the property to the trustees because a lifetime transfer to any trust is a chargeable lifetime transfer subject to inheritance tax. The election must be signed by Dana and submitted by 5 April 2017 (i.e. four years after the end of the tax year in which the gift was made).

(ii) Inheritance tax

Information required in respect of the transfer to the trust in December 2007

– The value of the property at the time of the gift

The gift in December 2007 is within the seven-year period prior to the gift on 1 September 2012, such that it will affect the nil rate band available in respect of the latter gift.

Information required in respect of the gifts to family members

– Date, value, recipient and occasion of each gift

This information is required in order to determine whether the gifts to family members are exempt or not. This will affect the annual exemptions available in respect of each of the gifts to the trusts.

In addition to the annual exemption, the following lifetime gifts are exempt:

– Gifts of less than £250 in total to any individual in a tax year.

– Gifts of no more than £1,000, made on the occasion of a marriage or civil partnership.

– Regular gifts made out of income that do not affect Dana's standard of living.

3 Banger Ltd and Candle Ltd

(a) Banger Ltd

(i) Minority shareholder's taxable income in respect of the use of the motor car

The minority shareholder is not employed by Banger Ltd. Accordingly, because Banger Ltd is a close company (it is controlled by Katherine), the use of the motor car will be treated as a distribution. The distribution will equal the amount that would have been taxable as employment income in respect of the motor car as set out below:

£22,900 x 18% (15% + (140 – 125)/5) = £4,122.

The taxable income will be the distribution multiplied by 100/90, i.e. £4,122 x 100/90 = £4,580.

(ii) The tax implications of the distributions being considered

Banger Ltd

The distribution of cash will be a normal dividend with no tax implications for Banger Ltd.

The distribution of the building (a dividend *in specie*) will give rise to a deemed disposal of the building by Banger Ltd at market value. This will result in a chargeable gain or allowable loss equal to the market value of the building less its cost. Indexation allowance will be deducted from any chargeable gain arising.

The shareholders

– The distribution of cash

The distribution of cash is to be made prior to the appointment of the liquidator and will therefore be taxed as a normal dividend. It will be grossed up at 100/90 and subject to income tax at 10%, 32·5% and 42·5%, depending on the tax position of the individual shareholders. A 10% tax credit will be available.

– The distribution of the building to Katherine

The distribution is to be made after the appointment of the liquidator and will therefore be taxed as a capital receipt. The market value of the building will be treated as the sales proceeds of Katherine's shares in Banger Ltd from which the base cost (or part of the base cost if there are to be further distributions to Katherine) will be deducted in order to calculate the capital gain.

The gain will be taxable at 18% and/or 28% depending on Katherine's tax position or, alternatively, at 10% where entrepreneurs' relief is available. Banger Ltd is a trading company. Accordingly, entrepreneurs' relief will be available, provided Katherine has both owned at least 5% of the shares and been employed by Banger Ltd for a period of at least a year ending with the date of disposal (i.e. the date of the distribution).

(b) Candle Ltd – Corporation tax liability for the year ended 31 March 2012

	£
Chargeable gains realised in Sisaria (£14,630 x 100/77)	19,000
Chargeable gains realised in the UK	83,700
Sale of shares in Rockette plc (explanation 1)	nil
	102,700
Less:	
Deficit on non-trading loan relationships (W)	(25,800)
General expenses of management	(38,300)
Taxable total profits	38,600
Corporation tax at 26% (explanation 2)	10,036
Double tax relief:	
Overseas tax (£19,000 x 23%) (the overseas rate is less than the UK rate)	(4,370)
Corporation tax liability	5,666

Tutorial note: *Candle Ltd will choose to offset the expenses of management and the deficit on the non-trading loan relationship against profits other than the chargeable gains realised in Sisaria in order to maximise double tax relief.*

Explanations

1. **Disposal of shares in Rockette plc**

The disposal of the shares in Rockette plc was a qualifying share for share disposal because Piro plc acquired more than 25% of Rockette plc and the acquisition was a commercial transaction that did not have the avoidance of tax as one of its main purposes. Accordingly, no gain arose in respect of the shares received.

In addition, no gain arose in respect of the cash received because the cash represented less than 5% of the value of the total consideration received as set out below:

	£
Value of shares received in Piro plc	147,100
Cash received	7,200
	154,300

Cash received represents 4·67% of the total consideration.

2. **Rate of corporation tax payable**

Candle Ltd is a close investment-holding company such that it pays corporation tax at the main rate of 26%.

Working

Deficit on non-trading loan relationships

	£
Interest receivable	41,100
Interest payable	(52,900)
Fees charged by financial institution	(14,000)
	(25,800)

It has been assumed that the company has chosen to offset the deficit against its current period profits.

4 Ash

(a) (i) The availability of entrepreneurs' relief in respect of the assignment of the lease

The following conditions must be satisfied in order for the assignment of the lease to qualify as an associated disposal such that entrepreneurs' relief will be available.

- Ash's disposal of the shares in Lava Ltd must qualify for entrepreneurs' relief.
- The lease must have been owned by Ash and used for the purposes of the trade of Lava Ltd for at least a year.
- Ash must have sold the shares in Lava Ltd and the lease as part of a process of withdrawing from participating in the business of Lava Ltd.

(ii) Ash – capital gains tax (CGT) liability for the tax year 2011/12

	Entrepreneurs' relief available	Entrepreneurs' relief not available
	£	£
Gain on sale of shares	235,000	
Gain on assignment of lease (£79,812 (W1) x 60%/40%)	47,887	31,925
Gain on sale of land (W2)		21,780
Loss on sale of quoted shares		(17,400)
		36,305
Annual exempt amount		(10,600)
	282,887	25,705
CGT at 10%/28%	28,289	7,197
Total CGT liability (£28,289 + £7,197)		35,486

Workings

1. Gain on the assignment of the lease

	£
Proceeds	110,000
Less: cost (£31,800 x 93·497/98·490)	(30,188)
	79,812

2. Gain on the sale of the land

	£
Proceeds	30,000
Less: cost (£27,400 – (£27,400 x (£42,000/£42,000 + £18,000)))	(8,220)
	21,780

Tutorial notes

1. *Entrepreneurs' relief in respect of the lease will be restricted to 60% (100% – 40%) of the gain, due to the rent charged by Ash to Lava Ltd.*
2. *Ash's taxable income is less than his basic rate band. However, the gains qualifying for entrepreneurs' relief use up the remainder of the basic rate band such that all of the non-qualifying gains are taxed at 28%.*

(b) Vulcan Partnership (Vulcan) – Value added tax (VAT) registration

Whether or not Vulcan may be required to register

Subject to the exceptions noted below, Vulcan will be required to register for VAT once its cumulative taxable supplies (those that are standard rated or zero rated) in a 12-month period exceed £73,000.

However, Vulcan will not be required to register if HM Revenue and Customs are satisfied that its total supplies for the following 12 months will be less than £71,000.

Vulcan could request to be exempt from registration because only a small proportion of its supplies are standard rated. This exemption will be available provided it would be in a repayment position if registered.

Advantages of registration

Vulcan will be able to recover all of its input tax if the amount relating to exempt supplies is *de minimis*. Where Vulcan is not *de minimis*, it will still be able to recover the majority of its input tax.

Registration will prevent third parties from knowing the size of Vulcan's business.

Disadvantages of registration

Registration will add to the amount of work required to administer the business. In addition, Vulcan may be subject to financial penalties if it fails to comply with the obligations imposed by the VAT regime.

The partnership's customers would be unable to recover any output tax charged by the partnership as they are not registered for VAT. Accordingly, the prices charged to the small proportion of customers purchasing standard rated items would increase unless Vulcan decides to reduce its profit in respect of these sales.

(c) Payment on account on 31 January 2013

The payment on account due on 31 January 2013 is the first payment in respect of Ash's income tax payable (income tax liability as reduced by tax deducted at source) for 2012/13. The payment due is half of the income tax payable for 2011/12 unless Ash makes a claim to reduce the payment.

Ash can make a claim to reduce the payment if he expects the amount payable for 2012/13 to be less than that for 2011/12. The income tax payable for 2012/13 is likely to be less than that for 2011/12 due, principally, to Ash receiving less profit from Vulcan.

Ash will need to estimate his income tax payable for 2012/13 in order to decide whether or not to reduce the payment on account. Ash will be charged interest if the payment on account is reduced to an amount that is less than half of the final agreed amount payable for 2012/13. In addition, a penalty may be charged if Ash is fraudulent or negligent when he makes the claim to reduce the payment.

5 Cuthbert

(a) Payment of capital gains tax (CGT) by instalments

Availability

Payment of CGT by instalments is available in respect of gifts of certain assets, including land and buildings, where gift relief is not available. Gift relief will not be available in respect of the gift of the building as the building is not used in a business and is let to a long-term tenant such that it cannot be a furnished holiday letting.

Matters that Cuthbert would need to be aware of

It is necessary to make an election to pay by instalments before the date that the CGT is normally due (i.e. 31 January 2014). There will be ten annual instalments beginning on 31 January 2014. Interest will be charged on the outstanding balance of the tax liability.

Cuthbert will be required to pay all of the remaining instalments immediately if the property is sold because Cuthbert and his brother are connected persons for the purposes of CGT.

(b) The penalty due in respect of a careless error in Cuthbert's tax return

The maximum penalty for a careless error is 30% of the potential lost revenue. The potential lost revenue is the additional tax due following the correction of the error.

The penalty may be reduced depending on the level of disclosure Cuthbert provides to HM Revenue and Customs (HMRC) in terms of telling them about the error, providing them with assistance in quantifying it and allowing them access to his records.

Any disclosure provided by Cuthbert will be regarded as prompted, rather than unprompted, because Cuthbert is aware that HMRC suspect that an error has been made. The minimum penalty in these circumstances is 15% of the potential lost revenue.

(c) Pugh – UK inheritance tax (IHT) liability

Gift in the seven years prior to death

There would be no further tax due in respect of the gift on 10 June 2007 as the gross transfer of £317,500 (W1) is covered by the nil rate band of £325,000. However, the tax already paid will not be repaid.

Death estate

Pugh was UK domiciled and will therefore be subject to IHT on his Camberian assets as well as his UK assets.

	£	£
Home in the UK		720,000
Cash held in bank accounts in the UK		45,000
Vintage motor cars located in Camberia		490,000
Quoted shares registered in Camberia		330,000
		1,585,000
Nil rate band	325,000	
Transfers in the previous seven years (W1)	(317,500)	
		(7,500)
		1,577,500
IHT at 40%		631,000
Estate rate 39·811% (£631,000/£1,585,000)		
Double tax relief at the lower of estate rate and rate in Camberia: £330,000 x 25%		(82,500)
		548,500

The additional IHT due is £372,500 (£548,500 – £176,000 (W2)).

Interest of £3,725 (£372,500 x 3% x 4/12) will be charged in respect of the period from 31 August 2012 (six months after the end of the month of death) until the tax is paid on 1 January 2013.

Workings

1. **Gift in the seven years prior to death**

	£
Value transferred	320,000
Annual exemptions (2007/08 and 2006/07)	(6,000)
	314,000
Nil rate band for 2007/08	(300,000)
	14,000
IHT at 25%	3,500
Net transfer	314,000
Gross chargeable transfer	317,500

2. **Original calculation of IHT liability**

The original calculation would have excluded the assets located in Camberia and the gift to the trust.

	£
Home in the UK	720,000
Cash held in bank accounts in the UK	45,000
	765,000
Nil rate band	(325,000)
	440,000
IHT at 40%	176,000

Tutorial note: *Business property relief is not available in respect of quoted shares unless the donor controls the company.*

				Available	Maximum
1	(a)	(i)	Sale of share capital		
			Calculations		
			Degrouping charge	2	
			Other matters	1·5	
			Narrative – one mark for each relevant point	6	
			Sale of trade and assets		
			Calculations		
			Equipment and milling machine	2	
			Goodwill	0·5	
			Premises	1·5	
			Liability	0·5	
			Narrative – one mark for each relevant point	4	
				18	15
		(ii)	Advantages		
			Timing	2·5	
			Taxes	3·5	
			Suitability of company share option plan	1	
			Restrictions	2	
				9	8
		(iii)	Nature of supply	1	
			Recoverable input tax	2	
				3	3
			Format and presentation	1	
			Analysis	2	
			Quality of calculations and explanations	1	
				4	4
	(b)		The need to repay the tax	3	
			Ceasing to act	3	
				6	5
			Total		**35**
2	(a)		Identification of years in which relief available	4	
			Employment income	1	
			Trading income	4	
			Income taxable at the higher rate	4	
			Capital gains taxable at the higher rate	1·5	
			Tax savings	5	
			Notes in respect of additional information	2	
				21·5	18
	(b)	(i)	Capital gains tax	2	
				2	2
		(ii)	Inheritance tax		
			Gift in December 2007	1·5	
			Gifts to family members		
			Information required	1·5	
			Relevance of information	3	
				6	5
			Total		**25**

				Available	Maximum
3	**(a)**	**(i)**	Explanation	2	
			Calculations	1·5	
				3·5	3
		(ii)	Banger Ltd	2·5	
			Shareholders – distribution of cash	1·5	
			Katherine		
			Capital gain	1·5	
			Taxation	2·5	
				8	7
	(b)		Taxable total profits		
			Loan relationships	3·5	
			Chargeable gains	1·5	
			Sale of shares in Rockette plc	0·5	
			Expenses of management	0·5	
			Corporation tax liability		
			Corporation tax	0·5	
			Double tax relief	1	
			Explanations	4	
				11·5	10
			Total		**20**
4	**(a)**	**(i)**	Conditions – 1 mark each	3	
				3	3
		(ii)	Taxable capital gains		
			Assignment of lease	2·5	
			Sale of land	2	
			Other matters	1·5	
			Capital gains tax	1·5	
				7·5	7
	(b)		Requirement to register	1·5	
			Exceptions	2	
			Advantages	2	
			Disadvantages	2	
				7·5	7
	(c)		Context	1·5	
			Circumstance in which a claim can be made	1	
			Interest and penalties	1·5	
				4	3
			Total		**20**

			Available	Maximum
5	**(a)**	Payment of capital gains tax by instalments		
		Availability of payment by instalments	1·5	
		Availability of gift relief	1·5	
		Matters that Cuthbert would need to be aware of		
		Need for election	1·5	
		Payment and interest	2	
		Subsequent sale of asset	1	
			7·5	6
	(b)	Maximum penalty	1·5	
		Disclosure	1·5	
		Minimum penalty	1·5	
			4·5	4
	(c)	Gift in the seven years prior to death	2·5	
		Death estate – if UK domiciled		
		Assets in UK	1	
		Assets in Camberia	1·5	
		Nil rate band	1	
		Inheritance tax and double tax relief	2·5	
		Death estate – if non-UK domiciled	1	
		Interest on underpayment	1·5	
			11	10
		Total		**20**