
Answers

1 Nelson

Memorandum

For The files
Subject Nelson – Incorporation of business and other matters
Prepared by Tax senior
Date 3 December 2019

(a) Becoming tax advisers to Nelson

Information required:

- Proof of Nelson's identity and his address.

Matters to consider:

- We must give consideration to the fundamental principles of professional ethics, for example, integrity and professional competence and due care. This requires us to consider whether becoming tax advisers to Nelson would create any threats to compliance with these principles.

If any such threats are identified, we should not accept the appointment unless the threats can be reduced to an acceptable level via the implementation of safeguards.

Nelson is planning to sell mainly to overseas customers in the future, possibly via companies resident overseas. We should consider the likelihood of these plans being realised and whether or not we would have the necessary technical expertise to provide Nelson with the best advice.

- We must assure ourselves that Nelson is not involved in any form of money laundering.

Actions to take:

- We need permission from Nelson to contact his existing tax advisers in order to ensure that there is nothing in the past which would preclude us from accepting the appointment on ethical grounds.

If Nelson refuses to give permission, we should seriously consider refusing to act for him.

(b) Trading through a limited company rather than as an unincorporated business

Total taxes payable if Nelson had commenced trading through a limited company

Taxes payable by the company for the accounting period ending 31 March 2020

	£	£
Trading profit (£7,050 x 10)	70,500	
Salary for Nelson (£1,200 x 10)	(12,000)	
Employer's class 1 national insurance contributions (NIC) £4,980 (£12,000 – (£8,424 x 10/12)) x 13.8%	(687)	687
Taxable total profits	57,813	
Corporation tax (£57,813 x 19%)	(10,984)	10,984
Available for dividend	46,829	
Total taxes payable		11,671

Taxes payable by Nelson for the tax year 2019/20

	£	£
Salary	12,000	
Dividend income	46,829	
	58,829	
Less: personal allowance	(11,850)	
	<u>46,979</u>	
Income tax for the tax year 2019/20		
Employment income		
£150 (£12,000 – £11,850) x 20%	30	
Dividend income		
£2,000 x 0%	0	
£32,350 (£34,500 – £150 – £2,000) x 7.5%	2,426	
£12,479 (£46,829 – £2,000 – £32,350) x 32.5%	<u>4,056</u>	
		6,512
Employee's class 1 NIC		
£4,980 (£12,000 – (£8,424 x 10/12)) x 12%		<u>598</u>
Total taxes payable		<u>7,110</u>
Total taxes payable (£11,671 + £7,110)		<u>18,781</u>

The total tax payable for the tax year 2019/20 would have been £1,808 (£20,589 – £18,781) less if Nelson had commenced trading through a limited company rather than as an unincorporated business.

Tutorial note: *The employment allowance which provides relief of up to £3,000 from employer's class 1 NIC would not be available to the company because Nelson would be the company's only employee.*

Reasons for advice given by existing tax adviser

Trading loss

If Nelson's business had made a tax adjusted trading loss for the period ending 30 April 2020, Nelson would have had a trading loss for the tax year 2019/20 equal to 10/11 of the loss for the trading period.

Where a self-employed individual makes a trading loss in any of the first four tax years of trading, the loss can be offset against the individual's total income of the three tax years prior to the year of loss starting with the earliest year. Accordingly, Nelson could have offset the loss against his employment income for 2016/17 and 2017/18. This would have resulted in a repayment of income tax at 40% and 20%.

Nelson's tax adjusted trading profit/loss for the tax year 2020/21, the second tax year, is based on the results of the first 12 months of trading. However, the loss for the first 10 months would not have been counted again, such that the profit/loss would have been 1/11 of the loss for the first trading period less 1/12 of the profit of the second trading period. This is likely to be either a small loss or a profit.

If Nelson had begun trading through a limited company, there would have been no immediate relief for a trading loss. It would have been carried forward for relief against the future total profits of the company.

Other possible reasons

- Trading via a company would have increased the complexity of Nelson's financial affairs.
- Trading via a company would have meant that Nelson's ability to access the profits of the business would not have been as straight forward as it has been.

Tutorial note: *Nelson would not have been able to relieve a trading loss against total income of the year of loss or the preceding year because he had no income in the tax year 2018/19 and, if his business had made a loss, he would have had no income in the tax year 2019/20.*

(c) Other matters

Nelson retaining personal ownership of the Arch building

If Nelson retains personal ownership of the business premises, incorporation relief (the relief which is available where a business is transferred to a company in exchange for shares) will no longer be available. This is because he will not be transferring all of the assets of the business (excluding cash) to NQA Ltd.

As a result, the chargeable gain arising in respect of the goodwill will be subject to capital gains tax (CGT). The annual exempt amount of £11,700 will be deducted from the gain and the balance of £33,300 will be taxed at 20% (on the assumption that Nelson will be a higher rate taxpayer in the tax year 2020/21). Accordingly, there will be a CGT liability of £6,660, which will be due on 31 January 2022.

Tutorial note: *Entrepreneurs' relief is not available in respect of a chargeable gain on goodwill as a result of incorporating a company in this way. Even if it were, it would not be available to Nelson because he will not have owned the business for 12 months at the time of disposal.*

Nelson borrowing money from NQA Ltd

Nelson will control NQA Ltd because he will own all of the company's issued share capital. As a result, because NQA Ltd will be controlled by five or fewer shareholders, it will be a close company.

Where a close company (NQA Ltd) makes a loan to a shareholder (Nelson), it is required to make a payment equal to 32.5% of the loan to HM Revenue and Customs (HMRC) within nine months and one day of the end of the accounting period.

There is no need to make this payment to HMRC if Nelson repays the loan prior to the date on which the tax is due to be paid.

HMRC will repay the tax to NQA Ltd when the loan is repaid by Nelson.

Value added tax (VAT)

The VAT paid to HMRC in respect of the irrecoverable debt is not lost. It can be recovered, provided:

- the debt has been written off by Nelson; and
- six months have elapsed since the date on which the payment was due.

Use of the cash accounting scheme would have avoided this problem, as Nelson would not have had to account for output tax until he had received payment from the customer. This would also result in a cash flow advantage to Nelson where a customer does not pay promptly.

On the downside, Nelson would not be able to recover input tax until he has paid for the relevant goods or services.

Accordingly, whether or not the cash accounting scheme would benefit Nelson's cash flow position depends on the timing of payments to creditors and receipts from debtors.

2 Emma

(a) Rental income in the country of Falgar

The rental income arising in Falgar will be subject to income tax in the UK because Emma will be UK resident. This will be true regardless of whether or not Emma brings the money into the UK because the remittance basis will not be available to Emma.

The remittance basis will not be available because, although Emma is domiciled in Falgar, she is deemed to be domiciled in the UK for the purposes of income tax. This is because she will have been UK resident for 15 of the 20 tax years prior to the tax year in which the income arises.

However, the UK income tax due in respect of the rental income will be reduced by double tax relief. Double tax relief will be the lower of the UK tax and the Falgarian tax on the rental income, such that the effective UK rate will be 14% (40% – 26%).

(b) Gift of shares in Vyc Ltd

Circumstances resulting in the maximum inheritance tax (IHT) liability

The maximum IHT liability will occur where both condition (i) and condition (ii), set out below, are satisfied.

- (i) Emma dies by 30 September 2022, i.e. within seven years of 1 October 2015, the date on which she made the cash gift to her daughter.

Once seven years have elapsed, the gift on 1 October 2015 will no longer be accumulated in determining the nil rate band available in respect of the gift of the shares in Vyc Ltd.

Tutorial note: *If Emma dies within seven years of 1 October 2015, i.e. by 30 September 2022, she will have died within three years of the gift of the shares to Edward. Accordingly, taper relief will not be available.*

- (ii) At the time of Emma's death, business property relief (BPR) IS NOT available.

The gift of the shares in Vyc Ltd will qualify for 100% BPR at the time of the gift because:

- Vyc Ltd is an unquoted trading company, such that the shares are relevant business property; and
- Emma has owned the shares for at least two years.

However, BPR will not be available on Emma's death if:

- the shares are no longer qualifying business property; or
- Edward has disposed of the shares prior to Emma's death, unless:
 - Edward has replaced the shares with qualifying business property; or
 - Edward has died before Emma, whilst still owning the shares (or qualifying replacement business property).

Tutorial note: *The shares in Vyc Ltd are UK assets because Vyc Ltd is a UK registered company. Accordingly, a gift of the shares will be subject to UK inheritance tax regardless of Emma's domicile status.*

Maximum possible IHT liability

	£	£
Transfer of value (W)		340,000
Annual exemptions:		
2020/21		(3,000)
2019/20		(3,000)
		<u>334,000</u>
Nil rate band	325,000	
Less: chargeable transfer in the previous seven years	<u>(280,000)</u>	
		<u>(45,000)</u>
Taxable amount		<u>289,000</u>
IHT payable (£289,000 x 40%)		<u>115,600</u>

Working

Transfer of value by reference to related property

	£
Value of shares held prior to the gift: (35,000 x £19 (54% (35% + 19%)))	665,000
Value of shares held after the gift: (25,000 x £13 (44% (25% + 19%)))	<u>(325,000)</u>
	<u>340,000</u>

Assumption: The transfer of value has been calculated by reference to related property on the assumption that the fall in value would be a lower figure if related property were ignored.

Tutorial notes:

1. *The value of Emma's shares is determined by reference to the shares held by her and her husband under the related property rules.*
2. *Candidates who prepared calculations both with and without reference to related property to determine which resulted in the higher figure (rather than stating an assumption) received equal credit.*

Capital gains tax (CGT)

Vyc Ltd is an unquoted trading company, such that shares in the company qualify for CGT gift relief. However, for the relief to be available, it is necessary for Edward, the recipient of the gift, to be resident in the UK in the tax year in which the gift is made.

(c) Sale of industrial property in Manchester, England

For the purposes of UK CGT, Emma is a temporary non-UK resident whilst she is living in Falgar. This is because:

- she was UK resident for at least four of the seven tax years immediately prior to 2016/17 (the tax year of departure); and
- on her return to the UK, she will have been absent for less than five years.

Accordingly, if Emma sells the property now, the chargeable gain of £330,000 will still be subject to UK CGT, albeit in 2020/21 (the tax year in which she returns to the UK) as opposed to 2019/20, the tax year of sale. This rule applies because Emma owned the property on 1 February 2017 (the date she left the UK) and will have disposed of it whilst living in Falgar.

If Emma waits until she has returned to the UK, the chargeable gain will increase by £60,000 to £390,000. It will be subject to CGT in 2020/21, the tax year of disposal.

Accordingly, the chargeable gain will be subject to CGT in the tax year 2020/21 regardless of the date of sale and therefore UK CGT, at the rate of 20%, will be due on 31 January 2022.

In order to maximise her post-tax proceeds, Emma should sell the house after she has returned to the UK. By doing so, she will realise additional post-tax proceeds of £48,000 (£60,000 x 80% (100% – 20%)).

3 Kitz Ltd

(a) Chargeable gains implications for Kitz Ltd arising from the sale of the shares in Mayr Ltd on 1 July 2019

The sale of the 75% shareholding in Mayr Ltd on 1 July 2019 will be exempt from corporation tax under the substantial shareholding exemption (SSE). This is because Kitz Ltd owned more than 10% of the shares in Mayr Ltd for a continuous 12-month period out of the six years prior to sale, and Mayr Ltd is a trading company.

The sale of the warehouse to Mayr Ltd on 8 April 2014 was originally a no gain no loss transfer, because Kitz Ltd and Mayr Ltd were in a capital gains group, as Kitz Ltd owned 75% of Mayr Ltd. As Mayr Ltd left the group within six years of this transfer, still owning the warehouse, a degrouping charge will arise. This is added to the consideration received by Kitz Ltd on the sale

of the Mayr Ltd shares. However, the SSE, which applies to sale of the shares, will also apply to the degrouping charge, such that this will also be exempt.

(b) Corporation tax implications of the interest charged on the loan by Kitz Ltd to Feld Ltd for the year ending 31 March 2021

Feld Ltd has been offered an interest rate of 10% per annum from a bank (which is an unrelated party), so this would appear to be an arm's length rate of interest.

As Kitz Ltd controls Feld Ltd, they are connected companies for the purpose of transfer pricing. No exemption is available as the companies are not small or medium-sized enterprises (SMEs).

As the interest receivable by Kitz Ltd is 7% per annum, i.e. lower than the arm's length rate, Kitz Ltd must make a transfer pricing adjustment, and include interest receivable in its corporation tax computation calculated at the rate of 10%. This will be an addition of £13,500 ($£450,000 \times (10\% - 7\%)$) for the year ending 31 March 2021. Interest receivable of £45,000 ($£450,000 \times 10\%$) will be included as non-trading loan relationship (NTLR) income.

As Feld Ltd is also within the charge to UK corporation tax, it can make a claim to amend its computation to an arm's length basis, and deduct a total of £45,000 in respect of the interest payable on the loan.

The interest payable in respect of the proportion of the loan used to acquire assets for use in Feld Ltd's business will be deducted from trading income; the interest payable in respect of the proportion of the loan used to acquire shares in Durn Ltd will be deducted from NTLR income.

Accordingly, for the year ending 31 March 2021, £20,500 ($£45,000 \times 205/450$) is deductible from Feld Ltd's trading income of £587,000, and £24,500 ($£45,000 \times 245/450$) is deductible from its NTLR income of £48,100.

(c) (i) Corporation tax implications for Kitz Ltd of the sale of the patent to Durn Ltd

Durn Ltd will not be in a capital gains group with Kitz Ltd and Feld Ltd, as Feld Ltd will not have the minimum 75% holding in Durn Ltd which is required for this. Accordingly, the sale of the patent, which is an intangible asset, will give rise to a trading profit for Kitz Ltd, equal to the excess of the sale proceeds over the tax written down value of the patent at the date of sale. The profit on sale of the patent will therefore be £42,000 ($£72,000 - £30,000$). This will be included in Kitz Ltd's taxable trading profit for the year ending 31 March 2021.

(ii) Impact on Kitz Ltd's corporation tax liability for the year ending 31 March 2021 if the maximum rollover relief claim is made

As Feld Ltd is a UK resident, wholly owned subsidiary of Kitz Ltd, the two companies are in a capital gains group.

Feld Ltd will acquire an intangible fixed asset (goodwill of an unincorporated business) on 1 April 2020, which is within the 12 months prior to the sale of the patent by Kitz Ltd.

Accordingly, rollover relief will be available for part of the profit on the sale of the patent to be deferred against the cost of the goodwill. As the cost of the goodwill is less than the sale proceeds for the patent, the maximum profit which can be deferred is restricted to the excess of the amount invested in the goodwill over the original cost of the patent.

Therefore the maximum profit which can be deferred is £8,000 ($£68,000 - £60,000$).

This would lead to a reduction in Kitz Ltd's corporation tax liability of £1,520 ($£8,000 \times 19\%$).

4 Rosa

(a) Difference in the total amount of income tax and national insurance contributions (NICs) payable by Siena and Rosa for the tax year 2020/21 if Siena becomes (i) a partner, or (ii) an employee on 1 April 2020

(i) Siena becomes a partner

If Siena becomes a partner in RS Trading on 1 April 2020, she will be allocated £2,800 of the partnership loss of the year ending 31 March 2021 (W), such that she will have no taxable income for the tax year 2020/21. Accordingly, she will have no liability to income tax or class 2 or class 4 NIC.

Rosa will be allocated a trading loss of £59,200 in the tax year 2020/21 (W). As she will have no other source of income in that year, Rosa will have no liability to income tax or class 2 or class 4 NIC.

(ii) Siena becomes an employee

If Siena becomes an employee, on an annual salary of £22,000, she will have an income tax liability of £2,030 ($(£22,000 - £11,850) \times 20\%$), and a class 1 employee's NIC liability of £1,629 ($(£22,000 - £8,424) \times 12\%$).

In this case, RS Trading will also have a liability to class 1 employer's NIC of £1,873 ($(£22,000 - £8,424) \times 13.8\%$). As this is covered by the £3,000 employment allowance, no class 1 contributions would be payable.

Rosa will, again, have no personal liability to income tax or NIC, as she will incur a trading loss of £84,000 ($£62,000 + £22,000$).

Therefore, the total income tax and NIC payable by Siena and Rosa for the tax year 2020/21 will be reduced by £3,659 ($£2,030 + £1,629$) if Siena becomes a partner.

However, although the total tax and NIC payable by Siena and Rosa is lower if Siena becomes a partner, the amount of trading loss available for relief is higher if Siena becomes an employee (£84,000, rather than £62,000).

Working:

Allocation of RS Trading loss for the year ending 31 March 2021:

	Total £	Rosa £	Siena £
Budgeted loss	(62,000)		
Salary to Siena	(12,000)		12,000
Balance (80:20)	(74,000)	(59,200)	(14,800)
Total share of loss	(62,000)	(59,200)	(2,800)

Tutorial note: Although Rosa will have no personal liability to NIC, she can voluntarily continue to pay Class 2 contributions in order to ensure entitlement to contributions-based benefits.

(b) Loss reliefs available to Rosa in respect of the budgeted trading loss of RS Trading

Rosa will have a trading loss of £84,000 in the tax year 2020/21.

As Rosa has no other income in 2020/21, she can only carry back the loss to 2019/20, and offset the loss against her total income of that year, and then against the chargeable gains arising on the sale of the investment properties in 2019/20.

Rosa's total income in 2019/20 is £87,000 (£27,000 + £60,000). There is no restriction on the amount of loss which can be used against trading income from the same trade, but relief against the property income will be capped at the greater of £50,000 and 25% of Rosa's adjusted net income for the year, which is £21,750 (£87,000 x 25%).

Accordingly, a maximum of £50,000 can be offset against the property income. Therefore, a total of £77,000 (£27,000 + £50,000) can be offset against income leaving net income of £10,000 (£87,000 – £77,000), which will be covered by Rosa's personal allowance.

The balance of the loss of £7,000 (£84,000 – £77,000) can be relieved against the chargeable gains of £92,000 on the sale of the investment properties.

Maximum tax saving 2019/20:

	£
Income tax (No liability to income tax remains, so the whole amount is repayable)	23,160
Capital gains tax (CGT) (Working)	5,410
	<u>28,570</u>

Working:

CGT payable after taking loss relief:

	£
Gains remaining chargeable (£92,000 – £7,000)	85,000
Less: annual exempt amount	(11,700)
Taxable gains	<u>73,300</u>
CGT: £34,500 x 18%	6,210
£38,800 x 28%	10,864
	<u>17,074</u>

CGT saving is £5,410 (£22,484 – £17,074)

Tutorial note: Before taking loss relief, Rosa's taxable gains would all be taxed at 28% as Rosa's taxable income exceeded £34,500. After taking loss relief against Rosa's total income for 2019/20, the full amount of the basic rate band will be available to use against taxable gains.

(c) Value added tax (VAT) implications of the disposal of the retail unit

On 6 April 2020, when the retail unit is sold, it will be more than three years old. Accordingly, the sale will be exempt from VAT as Rosa has not opted to tax it.

On acquisition, the retail unit was newly constructed, so VAT of £58,000 (£290,000 x 20%) will have been charged. Rosa will have reclaimed the whole of this in the year ended 31 March 2014, as she used it in her business, making wholly standard rated supplies.

However, as the sale of the retail unit will be an exempt disposal, for the purpose of the capital goods scheme it is deemed to have 0% taxable use for the remainder of the ten-year adjustment period. As the warehouse is sold during the eighth year of the

adjustment period, there are two years of the adjustment period remaining, and therefore a final VAT adjustment of £11,600 ($£58,000 \times 2/10 \times (100\% - 0\%)$) will be repayable by Rosa to HM Revenue and Customs (HMRC) in respect of the sale.

	<i>Available</i>	<i>Maximum</i>
1 (a) Information required	1	
Matters to consider	4	
Actions to take	1	
	<u>6</u>	5
(b) Trading as a limited company		
Corporation tax	3	
Income tax	3.5	
Employee's class 1 national insurance contributions	1	
Reasons for advice to trade as an unincorporated business		
Relief for expected trading loss	6.5	
Other reasons	2	
	<u>16</u>	14
(c) The Arch building		
Incorporation relief not available	2	
Capital gains tax	2	
Loan to Nelson		
Reason why NQA Ltd will be a close company	1	
Tax payment required	3	
Repayment of tax	1	
Value added tax		
Recovery of output tax	3	
Cash accounting scheme and cash flow	2	
	<u>14</u>	12
Problem solving	1	
Clarity of explanations and calculations	1	
Effectiveness of communication	1	
Overall presentation and style	1	
	<u>4</u>	4
Total		<u>35</u>
2 (a) Basis of taxation	3	
Tax rate	2	
	<u>5</u>	4
(b) Emma's death	2	
Ownership of shares	5	
Calculation		
Fall in value	3.5	
Inheritance tax liability	2.5	
Capital gains tax	2	
	<u>15</u>	13
(c) Temporary non-UK resident	3	
Capital gains tax liability		
Sale before returning to the UK	2	
Sale after returning to the UK	1.5	
Payment date	1	
Advice	2.5	
	<u>10</u>	8
Total		<u>25</u>

	<i>Available</i>	<i>Maximum</i>
3 (a) Availability of substantial shareholding exemption	3	
Implications re degrouping charge	4	
	<u>7</u>	6
(b) Implications for Kitz Ltd	4	
Implications for Feld Ltd	3·5	
	<u>7·5</u>	7
(c) (i) Implications of the sale of the patent	2·5	
Calculation of trading profit	1	
	<u>3·5</u>	3
(ii) Reason for availability of rollover relief	2	
Maximum rollover relief available	2·5	
Calculation of reduction in corporation tax liability	0·5	
	<u>5</u>	4
Total		<u>20</u>
4 (a) Siena as partner	3	
Siena as employee	4	
Calculation of shares of loss	2	
Conclusion	2	
	<u>11</u>	9
(b) Availability of loss relief	2	
Relief against total income in 2019/20	3·5	
Tax saving	3·5	
	<u>9</u>	7
(c) Disposal exempt	1·5	
Initial reclaim	1·5	
Implications of sale	2	
	<u>5</u>	4
Total		<u>20</u>