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P6 UK Study Text
Advanced Taxation
(Finance Act 2009)

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Paper P6 (UK)

Advanced Taxation (FA 2009)

Welcome to Emile Woolf's study text for
Paper P6 *Advanced Taxation FA2009* (UK) which is:

- Written by tutors
- Comprehensive but concise
- In simple English
- Used around the world by Emile Woolf Colleges including China, Russia and the UK

Emile Woolf International
Publishing

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Syllabus and study guide

Aim

To apply relevant knowledge and skills and exercise professional judgement in providing relevant information and advice to individuals and businesses on the impact of the major taxes on financial decisions and situations.

Main capabilities

On successful completion of this paper, candidates should be able to:

A Apply further knowledge and understanding of the UK tax system through the study of further capital taxes, together with more advanced topics within the taxes studied previously.

B Evaluate and explain the importance of taxation to personal and corporate financial management.

C Identify and evaluate the impact of relevant taxes on various situations and courses of action, including the interaction of taxes.

D Provide advice on minimising and/or deferring tax liabilities by the use of standard tax planning measures.

E Communicate with clients, HM Revenue and Customs and other professionals in an appropriate manner.

Syllabus

A Knowledge and understanding of the UK tax system through the study of further capital taxes, together with more advanced topics within the taxes studied previously

1 Income and income tax liabilities in situations involving further overseas aspects and in relation to trusts, and the application of additional exemptions and reliefs.

2 Corporation tax liabilities in situations involving further overseas and group aspects and in relation to special types of company, and the application of additional exemptions and reliefs.

3 Chargeable gains and capital gains tax liabilities in situations involving further overseas aspects and in relation to closely related persons and trusts, and the application of additional exemptions and reliefs.

4 Inheritance tax

5 Stamp duty and stamp duty land tax

6 National insurance, value added tax and tax administration

B The importance of taxation to personal and corporate financial management

1 The principles underlying personal financial management.

2 How an individual's personal financial objectives may differ depending on their circumstances and expectations.

3 The common forms of personal finance and investment products in a given set of circumstances, including ethical considerations.

4 How a business' financial objectives may differ depending on its circumstances and the business environment.

5 How taxation can affect the financial decisions made by businesses (corporate and unincorporated) and by individuals.

6 Other considerations, personal and commercial, which might affect a financial decision.

C The impact of relevant taxes on various situations and courses of action, including the interaction of taxes

1 Taxes applicable to a given situation or course of action and their impact.

2 Alternative ways of achieving personal or business outcomes may lead to different tax consequences.

3 Tax advantages and/or disadvantages of alternative courses of action.

4 Statutory obligations imposed in a given situation, including any time limits for action and the implications of non-compliance.

D Minimising and/or deferring tax liabilities by the use of standard tax planning measures

1 Types of investment and other expenditure that will result in a reduction in tax liabilities for an individual and/or a business.

2 Legitimate tax planning measures, by which the tax liabilities arising from a particular situation or course of action can be mitigated.

3 The appropriateness of such investment, expenditure or measures, given a particular taxpayer's circumstances or stated objectives.

4 The mitigation of tax in the manner recommended, by reference to numerical analysis and/or reasoned argument.

5 Ethical and professional issues arising from the giving of tax planning advice.

6 Current issues in taxation.

E Communicating with clients, HM Revenue and Customs and other professionals

1 Communication of advice, recommendations and information in the required format.

2 Presentation of written information, in language appropriate to the purpose of the communication and the intended recipient.

3 Conclusions reached with relevant supporting computations.

4 Assumptions made or limitations in the analysis provided; together with any inadequacies in the information available and/or additional information required to provide a fuller analysis.

5 Other non-tax factors that should be considered.

Approach to examining the syllabus

The paper consists of two sections:

Section A consists of two compulsory questions for a total of between 50 and 70 marks. Marks may not be allocated evenly between the two questions.

Section B consists of three questions, two of which must be answered. Each question will have the same number of marks, ranging from 15 marks each to 25 marks each.

Questions will be scenario based and will normally involve consideration of more than one tax, together with some elements of planning and the interaction of taxes. Computations will normally only be required in support of explanations or advice and not in isolation.

The examination is a three hour paper, with 15 minutes additional reading and planning time.

Tax rates, allowances and information on certain reliefs will be given in the examination paper.

Study guide

This study guide provides more detailed guidance on the syllabus. You should use this as the basis of your studies.

A Apply further knowledge and understanding of the UK tax system through the study of further capital taxes, together with more advanced topics within the taxes studied previously.

1 Income and income tax liabilities in situations involving further overseas aspects and in relation to trusts, and the application of exemptions and reliefs

(a) The contents of the paper F6 study guide for income tax, under headings:
- B1 The scope of income tax
- B2 Income from employment
- B3 Income from self employment
- B4 Property and investment income
- B5 The comprehensive computation of taxable income and the income tax liability
- B6 The use of exemptions and reliefs in deferring and minimising income tax liabilities

The following additional material is also examinable:

(b) The scope of income tax:
- (i) Explain and apply the concepts of residence, ordinary residence and domicile and advise on the relevance to income tax
- (ii) Advise on the availability of the remittance basis to UK resident individuals
- (iii) Advise on the tax position of individuals coming to and leaving the UK
- (iv) Determine the income tax treatment of overseas income
- (v) Understand the relevance of the OECD model double tax treaty to given situations
- (vi) Calculate and advise on the double taxation relief available to individuals

(c) Income from employment:
- (i) Advise on the tax treatment of share option and share incentive schemes
- (ii) Advise on the tax treatment of lump sum receipts
- (iii) Advise on the overseas aspects of income from employment, including travelling and subsistence expenses
- (iv) Identify personal service companies and advise on the tax consequences of providing services via a personal service company

(d) Income from self employment:
- (i) Recognise the tax treatment of overseas trade travelling expenses
- (ii) Advise on the allocation of the annual investment allowance between related businesses
- (iii) Identify the capital allowances available in respect of expenditure on green technologies
- (iv) Recognise the tax treatment of the investment income and charges of a partnership

(e) Property and investment income:
- (i) Assess the tax implications of pre-owned assets
- (ii) Recognise income subject to the accrued income scheme
- (iii) Advise on the tax implications of jointly held assets

(iv) Income from trusts and settlements:
Understand the income tax position of trust beneficiaries

(f) The comprehensive computation of taxable income and the income tax liability;

(i) Advise on the income tax position of the income of minor children

(g) The use of exemptions and reliefs in deferring and minimising income tax liabilities:

(i) Understand and apply the rules relating to investments in the enterprise investment scheme

ii) Understand and apply the rules relating to investments in venture capital trusts

iii) Explain the conditions that need to be satisfied for pension schemes to be approved by HM Revenue and Customs

Excluded topics

The scope of income tax:

- Details of specific anti-avoidance provisions, except as stated in the study guide.

Income from employment:

- Explanation of the PAYE system.
- The calculation of a car benefit where emission figures are not available.

Income from self employment:

- The 100% first year allowance for renovating business premises in disadvantaged areas and flats above shops.
- The calculation of industrial buildings allowance on the purchase of a secondhand industrial building.
- Capital allowances for agricultural buildings, patents, scientific research and know how.
- Enterprise zones.
- The allocation of notional profits and losses for a partnership.
- Farmers averaging of profits.
- The averaging of profits for authors and creative artists.
- Details of specific anti-avoidance provisions, except as stated in the study guide.

Property and investment income:

- The deduction for expenditure by landlords on energy-saving items.

Income from trusts and settlements:

- The computation of income tax payable by trustees.
- Overseas aspects.

The comprehensive computation of taxable income and the income tax liability:

- The blind person's allowance and the married couple's age allowance.

- Tax credits.
- Maintenance payments.
- Charitable donations.
- Social security benefits apart from the State Retirement Pension.

2 Corporation tax liabilities in situations involving further overseas and group aspects and in relation to special types of company, and the application of additional exemptions and reliefs

(a) The contents of the Paper F6 study guide, for corporation tax, under headings:
- C1 The scope of corporation tax
- C2 Profits chargeable to corporation tax
- C3 The comprehensive computation of corporation tax liability
- C4 The effect of a group structure for corporation tax purposes
- C5 The use of exemptions and reliefs in deferring and minimising corporation tax liabilities

The following additional material is also examinable:

(b) The scope of corporation tax:

(i) Identify and calculate corporation tax for companies with investment business.

(ii) Close companies:
- Apply the definition of a close company to given situations
- Conclude on the tax implications of a company being a close company or a close investment holding company

(iii) Identify and evaluate the significance of accounting periods on administration or winding up

(iv) Conclude on the tax treatment of returns to shareholders after winding up has commenced

(v) Advise on the tax implications of a purchase by a company of its own shares

(vi) Identify personal service companies and advise on the tax consequences of services being provided by a personal service company

(c) Profits chargeable to corporation tax:

(i) Identify qualifying research and development expenditure, both capital and revenue, and determine the amount of relief by reference to the size of the individual company/group

(ii) Identify the enhanced capital allowances available in respect of expenditure on green technologies, including the tax credit available in the case of a loss making company

(iii) Determine the tax treatment of non trading deficits on loan relationships

(iv) Recognise the alternative tax treatments of intangible assets and conclude on the best treatment for a given company

(v) Advise on the impact of the transfer pricing and thin capitalisation rules on companies

(vi) Advise on the restriction on the use of losses on a change in ownership of a company

(d) The comprehensive calculation of corporation tax liability:

(i) Advise on the application of the corporate venturing scheme

(ii) Assess the impact of the OECD model double tax treaty on corporation tax

(iii) Evaluate the meaning and implications of a permanent establishment

(iv) Identify and advise on the tax implications of controlled foreign companies

(v) Advise on the tax position of overseas companies trading in the UK

(e) The effect of a group structure for corporation tax purposes:

(i) Advise on the allocation of the annual investment allowance between group or related companies

(ii) Advise on the tax consequences of a transfer of intangible assets

(iii) Advise on the tax consequences of a transfer of a trade and assets where there is common control

(iiv) Understand the meaning of consortium owned company and consortium member

(v) Advise on the operation of consortium relief

(vi) Determine pre-entry gains and losses and understand their tax treatment

(vii) Determine the degrouping charge where a company leaves a group within six years of receiving an asset by way of a no gain/no loss transfer

(viii) Determine the effects of the anti-avoidance provisions, where arrangements exist for a company to leave a group

(ix) Advise on the relief for trading losses incurred by an overseas subsidiary

(f) The use of exemptions and reliefs in deferring and minimising corporation tax liabilities:

No additional material at this level

Excluded topics

The scope of corporation tax:

- Details of specific anti-avoidance provisions (except as stated in the Study Guide).

The comprehensive calculation of the corporation tax liability:

- Corporation tax rates for companies in the process of winding up.
- Relief for overseas tax as an expense.
- Detailed knowledge of specific double taxation agreements.
- Migration of a UK resident company.
- Mixer companies.

- Detailed computational questions on the carry back and carry forward of unrelieved foreign tax.
- Quarterly accounting for income tax.

3 Chargeable gains and capital gains tax liabilities in situations involving further overseas aspects and in relation to closely related persons and trusts together with the application of additional exemptions and reliefs

(a) The contents of the Paper F6 study guide for chargeable gains under headings:

- D1 The scope of the taxation of capital gains
- D2 The basic principles of computing gains and losses
- D3 Gains and losses on the disposal of movable and immovable property
- D4 Gains and losses on the disposal of shares and securities
- D5 The computation of the capital gains tax payable by individuals
- D6 The use of exemptions and reliefs in deferring and minimising tax liabilities arising on the disposal of capital assets

The following additional material is also examinable:

(b) The scope of the taxation of capital gains:

(i) Determine the tax implications of independent taxation and transfers between spouses

(ii) Identify the concepts of residence, ordinary residence and domicile and determine their relevance to capital gains tax

(iii) Advise on the availability of the remittance basis to non-UK domiciled individuals

(iv) Determine the UK taxation of foreign gains, including double taxation relief

(v) Conclude on the capital gains tax position of individuals coming to and leaving the UK

(vi) Identify the occasions when a capital gain would arise on a partner in a partnership

(c) Capital gains tax and trusts:

(i) Advise on the capital gains tax implications of transfers of property into trust

(ii) Advise on the capital gains tax implications of property passing absolutely from a trust to a beneficiary

(d) The basic principles of computing gains and losses:

(i) Identify connected persons for capital gains tax purposes and advise on the tax implications of transfers between connected persons

(ii) Advise on the impact of dates of disposal and conditional contracts

(iii) Evaluate the use of capital losses in the year of death

(e) Gains and losses on the disposal of movable and immovable property:
   (i) Advise on the tax implications of a part disposal, including small part disposals of land
   (ii) Determine the gain on the disposal of leases and wasting assets
   (iii) Establish the tax effect of appropriations to and from trading stock
   (iv) Establish the tax effect of capital sums received in respect of the loss, damage or destruction of an asset
   (v) Advise on the tax effect of making negligible value claims
   (vi) Determine when the capital gains tax can be paid by instalments and evaluate when this would be advantageous to taxpayers

(f) Gains and losses on the disposal of shares and securities:
   (i) Extend the explanation of the treatment of rights issues to include the small part disposal rules applicable to rights issues
   (ii) Determine the application of the substantial shareholdings exemption
   (iii) Define a qualifying corporate bond (QCB), and understand what makes a corporate bond non-qualifying. Understand the capital gains tax implications of the disposal of QCBs in exchange for cash or shares
   (iv) Apply the rules relating to reorganisations, reconstructions and amalgamations and advise on the most tax efficient options available in given circumstances
   (v) Establish the relief for capital losses on shares in unquoted trading companies

(g) The use of exemptions and reliefs in deferring and minimising tax liabilities arising on the disposal of capital assets:
   (i) Understand and apply enterprise investment scheme reinvestment relief
   (ii) Advise on the availability of entrepreneurs' relief in relation to associated disposals
   (iii) Understand the capital gains tax implications of the variations of wills

Excluded topics

The scope of the taxation of capital gains:

- Detailed knowledge of the statements of practice on partnership capital gains.

Capital gains tax and trusts:

- Overseas aspects of capital gains tax and trusts
- The computation of capital gains tax payable by trustees
- Transfer of property to or from trustees prior to 22 March 2006

- Knowledge of situations where property is transferred between trusts or where the terms or nature of the trust is altered
- Knowledge of situations where property within a trust with an immediate post-death interest passes to the spouse or civil partner of the settlor on the death of the life tenant
- Knowledge of the special rules concerning trusts for the disabled, trusts for bereaved minors, transitional serial interest trusts and age 18 to 25 trusts

The basic principles of computing gains and losses:

- Assets held at 31 March 1982.
- Relief for losses on loans made to traders.

Gains and losses on the disposal of movable and immovable property:

- Chattels where the cost or proceeds are less than £6,000.
- Sets of chattels in relation to the chattels exemption.
- The grant of a lease or sub-lease out of either a freehold, long lease or short lease.

Gains and losses on the disposal of shares and securities:

Computation of cost and indexed cost within the s.104 TCGA 1992 share pool

4 Inheritance tax

(a) The scope of inheritance tax:
   - (i) Identify and explain the persons chargeable
   - (ii) Explain the concepts of domicile and deemed domicile and understand the application of these concepts to inheritance tax

(b) The basic principles for computing transfers of value:
   - (i) State, explain and apply the meaning of transfers of value, chargeable transfers and potentially exempt transfers
   - (ii) Demonstrate the fall in value principle
   - (iii) Demonstrate the seven year accumulation principle
   - (iv) Identify excluded property
   - (v) Identify and advise on the tax implications of the location of assets
   - (vi) Identify and advise on gifts with reservation of benefit
   - (vii) Identify and advise on the tax implications of associated operations

(c) The liabilities arising on chargeable lifetime transfers and death transfers by individuals:
   - (i) Advise on the tax implications of chargeable lifetime transfers
   - (ii) Advise on the tax implications of transfers within seven years of death
   - (iii) Compute the death estate

(iv) Advise on the relief for the fall in value of lifetime gifts

(v) Advise on the operation of quick succession relief

(vi) Advise on the operation of double tax relief for inheritance tax

(vii) Advise on the inheritance tax effects and advantages of the variation of wills

(d) Computing transfers of value:

(i) Advise on the principles of valuation

(ii) Advise on the availability of business property relief and agricultural property relief

(iii) Identify exempt transfers

(e) The liabilities arising in respect of transfers to and from trusts and on property within trusts:

(i) Define a trust

(ii) Distinguish between different types of trust

(iii) Advise on the inheritance tax implications of transfers of property into trust

(iv) Advise on the inheritance tax implications of property passing absolutely from a trust to a beneficiary

(v) Advise on occasions on which inheritance tax is payable by trustees

(f) The use and exemptions and reliefs in deferring and minimising inheritance tax liabilities:

(i) Advise on the use of reliefs and exemptions to minimise inheritance tax liabilities, as mentioned in the sections above

(g) The system by which inheritance tax is administered, including the instalment option for the payment of tax:

(i) Identify those responsible for the payment of inheritance tax.

(ii) Identify the occasions on which inheritance tax may be paid by instalments.

(iii) Advise on the due dates, interest and penalties for inheritance tax purposes.

Excluded topics

The scope of inheritance tax:

- Pre 18 March 1986 lifetime transfers
- Transfers of value by close companies

The liabilities arising on chargeable lifetime transfers and on death:

- Double grossing up on death
- Post mortem reliefs
- Relief on relevant business property and agricultural property given as exempt legacies
- Detailed knowledge of the double charges legislation

Computing transfers of value:

- Valuation of an annuity or an interest in possession where the trust interest is subject to an annuity
- Woodlands relief
  Conditional exemption for heritage property

Inheritance tax and trusts:

- IHT aspects of discretionary trusts prior to 27 March 1974
- Computation of ten year charges and exit charges
- Overseas aspects of inheritance tax and trusts
- The conditions that had to be satisfied for a trust to be an accumulation and maintenance trust
- Knowledge of situations where property is transferred between trusts or where the terms or nature of the trust is altered
- Knowledge of situations where within a trust with an immediate post-death interest passes to the spouse or civil partner of the settler on the death of the life tenant
- Knowledge of the special rules concerning trusts for the disabled, trusts for bereaved minors, transitional serial interest trusts and age 18 to 25 trusts

5 Stamp duties (stamp duty and stamp duty land tax)

(a) The scope of stamp duty and stamp duty land tax:

(i) Identify the property in respect of which stamp duty and stamp duty land tax is payable.

(b) Identify and advise on the liabilities arising on documented transfers.

(i) Advise on the stamp duties payable on transfers of shares and securities

(ii) Advise on the stamp duties payable on transfers of land

(c) The use of exemptions and reliefs in deferring and minimising stamp duties:

(i) Identify transfers involving no consideration

(ii) Advise on group transactions

(d) Understand and explain the systems by which stamp duties are administered.

Excluded topics

The scope of stamp duty and stamp duty land tax:

- Leases

The liabilities arising on documented transfers:

- The contingency principle

The systems by which stamp duties are administered:

- Detailed rules on interest and penalties

6 National insurance, value added tax, tax administration and the UK tax system:

(a) The contents of the Paper F6 study guide for national insurance under headings:

- E1 The scope of national insurance
- E2 Class 1 and class 1A contributions for employed persons
- E3 Class 2 and class 4 contributions for self-employed persons

No additional material at this level.

(b) The contents of the Paper F6 study guide for value added tax (VAT) under headings:

- F1 The scope of value added tax (VAT)
- F2 The VAT registration requirements
- F3 The computation of VAT liabilities
- F4 The effect of special schemes

The following additional material is also examinable:

(i) Advise on the impact of the disaggregation of business activities for VAT purposes.

(ii) Advise on the impact of group registration and divisional registration.

(iii) Advise on the VAT implications of the supply of land and buildings in the UK

(iv) Advise on the VAT implications of imports and exports

(v) Advise on the VAT implications of acquisitions and supplies within the EU

(vi) Advise on the VAT implications of partial exemption

(vii) Advise on the application of the capital goods scheme

(c) The contents of the Paper F6 study guide for the obligations of taxpayers and/or their agents under headings:

- G1 The systems for self assessment and the making of returns
- G2 The time limits for the submission of information, claims and payment of tax, including payments on account
- G3 The procedures relating to enquiries, appeals and disputes
- G4 Penalties for non-compliance

No additional material at this level

(d) The contents of the Paper F6 study guide for the UK tax system under headings:

- A1 The overall function and purpose of taxation in a modern economy
- A2 Different types of taxes
- A3 Principal sources of revenue law and practice
- A4 Tax avoidance and tax evasion

Excluded topics

National insurance:

- The calculation of directors' national insurance on a month by month basis
- Contracted out contributions
- The offset of trading losses against non-trdaing income and capital gains

Value added tax:

- The determination of the tax point
- The contents of a valid VAT invoice
- Do it yourself builders
- Second hand goods scheme
- Retailers' schemes
- Schemes for farmers

B THE IMPORTANCE OF TAXATION TO PERSONAL AND CORPORATE FINANCIAL MANAGEMENT

1 The principles underlying personal financial management

(a) Calculate the receipts from a transaction, net of tax and compare the results of alternative scenarios and advise on the most tax efficient course of action.

2 How an individual's personal financial objectives may differ depending on their circumstances and expectations

(a) Understand and apply the effect of age, family commitments, aspirations and the economy on personal financial objectives.

3 The common forms of personal finance and investment products in a given set of circumstances, including ethical considerations

(a) Understand and be able to compare and contrast the tax treatment of the sources of finance available to individuals.

(b) Understand and be able to compare and contrast the tax treatment of investment products:

(i) Deposit based investments
(ii) Fixed interest securities
(iii) Packaged investments
(iv) Collective investments
(v) Equities
(vi) Enterprise investment scheme
(vii) Venture capital trusts
(viii) Fixed interest securities

4 How a business' financial objectives may differ depending on its circumstances and the business environment

(a) Understand and be able to explain the effect of profitability, future plans, actions of competitors and the economy on a business' financial objectives.

5 **How taxation can affect the financial decisions made by businesses (corporate and unincorporated) and by individuals**

(a) Understand and explain the tax implications of the effect of the raising of equity and loan finance.

(b) Explain the tax differences between decisions to lease, use hire purchase or purchase outright.

(c) Understand and explain the impact of taxation on the cash flows of a business.

6 **Other considerations, personal and commercial, which might affect a financial decision.**

C THE IMPACT OF RELEVANT TAXES ON VARIOUS SITUATIONS AND COURSES OF ACTION, INCLUDING THE INTERACTION OF TAXES

1 **Identifying and advising on the taxes applicable to a given course of action and their impact.**

2 **Identifying and understanding that the alternative ways of achieving personal or business outcomes may lead to different tax consequences.**

3 **Assessing the tax advantages and disadvantages of alternative courses of action.**

4 **Understanding the statutory obligations imposed in a given situation, including any time limits for action and advising on the implications of non-compliance.**

D MINIMISING AND/OR DEFERRING TAX LIABILITIES BY THE USE OF STANDARD TAX PLANNING MEASURES

1 **Identifying and advising on the types of investment and other expenditure that will result in a reduction in tax liabilities for an individual and/or a business.**

2 **Advising on legitimate tax planning measures, by which the tax liabilities arising from a particular situation or course of action can be mitigated.**

3 **Advising on the appropriateness of such investment, expenditure or measures given a particular taxpayer's circumstances or stated objectives.**

4 **Advise on the mitigation of tax in the manner recommended by reference to numerical analysis and/or reasoned argument.**

5 **Be aware of the ethical and professional issues arising from the giving of tax planning advice.**

6 **Be aware of and give advice on current issues in taxation.**

E COMMUNICATING WITH CLIENTS, HM REVENUE AND CUSTOMS AND OTHER PROFESSIONALS IN AN APPROPRIATE MANNER

1 Communication of advice, recommendations and information in the required format:

For example the use of:

- Reports
- Letters
- Memoranda
- Meeting notes

2 Presentation of written information, in language appropriate to the purpose of the communication and the intended recipient.

3 Communicating conclusions reached, together, where necessary with relevant supporting computations.

4 Stating and explaining assumptions made or limitations in the analysis provided; together with any inadequacies in the information available and/or additional information required to provide a fuller analysis.

5 Identifying and explaining other, non-tax, factors that should be considered.

t

Tax rates and allowances

Contents

A Tax rates and allowances

Tax rates and allowances given in the examination paper

Income tax

		%
Basic rate	£0 – £37,400	20
Higher rate	£37,401 and above	40

A starting rate of 10% applies to savings income where it falls within the first £2,440 of taxable income.

Personal allowance

		£
Personal allowance		6,475
	65 – 74	9,490
	75 and over	9,640
Income limit for age related allowances		22,900

Car benefit percentage

The base level of CO_2 emissions is 135 grams per kilometre. A lower rate of 10% applies to petrol cars with CO_2 emissions of 120 grams per kilometre or less.

Car fuel benefit

The base figure for calculating the car fuel benefit is £16,900.

Personal pension contribution limits

Annual allowance	£245,000
Lifetime allowance	£1,750,000

The maximum contribution that can qualify for tax relief without evidence of earnings is £3,600.

Authorised mileage allowances: cars

Up to 10,000 miles	40p
Over 10,000 miles	25p

Capital allowances

Plant and machinery

Annual investment allowance		£50,000
Main pool	– First year allowance (Applies to expenditure during the period 6 April 2009 to 5 April 2010 (1 April 2009 to 31 March 2010 for limited companies).)	40%
	– Writing down allowance	20%
Special rate pool	– Writing down allowance	10%
	– CO_2 emissions up to 110 grams per kilometre	100%
	- CO_2 emissions between 111 and 160 g/km	20%
	- CO_2 emissions over 160 g/km	10%
	– Energy-saving or environmentally-beneficial plant and machinery	100%
Industrial buildings	- Writing-down allowance	2%

Corporation tax

Financial year	**2007**	**2008**	**2009**
Small companies rate	20%	21%	21%
Full rate	30%	28%	28%
Small companies rate:			
lower limit	300,000	300,000	300,000
upper limit	1,500,000	1,500,000	1,500,000
Marginal relief fraction:			
Small companies rate	1/40	7/400	7/400

Marginal relief

(M – P) × I/P × Marginal relief fraction

Value added tax

Standard rate	- Up to 31 December 2009	15.0%
	- From 1 January 2010 onwards	17.5%

	£
Registration limit	68,000
Deregistration limit	66,000

Inheritance tax

	%
£1 – £325,000	Nil
Excess	40

Capital gains tax

Rate of tax			18%
Annual exemption			£10,100
Entrepreneurs' relief	-	Lifetime limit	£1,000,000
	-	Relief factor	4/9ths

National Insurance contributions

		%
Class 1 Employee	£1 – £5,715 per year	Nil
	£5, 716 – £43,875 per year	11.0
	£43,876 and above per year	1.0
Class 1 Employer	£1 – £5,715 per year	Nil
	£5,716 and above per year	12.8
Class 2	£2.40 per week	
	Small earnings exception limit - £5,075	
Class 4	£1 – £5,715 per year	Nil
	£5,716 – £43,875 per year	8.0
	£43,876 and above per year	1.0
Class 1A		12.8

Rates of interest

Official rate of interest:	4.75%
Rate of interest on underpaid tax:	2.5% (assumed)
Rate of interest on overpaid tax:	nil (assumed)

Stamp duty land tax

Ad Valorem Duty - Residential property	Rate
£175,000 or less (1)	Nil
£175,001 – £250,000	1%
£250,001 – £500,000	3%
£500,001 or more	4%

(1) For non-residential property, the nil rate is restricted to £150,000.

Stamp duty – Shares 0.5%

B Retail price indices

RPIs used for examples and questions in this text

	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991
January	–	82.61	86.84	91.20	96.25	100.0	103.3	111.0	119.5	130.2
February	–	82.97	87.20	91.94	96.60	100.4	103.7	111.8	120.2	130.9
March	79.44	83.12	87.48	92.80	96.73	100.6	104.1	112.3	121.4	131.4
April	81.04	84.28	88.64	94.78	97.67	101.8	105.8	114.3	125.1	133.1
May	81.62	84.64	88.97	95.21	97.85	101.9	106.2	115.0	126.2	133.5
June	81.85	84.84	89.20	95.41	97.79	101.9	106.6	115.4	126.7	134.1
July	81.88	85.30	89.10	95.23	97.52	101.8	106.7	115.5	126.8	133.8
August	81.90	85.68	89.94	95.49	97.82	102.1	107.9	115.8	128.1	134.1
September	81.85	86.06	90.11	95.44	98.30	102.4	108.4	116.6	129.3	134.6
October	82.26	86.36	90.67	95.59	98.45	102.9	109.5	117.5	130.3	135.1
November	82.66	86.67	90.95	95.92	99.29	103.4	110.0	118.5	130.0	135.6
December	82.51	86.89	90.87	96.05	99.62	103.3	110.3	118.8	129.9	135.7

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
January	135.6	137.9	141.3	146.0	150.2	154.4	159.5	163.4	166.6	171.1
February	136.3	138.8	142.1	146.9	150.9	155.0	160.3	163.7	167.5	172.0
March	136.7	139.3	142.5	147.5	151.5	155.4	160.8	164.1	168.4	172.2
April	138.8	140.6	144.2	149.0	152.6	156.3	162.6	165.2	170.1	173.1
May	139.3	141.1	144.7	149.6	152.9	156.9	163.5	165.6	170.7	174.2
June	139.3	141.0	144.7	149.8	153.0	157.5	163.4	165.6	171.1	174.4
July	138.8	140.7	144.0	149.1	152.4	157.5	163.0	165.1	170.5	173.3
August	138.9	141.3	144.7	149.9	153.1	158.5	163.7	165.5	170.5	174.0
September	139.4	141.9	145.0	150.6	153.8	159.3	164.4	166.2	171.7	174.6
October	139.9	141.8	145.2	149.8	153.8	159.5	164.5	166.5	171.6	174.3
November	139.7	141.6	145.3	149.8	153.9	159.6	164.4	166.7	172.1	173.6
December	139.2	141.9	146.0	150.7	154.4	160.0	164.4	167.3	172.2	173.4

	2002	2003	2004	2005	2006	2007	2008	2009	2010
January	173.3	178.4	183.1	188.9	193.4	201.6	209.8	210.1	*215.6*
February	173.8	179.3	183.8	189.6	194.2	203.1	211.4	211.4	*216.0*
March	174.5	179.9	184.6	190.5	195.0	204.4	212.1	211.3	*216.3*
April	175.7	181.2	185.7	191.6	196.5	205.4	214.0	211.5	*216.8*
May	176.2	181.5	186.5	192.0	197.7	206.2	215.1	212.8	
June	176.2	181.3	186.8	192.2	198.5	207.3	216.8	213.4	
July	175.9	181.3	186.8	192.2	198.5	206.1	216.5	213.4	
August	176.4	181.6	187.4	192.6	199.2	207.3	217.2	214.4	
September	177.6	182.5	188.1	193.1	200.1	208.0	218.4	*214.6*	
October	177.9	182.6	188.6	193.3	200.4	208.9	217.7	*214.8*	
November	178.2	182.7	189.0	193.6	201.1	209.7	216.0	*215.0*	
December	178.5	183.5	189.9	194.1	202.7	210.9	212.9	*215.2*	

Note: The figures in italics are estimated

C Short lease depreciation percentages

The lease percentages to be used when working examples and questions in this manual

Years	%	Years	%	Years	%	Years	%	Years	%
≥ 50	100	40	95.457	30	87.330	20	72.770	10	46.695
49	99.657	39	94.842	29	86.226	19	70.791	9	43.154
48	99.289	38	94.189	28	85.053	18	68.697	8	39.399
47	98.902	37	93.497	27	83.816	17	66.470	7	35.414
46	98.490	36	92.761	26	82.496	16	64.116	6	31.195
45	98.059	35	91.981	25	81.100	15	61.617	5	26.722
44	97.595	34	91.156	24	79.622	14	58.971	4	21.983
43	97.107	33	90.280	23	78.055	13	56.167	3	16.959
42	96.593	32	89.354	22	76.399	12	53.191	2	11.629
41	96.041	31	88.371	21	74.635	11	50.038	1	5.983

CHAPTER

1

The UK tax system

Contents

The overall function and purpose of taxation in a modern economy

- The economic function of taxation
- The social justice purpose of taxation
- The main UK taxes
- Direct and indirect taxation

1 The overall function and purpose of taxation in a modern economy

1.1 The economic function of taxation

The UK government raises billions of pounds in taxation every year and the system of taxation and spending by government impacts on the whole economy of a country.

Taxation policies have been used to influence many economic factors such as inflation, employment levels, imports/exports, etc.

Taxation policies can also influence the behaviour of individuals and businesses, which will then have an effect on the economy of the country.

Examples of this influence may be:

- Using interest rate changes to encourage either spending or saving.
- Encouraging individuals to save and invest, by offering tax incentives such as Individual Savings Accounts (ISAs) or Venture Capital Trusts (VCTs), etc.
- Encouraging charitable giving by offering tax relief on donations and gifts.
- Increasing car tax on large cars, to try to cut down CO_2 emissions.
- Discouraging smoking and drinking alcohol by increasing tax on these goods.

1.2 The social justice purpose of taxation

The type of taxation structure imposed has a direct impact on the redistribution of the wealth of a country. The main ways of structuring the tax system are listed below.

Proportional taxation

As income rises, the proportion of tax remains constant. For example, a proportional tax is one that takes 20% of all earnings regardless of their level.

Progressive taxation

As income rises, the amount of tax also rises by proportion. An example of this would be 10% on £100,000 of income, rising to 40% on £400,000 of income. The UK's system of income tax is an example of a progressive tax system.

Regressive taxation

As income rises, the proportion of taxation paid falls. An example of this would be a tax on fuel that must be paid by both lower and higher earners. It would be described as regressive, because the amount of tax represents a greater proportion of the lower earner's income.

Ad valorem principle

This is the percentage of tax added to the value of goods. An example of this would be the VAT imposed on most goods sold in the UK. VAT is said to be a regressive tax as a low earner will spend more of their income than a high earner.

1.3 The main UK taxes

Income tax

Income tax is payable by individuals on their earned income, such as employment income, profits from self-employment and pensions.

It is collected from employees using the PAYE system, and from self-employed individuals using the self assessment tax system.

Income tax is also payable by individuals on their other income, such as bank interest, dividends and rental income.

National insurance contributions (NICs)

NICs are payable by most individuals who are either employed or self-employed. NICs are also payable by businesses in relation to their employees.

Corporation tax

Corporation tax is payable by companies on all their income and gains.

Capital gains tax

Capital gains tax is payable by individuals on the disposal of chargeable assets, such as land, buildings and shares.

Inheritance tax

Inheritance tax is a tax on capital rather than income. It is charged when an individual's wealth or estate is given away. IHT can be charged during an individual's lifetime, for example on gifts of money or assets. It is also charged when an individual dies, on their death estate.

Value added tax

VAT is payable on most goods and services purchased by consumers.

Stamp duty

Stamp duty is payable on the sale of land and buildings and shares.

1.4 Direct and indirect taxation

Taxes can be classified as either direct or indirect.

Direct taxation

This is where a taxpayer pays their tax directly to HM Revenue & Customs (HMRC). Examples of direct taxes include income tax, corporation tax, capital gains tax and inheritance tax.

Indirect taxation

This is where tax, such as VAT, is paid indirectly to HM Revenue & Customs. The consumer pays indirect taxes to the supplier, who then pays the tax to HMRC.

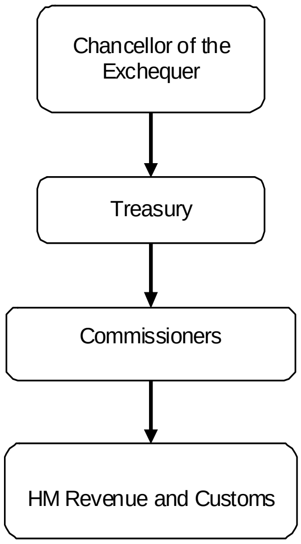
Principle sources of revenue law and practice

- Ths structure of the UK tax system
- The different sources of revenue law
- The interaction of the UK tax system with that of other tax jurisdictions

3 Principal sources of revenue law and practice

3.1 The structure of the UK tax system

The structure of the UK tax system can be shown as follows:



Chancellor of the Exchequer

The Chancellor has the overall responsibility for the UK tax system and one of his roles includes producing the Budget each year.

The Treasury

The Treasury is the ministry responsible under the Chancellor for the imposition and collection of taxation.

The Commissioners

The Treasury appoint permanent civil servants, the Commissioners for HM Revenue and Customs.

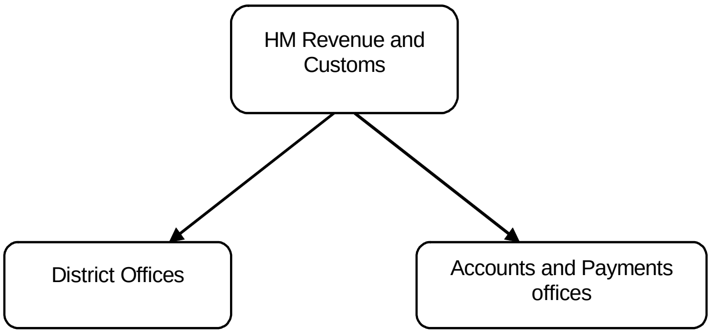
Their duties include:

- Administering the UK tax system
- Implementing statute law.

HM Revenue and Customs

HM Revenue and Customs (HMRC) is a single body that controls and administers all areas of UK tax law.

The structure of HM Revenue and Customs can be shown as follows:



District offices

The Commissioners appoint Officers of HMRC to carry out the day to day work in managing the tax system. Their roles include:

- Issuing tax returns
- Examining tax returns and accounts
- Calculating tax liabilities under the self assessment tax systems and PAYE.

Accounts and payments offices

Accounts and payments offices deal with the collection and payment of tax.

3.2 The different sources of revenue law

Although tax law constantly changes, it has been established over a long period of time.

The different sources of revenue law are as follows:

Tax legislation and statutes

Tax legislation/statutes are the main source of revenue law. Each year, following the Budget, the legislation is updated by passing a new Finance Act.

In addition to Acts of Parliament, the government issues statutory instruments which add detail, where needed, to any part of the legislation.

Case law

Case law refers to the decisions made in tax cases tried and tested through the courts. The results of cases that have been through the courts tend to set a precedent for the tax treatment of a particular item.

HMRC manuals

HMRC have their own manuals that are used by the Officers of HMRC. These manuals are also available for use by the general public. You can view them by using the search facility on the HMRC website – www.hmrc.gov.uk.

HMRC guidance

As the tax legislation can be complex to understand and is also open to misinterpretation, further guidance is issued by HMRC in order to:

- explain how to implement the law
- give their interpretation of the law.

The main statements of guidance are as follows:

- **Statements of practice** - These provide explanation on how the tax law is applied.
- **Extra-Statutory Concessions** – These are sometimes available to soften areas of tax law where it would seem to be unduly harsh or unfair. These concessions usually have to be claimed and sometimes taxpayers are unaware that they are available.
- **Press Releases** - These provide news of topical tax issues that arise during the year.
- **Leaflets** - Leaflets are available on all types of tax topics and they are an informative source of revenue law for the general public. For instance, the Revenue leaflet on 'residence' explains all the related issues in a way that is understandable to most taxpayers.

3.3 The interaction of the UK tax system with that of other tax jurisdictions

The UK's tax law uses the concepts of residence, ordinarily residence and domicile to determine how an individual or entity is taxed. However, overseas countries will also have their own tax laws and practices.

It is therefore possible for an individual to be liable to tax in more than one country at the same time, under completely different tax rules.

Tax treaties

A tax treaty, or agreement, between two countries may over-rule the tax law of one or both of those countries. In this case, the individual or entity is taxed in accordance with the tax treaty.

However, if there is no treaty between two countries, an individual or entity may be taxed in both countries. As this is unfair, double taxation relief will apply.

Double taxation relief

Where an individual or entity is taxed in two countries, relief is given where tax has been paid twice.

This relief is called Double Taxation Relief and will be covered in detail in later chapters.

Tax avoidance and tax evasion

- The difference between tax avoidance and tax evasion
- The need for an ethical and professional approach

4 Tax avoidance and tax evasion

4.1 The difference between tax avoidance and tax evasion

It is important to know the difference between tax avoidance and tax evasion, as the consequences of getting it wrong can be very different.

Tax avoidance

Tax avoidance is legal. It involves complying with the tax legislation in such a way as to minimise a taxpayer's tax liability.

- For example, an individual arranging their will in such a way as to minimise their inheritance tax liability is using tax planning opportunities and avoiding tax in a legal way in accordance with the tax law.
- Another example may be an individual making a capital gains tax election to tax the disposal of their business in such a way as to minimise their capital gains tax liability.

Promoters (i.e. tax advisors) who market tax avoidance schemes are required to provide details of their schemes to HM Revenue and Customs. HMRC may register a scheme and issue the promoter with a reference number. Any of the promoter's clients making use of the scheme will need to include this reference number in their tax return.

Tax evasion

Tax evasion is illegal. It involves reduce one's tax liability in a way that is not following the tax legislation.

- For example, tax evasion is deliberately omitting some investment income from a tax return in order not to pay tax on that source of income.
- Another example of tax evasion is to overstate expenses in order to reduce the tax liability.

Any taxpayer who carries out tax evasion could face criminal prosecution, including penalties, surcharges, interest and sometimes imprisonment.

4.2 The need for an ethical and professional approach

The ACCA expects its members to:

- Adopt an ethical approach to work, employers and clients.
- Acknowledge their professional duty to society as a whole.

- Maintain an objective outlook.
- Provide professional, high standards of service, conduct and performance at all times.

The ACCA's 'Code of Ethics and Conduct' sets out five fundamental principles, which help members to meet these expectations:

- **Integrity** - Members should act in a straightforward and honest manner in performing their work.
- **Objectivity** - Members should not allow prejudice, or bias, or the influence of others to override objectivity.
- **Professional competence and due care** - Members should not undertake work that they are not competent to carry out. Members have an ongoing duty to maintain professional knowledge and skills. A member should carry out their work with due care having regard to the nature and scope of the assignment.
- **Confidentiality** - Members should respect the confidentiality of information acquired as a result of professional and business relationships and should not disclose any such information to third parties unless:
  - they have proper and specific authority; or
  - there is a legal or professional right or duty to disclose e.g. Money Laundering.

  Confidential information acquired as a result of professional and business relationships should not be used for the personal advantage of members or third parties.
- **Professional behaviour** - Members should refrain from any conduct that might bring discredit to the profession.

CHAPTER 2

The principles of income tax

Contents

An overview of income tax

- The basic charging rules
- The classification of income
- Allowable interest payments
- The basic personal allowance
- The set-off of personal allowances and interest payments
- The income tax computation
- The treatment of Gift Aid donations
- The treatment of personal pension contributions

1 An overview of income tax

1.1 The basic charging rules

Individuals are liable to pay income tax on their *taxable income* for a *tax year*.

Taxable income is income generated from all sources which is not specifically exempt less tax allowable interest payments and personal allowances.

A **tax year** (also referred to as a 'fiscal year' or 'year of assessment') runs from 6 April in one year to the following 5 April.

For the 2010 examinations, questions will be based on the 2009/10 tax year.

The scope of income tax for individuals is as follows:

Taxable person:	Liable on:
UK resident individual	Worldwide taxable income
Non-UK resident individual	UK income only

1.2 The classification of income

Taxable income is income which is not specifically exempt.

Exempt income

The main types of income which are exempt from income tax are:

- statutory redundancy pay
- some termination payments
- competition prizes, National Lottery and Premium Bond prizes, betting winnings
- income from ISAs (Individual Savings Accounts)

- repayment interest (i.e. interest on overpaid income tax which has been repaid by HMRC)
- interest on National Savings Certificates
- the first £70 interest on National Savings Bank (NSB) ordinary accounts
- some social security benefits (e.g. income support, housing benefit)
- working tax credits and child tax credits.

Taxable income

All taxable income must be brought into the income tax computation 'gross' regardless of whether any tax has already been deducted at source before payment to the individual.

Taxable income is classified according to its nature and source. Each source of income must be shown separately as the rules to determine the amount of income that is taxable differ for each source.

A summary of the key sources of income is given below.

Type of income	Basis of assessment	Received
Savings income		
UK interest (see below)	Receipts basis	Some sources = gross Some sources = net of 20% tax
Foreign interest	Receipts basis	Net of foreign tax
Dividend income		
UK dividends	Receipts basis	Net of 10% tax
Foreign dividends	Receipts basis	Net of foreign tax
Other income		
Employment income	Receipts basis	Net of PAYE (Pay-as-you-earn)
Trading income	Current year basis	Gross
Pension income (see below)	Accruals basis	Gross or Net
UK property income	Accruals basis	Gross
Other foreign income	Accruals basis	Net of foreign tax
Miscellaneous income (e.g. patent royalties)	Receipts basis	Net of 20% tax
Interest in possession trust income (see below)	Distributable share	Net of various rates of tax
Discretionary trust income (see below)	Receipts basis	Net of 40% tax

Notes:

Receipts basis means the amount received in the tax year (i.e. from 6 April to 5 April) and accruals basis means the amounts accrued in the tax year.

UK interest income

Some UK interest is received gross and some is received net of 20% income tax as follows:

Received net of 20% income tax	Received gross
■ Bank interest	■ Gilt-edged security interest (i.e. Government stock interest)
■ Building society interest	■ (e.g. Treasury stock interest, Exchequer stock interest, 3½% War Loan interest)
■ Interest from unquoted UK companies (e.g. debenture interest and loan stock interest)	■ Interest on quoted Eurobonds (i.e. securities, such as debentures and loan stock, listed on a recognised stock exchange)
	■ Interest on loans made to other individuals
	■ National Savings Bank interest (see below)

All taxable income must be included gross in an income tax computation. The individual must therefore gross up the interest income received net of 20% tax by 100/80 and include the gross income in his income tax computation.

The National Savings Bank has many types of accounts available for an individual. The most common accounts are the NSB Easy Access Savings Account (EASA), the NSB Ordinary Account and the NSB Investment Account.

Interest on all NSB accounts is received gross and is taxable in full, except that the first £70 of interest on an NSB Ordinary Account is exempt from income tax.

However, EASAs have replaced the NSB Ordinary Account. It is no longer possible to open a new NSB Ordinary Account or add to an existing account. If an individual wishes to make a withdrawal from an NSB Ordinary Account, the full amount must be withdrawn and the account will be closed. There are therefore only a few NSB Ordinary Accounts remaining to which the first £70 exemption still applies.

Non-taxpayers

Individuals who are non-taxpayers (e.g. an individual who has income below the personal allowance), such as some pensioners and children, can reclaim any tax suffered at source.

However, it is possible to receive bank and building society interest gross by completing a Form R85 to declare a non-taxpayer status and submitting the form to the appropriate bank or building society.

The individual must be certain that he is not liable to income tax, as penalties are payable for incorrect declarations of non-taxpayer status.

Pension income

Pension income is taxed on an accruals basis (not cash receipts basis).

All pension income accrued in the tax year is taxable as earned income, liable to tax in the normal way at 20% or 40%. A credit is given in the individual's income tax computation for any income tax deducted at source by the payer of the pension.

State pension income is received gross. Occupational pensions are usually paid by the employer net of PAYE. Personal pensions are paid net of 20% tax.

Trust income

Trusts are covered in more detail in a later chapter. However, consideration is given here to the calculation of the income tax payable by an individual who is a beneficiary of a trust and receives income from a trust fund.

Trust income will have suffered tax at source, paid by the trustees of the trust. The amount of tax suffered at source depends on the type of trust.

For interest in possession trusts (IIP trusts)

- **All** of the trust income for a tax year **must** be distributed to the beneficiaries (known as life tenants) each year.
- The beneficiaries are therefore taxed on their **distributable share** of the income for the tax year, regardless of when the income is received.
- The income retains its nature. Therefore, for example, if the distributable income is savings income, the individual is treated as receiving savings income net of 20% income tax.

For discretionary trusts

- The beneficiaries are assessed on the actual income **received** in the tax year.
- The individual is usually deemed to receive the income **net of 40% income tax,** regardless of the source of income out of which it is paid.
- The income is treated as 'other income' (i.e. not savings and not dividend income).

In summary:

Type of trust	Type of income	Income received	Treated in the beneficiary's computation as
Discretionary trusts	Any income	Net of 40% tax	Other income
IIP trusts	Savings income	Net of 20% tax	Savings income
	Dividend income	Net of 10% tax	Dividend income
	Other income	Net of 20% tax	Other income

Whatever amount of tax is deducted at source, the individual must gross up the trust income at the appropriate rate and include the gross income in his income tax computation.

Dividend income

Paper P6, dividends from companies resident in the UK and abroad are examinable. In addition, dividends from unit trusts, open-ended investment trusts (OEIT) and Real Estate Investment Trusts (REIT) are examinable.

UK resident individuals holding less than 10% of the shares of non-UK resident companies are entitled to a 10% tax credit. The tax credit operates in the same way as it does in relation to dividends from UK resident companies; the grossed up foreign dividend income is grossed up again at 100/90, the gross income is taxed at 10%/32.5% and there is a 10% tax credit. The tax credit is not repayable in cash.

From 2009/10 this 10% tax credit is also available to UK resident individuals holding more than 10% of the shares of a non-UK resident company, provided:

- the company paying the dividend is resident in a qualifying territory at the time of the distribution, and
- the dividend payment is not part of a tax advantage scheme. (A tax advantage scheme is an arrangement which has the obtaining of a tax credit as its primary purpose.)

A qualifying territory is a country which has a double taxation agreement with the UK that includes a non-discrimination article. This is a provision that means a UK citizen is not subject to a more onerous tax regime in the overseas country than a local citizen would be.

The gross amount of dividend income must be included in an income tax computation as follows:

Type of dividend	Dividend received	Calculation of gross amount	Treated in the individual's computation as
UK dividend	Net of deemed tax credit of 10%	× (100 / 90)	Dividend income
Foreign dividend (meeting above conditions)	Net of overseas tax suffered	× (100 / 100 – overseas tax rate) Then × (100 / 90)	Dividend income

Foreign dividend (not meeting above conditions)	Net of overseas tax suffered	× (100 / 100 – overseas tax rate)	Dividend income
Unit trust dividend	Net of deemed tax credit of 10%	× (100 / 90)	Dividend income
OEIT dividend	Net of deemed tax credit of 10%	× (100 / 90)	Dividend income
REIT dividend	Net of 20% tax	× (100 / 80)	Property income = other income

Liability to income tax

An individual's income is taxed in the following order and is liable to income tax at the following rates:

Tax in the order:		**1**	**2**	**3**
		Other income	**Savings income**	**Dividend income**
Income bands:		**Rates of income tax:**		
Basic rate band	£0 - £37,400	20%	20%	10%
Higher rate band	Excess over £37,400	40%	40%	32½%

There is also a 10% rate band of £2,440 in respect of savings income. However, it only applies where savings income falls within the first £2,440 of taxable income. As non-savings income is taxed before savings income, it is therefore unlikely that the 10% band for savings income will apply.

1.3 Allowable interest payments

If a loan is taken out to finance expenditure which is wholly and exclusively for the purpose of a trade, the interest is treated as a trading expense and is an allowable deduction in the trading income computation. Similarly, if a loan is taken out to finance expenditure which is wholly and exclusively for the purpose of a property business, the interest is an allowable deduction in the property business income computation.

Interest on loans taken out **for other qualifying purposes** will receive relief as a deduction from total income.

Qualifying loan interest is interest on a loan taken out by an individual in order to:

- buy a share in, increase capital to, make a loan to, or purchase plant or machinery for use in a partnership in which the individual is a partner
- buy plant or machinery for use in the individual's employment
- buy ordinary shares in an employee controlled company in which the individual is a full-time employee and the company is a UK resident unquoted trading company
- buy ordinary shares in, or make a loan to, a 'close company' (see later chapter).

All qualifying loan interest is paid gross.

1.4 The basic personal allowance

Every individual is entitled to a basic personal allowance (PA) to ensure that some of his income is tax-free. For 2009/10 the PA is £6,475.

The allowance is available **in full** in the year of birth and all subsequent years up to and including the year of death. The PA is never time-apportioned.

The PA is deducted from the individual's net income (i.e. income **after a**llowable interest payments have been deducted).

1.5 The set-off of personal allowances and allowable interest payments

Allowable interest payments and the PA must be set off against income in the following strict order:

(1) Other income (i.e. income other than savings income and dividends), then

(2) Savings income (i.e. interest income), then

(3) Dividend income

If there is insufficient income to utilise in full, relief for the excess PA and allowable interest payments is lost (i.e. they cannot be carried forward or back).

1.6 The income tax computation

Step 1: The taxable income statement

Name of individual
Income tax computation: 2009/10

	Total income	*Other income*	*Savings income*	*Dividend income*
	£	£	£	£
Earned income				
Trading income	X	X		
Employment income (gross)	X	X		
Pension income	X	X		
Property business income (FHLs)	X	X		
Savings income				
Bank/Building society interest (100/80)	X		X	
Debenture/Gilt/NSB interest	X		X	
Foreign interest (gross)	X		X	
Interest from IIP trust (100/80)	X		X	
Dividend income				
UK dividends received (100/90)	X			X
Foreign dividends (100/90)	X			X
Dividends from IIP trust (100/90)	X			X
Other investment income				
Patent royalties received (100/80)	X	X		
Discretionary trust income (100/60)	X	X		
UK Property income (excluding FHLs)	X	X		
REIT income (100/80)	X	X		

Other foreign income	X	X		
Other income from an IIP trust (100/80)	X	X		
Total Income	X	X	X	X
Less Allowable interest	(X)	(X) [1]	(X) [2]	(X) [3]
Net income	X	X	X	X
Less Personal allowance (PA)	(6,475)	(X) [1]	(X) [2]	(X) [3]
Taxable income	X	X	X	X

Step 2: The computation of income tax payable

		£	£	£
Income tax				
Basic rate band:	Other income	X	at 20%	X
	Savings *(see Note (1) below)*	X	at 20%	X
	Dividends	X	at 10%	X
(see Note (2) below)		37,400		
Higher rate band:	Other income	X	at 40%	X
	Savings	X	at 40%	X
	Dividends	X	at 32.5%	X
Total taxable income		X		
				X
Less Investment reliefs (see later)				
VCT relief at 30%				(X)
EIS relief at 20%				(X)
				X
Less Double taxation relief (DTR) (see later)				(X)
Income tax liability				X
Less Tax credits/deducted at source: *(see Note (3) below)*				
Dividends at 10%				(X)
Savings at 20%				(X)
Patent royalties at 20%				(X)
REIT income at 20%				(X)
Discretionary trust income at 40%				(X)
PAYE				(X)
Income tax payable under self assessment				X

Notes

(1) If savings income falls within the first £2,440 of taxable income, it will be taxable at 10% to the extent that it does not exceed £2,440.

(2) The higher rate band starts when taxable income exceeds £37,400 unless the higher rate band is extended due to Gift Aid payments and/or contributions into a personal pension scheme.

(3) The tax credit on dividends cannot be refunded; therefore to ensure maximum benefit it is deducted first. Tax deducted at source on any other source of income may be refunded by HMRC.

Example

Mr Ascott is single, aged 28 and received the following income in 2009/10:

	£
Gross salary (from which £3,545 PAYE has been deducted)	24,150
Dividends from a UK company	3,600
Bank interest	800
NSB investment account interest	240
UK property income	2,300
Discretionary trust income	1,500
Patent royalty received	472

Mr Ascott paid £2,000 interest on a loan taken out to buy ordinary shares in a 'close company'.

Required

Calculate Mr Ascott's income tax payable/repayable for 2009/10.

Answer

Mr Ascott
Income tax computation: 2009/10

	Total income	*Other income*	*Savings income*	*Dividend income*
	£	£	£	£
Earned income				
Employment income	24,150	24,150		
Savings income				
Bank interest (£800 × 100/80)	1,000		1,000	
NSB investment account interest	240		240	
Dividend income				
UK dividends received (£3,600 × 100/90)	4,000			4,000
Other investment income				
UK property income	2,300	2,300		
Discretionary trust income (£1,500 × 100/60)	2,500	2,500		
Patent royalty received (£472 × 100/80)	590	590		
	34,780	29,540	1,240	4,000
Less Total income				
Qualifying loan interest (paid gross)	(2,000)	(2,000)		
Net income	32,780	27,540	1,240	4,000
Less PA	(6,475)	(6,475)		
Taxable income	26,305	21,065	1,240	4,000

Income tax		£		£
Basic rate band:	Other income	21,065	at 20%	4,213
	Savings income	1,240	at 20%	248
	Dividend income	4,000	at 10%	400
Total taxable income		26,305		
Income tax liability				4,861
Less Tax credits/deducted at source:				
Dividends (£4,000 × 10%)				(400)
Bank interest (£1,000 × 20%)				(200)
Discretionary trust income (£2,500 × 40%)				(1,000)
Patent royalty (£590 × 20%)				(118)
PAYE				(3,545)
Income tax repayable under self assessment				(402)

1.7 The treatment of Gift Aid donations

Tax relief is available for individuals making cash donations to registered charities (including donations made by means of charitable deeds of covenant) under the Gift Aid Scheme as follows:

- Payments to the charity are deemed to be made net of 20% income tax; therefore 20% tax relief is automatically obtained at source in making the payment to the charity
- A basic rate taxpayer ignores Gift Aid donations in his income tax computation as he has received tax relief at 20% already at source
- A higher rate taxpayer receives the additional 20% (40% – 20%) tax relief by extending the basic rate band by the gross amount paid in the tax year.

An election is available to treat a Gift Aid donation as if it were made in the preceding year.

To relate a payment in 2009/10 back to 2008/09, the election must be made by 31 January 2011 (i.e. by 31 January following the tax year in which the donation was paid).

The election is beneficial if the individual is a basic rate taxpayer in 2009/10, but a higher rate taxpayer in 2008/09.

1.8 The treatment of personal pension contributions

Relief for contributions made by an individual into a personal pension plan (PPP) is given in the same way as for Gift Aid donations.

- Basic rate relief (20%) is **automatically** given at source as pension contributions are paid **net** of 20% tax. Therefore pension contributions are ignored in the individual's income tax computation.
- For higher rate taxpayers the additional 20% relief is obtained by extending the basic rate band. The basic rate band is extended by adding to the £37,400 threshold, the **gross** amount of the pension contributions.

Independent taxation

- The concept of independent taxation
- The taxation of husband and wife
- Civil partnerships
- The taxation of children's income

2 Independent taxation

2.1 The concept of independent taxation

In tax law every individual adult and child is treated as a separate taxable person. Each taxable person is liable to income tax on his or her own income.

Accordingly, if an individual receives sufficient income to pay tax, a separate income tax computation is required for each individual whether or not he is married and regardless of age.

However, special tax rules are needed to enable separate computations to be produced where there are close relationships between individuals (e.g. to allocate income produced from jointly held assets, or to allocate jointly paid tax allowable payments).

As a result, special tax rules exist for the taxation of husband and wife, civil partnerships and children's income.

2.2 The taxation of husband and wife

A separate income tax computation is produced for each spouse, but special rules apply for the allocation of joint income and joint tax allowable payments.

Joint income

Where the couple have jointly held assets generating income, regardless of the actual ownership of the asset, the income generated is *shared equally* between the spouses (known as the 50:50 rule).

For example, if a couple have a jointly owned house which generates £10,000 of taxable property income, each spouse will include £5,000 in their individual income tax computation. This will be the case whether the couple contributed to the purchase cost equally or whether one spouse contributed 75% and the other 25% towards the capital cost.

However, if the couple enjoy the income in unequal proportions, they can make an 'actual entitlement declaration' to HMRC and ask to be taxed on the income in the proportion of their actual entitlement to that income (i.e. 75%:25% in the above illustration) rather than a 50:50 allocation.

It is important to note that the declaration:

- is optional, but once made it is irrevocable
- must be sent within 60 days of requiring it to be effective for tax purposes, and
- can only be made for a different allocation based on the facts of actual entitlement (i.e. the couple cannot choose to allocate in any proportion they wish to in order to minimise their tax liabilities).

Exception to the 50:50 rule

There is one exception to the assumed 50:50 allocation rule for husband and wife, dividends received from shares held in a 'close company' (see later chapter) will always be allocated according to actual entitlement to the jointly owned shares and cannot be allocated in any other way.

Joint tax allowable payments

Tax relief is given in the normal way for allowable interest and Gift Aid payments made by either spouse according to the amount paid by each spouse.

Where payments are made jointly out of a joint bank account and the appropriate allocation is not clear, the 50:50 rule applies.

2.3 Civil partnerships

Same-sex couples who acquire legal status for their relationship under the Civil Partnership Act 2004 are treated as married couples for taxation purposes.

2.4 The taxation of children's income

Every individual (i.e. adult and child) is treated as a separate taxable person.

Therefore, from birth a child should be assessed for income tax on his income. However, all individuals (including children) are entitled to the full personal allowance.

Most children do not receive sufficient income to pay tax, and if they receive income which has already had tax deducted at source, they can reclaim the tax suffered.

If a child's income is taxable, the child is assessed on its income in its own right and is liable to pay income tax under self assessment in the normal way.

The parents or legal guardian will normally act for the child in a representative capacity until the child is 18 and will ensure that the appropriate forms are completed and payments made.

Normal rules apply to determine whether a child has received sufficient income to be taxable, i.e. consider income from all sources after deducting the personal allowance.

However, a child's income is assessed on the parent, not the child, where:

- the capital giving rise to the income was derived from the parent, and
- the income is in excess of £100 gross per annum, and
- the child is unmarried and under the age of 18.

Common examples are trust income from a trust fund or interest from a bank or building society account set up by the parent for the child, or dividends from shares purchased by the parent for the child.

Example

Mr Braham is married with two children. In 2009/10 he received the following income:

		£
Trading income		32,750
Rental income	(from jointly owned property with wife)	7,600
Bank interest		4,200
UK dividends		7,200

Mr Braham made a Gift Aid payment of £564 to Cancer Research on 14 June 2009 and paid allowable interest of £1,795 on 15 December 2009.

The Brahams have two unmarried children, Belinda aged 19 and Colin aged 15. Both Belinda and Colin received £270 dividend income from shares purchased for them by Mr Braham.

Required

Calculate Mr Braham's income tax payable for 2009/10.

Answer

Mr Braham
Income tax computation: 2009/10

	Total income	*Other income*	*Savings income*	*Dividend income*
	£	£	£	£
Earned income				
Trading income	32,750	32,750		
Savings income				
Bank interest (£4,200 × 100/80)	5,250		5,250	
Dividend income				
UK dividends received (£7,200 × 100/90)	8,000			8,000
Colin's dividends (£270 × 100/90) *(Note 1)*	300			300
Other investment income				
UK property income (£7,600 × 50%)	3,800	3,800		
	50,100	36,550	5,250	8,300

	Total income	Other income	Savings income	Dividend income
	£	£	£	£
Less allowable interest	(1,795)	(1,795)		
Net Income	48,305	34,755	5,250	8,300
Less PA	(6,475)	(6,475)		
Taxable income	41,830	28,280	5,250	8,300

Income tax		£		£
Basic rate band:	Other income	28,280	at 20%	5,656
	Savings income	5,250	at 20%	1,050
	Dividend income	4,575	at 10%	457
	(Note 2)	38,105		
Higher rate band:	Dividend income	3,725	at 32.5%	1,211
Total taxable income		41,830		
Income tax liability				8,374
Less Tax credits/deducted at source:				
Dividends (£8,300 × 10%)				(830)
Savings (£5,250 × 20%)				(1,050)
Income tax payable under self assessment				6,494

Notes

(1) Mr Braham is assessed on Colin's dividends. This is because Mr Braham bought the shares from which the dividends are received. In addition, Colin is unmarried, under 18 and the income is in excess of £100. Accordingly, the income is assessed on the parent, not the child.

Mr Braham is not assessed on the dividends received by Belinda as she is over 18.

(2) As Mr Braham is a higher rate taxpayer and made a Gift Aid payment, the basic rate band is extended by the gross Gift Aid payment of £705 (£564 × 100/80) from £37,400 to £38,105 (£37,400 + £705).

Personal allowances

- The allowances available
- The personal age allowance

3 Personal allowances

3.1 The allowances available

As previously stated, every individual is entitled to the basic personal allowance.

Elderly taxpayers are entitled to higher rates of personal allowance known as the personal age allowance (PAA).

3.2 The personal age allowance

The basic personal allowance (PA) is available to all individuals under the age of 65 at the end of the tax year.

However, instead of receiving the PA, elderly taxpayers (aged 65 and over) are entitled to higher personal age allowances.

The amount of personal age allowance (PAA) available depends on two factors:

- the individual's age at the **end** of the tax year, and
- the level of that individual's **'net income'** in the tax year.

The PAAs available in 2009/10 are as follows:

Age at the end of the tax year:	**£**
65 to 74	9,490
75 and over	9,640

Note that the personal age allowance available in the year of death is based on the age the individual *would have been* at the end of the tax year.

The above allowances are the maximum amounts for the tax year. However, the personal age allowance must be reduced if the individual's net income exceeds the income limit of £22,900 (for 2009/10).

Net income for age allowance purposes means the net income in the individual's income tax computation *less:*

- the gross amount of any Gift Aid donations, and
- gross personal pension contributions, paid in the tax year, if any.

The personal age allowance and the income limit are given in the tax rates and allowances provided in the examination.

The PAA is calculated as follows:

		£		£
PAA based on age at end of tax year				X
Less	Reduction in allowance if net income exceeds £22,900			
	Net income per income tax computation	X		
	Less gross Gift Aid donation	(X)		
	Less gross personal pension contribution	(X)		
	Net income for age allowance reduction purposes	X		
	Less income limit	(22,900)		
		X	at 50%	(X)
PAA available (see note below)				X

Note: The PAA cannot be reduced below the basic PA of £6,475.

Example

Your tax files show the following information relating to 2009/10 in respect of three of your clients:

	Diane	**Edmund**	**Frank**
Net income	£23,350	£30,200	£24,150
Date of birth	13 April 1935	6 July 1939	18 November 1927
Gift Aid donation paid	Nil	Nil	£320

Required

Calculate the taxable income of each of your clients in 2009/10.

Answer

	Diane	**Edmund**	**Frank**
Age at end of tax year	74	70	82
	£	£	£
Net income	23,350	30,200	24,150
Less PAA (see workings)	(9,265)	(6,475)	(9,215)
Taxable income	14,085	23,725	14,935

Workings	Diane	Edmund	Frank
	£	£	£
PAA on age	9,490	9,490	9,640
Reduction based on Net income			
(£23,350 – £22,900) × 50% = £225	(225)		
(£30,200 – £22,900) × 50% = £3,650 (Note)		(3,015) restricted	
(£23,750 (below) - £22,900) × 50% = £425			(425)
PAA available	9,265	6,475	9,215

Note: The basic PA = Minimum allowance available to all individuals

Frank's net income for age allowance reduction purposes

	£
Net income per income tax computation	24,150
Less Gross Gift Aid donation (£320 × 100/80)	(400)
Net income for age allowance reduction purposes	23,750

CHAPTER

3

Income from investments

Contents

Income derived from land and buildings in the UK

1 Income derived from land and buildings in the UK

1.1 The scope of the syllabus

UK property income rules assess income receivable from land and buildings situated in the UK.

There are three key sources of property income:

- Rental income
- Lump sum premiums received on the granting of short leases, and
- Dividends from REITs. (These were covered in the previous chapter).

1.2 Rental income

Rental income receivable is assessed on an individual as 'other income' on an **accruals basis of assessment**.

A single assessment is made on the net profits of all properties let by the individual, as if there is one property business with a year ended 5 April each year.

Rental income therefore assesses rents receivable and expenses incurred in the tax year; the actual dates of receipt of income and payment of expenses are not relevant.

To calculate the rental income assessment:

- all **income accrued** from any rental property is pooled, and
- all **allowable revenue expenditure** incurred wholly and exclusively in relation to the rental properties is deducted.

The rental income assessment is therefore the overall net profits of all properties rented by that individual.

However, there are two exceptions to this rule. Profits/losses derived from the following properties are not pooled with the other properties but are calculated separately:

- furnished holiday lettings, and
- properties let at a nominal rent.

These are considered in detail in later sections of this chapter.

The proforma computation shown below can be used to calculate the rental income assessment for an individual. The computation is identical to that used for corporation tax, with the exception of the treatment of interest as explained in Note (5) below.

(W) UK property income		
	£	£
Rents accrued in the tax year		X
Less Allowable revenue expenses *(see Notes 1 to 3 below)*		
Accountant's fee	X	
Agent's management fees, advertising	X	
Council tax, water rates	X	
Gardener's wages, cleaner's wages	X	
Insurance for the property	X	
Insurance for the contents (if furnished)	X	
Repairs	X	
Painting and decorating	X	
Debts written off *(see Note 4 below)*	X	
Interest on loans in relation to the property *(see Note 5 below)*	X	
		(X)
Less Wear and tear allowance (if furnished) *(see Note 6 below)*		
10% × [rents received – council tax]		(X)
Property income assessment		X

Notes

(1) Allowable expenses must be incurred wholly and exclusively for the purposes of the property letting business and must be revenue, not capital, in nature.

(2) Allowable expenses include expenditure incurred in the seven years pre-letting, provided the expenses would normally be allowed if incurred whilst letting property.

(3) Expenditure is allowable if the property is **available** for letting. Therefore expenses are allowable if incurred while the property is empty (e.g. repairs carried out in between old tenants moving out and new tenants moving in). However, if the owners occupy the property at any time, expenses are not allowable if incurred while the property is occupied by the owner. It may be necessary to time apportion some expenses and only allow those incurred while the property is **available for letting**.

(4) Outstanding rents which are no longer recoverable (for example, due to a tenant leaving with no contact details and without paying) are an allowable deduction.

(5) For income tax, interest **payable** on any loan taken out to purchase or improve the property (including incidental costs of obtaining the loan finance and any bank overdraft interest in running the property business) **is an allowable expense** against the rental income.

For corporation tax, the interest is treated as non-trading loan interest under the loan relationship rules and is an allowable deduction from interest income not rental income.

(6) The wear and tear allowance is a tax allowance for the furnishings provided in a property, and therefore only applies to properties let furnished. Alternative allowances may available (see below).

Relief for capital expenditure

The general rule that capital expenditure is not an allowable deduction in calculating the property income assessment applies to all property which is let.

If the property is **non-residential** (e.g. offices, warehouse):

- Capital allowances are available for plant and machinery provided with the property in the normal way.

However, if the property is **residential** (e.g. a dwelling house or flat):

- Normal capital allowances cannot be claimed.
- An alternative relief known as the renewals basis is available, but this only allows relief for the cost of **replacing** furniture to the same standard. No relief is available for the original cost of the furniture or any improvement costs. No relief is available for any plant and machinery provided with the property.
- In practice, the wear and tear allowance is usually claimed instead of the renewals basis. In an examination question always give the wear and tear allowance unless the question specifically refers to the alternative allowance available.

UK property income losses

If the allowable revenue expenses exceed the rents accrued on all properties pooled together, an overall net loss arises.

In this case, for income tax purposes:

- the UK property income assessment for the tax year is £Nil, and
- the loss arising can **only** be **carried forward** and set **against future UK property income**.

These rules are more restrictive than the relief available for UK property income losses for companies (see later).

Example

Hannah rented out two properties in 2009/10: Nos. 47 and 49 St. Peter's Boulevard.

No. 47 is a furnished property which Hannah purchased several years ago. It was let all year at a rent of £2,500 per month.

No. 49 was purchased on 1 January 2010. It was immediately let on a six month agreement as unfurnished property at a rent of £1,800 per month. In order to purchase the property, Hannah took out a £100,000 loan with a bank on 1 January 2010, at a fixed mortgage interest rate of 9% pa.

The following additional expenses relate to 2009/10:

	No. 47	No. 49
	£	£
Advertising for new tenants	Nil	920
Estate agent management fees	2,440	740
Council tax	860	150
Insurance	1,100	160
Repairs	3,200	Nil
Extension	15,000	Nil

Required

Calculate the property income assessable on Hannah for 2009/10.

a

Answer

Hannah's property income – 2009/10

	£	£
Rents accrued in 2009/10 (£2,500 × 12) + (£1,800 × 3)		35,400
Less Allowable expenses		
Advertising	920	
Agents' management fees (£2,440 + £740)	3,180	
Council tax (£860 + £150)	1,010	
Insurance (£1,100 + £160)	1,260	
Repairs	3,200	
Extension (capital and therefore not allowable)	Nil	
Interest on loan to purchase No.49 (£100,000 × 9% × 3/12)	2,250	
		(11,820)
Wear and tear allowance (furnished property only)		
10% × [rents – council tax]		
10% × [(£2,500 × 12) – (860)]		(2,914)
Property income assessment		20,666

Note that if the rents accrued had been less than £14,734, an overall net loss would have arisen. This loss could only have been carried forward to set off against future property income.

1.3 Nominal rent leases

A nominal rent lease (also known as a non-commercial lease) is where a property is let but the tenant is not charged the full market rent; only a small nominal rent is charged or no rent is charged. These arrangements usually occur when a landlord lets property to members of his family.

If a property is not let at a full commercial rate:

- The property is not pooled with other properties, but separate records are kept

- The rents receivable under the lease are taxable as property income in the normal way, net of expenses incurred
- A portion of the expenses will not be allowed on the grounds of not being wholly and exclusively incurred for the purposes of the business (e.g. if the rent charged to the relative is 30% of the normal commercial rent, only 30% of the normal allowable expenses will be allowed)
- Expenses will only be allowable up to a maximum of the rents receivable (i.e. no allowable loss can arise on nominal rent leases).

1.4 Furnished holiday lettings

Income from FHL is assessed separately from other UK property income and treated as earned income, not investment income.

Therefore, profits of FHL are:

- not pooled with other UK property income
- treated as if profits of a separate **trade**
- assessed using the **trading income assessment rules**, not the property income rules, and
- included in the income tax computation as earned income, not as investment income.

There are several key advantages in treating the income as earned income as opposed to investment income as outlined in the table below.

Tax	Advantage
Income tax	■ instead of a wear and tear allowance or renewals basis, normal capital allowances are available on *all* plant and machinery, including fixtures, fittings and furniture ■ if a loss arises, relief is available under the trading income rules (see later) rather than the property income rules which only allow the carry forward of relief against future property income ■ the profits are treated as net relevant earnings for personal pension relief purposes
Capital gains tax	■ the property is treated as a business asset rather than an investment asset, therefore the following reliefs are available: – Entrepreneurs' relief – Rollover relief – Gift relief.

However, property income can only be treated in this way if the property satisfies the definition of furnished holiday lettings.

To be treated as FHL **all** of the following conditions must be satisfied:

- the property is situated in the **European Economic Area**, and
- is **furnished**, and
- is let on a **commercial** basis with a view to making profits, and

- is **available** for letting as holiday accommodation for at least **140 days** in the tax year, and
- is actually **let** for at least **70 days** in the tax year, and
- is **not normally** occupied for periods of longer-term occupation (i.e. **more than 31 consecutive days** by the **same** person).

If an individual has more than one property, a property may be treated as a FHL if it fails the 70 day test provided the average number of days letting for all properties is at least 70 days.

If the property is let continuously to the same person for more than 31 days, and the **total** of all periods of longer-term occupation **exceeds 155 days** in any 12 month period, the property will **not** be treated as a **FHL**.

1.5 Rent-a-room relief

Where an individual rents out **furnished** accommodation which is **part of his main residence** (e.g. rents a furnished bedroom in his house or flat to a lodger), any rental income receivable is assessed to income tax as property income. However, rent-a-room relief is available.

The relief operates as follows:

Gross rental income (before expenses and allowances):	**Property income assessment**	**If a loss arises**
£4,250 or less	Nil – the income is exempt	No allowable loss arises **unless** an election made for a normal property income loss to arise The election: ■ must be made within 12 months after 31 January following the end of the tax year ■ is only valid for the tax year of that loss
More than £4,250	Lower of ■ Normal property income assessment ■ (Rents accrued less £4,250) but only if an election is made	Normal property income loss arises
	The election: ■ must be made within 12 months after 31 January following the end of the tax year	

Gross rental income (before expenses and allowances):	Property income assessment	If a loss arises
	■ is binding until revoked, or gross rents accrued are £4,250 or less.	

Note that the limit of £4,250 is halved to £2,125 if the income received from letting the room is shared with any other person(s).

Example

Ivor rented a furnished bedroom in his house to a lodger for the whole of 2009/10.

Required

Calculate Ivor's property income assessment for 2009/10 assuming the following four different situations:

	Rental income	Allowable expenses including wear and tear allowance
		£
(a)	£500 per month	3,260
(b)	£500 per month	5,260
(c)	£335 per month	3,260
(d)	£335 per month	5,260

Answer

Ivor's property income assessment – 2009/10

(a)

Gross rents exceed £4,250	No election	With election
	£	£
Gross rents accrued (£500 × 12)	6,000	6,000
Less Allowable expenses/Rent-a-room relief	(3,260)	(4,250)
Assessed on the lower of	2,740	1,750

Ivor will be assessed on £1,750 but only if he makes an election by 31 January 2012 for the rent-a-room relief to apply. The election will remain in force until revoked by Ivor or until the gross rents in the future are £4,250 or less.

(b)

Gross rents exceed £4,250	No election	With election
	£	£
Gross rents accrued (£500 × 12)	6,000	6,000
Less Allowable expenses/Rent-a-room relief	(5,260)	(4,250)
Assessed on the lower of	740	1,750

Ivor will be assessed on £740 automatically. He will not wish to make the rent-a-room relief election.

(c)

Gross rents less than £4,250

Gross rents accrued (£335 × 12) = £4,020

Expenses are less than the rents accrued; therefore a profit is made but is exempt under the rent-a-room relief provisions.

Property income assessment is £Nil.

(d)

Gross rents less than £4,250	No election	With election
		£
Gross rents accrued (£335 × 12)	No allowable	4,020
Less Allowable expenses	loss arises	(5,260)
Allowable loss		(1,240)

Ivor will not be eligible for an allowable loss unless he makes an election for the normal property income loss of £1,240 to arise. He must elect by 31 January 2012 and the election is valid for 2009/10 only.

Income from leases

- Premiums received on the granting of a short lease
- Granting a sub-lease
- Reverse premiums

2 Income from leases

2.1 Premiums received on the granting of a short lease

The treatment of lease premiums is the same for both individuals and companies. The key points to remember are as follows:

- An assessment only arises on the **granting** of a **short** lease.
- **Granting** a leasehold interest in a property means that the owner of the property (i.e. the landlord) is giving the tenant the **exclusive right of use** of the property for the duration of the lease; when the lease terminates, the property reverts back to the owner.
- A **short** lease is defined as a leasehold interest of **not more than 50 years** in duration.
- A property income assessment arises on:
  - the **premium** (i.e. a lump sum amount) received at the start of the lease
  - the rent receivable for the use of the property.
- The assessment on the premium received is calculated as follows:

	£
Premium received	X
Less 2% × premium × (n – 1)	(X)
Property income assessment on the landlord	X
where: n = number of years of the lease	

- The number of years of the lease runs from the start of the lease to the **earliest date on which the lease may be terminated** by either the landlord or the tenant under the terms of the lease.

Example

Jacob granted a 35 year lease to Karen on 1 October 2009 for a premium of £65,000. Jacob charges rent of £5,000 pa payable in advance on a quarterly basis starting on 1 October 2009.

Required

Calculate Jacob's property income assessment for 2009/10.

Answer

	£
Premium received	65,000
Less 2% × £65,000 × 34	(44,200)
Assessable premium	20,800
Rental income accrued in 2009/10 (£5,000 × 6/12)	2,500
Total UK property income assessment for 2009/10	23,300

2.2 Granting a sub-lease

Where a taxpayer has been granted a short lease, he has exclusive right of use of the property for the duration of the lease. If he does not wish to use the property himself, he may be allowed under the terms of the lease to sub-lease the property (i.e. grant a short lease out of his own short lease interest).

For granting the sub-lease the taxpayer may receive a premium which will give rise to a property income assessment. However, an allowable deduction is available. This allowable deduction is based on the amount of the premium originally assessed as property income on the original lease (known as the 'head lease').

The calculation of the property income assessment on granting a sub-lease is as follows:

	£
Premium received from granting sub-lease	X
Less 2% × premium × (n – 1)	(X)
	X
Less Allowable deduction	
Amount of premium originally assessed as property income on the head lease $\times \dfrac{\text{Length of sub-lease}}{\text{Length of head lease}}$	(X)
Property income assessment	X
where: n = number of years of the lease	

Example

Assume in the previous example that Karen, the holder of the short lease, grants a 10 year sub-lease to Lena for a premium of £12,500 on 31 July 2010.

Required

Calculate Karen's property income assessment on the premium received in 2010/11.

Answer

	£
Premium received from granting the 10 year sub-lease	12,500
Less 2% × £12,500 × 9	(2,250)
	10,250
Less Allowable deduction $£20{,}800 \times \frac{10 \text{ years}}{35 \text{ years}}$	(5,943)
Karen's property income assessment re-premium received in 2010/11	4,307

2.3 Reverse premiums

A reverse premium occurs when a landlord pays the tenant a lump sum in order to encourage the tenant to enter into the lease arrangement with him.

The landlord cannot obtain tax relief for the reverse premium paid unless he deals in land and buildings, in which case he can deduct the amount paid as a trading expense.

The tenant is normally taxed on the premium received over the duration of the lease as property income. However, if the transaction was for a trading purpose, the income is assessed as trading income.

Tax-free investments
■ Individual Savings Accounts ■ The Enterprise Investment Scheme and Venture Capital Trusts

3 Tax-free investments

3.1 Individual Savings Accounts

An investment in an Individual Savings Account (ISA) has the following taxation advantages:

- All income is exempt from income tax (e.g. interest, dividends, bonuses)
- All capital gains on the disposal of capital assets (e.g. shares) while in the ISA are exempt from capital gains tax
- If capital assets are transferred out of the ISA to the individual, the deemed base cost of the asset to the individual is equal to the market value at the date of transfer (i.e. any increase in value in the asset while it was in the ISA is exempt from capital gains tax).

The taxation exemptions are available even if the individual makes withdrawals from the account at any time.

Investment is allowed in accounts comprised of the following components:

- Cash products

  (e.g. bank and building society accounts, some NSB accounts)
- Qualifying stocks and shares and insurance products

  (e.g. quoted ordinary or preference shares and securities with at least five years until maturity such as debentures, other corporate bonds and gilt-edged securities, unit trust investments and term assurance or whole life insurance).

  Note that qualifying shares and securities must be quoted on a recognised stock exchange anywhere in the world, but do not include those quoted on the Alternative Investment Market (AIM).

Maximum annual investment in each component:	
– cash products	£3,600 (£5,100 if the individual is aged 50 or over)
– stocks, shares and insurance products	£7,200 (£10,200 if the individual is aged 50 or over)
Maximum annual total investment:	£7,200
Individual must be:	■ Aged 16 or over (for the cash component) ■ Aged 18 or over (for the shares component) ■ Resident and ordinarily resident in the UK

Notes

(1) An individual can invest all £7,200 (£10,200 if applicable) in qualifying stocks and shares and insurance products, or he can invest in both components. If he invests in both components, he cannot invest more than £3,600 (£5,100 if applicable) in cash products.

(2) The cash and shares components can be invested with different providers or with the same provider.

3.2 The Enterprise Investment Scheme and Venture Capital Trusts

To encourage individuals to invest in more risky investments, the Government created the Enterprise Investment Scheme (EIS) and Venture Capital Trusts (VCTs).

The EIS encourages investment in small unquoted UK trading companies. An individual can invest **directly** in any fresh issues of ordinary shares from a company eligible for the scheme and thereby obtain tax advantages.

A VCT is a quoted company with readily marketable shares, approved by HMRC, whose income is derived wholly or mainly from shares and securities of small unquoted trading companies.

An individual can therefore invest **indirectly** in a wide portfolio of unquoted trading company investments by investing in a fresh issue of ordinary shares in a VCT (i.e. a single investment) and obtain tax advantages.

Investments in either an EIS company or a VCT are high risk investments as they are in small unquoted companies which do not usually have a proven track record. An investment in a VCT spreads the risk over a number of unquoted companies, but nonetheless is a high risk investment.

The schemes provide a valuable source of funds to small companies trading in the UK which would otherwise find difficulty in raising external finance.

Provided the individual is a qualifying investor who:

- subscribes wholly in cash
- for new ordinary shares
- in a qualifying EIS company or VCT, and
- keeps the shares for a minimum retention period

the following tax advantages are available:

- Income tax investment relief on the cost of the investment, and
- Income tax exemption on dividends received from VCT shares, and
- Capital gains tax exemption on the disposal of the shares, and
- Capital gains tax reinvestment relief on the gain arising on other assets if the reinvestment is in EIS shares.

Conditions for reliefs

The conditions for both schemes are similar and summarised below:

	EIS	VCT
Qualifying investor	Any individual except: ■ employees or directors of the company ■ those holding at least 30% of the shares in the company ■ however, the individual can become a paid director after the shares are issued	
Qualifying EIS company or VCT	Unquoted company trading in the UK: ■ includes AIM shares ■ does not have to be UK resident	Quoted company approved by HMRC: ■ at least 70% of VCT's investments must be in unquoted trading companies ■ not more than 15% in any one company ■ at least 30% of VCT's investments = new ordinary shares ■ at least 10% of every investment in any company must be in ordinary shares
Unquoted companies ultimately invested in	Must be carrying on a qualifying trade (excluding financial, accountancy and legal services, and property based businesses) Must use the whole of the funds in the qualifying trade within two years of the share issue Must have no more than 50 full-time employees Gross asset value: £7 million before the share issue £8 million after the share issue	
Amount of investment qualifying for relief	Min £500 per company Max £500,000 per annum	No minimum Max £200,000 per annum
Retention period	Minimum three years	Minimum five years

Tax advantages

The tax advantages for both schemes are similar and summarised below:

	EIS	VCT
Income tax investment relief	*Method of relief:* ■ Deduct a tax credit from the income tax liability ■ In the tax year in which the shares are issued	

	EIS	VCT
	■ VCT relief given before EIS relief ■ Reliefs can reduce the liability to nil but cannot create a repayment of tax ■ Carry back relief available for EIS but not VCT (see below) *Withdrawal of relief:* Relief withdrawn if shares not held for minimum retention period *Amount of relief:*	
	subscription price × 20%	subscription price × 30%
Dividend income from the shares	Taxable as normal dividends	Exempt if from the £200,000 qualifying shares Excess = taxable as normal dividends (10% tax credit is not repayable)
Capital gains tax exemption	*Gain on the disposal of the qualifying investment:*	
	Exempt if held more than three years Chargeable if not held for at least three years	Exempt regardless of retention period
	Loss on the disposal of the qualifying investment:	
	Allowable loss arises regardless of retention period The cost must be reduced by any income tax relief that has not been withdrawn	Not an allowable loss regardless of retention period
Capital gains tax reinvestment relief	Available (see below)	Not available

Carry back relief

A claim can be made to treat the whole or part of any EIS shares as if they were issued in the previous year. As a result relief is obtained in the previous tax year. There is no limit on the amount that can be carried back provided the EIS limit for the previous year is not exceeded.

There is no carry back relief available for VCT investments.

Allowable capital loss arising on the disposal of EIS shares

Where a capital loss arises on the disposal of qualifying EIS shares the loss can be utilised as follows:

- against capital gains in the normal way, or

- under s131 ITA 2007, against the individual's total income for:
  - the year of the loss and/or
  - the preceding year

    (i.e. treat in the same way as a s64 trading loss – see later).

A s131 claim must be within one year of 31 January following the end of the tax year of the loss (i.e. for 2009/10 by 31 January 2012).

The maximum amount possible must be set off against total income in any tax year in which the claim is made.

Reinvestment relief

The chargeable gain arising on the disposal of **any asset** may be deferred where the disposal proceeds are invested in new **EIS shares** within 12 months before and 36 months after the date of the disposal.
The gain on the disposal of the asset is calculated in the normal way. A reinvestment relief claim can then be made to defer the gain until the later disposal of the EIS shares.
The individual can defer **any amount** of the gain up to a maximum amount. The maximum deferral is the lower of:

- all of the gain
- the amount invested in subscribing for new EIS shares.

Note that the £500,000 maximum limit for investment in EIS shares does not apply for capital gains reinvestment relief, as there is no requirement for the EIS shares to qualify for income tax relief.

If an individual invests £600,000 in EIS shares, he will obtain income tax investment relief on £500,000 but £600,000 will be the figure taken into account for capital gains reinvestment relief.

As the individual can defer any amount of the gain up to the maximum amount, the individual can choose:

- to crystallise a gain which will utilise his annual exemption and available losses, and
- to defer the balance.

When the EIS shares are disposed of, there are two capital gains implications:

- the gain arising on the EIS shares is exempt if the shares have been held for three years or an allowable loss arises (as explained above)
- in addition, the deferred gain under the reinvestment relief claim becomes chargeable.

Example

Lucy disposed of an asset for £250,000 which gave rise to a gain of £68,000 on 14 June 2009.

In August 2009 Lucy subscribed for shares in KPG Ltd, a qualifying EIS company. The shares cost £90,000. Lucy has made no other capital disposal in 2009/10 and has capital losses of £1,900 brought forward.

Required

(a) Calculate the amount of the reinvestment relief claim Lucy should make and the base cost of the EIS shares for capital gains tax purposes.

(b) Explain the consequences of disposing of the EIS shares in five years time at a substantial profit.

Answer

(a) Maximum deferral = lower of

(i)	the gain	£68,000
(ii)	the amount invested in EIS shares	£90,000

Lucy can therefore defer **any amount up to** £68,000.
Lucy has no other gains and therefore wants to utilise her annual exemption and capital losses in full and defer the balance of the gains as follows:

	£
Gain	68,000
Less Reinvestment relief	(56,000)
Gain after reinvestment relief	12,000
Less Capital losses	(1,900)
Chargeable gain	10,100
Less Annual exemption	(10,100)
Taxable amount	Nil

Lucy will therefore make a reinvestment relief claim for £56,000.

The base cost of the EIS shares will be £90,000.

(b) The £56,000 gain is deferred and becomes chargeable when the EIS shares are disposed of in five years' time. The gain is not rolled over and deducted from the base cost of the EIS shares. A record of the gain is kept until the gain crystallises in the future.

The chargeable gain in five years' time will be £56,000.

Any gain arising on the EIS shares will be exempt as they have been held for more than three years.

The deferred gain will also become chargeable if the EIS shares cease to be eligible shares and if the individual ceases to be UK resident within three years of the issue of the EIS shares.

The accrued income scheme

- The need for the accrued income scheme
- The taxation of accrued income on the sale of securities

4 The accrued income scheme

4.1 The need for the accrued income scheme

Anti avoidance legislation exists to prevent interest on marketable securities (e.g. gilt-edged securities, debentures and loan stock) from escaping tax.

As interest payments are made on predetermined dates, it is possible for a vendor to sell securities shortly **before** the interest payment date **at an inflated price** to reflect the fact that they will not receive the next interest payment. The securities are being sold 'cum interest', at a price which includes accrued interest.

However, the interest element of the selling price is treated as a capital receipt and is therefore not liable to income tax. In addition, as gilt-edged securities and qualifying corporate bonds are exempt assets for capital gains purposes, there is no capital gains tax liability on the sale.

4.2 The taxation of accrued income on the sale of securities

If an individual owns securities with a total nominal value in excess of £5,000 at some time in the tax year, the accrued income scheme requires the selling price of those securities to be apportioned between an income element and a capital element.

The interest is deemed to accrue on a daily basis and is assessed as savings income in the normal way. The capital element is exempt from tax.

CHAPTER

4

Income from employment

Contents

Deciding whether an individual is employed or self-employed

- The problem of deciding whether an individual is employed
- Factors to determine the status of an individual

1 Deciding whether an individual is employed or self-employed

1.1 The problem of deciding whether an individual is employed

An employed person is taxed under the employment income rules and a self-employed individual is taxed under the trading income rules. It is therefore important to establish whether an individual is employed or self-employed.

To determine the status of an individual it is necessary to establish the terms of the relationship between the individual and the organisation paying for the work.

The tax legislation states that:

- an employee is deemed to have a **'contract of service'** with an employer, whereas
- a self-employed individual is deemed to have a **'contract for services'**, i.e. a supplier/client contract where the individual is contracted to provide his services to the client organisation which pays for the services.

1.2 Factors to determine the status of an individual

In cases where there is doubt regarding the status of the individual, HMRC will consider the factors outlined below.

There is no single factor that is more important than another, and no single factor on its own will determine the treatment. HMRC will look at all of the facts of the given situation and make a decision.

Degree of control

A **self-employed individual** usually controls his own work, is not supervised in the performance of the work, and is contracted to produce a result.

Once the contract has been completed, a self-employed individual has no right to expect further work from the organisation, but equally has no obligation to take on further work with the organisation if he does not wish to do so.

However, an **employee** usually expects the employer to specify each task to be performed, to determine where, when and how it is to be performed, and to control and supervise the performance of each task. Once a task is completed, an employee has the right to expect further work and has an obligation to perform the work.

Provision of the tools of the trade

A **self-employed individual** is usually expected to provide his own equipment and materials for the work to be performed. However, an **employee** would expect the employer to provide the tools required to perform the tasks expected of him.

Degree of financial risk

A **self-employed individual** runs the risk of losing his own personal assets and capital if the business operates at a loss and/or fails. He is also personally responsible for the cost of his mistakes and the correction of sub-standard work.

However, an **employee** bears no personal financial risk. He will be paid whether or not the business is profitable and is not personally responsible for the cost of correcting mistakes.

Ability to delegate work

A **self-employed individual** is usually contracted to produce a result, but he may subcontract and delegate work to others. This is often referred to as the ability to provide a substitute.

An **employee** has an obligation to perform the tasks asked of him. Delegation to another employee within the same organisation is normal business practice; however an employee has no right to delegate work to others outside the organisation.

The client base

A **self-employed individual** will usually have a wide client base with a number of customers. However, an **employee** normally works for one employer only and is often prevented from working for others under the terms of his employment contract.

Extent of enjoyment of normal employment rights

An **employee** is entitled to normal employment rights such as the receipt of an agreed remuneration package. In addition, the individual and the employer are protected by employment law.

By law, an employee has the right to claim holiday pay, statutory sick pay etc. However, he is also subject to the disciplinary rules of the organisation. He is usually paid at regular intervals, and his tax and national insurance are deducted at source under the PAYE (pay-as-you-earn) scheme.

A **self-employed individual** is not entitled to the same rights and is not protected by employment law. He will not be paid unless the work is satisfactorily completed and he has no entitlement to holiday pay or sick pay. To be paid he must issue an invoice for the work performed and he will receive the income gross. It is his responsibility to self-assess the tax due on his trading profits.

The employment income assessment

2 The employment income assessment

2.1 The scope of employment income

An employed individual is assessed on all earnings received from his employment after allowable expenses and deductions.

Earnings in this context means not only cash amounts received (such as salary, bonuses, commissions, termination payments) for services provided in the past but includes **all** forms of remuneration **including:**

- **benefits** derived from the employment
- amounts paid for services to be provided **in the future** (for example, an inducement to enter into employment, known as a 'golden hello', where the payment represents an advance of salary)
- amounts paid for the acceptance of a **restrictive covenant** (for example, where an employee agrees not to work for a competitor for a defined period after leaving employment)
- amounts the employee is **contractually entitled** to under his employment contract (for example, awards or presents, payments in lieu of notice and loss of office payments, known as 'golden handshakes') (but redundancy and **ex gratia** payments are treated differently as explained later).

Employment income also includes:

- any payments received as a result of the office or employment **regardless** of who pays them (for example, payments by third parties such as tips and gifts are assessable if received as a result of the employment), and
- some taxable social security income, such as statutory sick pay (SSP), statutory maternity pay (SMP), incapacity benefit, jobseeker's allowance.

2.2 The basis of assessment for employment income

Employment income is assessed on a **cash receipts basis**. This means that employment income is assessed in the tax year in which the cash or benefit is **received**, not necessarily when it is earned.

Date of receipt

The date of receipt is the **earlier** of:

(1) the date the employee becomes **entitled** to receive the income, and

(2) the date the income is **actually received** by the employee.

Date of receipt for directors

As directors are in a position to manipulate their income tax liability by deliberately accelerating or delaying the receipt of income between tax years, the date of receipt for directors is the **earliest** of:

(1) the date the director becomes **entitled** to receive the income

(2) the date the income is **actually received** by the director

(3) the date the **financial accounts are credited** with an amount for the director on account of earnings

(4) where earnings are determined (for example, at a directors' board meeting):

- before the end of the accounting period, the last date of the accounting period, or
- **after** the end of the accounting period, the **date the amount of earnings** for that period is **determined.**

2.3 The basis for assessing benefits

Benefits which are not received in cash (e.g. company cars) are assessed according to the benefits code provided in the tax legislation which sets out:

- the general rules that must be applied to value a benefit for taxation purposes, and
- specific statutory rules to value some particular benefits.

There are three main sets of rules on benefits:

- Exempt benefits
- Benefits assessed on all employees
- Benefits assessed on 'P11D employees' only.

2.4 Exempt benefits

Exempt benefits are not subject to income tax. The most common examples are listed below:

- Employer contributions to a registered pension scheme
- Pension advice, provided it is available to all employees and costs no more than £150 per employee per tax year
- Employee liability insurance, permanent health insurance (note: this is not the same as private medical insurance, which is a taxable benefit) and death in service benefit
- The provision of eye tests and corrective glasses for employees using VDUs
- Subsidised canteen meals, provided they are available to all employees
- Work place nurseries
- Child care payments of up to £55 per week, provided the childcare is available to all employees and the employer either contracts with an approved child carer or provides vouchers to pay an approved child carer (any excess over £55 is taxable)
- Overnight expense allowance of up to £5 per night if working in the UK and £10 per night if working overseas. If exceeded, the full allowance is taxable, not just the excess
- Overseas medical insurance and treatment, if the employee is working abroad
- The provision of one mobile phone per employee (but not the cost of the employee's own phone or top-up vouchers for the employee's own phone)
- The provision of a car parking space (or reimbursement of the cost of parking) at or near the place of work
- Benefits aimed at encouraging employees to travel to work by means other than by car (for example, the provision of bicycles, bicycle safety equipment, buses to work – note that trains, trams and tubes are not included within these provisions)
- Car mileage allowances for the use of employee's own car within statutory limits (Authorised mileage allowance payments, known as 'AMAPs')
- Sporting and recreational facilities, provided they are available to all employees and are not available to members to the public generally (for example, membership of a gym open to the public is not an exempt benefit)
- The provision of work-related training courses
- Staff entertaining (such as the staff Christmas party, staff outings), provided this is available to all staff and the total cost of all events in a tax year does not exceed £150 per employee. Any excess over £150 is taxable.
- Entertainment provided by a third party (such as a ticket to attend a sporting event or concert) to generate goodwill. No monetary limit applies.
- Contributions towards costs of working at home, up to £3 per week without the need for supporting documentation: contributions in excess of £3 require documentation in order to be tax-free
- Relocation / removal costs of up to £8,000. The exemption covers all the expenses of disposing of the old property and buying the new one, removal

expenses, purchasing replacement goods such as carpets and curtains, and bridging loan costs. To qualify, the expenditure must be incurred by the end of the tax year following that in which the new job commenced

- Luncheon vouchers of up to 15p per day
- Counselling services for the welfare of employees (for example, outplacement counselling for redundant employees)
- Gifts from third parties of up to £250 per tax year if received as a result of employment
- Non-cash long service awards (for example, a gold watch) with a value of up to £50 per year of service, provided the employee has had at least 20 years of service with the employer and has received no similar award in the previous 10 years
- One health screening and one medical check-up per tax year.

2.5 Definition of 'P11D' and 'lower paid' employees

Under the PAYE system, the employer must complete P11D forms each year in respect of certain employees, declaring the benefits received by those employees in the tax year.

P11D employees are defined as:

- directors (see below), and
- employees who earn **at a rate of** more than £8,500 per annum.

Employees who do not satisfy the definition of a P11D employee are usually referred to as 'lower paid employees' (LPEs).

All directors are P11D employees **unless** they:

- work full-time in a technical or managerial capacity, **and**
- control no more than 5% of the company's ordinary share capital, **and**
- earn less than £8,500 per annum.

To determine whether an employee (or a director) earns at a rate of more than £8,500, the £8,500 limit is compared to the following calculation:

	£
Wages / salary	X
Bonuses / commissions	X
Assessable benefits (valued as if the employee **is** a P11D employee)	X
	X
Allowable deductions	
Employee pension contributions	(X)
Donations to charity under an approved payroll giving scheme	(X)
Earnings for the purposes of deciding whether an employee is a P11D employee	X

In order to calculate 'earnings' it is initially assumed that the employee **is** a P11D employee and **all** benefits applicable to a P11D employee are included in the calculation.

If it is decided that the employee is **not** a P11D employee, the benefits that do **not** apply to a LPE are excluded in the employment income computation.

2.6 The general rules for assessing benefits

There are two general valuation rules for assessing benefits. These rules apply to:

- all benefits not specifically exempt, and
- all benefits not subject to specific statutory valuation rules (described later).

There is one general valuation rule for LPEs and one for P11D employees.

Lower paid employees

In general, LPEs are only assessed on benefits which are convertible into cash, and the value of a benefit to an LPE is the cash equivalent of the benefit provided.

The **cash equivalent** of a benefit is defined as the cash sum that would be received if the benefit were sold to a third party (in essence, the second-hand value).

P11D employees

In general, P11D employees are assessed on benefits provided to them, or to a close relative, regardless of whether the benefit can be converted into cash.

The value of a benefit to a P11D employee is the cost to the employer of providing the benefit. **Cost to the employer** means the marginal cost or incremental cost to the employer providing the benefit.

Two further general valuation rules

When measuring the taxable amount of benefits, two further general rules apply to most assessable benefits as follows:

- **Contributions made by the employee.**
  Where the employee pays a contribution to his employer towards the provision of the benefit, the value of the benefit is **reduced by the employee's contribution**. The only exception to this general rule is the provision of private fuel (explained later).
- **Provision of a benefit for only part of the tax year.**
  Where a benefit is only provided for part of the tax year, the general rule is that the benefit is **time-apportioned** according to the number of months the benefit has been received during the tax year.

2.7 Proforma employment income computation

The employment income assessment is calculated as follows:

	£
Wages / salary	X
Bonuses / commissions	X
Assessable benefits (sections 3 and 4)	X
	X
Allowable deductions (section 5)	
Employee pension contributions	(X)
Donations to charity under an approved payroll giving scheme	(X)
Subscriptions to professional bodies	(X)
Expenses incurred wholly, exclusively and necessarily	
e.g. Travel and subsistence expenses	(X)
Entertaining expenses	(X)
AMAP deduction	(X)
Employment income	X

Benefits assessed on all employees

- Living accommodation benefits
- Vouchers
- Company credit cards

3 Benefits assessed on all employees

3.1 Living accommodation benefits

The amount of living accommodation benefit on which an employee is assessed varies according to:

- whether the employee is a LPE or P11D employee, and
- whether the living accommodation is job-related or not.

The detailed rules are covered in the next section.

3.2 Vouchers

- Vouchers exchangeable for goods or services (such as gift vouchers and travel season tickets) are assessable benefits unless they are specifically exempt.
- All employees are assessed on the cost to the person providing the vouchers.

3.3 Company credit cards

- Where an employee uses a company credit card, he will be assessed on whatever has been charged to the card but not any charges in relation to acquiring the card or in respect of late payment (e.g. interest).
- A deduction from employment income will be allowed in the normal way if the expenditure satisfies the 'wholly, exclusively and necessarily' tests (explained later).

Benefits assessed on P11D employees only

- The provision of a company car
- The provision of private fuel
- The provision of a van
- Authorised mileage allownce payments (AMAPs)
- Living accommodation benefits
- The private use and gifts of business assets
- The provision of beneficial loans

4 Benefits assessed on P11D employees only

4.1 The provision of a company car

If a P11D employee is provided with a company car that can be used for both business and private use, he will be assessed on the benefit of the private use. The benefit is based on the manufacturer's list price of the car and the CO_2 (carbon dioxide) emissions of the car.

If a P11D employee has the benefit of private use of one or more company cars, the assessable benefit for each car is calculated separately as follows:

	£		£
Manufacturer's list price (MLP)	X		
Less Employee's capital contribution			
(max £5,000)	(X)		
(max £80,000)	X	at appropriate %	X
Less Employee's contribution for the use of the car			(X)
Car benefit			X

The manufacturer's list price (MLP) is:

- the published price of the car when it was new and first registered, including VAT, delivery charges, standard accessories provided with the car, optional accessories provided with the car and optional accessories provided at a later date which cost in excess of £100
- reduced by any contribution by the employee towards the capital cost of the car, including qualifying accessories, subject to a **maximum deduction of £5,000**
- **restricted to a maximum of £80,000,** after deducting the employee's capital contribution.

The **appropriate annual percentage** to apply to the MLP depends on the car's CO_2 emissions.

- If the CO_2 emissions are more than 120 g/km but no more than 135 g/km, the appropriate annual percentage is 15% for a petrol engine car and 18% for a diesel engine car.
- The percentage increases by 1% per annum for each additional 5 g/km of emissions above the base figure of 135 g/km, up to a maximum percentage of 35% whether a petrol or diesel engine car.
- A lower rate of 10% is applied for motor cars with a CO_2 emission rate of 120 g/km or less. This lower rate is increased to 13% for diesel cars.

The appropriate annual percentage (for cars whose CO_2 is in excess of 135 g/km) is therefore calculated as follows:

	g/km		Petrol	Diesel
The car's CO_2 emissions in g/km			%	%
(rounded down to the nearest 5 g/km)	X			
Less Base level of CO_2 emissions (i.e. 135 g/km for 2009/10) (see tax rates and allowances)	(135)			
	X	÷ 5 g/km	X	X
Plus Minimum percentage			15	18
Appropriate annual percentage			X	X
			Restricted to a maximum of 35%	

If an employee does not have the use of the car for the whole tax year, the benefit is time-apportioned.

This applies if the car is:

- acquired or disposed of during the year, or
- made unavailable to the employee for at least 30 consecutive days during the year.

Note that the assessable benefit is for the car's availability for **private use.** There is no assessable benefit if the car is used **entirely for business** purposes. However, in practice, most company cars are considered to be available for private use and so a taxable benefit will arise.

Costs covered by the car benefit

The car benefit covers all the capital and running costs incurred by an employer in providing the use of the car (for example, car tax, insurance, repairs and maintenance).

Any information about these associated costs in an examination question should be ignored, as they have already been taken into account in the calculation of the car benefit.

Cash alternative

Where an employer offers a cash alternative to an employee instead of offering a company car, the employee will be taxable on the amount of cash received in lieu of a car.

Pool cars

There is no assessable benefit if the employee has the use of a pool car.

A pool car is defined as a car which is:

- **not** allocated to a particular employee and which is available for use by more than one employee, **and**
- **not** normally garaged at or near any employee's home overnight, **and**
- used primarily for business purposes, any private use by an employee being incidental to its use for business purposes.

4.2 The provision of private fuel

An additional benefit arises if an employee is provided with a company car and is also provided with fuel for his **private** mileage.

An employee is automatically taxed on a fuel benefit, **unless:**

- the employee pays for all his fuel and the employer only reimburses the business mileage cost, or
- the employer pays for all the fuel and the employee reimburses the employer for all his private mileage cost, or
- the fuel is for a pool car.

Note that where the employer pays for the private fuel and the employee makes a contribution towards the cost of private mileage but **does not pay for all the private mileage costs,** the fuel benefit will be assessed on the employee **in full** with no deduction allowed for the employee's contributions.

Calculating the private fuel benefit

The private fuel benefit is based on the car's CO_2 emissions and a base figure set by HMRC each tax year. The base figure for 2009/10 is £16,900 and is given in the tax rates and allowances provided in the examination.

The private fuel benefit is therefore calculated as follows:

Private fuel benefit	= £16,900	×	Appropriate percentage (same percentage as used in calculating the car benefit)

Note that the percentage is an **annual** percentage. Therefore, if an employee does not have the use of the car for the whole tax year, the fuel benefit as well as the car benefit is time-apportioned.

This applies if the car is:

- acquired or disposed of during the year, or
- made unavailable to the employee for at least 30 consecutive days during the year.

The fuel benefit can also be time-apportioned where the fuel is only provided for part of the year. However, time-apportionment in this situation applies only if the withdrawal of fuel is **permanent** rather than temporary.

Example

Matthew and Neville are higher paid employees. They are provided with the following company cars:

	Matthew	**Neville**
Type of car	Peugeot	Renault
Type of engine	Petrol	Diesel
Date car was made available	6 July 2008	6 November 2009
Manufacturer's list price	£22,260	£21,560
CO_2 emissions	158 g/km	194 g/km
Capital contribution	£5,700	Nil
Contribution for the use of the car	£65 per month	£30 per month

Required

Calculate the car and fuel benefits assessable on Matthew and Neville in 2009/10.

Answer

	Matthew	**Neville**		**Matthew**	**Neville**
	g/km	g/km		Petrol %	Diesel %
CO_2 emissions					
(rounded down to nearest 5 g/km)	155	190			
Base level of CO_2 emissions	(135)	(135)			
	20	55	÷ 5 g/km	4	11
Minimum percentages				15	18
Appropriate percentages				19	29
Number of months car available in 2009/10				12	5

	£		£
Matthew's car benefit			
Manufacturer's list price	22,260		
Less Matthew's capital contribution (restricted)	(5,000)		
	17,260	at 19%	3,279
Less Contribution for the use of the car (£65 × 12)			(780)
Car benefit			2,499
Neville's car benefit			
Manufacturer's list price	21,560		

	£		£
Less Neville's capital contribution	(Nil)		
	21,560	at 29% × 5/12	2,605
Less Contribution for the use of the car (£30 × 5)			(150)
Car benefit			2,455
Matthew's fuel benefit	16,900	at 19%	3,211
Neville's fuel benefit	16,900	at 29% × 5/12	2,042

4.3 The provision of a van

If a P11D employee is provided with a van which can be used for both business and private use, he will be assessed on the benefit of the private use **unless** the only private use is ordinary commuting (i.e. from home to work).

The assessable benefit is a fixed annual scale rate of £3,000.

There is also a separate private fuel benefit if fuel is provided for private mileage in a van. This is £500 a year.

Note that these scale rates are annual rates. Therefore if the van and/or the fuel are only available for part of the tax year, the scale rates are time-apportioned.

Note also that these scale rates are **not** provided in the tax rates and allowances in the examination.

4.4 Authorised mileage allowance payments (AMAPs)

As an alternative to an employer providing an employee with a company car, the employee may buy and run his own car and claim a mileage allowance from the employer for business travel.

HMRC allow tax-free authorised mileage allowance payments (AMAPs) for:

- the use of privately-owned cars, vans, motor cycles and bicycles, and
- carrying one or more colleagues as passengers in a privately-owned car or van making the same business trip.

If required, the appropriate AMAPs will be given in the examination question.

The consequences of receiving a mileage allowance from an employer are as follows:

If the mileage allowance received is:	**Consequence:**
■ equal to the AMAP	■ the allowance received is tax-free ■ no benefit arises
■ in excess of the AMAP	■ assessable benefit arises ■ benefit = excess allowance received

■ less than the AMAP	■ an allowable deduction from employment income is available ■ deduction = shortfall of allowances received

Example

Owen uses his own car for business travel. During 2009/10 his business mileage was 16,000 miles, for which his employer paid him 47p per mile. Included in this mileage was a trip to Plymouth to a business conference, totalling 480 miles. Owen took his colleague Penny to the conference in his car, and received £65 for taking Penny as a passenger.

The AMAP for a car is 40p for the first 10,000 miles and 25p thereafter. The passenger rate is 5p per passenger per mile.

Required

Calculate the assessable benefit, if any, arising on Owen as a result of receiving the mileage allowances.

Answer

		£	£
Mileage allowance received	16,000 × 47p		7,520
AMAP – for the car	10,000 × 40p	4,000	
	6,000 × 25p	1,500	
			(5,500)
			2,020
Passenger allowance received		65	
AMAP – passenger allowance	480 × 5p	(24)	
			41
Assessable benefit			2,061

4.5 Living accommodation benefits

As previously stated, the amount of the assessable benefit varies according to whether:

- the employee is a LPE or a P11D employee, and
- the living accommodation is job-related accommodation or not.

Definition of job-related accommodation

Job-related accommodation is accommodation provided by the employer for one of the following reasons:

- It is **necessary** for the employee to live in the accommodation for the **proper performance** of his duties (e.g. school caretaker)

- It is not necessary, but it is **customary** for such accommodation to be provided in that type of employment **and** it **assists the better performance of his duties** (e.g. vicar, hospital staff, hotel staff, policemen etc)
- It is provided as **part of security arrangements** as there is a special threat to the employee's security (e.g. Prime Minister's official residence).

Living accommodation that is not job-related

When the living accommodation is **not** job related, there may be four separate elements to calculate in order to arrive at the total amount of living accommodation benefit. These are listed in the table below. Two of these four elements apply only to P11D employees.

Living accommodation that is job-related

If the living accommodation is job-related, there are no benefits arising on a LPE and potentially only two benefits arising on a P11D employee which are subject to a maximum limit:

	Not job related accommodation		**Job related accommodation**		
Potential benefits arising:	**LPE**	**P11D**	**LPE**	**P11D**	
(1) Capital benefit	√	√	X	X	
(2) Expensive accommodation benefit	√	√	X	X	
(3) Revenue benefit	X	√	X	√	subject to
(4) Provision of furniture benefit	X	√	X	√	max limit

Living accommodation provided by employers is usually not job related accommodation and is provided to P11D employees rather than LPEs. Therefore all four benefits are potentially taxable.

In the examination, always assume the accommodation is not job related unless it is clearly stated or shown that it satisfies the definition of job related accommodation.

(1) The capital benefit

The capital benefit is the charge for the basic provision of the property to the employee, assuming an unfurnished property with no services.

The amount of the capital benefit is referred to as the annual value of the property, which is a notional rental value.

The annual value is calculated as the greater of:

- the rateable value of the property
- the rent paid by the employer on behalf of the employee.

(2) The expensive accommodation benefit

Where the property has been purchased by the employer and the cost of providing the accommodation is in excess of £75,000, an **additional** benefit arises as follows:

	£
Cost of acquiring the property (see note (a))	X
Plus Capital improvements incurred before the **start** of the tax year	X
Less Capital contributions made by the employee	(X)
Cost of providing accommodation	X
Less Limit	(75,000)
	X
× Official rate of interest at start of the tax year (see note (c))	= £XX

Notes

(a) If the property was purchased by the employer more than six years before the employee occupied it and the cost of providing the accommodation is in excess of £75,000, the market value of the property when the employee first occupied it should be used instead of the original cost of acquiring the property in the above formula.

(b) Only capital improvements from the date the employee occupied the property to the start of the tax year should then be brought into the computation, after deducting any capital contributions made by the employee, if any.

(c) The official rate of interest at the start of the tax year (i.e. 6 April) is the rate specified by HMRC. For 2009/10 the rate is 4.75%. This rate is given in the tax rates and allowances in the examination.

(3) The revenue benefit

Any running costs relating to the accommodation which are paid by the employer for a P11D employee are assessable.

For example, gas, electricity, cleaning, repairs and maintenance (but not structural alterations) would be assessed on the employee at the cost to the employer.

(4) Provision of furniture benefit

If furniture is provided with the accommodation to a P11D employee, the assessable benefit is calculated using the rules applicable to the private use of business assets (see below).

Note that LPEs provided with living accommodation are not assessed either on the revenue benefit or on the provision of furniture benefit.

Example

Richard was provided by his employer with unfurnished living accommodation on 5 August 2007. He pays all the running costs and a monthly contribution of £250 towards the provision of the accommodation.

His employer purchased the property for £325,000 and built an attached garage in September 2008 for £3,400. The annual value of the property is £8,700.

Required

Calculate the assessable benefits arising on Richard for the accommodation in 2009/10.

a

Answer

	£		£
Capital benefit = annual value of the property			8,700
Expensive accommodation benefit:			
Cost of acquiring the property	325,000		
Plus Capital improvements incurred to the *start* of the tax year	3,400		
Less Capital contributions made by the employee	(Nil)		
Cost of providing accommodation	328,400		
Less Limit	(75,000)		
	253,400	at 4.75%	12,037
			20,737
Less **Employee contributions towards the benefit**	(£250 × 12)		(3,000)
Total assessable accommodation benefits			17,737

Job-related accommodation: the revenue benefit and the provision of furniture benefit

If the accommodation is job-related, the total of the revenue benefit and the provision of furniture benefit for a P11D employee are subject to a maximum amount calculated as follows:

		£
10% of:	the employee's employment income assessment **excluding** the accommodation benefits	X
Less Employee contribution towards accommodation benefits		(X)
Maximum total benefit for P11D employee: job related accommodation		X

4.6 The private use and gifts of business assets

If a P11D employee is provided with a business asset (other than a car or van) and he has the benefit of private use of the asset, for every period of private use, the assessable benefit is calculated as:

the **higher of:**

- 20% × market value of the asset when **first** made available to **any** employee, and
- the rent or hire charge paid by the employer on behalf of the employee.

Gift of assets

If the asset used by the employee is later sold or gifted to him, a **further benefit** arises. This is calculated as:

The higher of:

		£
(1)	Market value at the date of sale/gift	X
	Less Price paid by employee, if any	(X)
		X
(2)	Market value when first provided to any employee	X
	Less All 20% benefits already assessed	(X)
	Less Price paid by employee, if any	(X)
		X

Exceptions

If the asset gifted is a car or van, the benefit is calculated as shown in (1) above.

The outright gift of a new asset acquired by an employer for a P11D employee would be assessed as a benefit using the general rule of cost to the employer.

Example

On 6 May 2007 a company provides one of its directors, Sally, with a home entertainment system for her own use. The system cost £3,500 in August 2006 and was used by the company until 5 May 2007 when its market value was estimated to be £3,000.

On 6 August 2009 Sally purchased the system from the company for £1,600. Its market value was estimated to be £1,800 at the date of sale.

Required

Calculate the assessable benefits arising on Sally for each year.

Answer

		£	£
2007/08	20% × £3,000 × 11/12 (private use for only 11 months)		550
2008/09	20% × £3,000		600
2009/10	20% × £3,000 × 4/12 (private use for only 4 months)		200
			1,350
In addition – benefit arising from sale – 2009/10			
Greater of			
(a)	MV at the date of sale	1,800	
	Less Price paid by employee	(1,600)	
		200	200
(b)	Market value when first provided to any employee	3,000	
	Less '20% benefits' already assessed	(1,350)	
	Less Price paid by employee, if any	(1,600)	
		50	
Total assessments			1,550

4.7 The provision of beneficial loans

Where an employer provides a P11D employee or any of his relatives with a loan and does not charge a commercial rate of interest, a taxable benefit arises on the P11D employee as follows:

	£
Interest on the loan at the official rate of interest	X
Less Interest paid by the employee or relative, if any	(X)
Assessable benefit	X

However, note that:

- no assessable benefit arises if the total loans to that employee (and/or his relatives) do not exceed £5,000 at any point in the tax year
- no assessable benefit arises if the loan is for a qualifying purpose (i.e. if the loan interest is an eligible deduction from total income).

Two methods of calculating the interest on the loan at the official rate

(1) The average method

The interest on the loan at the official rate is calculated:

- on the average of the loan outstanding at the beginning and end of the tax year, if the loan has been outstanding all year
- on the average of the opening and closing balance of the loan, if the loan is made/repaid part way through the year
- at 4.75%.

(2) The strict basis calculation

The interest on the loan at the official rate is calculated:

- on the actual loan outstanding during each month of the year
- at 4.75%.

This rate of 4.75% is an annual percentage; therefore if the loan is made/repaid part way through the year, the interest calculations must be time-apportioned.

Example

Tony is a P11D employee. His company lent him £67,000 on 6 July 2009. Tony repaid £16,000 on 6 January 2010. The company charged him £1,900 interest in 2009/10.

Required

Calculate the assessable benefit on Tony for 2009/10.

a **Answer**

Average method – Interest at the official rate

Loan taken out part-way through the year = £67,000

Balance outstanding at the end of the tax year = £51,000

Length of time loan outstanding = 9 months

	£
$\frac{67{,}000 + 51{,}000}{2} = £59{,}000 \times 4.75\% \times 9/12$	2, 102

Strict basis – Interest at the official rate

Balance outstanding from 6 July 2009 to 6 January 2010 (6 months) = £67,000

Balance outstanding from 6 January 2010 to 6 April 2010 (3 months) = £51,000

Interest at the official rate:

	£
Interest from 6 July 2009 to 6 January 2010 (6 months)	
£67,000 × 4.75% × 6/12	1,591
Interest from 6 January 2010 to 6 April 2010 (3 months)	
£51,000 × 4.75% × 3/12	606
	2,197

	Average method	**Strict basis**
	£	
Interest on the loan at the official rate of interest	2,102	2,197
Less Interest paid	(1,900)	(1,900)
Assessable benefit	202	297

Note that:

- the benefit is usually calculated using the average method, but the **individual** has the right to insist on the strict basis if he so wishes and will do so if the strict basis calculation gives a lower benefit
- HMRC also have the right to insist on the strict basis but will only do so if:
  - they believe that the individual has deliberately manipulated the loan payments and repayments during the year to minimise the assessable benefit by using the average method, **and**
  - the difference between the two methods is material.

Finally in relation to beneficial loans, if any part of the loan is written off by the employer, the amount written off is assessed as a further benefit.

Allowable deductions from employment income

5 Allowable deductions from employment income

5.1 An overview of allowable expenses

The tax legislation specifically allows the following deductions from employment income:

- Employee contributions to an occupational pension scheme up to the maximum annual amount
- Donations to charity under an approved payroll giving scheme
- Subscriptions to approved professional bodies, if relevant to the employment
- Any shortfall in mileage allowance received compared with the AMAP.

Expenses other than those referred to above are allowable against employment income if they are incurred 'wholly, exclusively and necessarily' in the performance of the employee's duties.

The expense must be:

- 'wholly and exclusively' incurred such that only the business benefits from the expenditure; any personal benefit gained by the employee as a result of the expenditure must be incidental to the primary purpose of the expense
- 'necessarily' (i.e. unavoidably) incurred by the employee in order for him to carry out his duties. To satisfy the necessarily test, the employee must be able to show that it is necessary for **any** employee to have to incur the expense in order to perform the task. Expenses are not allowable if they are necessary for that individual to perform the task, but would not be necessary for another employee
- incurred 'in the performance of the duties'; therefore any expenses incurred in order to prepare the individual to be able to perform the duties (e.g. training courses) are not allowable.

Additional rules apply to travel and entertaining expenses. These are dealt with in the next two sections.

5.2 The treatment of travel expenses

Travelling and subsistence expenses are allowable provided that:

- they are not expenses of ordinary commuting (i.e. no relief for journeys from home to permanent place of work)
- they are not expenses of private travel, and
- they are necessary 'in the performance of the duties' (i.e. the job cannot be performed unless the employee travels to that location). For example, sales representatives and service engineers have to travel to clients in order to perform their duties.

Expenses of journeys from home to a temporary workplace (e.g. an associated office in another town) will be allowable provided the attendance at that work place lasts, or is expected to last, for no more than 24 months.

5.3 The treatment of business entertainment expenses

If the business entertaining is paid for by the employee and reimbursed by the employer:

- the individual is assessed on the cost of the entertaining, but can claim a deduction for the expenses under the 'wholly, exclusively and necessarily' rule
- the expenses are **disallowed** in the employer's adjustment of profit computation.

If the business entertaining is paid for with a specific entertainment allowance:

- the individual is assessed on the amount of the specific allowance, but can claim a deduction for the expenses under the 'wholly, exclusively and necessarily' rule.
- the expenses are **disallowed** in the employer's adjustment of profit computation.

If the business entertaining is paid for with a general round sum allowance or out of an increased salary:

- the individual is assessed on the amount of the general allowance or increased salary, but he **cannot** claim a deduction for the expenses under the 'wholly, exclusively and necessarily' rule.
- the round sum allowance or increased salary **is allowed** in the employer's adjustment of profit computation.

5.4 Dispensations

An employer can apply for a dispensation from HMRC. This allows the employer to exclude certain expenses payments from the end of year return. A dispensation will only be granted if HMRC are satisfied that the employees would be able to claim a deduction for the expenses and that their payment is properly controlled by the employer.

Items usually included in a dispensation are therefore travel and subsistence payments and reimbursement of business entertaining.

A dispensation will not affect the amount of income tax payable. However, it will avoid the need for the employee to include the expenses in his tax return and then claim a deduction.

5.5 Comprehensive example of employment income computation

Ursula is employed by Victory Enterprises plc. In 2009/10 she received a salary of £58,000 and a bonus of £12,000 paid on 25 February 2010.

She also received the following benefits:

(a) A petrol engined company car costing £21,000, with a list price of £24,500 and CO_2 emissions of 224g/km. She contributed £3,600 towards the purchase of the car and £75 per month towards the use of the car. The company paid the car tax of £160, insurance of £480, and repairs in the year which cost £1,680.

(b) Private fuel which cost the company £2,200.

(c) Employer contributions of 6% of salary into the company's registered occupational pension scheme.

(d) Private medical insurance which cost £1,420, permanent health insurance which cost £500, and death in service insurance cover which cost £360.

(e) Use of a new laptop computer and software which cost the company £2,800 from 6 July 2009.

(f) Vouchers for a car park next to the Victory Enterprise plc offices which cost £880.

Ursula paid the following amounts during 2009/10:

(a) 4% of her salary into the company's occupational pension scheme.

(b) £750 donation to charity under the approved payroll giving scheme administered by Victory Enterprises plc.

(c) £1,350 on entertaining clients and suppliers which Victory Enterprises plc reimbursed as they were genuine business expenses.

Required

Calculate Ursula's employment income assessment for 2009/10.

a

Answer

	£
Salary	58,000
Bonus	12,000
Assessable benefits	
Car benefit (W1)	5,788
Fuel benefit (W2)	5,408
Car parking vouchers = exempt	Nil
Private medical insurance	1,420
Permanent health insurance = exempt	Nil
Death in service insurance = exempt	Nil
Employer contributions to pension scheme = exempt	Nil
Use of laptop (W3)	420
Entertaining clients and suppliers	1,350
	84,386

Allowable deductions	
Employee pension contributions (£58,000 × 4%)	(2,320)
Donations to charity under an approved payroll giving scheme	(750)
Expenses incurred 'wholly, exclusively and necessarily' = entertaining expenses	(1,350)
Employment income	79,966

Workings

(W1) Car benefit

	g/km		Petrol %
CO_2 emissions (rounded down to nearest 5 g/km)	220		
Base level of CO_2 emissions	(135)		
	85	÷ 5	17
Minimum percentage			15
Appropriate percentage			32
	£		£
Manufacturer's list price	24,500		
Less Capital contribution towards the car	(3,600)		
	20,900	at 32%	6,688
Less Contribution for the use of the car (£75 × 12)			(900)
Car benefit			5,788

Note: The car tax, insurance and repairs are ignored as they are covered in the 32% use of car calculation.

(W2) Fuel benefit	£
Private fuel benefit (£16,900 × 32%)	5,408

(W3) Use of laptop	£
Private use of laptop (£2,800 × 20%) × 9/12	420

Shares and share option incentive schemes

- An introduction to share options and share incentives
- The taxation of share option schemes
- The taxation of share incentive schemes
- Approved share option and share incentive schemes
- The key features of share incentive plans (SIPs)
- The key features of approved share option schemes
- The key features of the Enterprise Management Incentive (EMI) scheme

6 Shares and share option incentive schemes

6.1 An introduction to share options and share incentives

Share options and share incentives are an increasingly popular form of remuneration offered to employees. They are usually intrinsically linked to the financial performance/results of the company.

By rewarding staff with an interest/stake in the company, share options and share incentives are designed to provide incentive and motivation to key employees:

- to work efficiently and effectively to increase the profitability of the business, and
- to encourage loyalty to the company.

A share option is a:

- gift of, or an offer to purchase, an option (i.e. a right)
- to buy shares in the employer company
- at a predetermined price
- in the future.

The predetermined price to be paid in the future is set on the date the share option is granted (i.e. offered) and is usually at a discount on the current share price.

Share options are usually granted to selected employees (e.g. directors and key employees).

A share incentive is the immediate gift of shares in the employer company or the sale of shares to an employee at a price below the current market value.

Share options and share incentives are a valuable form of tax-efficient remuneration to an employee as they provide:

- a risk-free investment in the profits of the company with the possibility of a future dividend income stream, and
- the possibility of making future capital gains which can be crystallised tax-free, if disposals are planned to take advantage of the annual capital gains exemption.

6.2 The taxation of share option schemes

The taxation of a share option depends on whether or not the scheme is approved by HMRC. A summary of the taxation consequences is as follows:

Event	Unapproved scheme	Approved scheme
Grant of the option (i.e. when the offer to buy shares in the future is made)	No tax	No tax
Exercise of the option (i.e. when the shares are purchased)	Income tax and NIC charge (see below)	No tax
Sale of shares	Capital gain arises (see below)	Capital gain arises (see below)

The income tax and NIC charge on unapproved schemes

The income tax charge will always arise; however, the NIC charge will only arise where the shares are readily convertible assets (which is usually the case).

The income tax and primary Class 1 NIC charges arising on unapproved schemes are calculated as follows:

		£
Market value of the shares acquired on the exercise date		X
Less	Cost of the option (if any)	(X)
	Price paid by employee (predetermined price set at the time of the grant of the option)	(X)
Employment income		X

The capital gains arising on unapproved schemes

The gain arising on the sale of unapproved scheme shares is calculated as follows:

		£
Sale proceeds		X
Less	Cost of the option (if any)	(X)
	Price paid by employee	(X)
	Employment income taxed on the exercise of the option	(X)
Gain		X

The capital gains arising on approved schemes

The gain arising on the sale of approved scheme shares is calculated in the same way as above, except that there is no deduction for the employment income taxed on the exercise of the shares as there is no such charge for approved scheme shares.

Example

Vishal is an employee of Wilson Ltd. In May 2006 he was granted an option to acquire 2,000 shares in Wilson Ltd at £9 each. The option is exercised on 19 September 2009 and Vishal buys the shares when they are worth £23 each. He plans to sell the shares in December 2012 when he anticipates the price will be £35 per share.

Vishal has a salary of £60,000 and is therefore a higher rate taxpayer. He has no other capital gains planned for 2012/13.

Required

Calculate the income tax, NIC and capital gains tax charges arising, assuming the share option scheme is:

(a) unapproved

(b) approved.

Assume the 2009/10 rates of tax and allowances continue in the future.

Answer

			Unapproved	**Approved**
			£	£
On the grant of the option			Nil	Nil
On the exercise of the option				
MV at exercise	(2,000 × £23)		46,000	
Cost of option			(Nil)	
Price paid	(2,000 × £9)		(18,000)	
Employment income			28,000	
Income tax	(28,000 × 40%)		11,200	Nil
Vishal:	Employee primary Class 1 NICs (28,000 × 1%)		280	Nil
Wilson Ltd:	Employer secondary Class 1 NICs (28,000 × 12.8%)		3,584	Nil
On the disposal of the shares				
Sale proceeds	(2,000 × £35)		70,000	70,000
Cost of option			(Nil)	(Nil)
Cost of shares	(2,000 × £9)		(18,000)	(18,000)
Employment income previously assessed			(28,000)	(Nil)
Chargeable gain			24,000	52,000
Annual exemption			(10,100)	(10,100)
Taxable gain			13,900	41,900
Capital gains tax	(13,900 × 18%)	(41,900× 18%)	2,502	7,542

6.3 The taxation of share incentive schemes

The taxation of a share incentive depends on whether or not the scheme is approved by HMRC.

A summary of the taxation consequences is as follows:

Event	Unapproved scheme	Approved scheme
When the shares are issued	Income tax and NIC charge (see below)	No tax
Where restrictions imposed on the issue of the shares are lifted or changed and, as a result, the value of the shares increases	Income tax and NIC charge (see below)	No tax
Sale of shares	Capital gain arises (see below)	Capital gain arises (see below)

The tax and NIC charges arising with unapproved schemes are calculated in the same way as for share options, except that there is no deduction for the cost of the option.

6.4 Approved share option and share incentive schemes

The advantage of gaining approval from HMRC for a share option or share incentive scheme is that the income tax and NIC charges are avoided when the shares are issued to the employee.

With approved schemes, all of the growth in the value of the shares is treated as a capital gain which is not taxable until the disposal of the shares. This enables disposals to be planned so as to utilise the annual exemption. It also means that any tax is payable at the capital gains tax rate of 18%, rather than the income tax rates of 20% or 40%.

However, to gain approval, a company must set up a scheme which satisfies stringent conditions with many limitations.

The main schemes are:

Share option schemes	Share incentive schemes
■ Company share option plan (CSOP)	■ Share incentive plans (SIPs)
■ Savings-related share option scheme (SAYE)	(formerly known as 'all-employee share ownership plans')
■ The enterprise management incentive scheme (EMI)	

6.5 The key features of share incentive plans (SIPs)

Participation in an approved share incentive plan (SIP) must be offered to all employees of the company, working full time or part time, unless the employee:

- is not resident and ordinarily resident in the UK

- participates in another company share ownership plan or profit sharing scheme
- has more than a 25% interest in the shares of the company.

The company can set a condition for a minimum period of employment before participation in the scheme is allowed; however, this cannot exceed 18 months. The company can allocate the shares based on conditions of reaching performance targets, but all employees must be allocated shares on similar terms based on objective criteria.

The shares must be quoted ordinary shares or shares in an unquoted company which is not controlled by another company.

The scheme operates as follows:

- the employer provides funds to purchase shares in the company (or its holding company) which are then allocated to the employees participating in the scheme. These shares are known as **free shares.**
- eligible employees are allowed to purchase additional shares in the scheme out of pre-tax remuneration (i.e. the cost is deducted from salary before PAYE income tax and NICs are calculated). These shares are known as **partnership shares.**
- the employer may match the partnership shares with additional free shares, but only if the employee has purchased partnership shares. These additional free shares are known as **matching shares.**
- Further shares may be obtained by reinvesting dividends received from the shares in the plan. These shares are known as **dividend shares.**

However, there are restrictions on the amount of shares that can be acquired and the length of time the shares must be held to obtain the tax advantages:

	Free shares	**Partnership shares**	**Matching shares**	**Dividend shares**
Amount of shares allowed	£3,000 per tax year	Lower of (i) £1,500 per tax year (ii) 10% of salary	Two matching shares for each partnership share purchased	£1,500 per tax year
Minimum retention period (see below)	3 – 5 years	Nil	3 – 5 years	3 – 5 years

The minimum retention period is three years, but this can be extended at the option of the company to five years. Partnership shares can be withdrawn at any time.

If the employee leaves that company, the free shares and matching shares must be surrendered. However, the shares purchased by the employee (i.e. the partnership shares and the dividend shares) can be retained.

If the conditions are satisfied, the tax advantages of SIPs are that:

- the employee's income tax and Class 1 primary NIC charge on the issue of the shares, and the employer's Class 1 secondary NIC charge are avoided
- in addition, the following costs are tax allowable deductions in the company's corporation tax trading income computation:
  - costs of setting up and running the scheme
  - cost of acquiring the free and matching shares allocated to the employees (i.e. market value at that time).

However, if the conditions are not satisfied, for example because the shares are not held for the minimum retention period, income tax and NIC charges arise as for unapproved schemes, based on:

- the market value when the shares are taken out of the plan (if removed within three years)
- the lower of the market value at the date of removal or at the date the shares were allocated (if removed between three to five years).

There is no capital gains tax charge when the shares are removed from the plan. Employees are only liable to capital gains tax on any increase in the value of the shares after they have been removed from the plan. Capital gains tax can therefore be avoided by retaining the shares in the plan until their disposal.

6.6 The key features of approved share option schemes

The key features of two approved share option schemes are shown in the following table.

Company share option plans (CSOPs) are more flexible in that they allow the company to select employees eligible and determine different terms of participation, and the total value of options that can be granted under this scheme can be considerably higher than under an approved SAYE scheme. These schemes are attractive to companies wishing to encourage senior management.

However, the key tax advantages for both SAYE and CSOP schemes are the same, and are the same as for share incentive schemes, as described above.

	Approved SAYE scheme	*Company share option plan (CSOP)*
Eligible employees	■ All of the following employees **must be offered participation** in the scheme: – full-time directors (working more than 25 hours per week), or – full-time and part-time employees ■ All employees must be able to participate on **similar terms** ■ Linked to a SAYE contract ■ The employee must contribute into a SAYE scheme for a set period (three or five years) and utilise the savings to purchase shares in the company at a later date (at the end of the three or five year savings period or after seven years)	■ The following employees **may participate** in the scheme: – full-time directors (working more than 25 hours per week), or – full-time and part-time employees ■ The scheme does **not have to offer** participation to **all** of the above employees ■ Can be offered to selected employees and can be offered on **unequal terms**
Minimum employment period	■ Can be specified ■ Not exceeding five years	■ Can be specified on unequal terms
Ineligible employees	■ Employees owning more than 25% of the shares	■ Employees owning more than 25% of the shares
Minimum retention period	■ Option must be exercised after three years from the grant	■ Option must be exercised after three and within ten years of the grant
Maximum limits	■ Maximum regular contribution by employee into SAYE savings scheme to purchase the shares in the future: £250 per month ■ Schemes can be established for a maximum period of three, five or seven years	■ Maximum value of unexercised options a participant can hold is £30,000
Price paid for shares on exercise of the option (i.e. predetermined price when option granted)	■ The shares must be paid for out of the savings ■ The price paid must be specified at the grant of the option ■ Cannot be less than 80% of MV of the shares on the date the option is granted	■ The price paid must be specified at the grant of the option ■ Must be not 'manifestly less' (not defined) than the MV of the shares on the date the option is granted

6.7 The key features of the Enterprise Management Incentive (EMI) scheme

The key features of the EMI scheme are as follows:

Eligible employees	■ Any employee **may** participate in the scheme as long as he works for the company at least 25 hours per week or, if not, at least 75% of his working time is for that company ■ The company can select the employees eligible to participate and usually select their key senior employees
Ineligible employees	■ Employees owning more than 30% of the shares
Minimum retention period	■ Option must be capable of being exercised within 10 years of the grant
Maximum limits	■ No limit on the number of employees who can benefit but total value of options a company can have in issue cannot exceed £3 million ■ An employee can obtain tax relief on all options in the scheme provided the value of his total share options (including those held in CSOPs but excluding SAYE options) is worth in total up to £120,000 ■ Any options held in excess of £120,000 are treated as unapproved share options ■ The company must have gross assets which do not exceed £30 million
Other conditions	■ Options can be granted at a discount or at a premium ■ The company must be a qualifying trading company (excluding financial, accountancy and legal services, dealing in shares and securities etc, and property based businesses) ■ The company together with its subsidiaries must have fewer than 250 full time employees at the time the options are granted

The key tax consequences of the EMI scheme are that:

- the employee's income tax and Class 1 primary NIC charge on the issue of the shares, and the employer's Class 1 secondary NIC charge are avoided if the options are offered at market value or at a premium
- if issued at a discount, there is an income tax and NIC charge calculated as MV at date of **grant** less exercise price
- a capital gain will arise on the disposal of the shares at a later date
- in addition, the costs of setting up and running the scheme are tax allowable deductions in the company's corporation tax trading income computation.

Termination payments

- An overview of termination payments
- The taxation of termination payments

7 Termination payments

7.1 An overview of termination payments

When an employee leaves his employment the following types of **lump sum** termination payments may be received:

Fully exempt	**Fully taxable**
■ Payment made on death, injury or disability of the employee	■ Any payment for which there is a contractual entitlement
■ Payment under an approved pension scheme	■ Compensation for loss of office for which there is a reasonable expectation of payment as usual employer practice
■ Statutory redundancy payment	■ Reward for services provided in the past

An ex-gratia payment (i.e. a discretionary payment) received as compensation for the loss of office is also potentially taxable depending on the amount received.

The first £30,000 of an ex-gratia payment is tax-free; any excess received is taxable as outlined below.

7.2 The taxation of termination payments

Termination payments are received:

- net of PAYE if paid before the employer issues the employee's P45, or
- net of 20% tax if received after the cessation of employment (i.e. after the P45 has been issued).

Termination payments are assessed in the tax year of receipt as earned income. They are treated as the top slice of the individual's taxable income (i.e. taxed after all other income, savings income and dividend income).

An ex-gratia payment may be made in the form of cash or other assets (e.g. the company car is often gifted to the employee as part of the redundancy package).

The £30,000 exemption is applied to the total payments received (including benefits and other assets). However, if the employee also receives statutory redundancy pay, the £30,000 exemption limit is reduced.

Example

Alan was made redundant by his company on 31 March 2010. In 2009/10 his salary was £31,000 and he had a company car with an assessable benefit of £5,200.

On his last day of employment Alan received a termination package which consisted of statutory redundancy pay of £2,600, an ex-gratia cash payment of £29,600 and his company car which had a value of £4,800. Alan also received savings income of £2,750 (gross).

Required

Calculate Alan's income tax liability for 2009/10.

Answer

The statutory redundancy payment is exempt from income tax but reduces the £30,000 exemption limit to £27,400 (30,000 – 2,600).

Taxable termination payment:	£
Cash payment	29,600
Company car	4,800
	34,400
Adjusted exemption limit	(27,400)
Taxable amount – treated as the top slice of income	7,000

Alan
Income tax computation: 2009/10

	Total income	*Other income*	*Savings income*
	£	£	£
Earned income			
Employment income (31,000 + 5,200)	36,200	36,200	
Termination payment	7,000	7,000	
Savings income (gross)	2,750		2,750
Total income	45,950	43,200	2,750
Less PA	(6,475)	(6,475)	
Taxable income	39,475	36,725	2,750

Income tax		£		£
Basic rate band:				
Other income excluding termination payment (36,725 – 7,000)		29,725	at 20%	5,945
	Savings income	2,750	at 20%	550
	Termination payment	4,925	at 20%	985
		37,400		
Higher rate band:	Termination payment (7,000 – 4,925)	2,075	at 40%	830
Total taxable income		39,475		
Income tax liability				8,310

CHAPTER

5

Income from self-employment

Contents

An overview of self-employment at Paper P6

- An overview of the trading income assessment
- The badges of trade

1 An overview of self-employment at Paper P6

1.1 An overview of the trading income assessment

An unincorporated business is a business owned and managed by an individual (i.e. a sole trader) or by two or more individuals operating in partnership.

The trading income assessment for an individual with an unincorporated business is based on the financial accounting results of the business, prepared in accordance with generally accepted accounting principles (UK GAAP or International Accounting Standards).

However, the accounting profits need to be adjusted for taxation purposes, because the treatment of some items for tax purposes differs from accepted accounting practice.

There are three key steps in the calculation of a trading income assessment for a sole trader, and an extra step if the business is operating as a partnership:

- **Step 1:** Prepare an adjustment of profit statement
- **Step 2:** Calculate the capital allowances available
- **Step 3:** For partnerships only, allocate the adjusted profit after capital allowances between the partners
- **Step 4:** Calculate the trading income assessment for the correct tax year

A reminder of the proforma trading income assessment is as follows:

		£
Net profit		X
Add/Deduct	Required adjustments of profit **(Step 1)**	X/(X)
Adjusted profits before capital allowances		X
Less	Capital allowances **(Step 2)**	
	Plant and machinery	(X)
	Industrial buildings	(X)
Adjusted profit after capital allowances		X

Notes

(1) For partnerships the adjusted profit after capital allowances is allocated to each partner in accordance with the profit sharing agreement in the accounting period **(Step 3)**.

(2) The current year basis of assessment rules are then applied to the adjusted profit after capital allowances figure to determine in which tax year the profits are to be assessed to income tax **(Step 4)**.

1.3 The badges of trade

What constitutes a trade is widely defined by UK tax law as including 'every trade, manufacture, adventure or concern in the nature of trade'.

In most cases it is clear that a trading business has been established and the profits should be taxed accordingly. However, in some cases the decision as to whether a trade exists is not clear-cut.

It is important to decide whether a trading activity exists as the profit must be taxed under the appropriate rules. If trading, the profit should be assessed under the trading income rules. However, if not trading, the profit may be assessed to capital gains tax as a one-off capital profit or, depending on the type of asset, may be exempt from tax.

There is a list of factors known as the 'badges of trade' which HMRC will consider in deciding whether:

- a trading activity exists, and
- the profits derived from the activity should be taxed as trading income.

No single factor is more important than another and no single factor will determine the treatment on its own. HMRC will look at all of the facts of the given situation in making a decision.

The six key badges of trade are as follows:

The subject matter of the transaction and the motive at the time of purchase

The intentions of the individual at the time of purchase are important. The courts have held that there are only three reasons for the purchase of an asset:

- for personal use
- as a long-term investment, to sell ultimately at a gain and possibly produce income during ownership (e.g. investment property, shares, paintings)
- for resale at a profit.

Only the last reason suggests that a trading activity exists.

However, there must be a profit motive **at the time the asset is acquired** to suggest that an individual is trading. The asset must be acquired with the intention of selling it at a profit at a later date. Therefore, acquiring an asset as a gift or by inheritance from a relative does not suggest a trading transaction.

The reason for the disposal

If the individual is forced to sell the asset in order to raise funds and alleviate personal financial problems, the transaction is unlikely to be treated as a trading activity. However, if the sale is not a forced sale, it is more likely to be considered part of a trading activity.

The length of ownership

In general the shorter the length of ownership before disposal, the more likely that HMRC will consider the transaction to be in the nature of a trading activity.

The frequency of transactions

Similarly, the more frequent the number of similar transactions, the more likely they will constitute a trading activity.

Altering the asset before resale

If an individual purchases an asset and then alters the asset in some way, it is more likely to be viewed as a trading activity. For example, any manufacturing process or repair that enhances the value of the asset or repackaging to increase its attractiveness in the marketplace will signify a trading activity.

Other general circumstances

Other circumstances such as evidence of the setting up of a business vehicle, advertising expenditure to promote the business, registering for VAT and printing business stationery suggests that a trading activity exists.

The raising of finance to purchase the asset also suggests that a trading activity exists, and the extent to which the individual relies upon the profit as a source of income is a factor to consider.

The adjustment of profit computation

- An overview of the adjustment of profit computation
- The proforma adjustment of profit computation
- Hire or lease charges
- The short lease allowable deduction

2 The adjustment of profit computation

2.1 An overview of the adjustment of profit computation

The adjustment of profit computation is based on the financial accounting results of the business.

To adjust the accounting profit, the expenditure charged in the accounts must be reviewed to identify the items that are not allowable for tax purposes under the trading income rules (known as disallowable expenditure). The amount charged in the accounts in respect of these items is added to profit.

The amounts credited to the accounts must also be reviewed to identify any items that are not assessable as trading income. These amounts are deducted from profit.

In order to be allowable for trading income purposes, the expenditure:

- must be revenue expenditure (not capital), and
- must be incurred **wholly and exclusively for the purposes of the trade,** and
- must not be specifically disallowed by statute.

The following proforma serves as a checklist of these general principles and the most common adjustments required in examination questions.

It is important to remember that adjustments are required for the **private use** of assets **by the owner** if the adjustment of profit computation is for income tax purposes (but not in corporation tax questions).

A reminder of the detail of two of the more complex adjustments that may be required is given after the proforma.

At Paper P6 the examiner is likely to give the tax adjusted trading profit figure in the question or a trading figure that requires only a few adjustments, rather than requiring a detailed calculation of adjusted profit.

2.2 The proforma adjustment of profit computation

To obtain the adjusted profit before capital allowances figure, a separate working is required as per the proforma below:

	£
Profit before taxation	X
Add Disallowable expenditure	
Capital expenditure (may be eligible for capital allowances)	X
Legal or professional fees re capital expenditure (including leases, except fees re the renewal of a short lease)	X
Depreciation/amortisation of non-current assets	X
Loss on the disposal of a non-current asset	X
Non-trade debt written off	X
Political donations and subscriptions	X
Charitable donations under Gift Aid	X
Interest on overdue tax	X
Interest on loans to purchase shares or property	X
Professional fees in relation to tax advice	X
Disallowable portion of lease rental on a car with CO_2 emissions over 160 g/km (see below)	X
Gifts to customers (if > £50 and no advert; or alcohol, food, tobacco)	X
Fines and penalties	X
Entertaining expenses (except employees)	X
Drawings/appropriation **by the owner**	X
Income tax/NICs of **the owner**	X
Cost of ordinary commuting *by* **the owner**	X
Private percentage of expenses of **the owner**	X
Interest allowed as a deduction from total income (e.g. interest on loan to buy into a partnership)	X
Add Trading income not recorded in the accounts	
Goods/stock taken out of business **by the owner**	X
	X
Less Income not assessable as trading income	
Income taxed under other assessment rules (e.g. property income, interest income, UK dividends)	(X)
Exempt income (e.g. betting winnings, interest on overpaid tax)	(X)
Capital profits (may be assessed as a chargeable gain) (e.g. profit on the disposal of a non-current asset, profit on the sale of shares etc)	(X)
Less Amounts not credited in the accounts which are allowable for trading income purposes	
Allowable deduction for short leases (see below)	(X)
Adjusted profit before capital allowances	X

2.3 Hire or lease charges

If a business hires, rents or leases capital assets, such as plant and machinery, the associated hire charges or rental costs are allowable for trading income purposes, as they have been incurred wholly and exclusively for the purposes of the trade.

However, 15% of the hire charge or rental cost relating to a car with CO_2 emissions in excess of 160 g/km is specifically disallowable for trading income purposes. (This rule applies to leases commencing on or after 6 April 2009. However, the previous rules are no longer examinable.)

Example

On 1 January 2009, Anita hired a car for £6,600 pa. The car was used by Anita in her business throughout the year ended 31 March 2010.

Required

Calculate the amount to add back to profit in the adjustment of profit computation for the year ended 31 March 2010 assuming:

(a) The car has CO_2 emissions of 170 g/km
(b) The car has CO_2 emissions of 130 g/km.

Answer

(a) £6,600 x 15% = £990 will be disallowed.

(b) As CO_2 emissions are less than 160 g/km, none of the rental cost will be disallowed.

2.4 The short lease allowable deduction

Where a person grants a short lease on a property and that person (the landlord) receives a premium, this is treated for tax purposes partly as property income and partly as a capital receipt.

The tenant who is granted the use of the property for the lease period pays the premium to the landlord and in addition is usually required to pay rent on a monthly or quarterly basis.

In the adjustment of profit computation for the tenant, the following treatment must be applied:

- The rent payable is allowable for trading income purposes as wholly and exclusively incurred; therefore no adjustment is required for the rent
- The amortisation (i.e. depreciation) of the lease is capital related and therefore not allowable; it must be added back to profit

- A specific allowable deduction is available against trading profit instead of the amortisation charge.

The **annual allowable deduction** available is based on the landlord's property income assessment in respect of the premium received (ignoring any rental income), spread over the length of the lease.

It is calculated as follows:

	£
Premium paid to landlord	X
Less 2% × premium × (n – 1)	(X)
Property income assessment on the landlord (re the premium only)	A
Annual allowable deduction against profit for the tenant = (A ÷ n)	X
where: n = number of years of the lease	

The allowable deduction from profit is sometimes referred to as notional rent.

If the business purchased the lease part way through the accounting period, the notional rent must be time-apportioned according to the number of months the lease was owned by the business in the accounting period.

Example

Basil owns a property which he decided to lease to a tenant on 1 February 2010. The lease granted was a 22-year lease to Comic Dress Hire, an unincorporated business, for a premium of £90,000 and quarterly rent of £6,000 payable in advance starting on 1 February 2010.

Comic Dress Hire prepares its accounts to 30 June each year. It has capitalised the lease on its balance sheet and in addition to the rent payable it has charged amortisation of £2,000 against its profit for the year ended 30 June 2010.

Required

Calculate the adjustments Comic Dress Hire needs to make to its profit for the year ended 30 June 2010.

Answer

Adjustment of profit – Comic Dress Hire – year ended 30 June 2010

Add back	Amortisation charge	£2,000
Deduct	Allowable deduction (see working below)	£989

No adjustment is required in respect of the rent payable because:

- it has been charged against the profit, and
- it is tax allowable since it is incurred wholly and exclusively for the purposes of the trade.

Working

Part of the premium taxed on Basil as rental income in 2009/10:

	£
Premium paid to Basil	90,000
Less 2% × £90,000 × 21 years	(37,800)
Property income assessment	52,200
Annual allowable deduction from profit (£52,200 ÷ 22 years)	2,373
Allowable deduction for year ended 30 June 2010: (£2,373 × 5/12) (leased for five months of the Comic Dress Hire's accounting year)	989

Capital allowances on plant and machinery

- The definition of plant and machinery
- The preparation of a capital allowances computation
- The proforma capital allowances computation
- The annual investment allowance
- First year allowances
- Writing down allowances
- Balancing adjustments
- Small pools
- The special rate pool
- Cars
- Short life assets
- Private use assets

3 Capital allowances on plant and machinery

3.1 The definition of plant and machinery

Tax legislation does not provide a comprehensive definition of plant and machinery. Statute law contains lists of some items of expenditure which are to be classified as plant and machinery and others which are specifically not to be classified as plant and machinery. Case law provides some further guidance for the treatment of some expenditure; however, there is no formal all-inclusive definition of plant and machinery available.

From case law, a key test known as the functional test, has been applied to decide whether or not an item is to be treated as plant and machinery.

The functional test looks at the role the asset plays in the business as follows:

- If the asset is 'apparatus with which the business is carried on', the asset performs an **active function** in the business and should be treated as plant and machinery
- If the asset is 'the setting in which the business is carried on', the asset performs a **passive function** in the business and should not be treated as plant and machinery.

Applying the functional test, it should be clear that plant and machinery includes many of the usual non-current assets used by a business such as motor vehicles, machines, computers, office furniture, equipment, fixtures and fittings etc.

3.2 The preparation of a capital allowances computation

The primary aim of the capital allowances rules is to give tax relief for the net cost of non-current assets (i.e. the original cost less eventual sale proceeds) by means of deductions from the adjusted profit figure.

This text uses the following abbreviations:

- AIA = annual investment allowance
- WDA = writing down allowance
- FYA = first year allowance
- BA = balancing allowance
- BC = balancing charge
- TWDV = tax written down value: this represents the cost of the assets less the capital allowances claimed on them so far.

There are seven key steps in preparing a capital allowances computation as follows:

- **Step 1:** Bring in additions that are **not** eligible for the annual investment allowance (AIA) or first year allowances (FYAs) and add to the tax written down value (TWDV) brought forward in the appropriate column
- **Step 2:** Bring in additions that qualify for the AIA and calculate the AIA available

  For assets purchased in the period for which the AIA is available, the cost is entered as an addition in the appropriate column, and the AIA is entered as a deduction
- **Step 3:** Deal with disposals of plant and machinery in the accounting period by deducting the lower of the sale proceeds received and the original cost of the asset disposed of
- **Step 4:** Calculate balancing allowances (BAs) and balancing charges (BCs), if applicable
- **Step 5:** Calculate the writing down allowances (WDAs) available
- **Step 6:** Bring in additions that are eligible for FYAs and calculate the FYAs available
- **Step 7:** Calculate the total capital allowances available for the accounting period and deduct from the tax adjusted profit figure for that period.

It is important to follow these steps **in strict order** and to lay out the computation as shown below to ensure that the rules for capital allowances are applied correctly.

3.3 The proforma capital allowances computation

Proforma capital allowances computation

Note: This proforma is the same as for corporation tax, except for the private use assets <u>which are specific to income tax</u>

		Main pool	Special rate pool	Expensive cars A	Expensive cars B	Short life assets C	Short life assets D	Private use assets E	Private use assets F		Total allowances
	£	£	£	£	£	£	£	£	£		£
TWDV b/f		X	X	X	X	X	X	**X**			
Acquisitions qualifying for AIA:											
Additions	X										
AIA	(X)										X
Acquisitions *not* qualifying for AIA:											
Private use assets									**X**		
Cars (depending on CO_2 emissions)		X	X								
		X	X	X	X	X	X	**X**	**X**		
Disposals: Lower of (i) sale proceeds, or (ii) original cost		(X)	(X)	(X)		(X)		**(X)**			
		X	X	(X)	X	X	X	**(X)**			
Balancing charge				X				**X**	**× Bus %**		(X)
Balancing allowance						(X)					X
				Nil		Nil		**Nil**			
WDA (**scale up or down re-the length of the accounting period**)											
20%		(X)					(X)		**(X)**	**× Bus %**	X
10%			(X)								X
Lower of (1) 20% or (2) maximum £3,000					(X)						X
		X	X		X		X		**X**		
Acquisitions qualifying for FYA											
Additions	X										
FYA (40% or 100%)	(X)										X
		X									
TWDV c/f		X	X		X		X		**X**		
Total capital allowances											XX

3.4 The annual investment allowance

The annual investment allowance (AIA) gives 100% relief for the first £50,000 of capital expenditure on plant and machinery, excluding motor cars. The AIA is given in the accounting period in which the asset is purchased.

The £50,000 limit is proportionally reduced or increased where a period of account is shorter or longer than 12 months. For example, the AIA for a nine-month period of account would be £37,500 (50,000 x 9/12).

Any expenditure in excess of the £50,000 limit will qualify **immediately** for either writing down allowances (WDA), **or** for the 40% first year allowance (FYA) if incurred in the period 6 April 2009 to 5 April 2010 (1 April 2009 to 31 March 2010 for companies).

If the full AIA is not used, the balance is lost. It cannot be carried forward or back.

The AIA must be split between related businesses/companies or between group companies.

Businesses/companies owned by the same individual(s) will be regarded as related where they are engaged in similar activities or share the same premises. In such circumstances the owner of the businesses/companies can choose how to allocate the single AIA between them. Unrelated businesses/companies owned by the same individual(s) will each be entitled to the full AIA.

3.5 First year allowances

A 40% FYA is available for capital expenditure on plant and machinery, **excluding motor cars**. To qualify, the expenditure must be incurred in the period 6 April 2009 to 5 April 2010 (1 April 2009 to 31 March 2010 for companies).

The 40% FYA is likely to be of benefit only to those businesses incurring capital expenditure in excess of £50,000 a year as the first £50,000 of qualifying expenditure is already covered by the AIA.

100% FYAs are given in respect of expenditure on:

- Low emission cars = cars with CO_2 emissions of less than 110 grams per kilometre
- Energy saving, water conservation or environmentally beneficial plant and machinery.

A business cannot claim both the FYA and a WDA in the same period in respect of the same expenditure. Therefore, if the FYA is claimed, the unrelieved balance of expenditure must not be added to the main pool until after the WDA has been calculated.

The length of ownership of the asset in the accounting period is irrelevant. The length of the accounting period is also irrelevant. The full FYA is available simply 7for incurring qualifying expenditure within the relevant period.

Date of expenditure

As a general rule, capital expenditure is treated as incurred on the date on which the obligation to pay becomes unconditional. However, if payment is not due until four months or more after that date, the expenditure is treated as incurred on the date on which payment is due.

Pre-trading expenditure is generally treated as incurred on the date on which trade commences. However, for the purpose of determining entitlement to the 40% FYA, pre-trading expenditure does not qualify unless **actually** incurred between 6 April 2009 and 5 April 2010 (1 April 2009 to 31 March 2010 for companies).

3.6 Writing down allowances

WDAs are given in each accounting period. They are calculated **after** bringing in additions and **after** taking account of asset disposals.

WDAs are available on all assets **except** those additions in the period on which FYAs were claimed.

No WDA is available in the period of disposal. Therefore disposals of assets in the period must be dealt with **before** calculating the WDA.

The rate of WDAs is 20% p.a. on all assets (except assets in the special rate pool). The rate applies to a **12 month accounting period** and is calculated using the reducing balance basis.

The length of ownership of the asset in the accounting period is not relevant. However, the **length of the accounting period is very important** as follows:

If accounting period is:	**WDA rules:**
Less than 12 months	■ Time apportion WDA *Example:* 9 months' accounts: WDA = 20% × 9/12
More than 12 months but not exceeding 18 months	■ One capital allowances computation ■ WDA scaled up *Example:* 17 months' accounts: WDA = 20% × 17/12
In excess of 18 months	■ Two capital allowances computations ■ First 12 months: WDA = normal allowance ■ Remaining balance period: time apportion WDA *Example:* 20 month accounts: ■ First 12 months: WDA = 20% ■ Balance 8 months: WDA = 20% × 8/12

Example

Ulrika prepared her accounts for the seven months ended 31 October 2009. In the period, she purchased the following items of plant and machinery:

		£
Purchases	Office furniture on 25 May 2009 – cost	40,000
	Factory equipment on 30 June 2009 – cost	25,000

On 1 April 2009 the tax written down value on the main pool was £76,500.

Required

Calculate the capital allowances available for the seven months ended 31 October 2009.

Answer

Ulrika - Capital allowances for the 7 months ending 31 October 2009

		Main pool (TWDV)	Total allowances
	£	£	£
TWDV b/f		76,500	
Acquisitions qualifying for AIA			
Office furniture	40,000		
Factory equipment	25,000		
	65,000		
AIA (50,000 x 7/12)	(29,167)		29,167
	35,833		
FYA (35,833 x 40%)	(14,333)		14,333
	21,500		
Writing down allowance (WDA) (£76,500 x 20% × 7/12)		(8,925)	8,925
Transferred to pool	(21,500)	21,500	
TWDV c/f		89,075	
Total allowances available			52,425

3.7 Balancing adjustments

A balancing allowance (BA) is the tax equivalent of a loss on disposal in the financial accounts. It will **increase** the capital allowances available in the accounting period.

A balancing charge (BC) is the tax equivalent of a profit on disposal in the financial accounts. It is additional taxable trading profit and is usually recognised by **reducing** the capital allowances available in the accounting period.

BAs and BCs are usually referred to collectively as balancing adjustments.

When an asset is disposed of the following disposal value is deducted from the appropriate asset category column:

Disposal value =	Lower of ■ Sale proceeds (or market value if gifted) ■ Original cost

The consequences are as follows:

	Effect on the column:	**Consequence:**
Disposal value > balance on the column	Negative balance	BC
Disposal value < balance on the column	Positive balance	BA

A BC can arise in any asset category in any accounting period.

A BA can arise on short life assets, expensive cars and private use assets in any accounting period.

A BA will only arise in the main pool and the special rate pool in the period in which the business ceases to trade (i.e. the last accounting period).

Example

In the year ended 31 March 2010, Vera sells for £23,000 some plant and machinery which originally cost £26,000 on 31 January 2009.

The TWDV b/f on the main pool on 1 April 2009 was £18,000. Additions not qualifying for the AIA totalled £3,000, and those qualifying for the AIA totalled £45,000.

Required

Calculate the capital allowances available for the year ended 31 March 2010.

Answer

Vera - Capital allowances – y/e 31 March 2010		**Main pool**	**Total allowances**
	£	£	£
TWDV b/f		18,000	
Acquisitions not qualifying for AIA		3,000	
		21,000	
Acquisitions qualifying for AIA			
Cost	45,000		
AIA	(45,000)		45,000
		Nil	

Vera - Capital allowances – y/e 31 March 2010		Main pool	Total allowances
	£	£	£
Disposals - Lower of (i) sale proceeds, or (ii) original cost		(23,000)	
		(2,000)	
Balancing charge		2,000	(2,000)
		Nil	
Writing down allowance (WDA)		(Nil)	Nil
		Nil	
TWDV c/f		Nil	
Total allowances available			43,000

3.8 Small pools

Where the balance of unrelieved expenditure in the main pool is less than £1,000, it can be written-off immediately.

The £1,000 limit is reduced or increased proportionately if the accounting period is less than or more than 12 months.

3.9 The special rate pool

The special rate pool contains the following categories of asset:

- Features that are integral to a building
- Long life assets
- Thermal insulation of a building used for a qualifying activity (e.g. a trade)
- Cars with CO_2 emissions of more than 160 g/km.

Integral features

The following items are treated as being integral to a building:

- Electrical and lighting systems
- Cold water systems
- Space or water heating systems
- Powered systems of ventilation, cooling or air purification
- Lifts and escalators.

Long life assets

Long life assets are defined as items of plant (other than cars, ships and plant and machinery used in shops, showrooms, offices and hotels) with:

- an expected working life of at least 25 years, and
- a total cost of over £100,000 in a 12 month period.

The expected working life relates to the **total** capability of the plant and machinery, not only to the expected useful life for the current owner.

The £100,000 limit must be time-apportioned in a short accounting period and is divided equally between the number of associated companies where the company is a member of a group.

If the definition is satisfied, long life assets must be put into the special rate pool.

If the definition of a long life asset is not satisfied, the item of plant and machinery is treated as a normal main pool asset.

The AIA

The AIA **is** available on assets (other than cars) qualifying for inclusion in the special rate pool. This presents a business with a valuable tax planning opportunity.

If the business has incurred capital expenditure in excess of £50,000, the AIA should first be allocated to assets within the special rate pool as the rate of WDA for these assets is lower than that available for main pool items. (In other words, the business can allocate the AIA to whichever assets it chooses.)

FYAs

FYAs are not available on assets qualifying for inclusion in the special rate pool.

The WDA

The WDA in the special rate pool is calculated in the same way as for the main pool but the rate of WDA is **10% for a 12 month period** (not 20%).

The 10% rate of WDA in respect of integral features applies to both initial and replacement expenditure. Replacement expenditure occurs where more than 50% of an asset is replaced in a 12-month period. This prevents substantial repairs being treated as revenue expenditure for tax purposes.

Balancing adjustments

On the disposal of assets in the special rate pool, a BC can occur in any accounting period. However, a BA can only occur on the cessation of trade.

Example

Felicity prepares her business accounts to the 31 March 2010.

On 1 April 2009 the TWDVs brought forward were as follows:

	£
Main pool	51,000
Special rate pool	137,000

During the year Felicity made the following acquisitions:

	£
New machine (May 2009)	76,800
Delivery van (June 2009)	12,500
Motor car (July 2009) (CO_2 emissions of 170 g/km)	17,000

Disposals made in the year were as follows:

	£
Fork lift truck (sold for less than cost)	4,500

The new machine is expected to have a useful working life of 30 years.

Required

Calculate the capital allowances available for the year ended 31 March 2010.

Capital allowances – y/e 31 March 2010		**Main Pool**	**Special rate pool**	**Total allowances**
	£	£	£	£
TWDV b/f		51,000	137,000	
Acquisitions qualifying for AIA (76,800 + 12,500)	89,300			
AIA	(50,000)			50,000
	39,300			
Acquisitions not qualifying for AIA			17,000	
Disposals		(4,500)	(Nil)	
		46,500	154,000	
WDA (20%)		(9,300)		9,300
WDA (10%)			(15,400)	15,400
FYA (40%)	(15,720)			15,720
	23,580			
Transferred to pool	(23,580)	23,580		
TWDV c/f		60,780	138,600	
Total allowances available				90,420

Notes

The new machine has a life of at least 25 years; however, it cost less than £100,000 and therefore is not treated as a long life asset. If it had been allocated to the special rate pool, it would be allocated the AIA in preference to the delivery van.

3.10 Cars

The new rules for cars

From 6 April 2009 (1 April 2009 for companies) the capital allowances system for cars depends on the car's CO_2 emissions:

- Cars with CO_2 emissions of no more than 110 grams per kilometre are treated as main pool items, but qualify for a 100% FYA. The FYA is never time-apportioned.
- Cars with CO_2 emissions of 111 to 160 g/km qualify for a 20% WDA and should therefore be allocated to the main pool.
- Cars with CO_2 emissions of more than 160 g/km qualify for a 10% WDA and should therefore be allocated to the special rate pool.

Note that the term 'car' does not include lorries, vans, taxis and motorcycles. These will be treated as main pool items unless there is an element of private use (see later). They will also qualify for the annual investment allowance.

Example

Ena prepares accounts to the 31 March 2010.

On 1 April 2009 the TWDVs brought forward were as follows:

	£
Main pool	44,000
Special rate pool	155,400

During the year Ena made the following acquisitions:

	£
Motor car (April 2009) (CO_2 emissions of 110 g/km)	12,000
Motor car (May 2009) (CO_2 emissions of 130 g/km)	14,500
Motor car (July 2009) (CO_2 emissions of 170 g/km)	18,000

Disposals made in the year were as follows:

	£
Plant (sold for less than cost)	3,600

Required

Calculate the capital allowances available for the year ended 31 March 2010.

Ena - Capital allowances – y/e 31 March 2010		**Main pool**	**Special rate pool**	**Total allowances**
	£	£	£	£
TWDV b/f		44,000	155,400	
Acquisitions		14,500	18,000	

Disposals		(3,600)	(Nil)	
		54,900	173,400	
WDA (20%)		(10,980)		10,980
WDA (10%)			(17,340)	17,340
Addition	12,000			
FYA (100%)	(12,000)			12,000
TWDV c/f		43,920	156,060	
Total allowances available				40,320

The old rules for expensive cars

Prior to 6 April 2009 (1 April 2009 for companies) the treatment of a car depended on its cost.

Cars costing less than £12,000 were allocated to the main pool unless there was an element of private use.

Cars costing more than £12,000 were described as expensive cars. They had special rules which will continue to apply until 2014.

There must be a separate column in the proforma capital allowances computation for **each** expensive car.

The maximum WDA for each expensive car is calculated as follows:

12 month accounting period:	**Short/long accounting period:**
Lower of ■ £3,000 ■ 20% of TWDV b/f	The lower of these two amounts must be time apportioned according to the length of the CAP

On the disposal of an expensive car, **either a BA or a BC will arise**, depending on the comparison of the disposal value with the TWDV b/f for that expensive car.

Where there is an element of private use of an asset **by the owner of the business**, only the business percentage of the WDAs, BAs and BCs can be claimed.

Example

Cassandra is self-employed. She has prepared accounts for the nine months ended 31 December 2009. The TWDVs b/f were £43,500 on the main pool, £26,000 in respect of a Renault car and £29,000 in respect of an Audi.

On 10 December 2009 Cassandra sold the Renault for £12,800 and replaced it with a Ford which cost £15,000. The new Ford has CO_2 emissions of 150 g/km. All the cars are used by her employees.

Required

Calculate the capital allowances available for the nine months ended 31 December 2009.

a **Answer**

Cassandra - Capital allowances - 9 months ended 31 December 2009	**Main Pool**	**Renault**	**Audi**	**Total allowances**
	£	£		£
TWDV b/f	43,500	26,000	29,000	
Acquisitions *not* qualifying for FYAs	15,000			
Disposals	(Nil)	(12,800)	(Nil)	
	58,500	13,200	29,000	
Balancing allowance		(13,200)		13,200
		Nil		
Writing down allowance (WDA)				
20% × 9/12 × £58,500	(8,775)			8,775
restricted to £3,000 × 9/12			(2,250)	2,250
TWDV c/f	49,725		26,750	
Total allowances available				24,225

3.11 Short life assets

Short life assets are items of plant and machinery, other than cars, with a useful economic life of no more than five years (i.e. when they are purchased, the intention is to dispose of them within the following four accounting periods).

Short life assets are treated as normal main pool items **unless** a de-pooling election is made within 12 months of the 31 January following the end of the tax year in which the accounting period of acquisition ends.

For example, if the expenditure is incurred on 13 March 2009 and the trader has a 31 December 2009 year end, the election should be made by 31 January 2012 (12 months from the 31 January after the end of 2009/10).

Once the election is made it is binding and cannot be reversed. However, the election is made for a particular asset and only applies to that asset.

A separate record is maintained for **each** short life asset where the de-pooling election is made in respect of that asset.

The AIA and 40% FYA are available in the normal way.

WDAs are also available in the normal way in the first four years. However, if the asset is not disposed of within four years of the end of the accounting period in which it is acquired, the TWDV of the asset must be transferred to the main pool.

If the short life asset is disposed of within four years of the end of the accounting period in which it is acquired, either a BA or a BC can arise in any accounting period in the normal way.

The de-pooling election is optional, but should **only** be made where it is anticipated that the asset will be sold for **less than its TWDV**. This is because the capital allowances claimed on that asset can be accelerated. The de-pooling election results in tax relief for the expenditure being received earlier than if the asset were included in the main pool.

It is important to note that the de-pooling **election would not be advantageous** where it is anticipated that the asset will be **sold for more than its TWDV**. This is because the disposal would crystallise a balancing charge early, whereas the deduction of the disposal value of this one asset from the main pool (which includes the TWDVs of many other assets) would be unlikely to give rise to a balancing charge.

Example

Daniel is self-employed. He prepares its accounts to 31 May each year. On 1 October 2008 he purchased a laptop computer and software for £4,620 for his financial controller to use. Daniel expects to have to replace the computer with new technology in two years' time.

Required

Calculate the capital allowance claims in respect of the computer for the four accounting periods ending on 31 May 2012, with and without the short life asset ('de-pooling') election, assuming the computer is disposed of on 30 September 2010 for £1,020. Assume also that there is a substantial balance brought forward on the main pool and that the AIA is not available.

Answer

Daniel **Capital allowances**	**Short life election made** **Short life asset**	 **Total allowances**	**Short life asset election not made** **Main pool**	 **Allowances re-computer**
y/e 31 May 2009	£	£	£	£
TWDV b/f			X	
Acquisitions	4,620		4,620	
WDA (20%)	(924)	924	(924)	924
TWDV c/f	3,696		3,696	
y/e 31 May 2010				
WDA (20%)	(739)	739	(739)	739
TWDV c/f	2,957		2,957	

Daniel Capital allowances	**Short life election made**		**Short life asset election not made**	
	Short life asset	**Total allowances**	**Main pool**	**Allowances re-computer**
	£	£	£	£
y/e 31 May 2011				
Disposal	(1,020)		(1,020)	
	1,937		1,937	
Balancing allowance	(1,937)	1,937		
WDA (20%)			(387)	387
TWDV c/f	Nil		1,550	
y/e 31 May 2012				
WDA (20%)	Nil	Nil	(310)	310
TWDV c/f	Nil		1,240	
Total allowances claimed to date		3,600		2,360

The net cost of the computer is £3,600 (£4,620 - £1,020).

The full net cost is allowed by 31 May 2011 if the short life asset election is made.

Only £2,050 will have been allowed by 31 May 2011 and £2,360 by 31 March 2012. The remaining £1,240 of cost will be relieved but over several years on a 20% reducing balance method.

The de-pooling election therefore accelerates the capital allowances claim.

Note that had the AIA been available to cover the full cost of the asset, a short life asset election would not have been beneficial as it would have given rise to a balancing charge of £1,020 on the disposal of the asset. In that situation, it would be better to leave the asset in the main pool.

3.12 Private use assets

Where **any** business asset is used partly for business use and partly for private use **by the owner,** a separate record of that asset must be kept.

The AIA, FYAs, WDAs, BAs and BCs on private use assets are calculated in the normal way and deducted from the appropriate private use asset column in the proforma. However, only the **business proportion** of the allowances calculated **can be claimed**.

Private use **by an employee** is not relevant and does not restrict the allowances available.

Example

Edith is a self-employed hair dresser. She prepares her accounts to 30 November each year. On 1 December 2009 she bought a Honda car for £10,500 and sold it for

£7,000 on 30 April 2011. The car had CO_2 emissions of 145 g/km. Her private mileage in the car was 6,000 out of her annual total of 30,000. The TWDV b/f on the main pool on 1 December 2009 was £15,100.

Required

Calculate the capital allowances available for the years ended 30 November 2010 and 30 November 2011.

a

Answer

Edith - Capital allowances	Main Pool	Honda car (80% business use)		Total allowances
y/e 30 November 2010	£	£		£
TWDV b/f	15,100			
Acquisitions *not* qualifying for AIA		10,500		
Disposals	(Nil)	(Nil)		
	15,100	10,500		
WDA (20%)	(3,020)			3,020
- business % claim only		(2,100)	at 80%	1,680
TWDV c/f	12,080	8,400		
Total allowances				4,700

Edith - Capital allowances	Main Pool	Honda car (80% business use)		Total allowances
y/e 30 November 2011	£	£		£
TWDV b/f	12,080	8,400		
Acquisitions *not* qualifying for AIA	Nil	Nil		
Disposals	(Nil)	(7,000)		
	12,080	1,400		
Balancing allowance		(1,400)	at 80%	1,120
WDA (20%)	(2,416)			2,416
TWDV c/f	9,664			
Total allowances				3,536

Industrial buildings allowances

- The definition of an industrial building
- Allowances for industrial buildings

4 Industrial buildings allowances

4.1 The definition of an industrial building

The tax legislation definition of an industrial building includes buildings and structures used:

- for the manufacturing or processing of goods or materials (e.g. factories)
- for the storage of goods or materials (e.g. warehouses)
- for the repair or maintenance of goods or materials (e.g. workshops)
- as technical drawing offices
- as employee welfare facilities (e.g. canteens, workplace nurseries, sports pavilions)
- as a qualifying hotel (see below).

Industrial buildings allowances (IBAs) are available on the qualifying cost of the building.

The qualifying cost includes:

- any costs incurred in preparing the site for the construction of the buildings (e.g. cutting, levelling or tunnelling the land)
- legal and professional fees relating to the building (e.g. architects' fees, solicitors' fees)
- associated car parks, roads, fencing.

However, IBAs are **never allowed on the cost of the land itself**, nor any associated incidental expenses (including legal and professional fees) related to acquiring the land.

IBAs are available on non-industrial buildings and structures such as shops, showrooms, residential accommodation and general offices in the following circumstances:

- the non-industrial buildings are an integral part of a factory site, and
- the cost of the non-industrial part is not more than 25% of the total cost of all of the buildings on the factory site (i.e. the total cost of all buildings, industrial and non-industrial, but excluding land).

If the cost of the non-industrial part exceeds 25% of the total cost of all of the buildings (excluding land), IBAs are only available on the industrial buildings element. The full cost of the non-industrial element is not eligible for IBAs.

Example

Graeme, an unincorporated trader, constructed a new factory site in the year ended 31 July 2009. The cost of construction was as follows:

	£
Land (including £3,500 legal costs re-purchase of land)	127,500
Preparation of the land before building commenced	35,000
Architect's fees	22,000
Main factory building	371,000
Canteen	13,200
General offices	61,300

Required

Calculate the cost which qualifies for IBAs.

Answer

			Qualifying cost For IBAs
	£		£
Land	124,000	*Not allowable*	Nil
Legal costs re the land	3,500	*Not allowable*	Nil
Preparation of the land	35,000	*Allowable*	35,000
Architect's fees	22,000	*Allowable*	22,000
Main factory building	371,000	*Allowable*	371,000
Canteen	13,200	*Allowable*	13,200
General offices	61,300	*See working below*	61,300
	630,000		502,500

Working

25% × Total cost of all buildings on the site (but excluding the cost of the land and associated legal costs) = 25% × (£630,000 - £127,500) = 25% × £502,500 = £125,625.

Cost of office space = £61,300 < £125,625; therefore the cost of the general offices qualifies for IBAs.

Qualifying hotels

A qualifying hotel is a hotel which meets **all** of the following conditions:

- it has at least 10 letting bedrooms available for short term stays (i.e. not more than 30 days)
- it is open for at least four months during the holiday season (i.e. April to October)
- it provides normal hotel services such as bed-making and cleaning services, and offers both breakfast and evening meals.

If the hotel is a qualifying hotel it is treated as if it were an industrial building. IBAs are calculated in the same way as described below.

4.2 Allowances for industrial buildings

A WDA of 2% is available for a 12-month period.

- It is calculated on a straight line basis (= 2% of cost for each 12-month period.)
- It is based on the qualifying cost of the building.

The WDA must be time-apportioned if the business has a short accounting period.

WDAs are only available if the building is in industrial use on the last day of the accounting period.

No balancing adjustments arise on the disposal of an industrial building.

Example

B plc prepares its accounts to 31 March each year. On 14 February 2009 it purchased a factory for £590,000 (including land of £90,000) and brought it into industrial use on 1 April 2009.

The business was very successful and grew considerably. B plc decided that to expand further, a larger factory site was needed. On 31 July 2010 it sold the old factory to C Ltd for £625,000 (including land of £90,000) and purchased a bigger factory in the next town.

Required

Calculate the IBAs available to B plc.

Answer

	Allowances claimed
y/e 31 March 2010	£
Qualifying cost (£590,000 - £90,000) = 500,000	
WDA (2% × £500,000)	10,000

Notes

No WDA is available in the year ended 31 March 2009 as the building is not in industrial use on that date.

There is no balancing adjustment on the disposal of an industrial building.

CHAPTER 6

The life cycle of an unincorporated business

Contents

An introduction to the life cycle of an unincorporated business

- Overview of the life of an unincorporated business
- The normal basis of assessment rules

1 An introduction to the life cycle of an unincorporated business

1.1 Overview of the life of an unincorporated business

There are three stages in the life of an unincorporated business:

(1) The opening years

(2) The ongoing (or middle) years

(3) The closing years.

Examination questions are scenario based and usually centre around one of the stages in the life of an unincorporated business.

1.2 The normal basis of assessment rules

For trading income from an unincorporated business, special basis of assessment rules need to be applied to determine how the business profits will be allocated to tax years.

Once a business has been trading for a number of years, the **current year basis** (CYB) of assessment rule applies as follows:

Current year basis = the 12 month **accounting period ending in the current tax year**

Example

Kensey has been trading for many years preparing accounts to 31 January each year. He has the following tax-adjusted profits after capital allowances:

Year ended 31 January	£
2009	45,750
2010	62,400

Required

What is Kensey's trading income assessment for 2009/10?

Answer

The accounts which **end** in the tax year 2009/10 = year ended 31 January 2010. Therefore, Kensey's trading income assessment for 2009/10 = £62,400.

The opening years

- The impact of opening years on tax-adjusted profits
- The impact of opening years on capital allowances
- The opening year basis of assessment rules
- The choice of accounting date

2 The opening years

2.1 The impact of opening years on tax-adjusted profits

In the opening years it is possible that the accounting period will not be 12 months in length.

However, the adjustment of profit computation is based on the financial accounting results of the business. It is calculated in the same way regardless of the length of the accounting period.

Pre-trading expenditure

Expenditure incurred prior to the start of trading is treated as if incurred on the first day of trading and is allowable for tax purposes, provided the expenditure:

- was incurred within the seven years prior to the first day of trading, and
- would be allowable expenditure if incurred after the first day of trading.

However, pre-trading expenditure on plant and machinery does not qualify for the 40% FYA unless **actually** incurred between 6 April 2009 and 5 April 2010.

2.2 The impact of opening years on capital allowances

Capital allowances are calculated for an accounting period. Additions and disposals relating to the accounting period are brought into the computation and the appropriate allowances calculated.

However, the **length of the accounting period is very important for capital allowances**.

If the accounting period is not 12 months in length the AIA and WDA must be time-apportioned, scaled up or calculated in two parts as explained in the previous chapter. This is likely to occur in opening year examination questions.

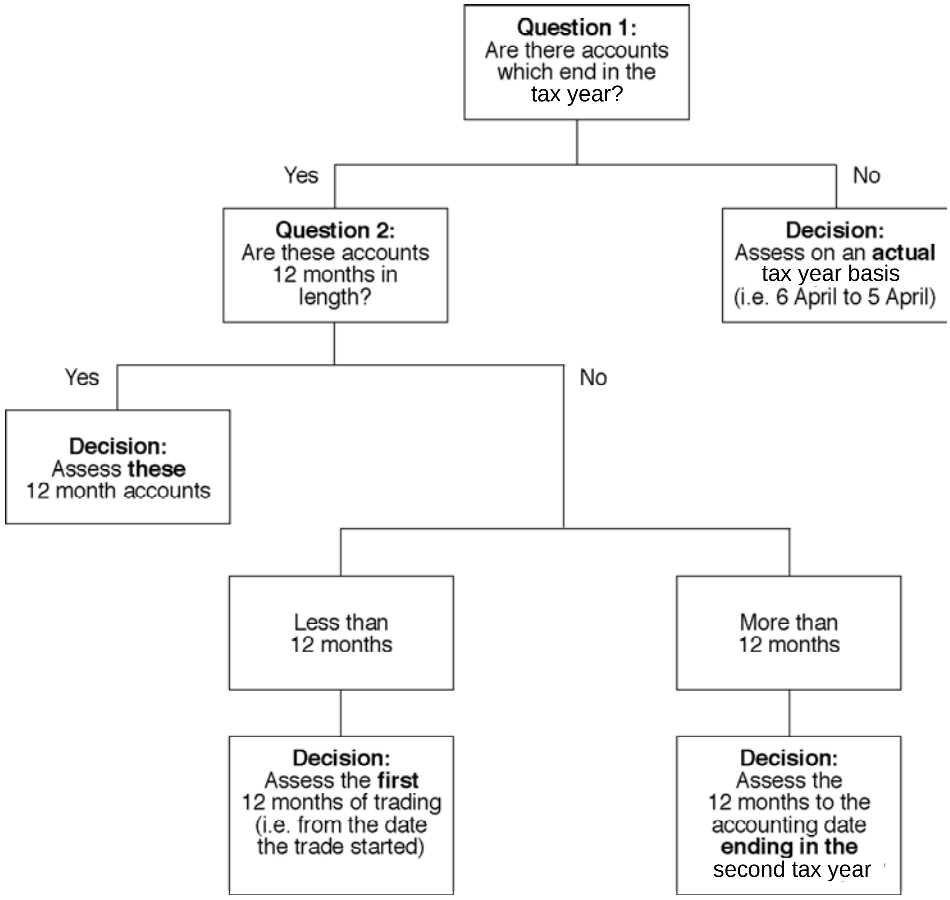
Note that FYAs and balancing adjustments are never time-apportioned; the impact of the length of the accounting period only affects the calculation of the AIA and WDA.

2.3 The opening year basis of assessment rules

The opening year basis of assessment rules are applied to the adjusted profit after capital allowances figure. The rules are summarised in the table below.

Tax year	Basis period
First tax year	Assess on an actual tax year basis (i.e. from the date trade started to the following 5 April)
Second tax year	See decision table below
Third tax year	Assess the 12 months to the accounting date ending in the third tax year
Fourth tax year onwards	Assess on a current year basis as described above

The rules for the second tax year are set out in the following decision table. The approach is based on the answers to two questions:



- In applying these assessment rules it is assumed that profits accrue evenly over time. In the examination, calculations are to be made to the nearest month.
- A consequence of applying the opening year rules is that some profits will be assessed to tax more than once. These profits are known as '**overlap profits**'.
- Relief is given for overlap profits in the final year of assessment on the cessation of trade or possibly earlier if the business changes its accounting date.

From these rules there are four possible outcomes for the second tax year of assessment. Each of these is illustrated in the following examples.

Example 1

Lena started to trade on 1 November 2008 and decided to prepare her accounts to 31 October each year. Her results for the first two years are as follows:

Year ended	Adjusted profit before capital allowances	Capital allowances
	£	£
31 October 2009	23,760	6,160
31 October 2010	71,280	7,150

Required

Calculate Lena's first three years' trading income assessments and the overlap profits arising from the application of the opening year rules.

Answer

Year ended		Adjusted profit after capital allowances
		£
31 Oct 2009	(£23,760 – £6,160)	17,600
31 Oct 2010	(£71,280 – £7,150)	64,130

Trading starts: 1 November 2008 = in tax year 2008/09 = first tax year

First tax year: Tax the profits from 1 November 2008 to 5 April 2009

Second tax year = 2009/10. Ask two questions:

Are there accounts which end in the tax year?	Yes = year ended 31 October 2009
Are these accounts 12 months in length?	Yes
Decision	Assess the profits of those 12 months

Tax year	Basis of Assessment	Basis period	Workings	Assessment
				£
2008/09	Actual	1.11.2008 – 5.4.2009	5/12 × £17,600	7,333
2009/10	12 months ending in second year	y/e 31.10.2009		17,600
2010/11	12 months ending in third year	y/e 31.10.2010		64,130

Overlap profits

1.11.2008 – 5.4.2009	5/12 × £17,600	£7,333

Example 2

Michael started to trade on 1 December 2008 and decided to prepare his accounts to 30 June each year. His results for the first two accounting periods are as follows:

Period ended	Adjusted profit after capital allowances
	£
30 June 2009	14,740
30 June 2010	56,620

Required

Calculate Michael's first three years' trading income assessments and the overlap profits.

Answer

Trading starts: 1 December 2008 = in tax year 2008/09 = first tax year

First tax year: Assess profits from 1 December 2008 to 5 April 2009

Second tax year = 2009/10. Ask two questions:

Are there accounts which end in the tax year?	Yes = 7 months ended 30 June 2009
Are these accounts 12 months in length?	No = less than 12 months
Decision	Assess first 12 months' profits

Tax year	Basis of assessment	Basis period	Workings	Assessment
				£
2008/09	Actual	1.12.2008 – 5.4.2009	4/7 × £14,740	8,423
2009/10	First 12 months	1.12.2008 – 30.11.2009	£14,740 + (5/12 × £56,620)	38,332
2010/11	12 months ending in third year	Year ended 30.6.2010		56,620

Overlap profits:		£
1.12.2008 – 5.4.2009	4/7 × £14,740	8,423
1.7.2009 – 30.11.2010	5/12 × £56,620	23,592
		32,015

Example 3

Nora started to trade on 1 July 2008 and decided to prepare her first accounts to 30 September 2009 and then to 30 September each year. Her results for the first two accounting periods are as follows:

Period ended	Adjusted profit after capital allowances
	£
30 September 2009	22,120
30 September 2010	84,920

Required

Calculate Nora's first three years' trading income assessments and the overlap profits.

a

Answer

Trading starts: 1 July 2008 = in tax year 2008/09 = first tax year

First tax year: Assess the profits from 1 July 2008 to 5 April 2009
Second tax year = 2009/10. Ask two questions:

Are there accounts which end in the tax year?	Yes = 15 months ended 30 Sept 2009
Are these accounts 12 months in length?	No = more than 12 months
Decision	Assess the 12 months' profits ending on 30 September 2009

Tax year	Basis of assessment	Basis period	Workings	Assessment
				£
2008/09	Actual	1.7.2008 – 5.4.2009	9/15 × £22,120	13,272
2009/10	12 months ending in second year	1.10.2008 – 30.9.2009	12/15 × £22,120	17,696
2010/11	12 months ending in third year	Year ended 30.9.2010		84,920

Overlap profits:

1.10.2008 – 5.4.2009	6/15 × £22,120	£8,848

e 4

Example 4

Oliver started to trade on 1 February 2008 and decided to prepare his first accounts to 31 May 2009 and thereafter to 31 May each year. His results for the first two accounting periods are as follows:

Period ended	Adjusted profit after capital allowances
	£
31 May 2009	37,550
31 May 2010	56,350

Required

Calculate Oliver's first four years' trading income assessments and the overlap profits.

a **Answer**

Trading starts: 1 February 2008 = in tax year 2007/08 = first tax year
First tax year: Assess the profits from 1 February 2008 to 5 April 2008
Second tax year = 2008/09. Ask two questions:

Are there accounts which end in the tax year?	No
Decision	Assess the actual profits of the tax year: from 6 April 2008 to 5 April 2009

Third tax year = 2009/10. The 16 month accounts to 31 May 2009 end in the third tax year.
Decision = Assess the 12 months running up to the accounting end date that ends in the third tax year (i.e. the 12 months to 31 May 2009).

Tax year	Basis of assessment	Basis period	Workings	Assessment
				£
2007/08	Actual	1.2.2008 – 5.4.2008	2/16 × £37,550	4,694
2008/09	Actual	6.4.2008 – 5.4.2009	12/16 × £37,550	28,162
2009/10	12 months ending in third year	1.6.2008 – 31.5.2009	12/16 × £37,550	28,162
2010/11	CYB	Year ended 31.5.2010		56,350

Overlap profits:

1.6.2008 – 5.4.2009	10/16 × £37,550	£23,468

2.4 The choice of accounting date

When commencing to trade an individual can choose his accounting date. The decision is often made on commercial grounds. However, the impact on the individual's total tax assessments in the opening years and the cash flow of the business in terms of due dates of payment are important and should not be ignored.

There is no clear cut answer in choosing an acceptable accounting date, but the following table summarises the factors to consider.

	31 March year end	30 April year end
To minimise total profits assessed to tax under the opening year rules:	Preferable if profits are **declining** in the opening years	Preferable if profits are **increasing** in the opening years
Overlap profits generated:	None	Maximum amount (i.e. 11 months)

Where the business has a year end other than 31 March for examination purposes (5 April in practice), overlap profits will arise. It is therefore advisable to ensure that the profits in the opening period are as low as possible to minimise the overlap profits.

The ongoing years

- The impact of the middle years on tax-adjusted profits
- The impact of the middle years on capital allowances
- The basis of assessment rules for a change of accounting date

3 The ongoing years

3.1 The impact of the middle years on tax-adjusted profits

In the middle years in the life of a business the accounts are usually twelve months in length, but when an unincorporated business decides to change its accounting date, it will need to produce a set of accounts which is either more than or less than 12 months in length.

However, the adjustment of profit computation is based on the accounting results of the business regardless of the length of the accounting period. There are no special or additional rules that apply to the middle years of a business.

3.2 The impact of the middle years on capital allowances

The **length of the accounting period is very important for capital allowances**.

If the accounting period is not exactly 12 months in length the AIA and WDA must be time-apportioned, scaled up or calculated in two parts as explained in the previous chapter. This is likely to occur in questions involving a change of accounting date.

Note that FYAs and balancing adjustments are never time-apportioned; the length of the accounting period only affects the calculation of the AIA and WDA.

3.3 The basis of assessment rules for a change of accounting date

Once a business has been trading for a number of years, the normal **current year basis** (CYB) of assessment rule usually applies. Each tax year assesses the 12 month **accounting period ending in the current tax year.**

When an unincorporated business decides to change its accounting date, the normal CYB rule cannot be used as the accounts ending in the tax year will not be 12 months. Therefore special rules are required to deal with a change in accounting date.

Certain conditions must be satisfied for a business to be allowed to treat a change in accounting date as valid for tax purposes. These conditions exist primarily to prevent businesses changing their accounting date frequently in an attempt to gain a tax advantage.

The conditions for a valid change of accounting date

For a change of accounting date to be valid for tax purposes, the following conditions must be satisfied:

- The first accounting period to the new accounting end date must not exceed 18 months in length.
- The business must not have changed its accounting date in the previous five years or, if it has, it must have justifiable commercial reasons for making a further change in the five year period.
- HMRC must be notified of the change by 31 January following the tax year in which the first accounting period to the new date ends.

If these conditions are not satisfied, HMRC will ignore the new accounting date for taxation purposes and continue to assess profits based on the old date. If necessary, profit figures are apportioned accordingly.

Calculating the change of accounting date assessments

The change of accounting date rules and approach are summarised below.

Step 1

Work out which tax year is the **tax year of change**.

This is the earlier of the first tax year where:

- the accounts are prepared to the new accounting date, or
- the accounts are not prepared to the old accounting date.

Usually these two events happen in the same tax year, but they could occur in different tax years.

Step 2

Work out the trading income assessment of the **year before the tax year of change** on a normal current year basis using the old accounting date.

Step 3

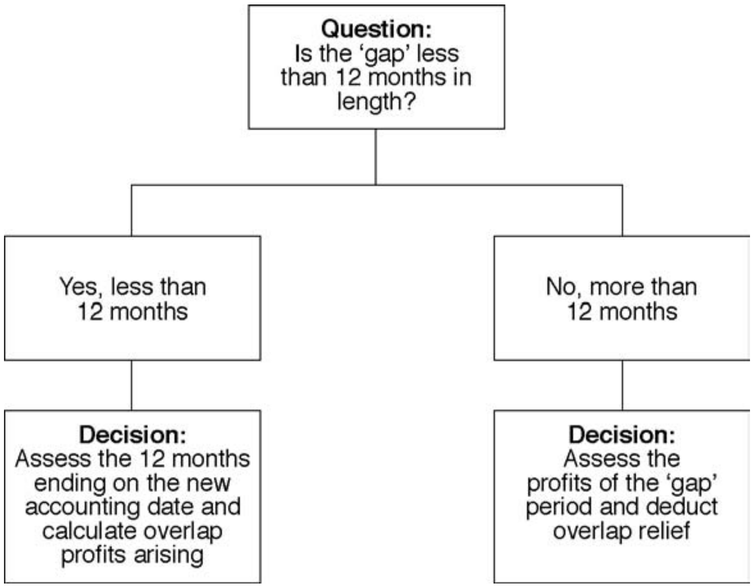
Work out the trading income assessment of the **year after the tax year of change** on a normal current year basis using the new accounting date.

Step 4

Work out the length of the **relevant period**, often referred to as the **gap period**.
This is the period that is not assessed in Step 2 or Step 3.

Step 5

Work out the trading income assessment in the **tax year of change** as follows:



- **If the gap is less than 12 months**, overlap profits arise. Relief is given for the overlap profits in the final year on the cessation of trade (or possibly earlier if there is another change of accounting date).
- **If the gap is more than 12 months**, overlap relief is available. The appropriate number of months of overlap profits can be deducted so that only 12 months profits are assessed in the tax year of the change.
- Overlap relief is calculated as follows:

$$\text{Overlap profits} \times \frac{\text{Length of the 'gap' period} - 12 \text{ months}}{\text{Number of months of overlap profits}}$$

From these rules there are three main scenarios that could occur. These are illustrated in the examples that follow.

Example 1

Rusty prepared his accounts to 30 November each year until 2009 when he changed his accounting date by preparing a short set of accounts to 31 August 2009. His adjusted profits after capital allowances are as follows:

	Adjusted profit after capital allowances
	£
Year ended 30 November 2008	46,200
Nine months ended 31 August 2009	41,580
Year ended 31 August 2010	69,300

In his opening years Rusty had three months of overlap profits of £13,200.

Required

Calculate the trading income assessments arising from these profits, and state how much overlap profits are carried forward for relief in the future.

Answer

Step 1 **Work out the tax year of change**

The tax year of change = 2009/10

This is the earlier of the first tax year where the accounts are

(i) prepared to the new accounting date (i.e. 2009/10), or

(ii) not prepared to the old accounting date (i.e. also 2009/10).

Step 2 **Work out the trading income assessment for the year before the tax year of change**

2008/09: CYB: year ended 30.11.2008: £46,200

Step 3 **Work out the trading income assessment for the year after the tax year of change**

2010/11: CYB: year ended 31.8.2010: £69,300

Step 4 **Work out the length of the gap**

The period not assessed under Steps 2 and 3 = 1 December 2008 to 31 August 2009 = Gap 9 months

Step 5 **Work out the trading income assessment in the tax year of change**

Gap is less than 12 months: Therefore assess the 12 months ending on the new accounting date in 2009/10

Tax year	Basis period	Workings	Assessment
			£
2009/10	1.9.2008 – 31.8.2009	(3/12 × £46,200) + £41,580	53,130

Step 6 **Calculate overlap profits**

			£
Opening years			13,200
On change of accounting date	1.9.2008 – 30.11.2008	(3/12 × £46,200)	11,550
Overlap profits to carry forward			24,750

Example 2

Sally prepared her accounts to 31 January each year until 2009 when she changed her accounting date by preparing a long set of accounts to 31 March 2010. Her adjusted profits after capital allowances are as follows:

	Adjusted profit after capital allowances
	£
Year ended 31 January 2009	60,000
14 months ended 31 March 2010	69,500
Year ended 31 March 2011	57,750

In her opening years Sally had three months of overlap profits of £15,000.

Required

Calculate the trading income assessments arising from these accounting profits, and state how much overlap profits are carried forward for relief in the future.

Answer

The tax year of change = 2009/10

This is the earlier of the first tax year where the accounts are:

(i) prepared to the new accounting date (i.e. 2009/10), or

(ii) not prepared to the old accounting date (i.e. also 2009/10).

Trading income assessment for the year before the change: 2008/09

2008/09: CYB: year ended 31.1.2009: £60,000

Trading income assessment for the year after the change: 2010/11

2010/11: CYB: year ended 31.3.2011: £57,750

Period not assessed = 1 February 2009 to 31 March 2010

Gap = 14 months

Gap is more than 12 months:

Therefore assess profits of the gap period and deduct overlap relief

		£
Profits of the gap period (1.2.2009 – 31.3.2010)		69,500
Less overlap relief	$15{,}000 \times \frac{14 - 12}{3}$	(10,000)
Trading income assessment for 2009/10		59,500

Overlap profits:		£
Opening years		15,000
On change of accounting date	– amount relieved	(10,000)
Overlap profits to carry forward		5,000

Example 3

Toby prepared his accounts to 31 August each year until 2010 when he changed his accounting date by preparing a short set of accounts to 28 February 2010. His adjusted profits after capital allowances are as follows:

	Adjusted profit after capital allowances
	£
Year ended 31 August 2008	16,500
Year ended 31 August 2009	13,500
Six months ended 28 February 2010	9,500
Year ended 28 February 2011	11,000

In his opening years Toby had six months of overlap profits of £10,000.

Required

Calculate the trading income assessments arising from these accounting profits, and state how much overlap profits are carried forward for relief in the future.

a

Answer

The tax year of change = 2009/10

This is the earlier of the first tax year where the accounts are:

(i) prepared to the new accounting date (i.e. 2009/10), or

(ii) not prepared to the old accounting date (i.e. 2010/11 in this example)

Trading income assessment for the year before the change: 2008/09

2008/09: CYB: year ended 31.8.2008: £16,500

Trading income assessment for the year after the change: 2010/11

2010/11: CYB: year ended 28.2.2011: £11,000

Period not assessed = 1 September 2008 to 28 February 2010

Gap = 18 months

Gap is more than 12 months:

Therefore assess profits of the gap period and deduct overlap relief

	£
Profits of the gap period (1.9.2008 – 28.2.2010)	
Year ended 31 August 2009	13,500
6 months ended 28 February 2010	9,500
Less overlap relief $10{,}000 \times \frac{18 - 12}{6}$	(10,000)
Trading income assessment for 2009/10	13,000

Overlap profits:	£
Opening years	10,000
On change of accounting date – amount relieved	(10,000)
Overlap profits to carry forward	Nil

The closing years

- The closing year scenarios
- The impact of closing years on tax-adjusted profits
- The impact of closing years on capital allowances
- The closing year basis of assessment rules

4 The closing years

4.1 The closing year scenarios

An unincorporated business may cease to trade for a variety of reasons. In examination questions it is common for one of the following closing year scenarios to be chosen:

- The death of the owner
- The cessation and closure of the business
- The sale or gift of the business to another individual
- The sale of the business to an existing company
- The incorporation of the business.

In all these scenarios, the closing year basis of assessment rules are applied to the adjusted profit after capital allowances to determine the final income tax assessments.

In addition to income tax considerations:

- inheritance tax may arise on the death of the individual,
- capital gains tax may arise on the cessation and sale of the business, and
- there are many different tax consequences to consider on the incorporation of a business.

This chapter concentrates on the income tax consequences of the closing years.

4.2 The impact of closing years on tax-adjusted profits

When an unincorporated business ceases to trade it is rarely on the normal accounting date. Therefore the last accounting period is usually not 12 months in length.

The adjustment of profit computation is exactly the same in the last accounting period as in any other period in the life of the unincorporated business.

However, special rules do apply where the business receives income or incurs expenditure after the cessation of trade (for example where debts are recovered or rectification work is required).

Post-cessation events

Income relating to the trade which is received after the business has ceased is taxable in the tax year of receipt.

Expenditure incurred after the trade has ceased is specifically deemed to be tax allowable provided the expenditure:

- is incurred within the seven years after the cessation of trade, and
- would be allowable expenditure if incurred whilst trading.

The expenditure is relieved:

- by deduction from total income in the tax year the expenditure is incurred, and
- if total income is insufficient to absorb the expenditure, the excess expenditure may be set against capital gains.

4.3 The impact of closing years on capital allowances

On the cessation of trade the capital assets of the business are usually sold, taken over by the owner or transferred to a new business at market value (MV). As a result, balancing charges or balancing allowances arise on the disposal of the capital assets.

The succession election

If the unincorporated business is transferred to another business and the owner of the old business is connected to the new trade, a **succession election** can be made and special rules are applied, provided the conditions are satisfied.

The special rules are as follows:

- The assets are transferred to the new business at TWDV (not MV)
- Any sale proceeds received are ignored
- Balancing charges and balancing allowances do not arise on the old business
- The new business claims capital allowances based on the TWDV.

The following conditions must be satisfied for this treatment to apply:

- The assets must be **used in the trade** both **before and after** the transfer
- Both businesses must be chargeable to UK tax on the profits of the trade
- A **joint** election must be made for this treatment to apply
- The election must be made **within two years** of the transfer of the business.

4.4 The closing year basis of assessment rules

The closing year rules and approach are summarised as follows:

- **Step 1:** Work out which tax year is the final year of assessment
- **Step 2:** Work out the trading income assessment of the **penultimate year** on a normal current year basis
- **Step 3:** Work out the final trading income assessment as follows:

	£
All profits not yet assessed (i.e. profits from the end of the year ending in the penultimate year to the date of cessation)	X
Less overlap relief	(X)
Closing year trading income assessment	X

Example

Peter has been trading for many years preparing accounts to 30 June each year. His overlap profits are £4,105. Peter ceased to trade on 31 October 2010 and has provided the following results for the last three accounting periods:

Period ended	Adjusted profit before capital allowances	Capital allowances
	£	£
30 June 2009	42,470	14,480
30 June 2010	25,520	11,000
31 October 2010	16,830	13,590

Required

Calculate Peter's last two trading income assessments.

Answer

Year ended		Adjusted profit after capital allowances
		£
30 June 2009	(£42,470 – £14,480)	27,990
30 June 2010	(£25,520 – £11,000)	14,520
31 Oct 2010	(£16,830 – £13,590)	3,240

Cessation of trade: 31 October 2010 = in tax year 2010/11 = last tax year

Penultimate year:

2009/10	CYB	Year ended 30.6.2009	£27,990

Final tax year:

	£
Profits not yet assessed (1.7.2009 – 31.10.2010)	
Year ended 30 June 2010	14,520
Period ended 31 October 2010	3,240
Less overlap relief	(4,105)
Closing year trading income assessment	13,655

The treatment of partnerships

- The taxation of a partnership's trading profits
- The allocation of partnership profits and losses
- The consequences of a change in the partnership agreement
- The calculation of a partner's trading income assessment
- The consequences of a change in the composition of the partnership
- The taxation of a partnership's non-trading income and gains

5 The treatment of partnerships

5.1 The taxation of a partnership's trading profits

A partnership is not treated as a separate entity and does not pay income tax itself.

Partners in a partnership are treated as a group of sole traders. Each partner is taxed separately on his share of the partnership profit (or loss). Each partner is responsible for paying income tax at the appropriate rate on his share of the profits in the partnership **as if** operating as a sole trader in his own right.

The adjusted profit (or loss) after capital allowances of the partnership must therefore be allocated between the individual partners before deciding in which tax year the profits are to be assessed.

In calculating the adjusted profit after capital allowances of a partnership it is important to remember the following:

- In the adjusted profit computation, add to profit any appropriations made by the partners that have been charged through the accounts (such as salaries paid to partners and interest on capital introduced by the partners).
- In the capital allowances computation, include any assets that are used in the partnership but are owned privately by the individual partners.

  Individual partners cannot claim capital allowances on privately owned assets. The assets must be included in the partnership claim. However, only the business proportion of the allowances available on these assets can be claimed.

5.2 The allocation of partnership profits and losses

The adjusted profit (or loss) after capital allowances is allocated in accordance with the **partnership agreement in the accounting period** in which the profit (or loss) arises.

A partnership agreement will specify the allocation rules which must be followed.

Typically, an agreement will allocate profits in three ways:

- a fixed salary for some or all of the partners
- a fixed interest rate on capital introduced to the partnership
- a profit sharing ratio (PSR) for the balance of the profits after any salary and interest is allocated.

Despite the terms used to describe the method of allocation between partners, the total share allocated to each partner is then assessable on that partner as trading income (**not** as employment income and interest income).

5.3 The consequence of a change in the partnership agreement

If a partner leaves, or a new partner joins, or the partners change the partnership agreement part way through an accounting period:

- the adjusted profit after capital allowances must be time-apportioned according to the date of change, and
- the appropriate partnership agreement rules are applied to each period separately.

Example

Ronald and Steven are in partnership and prepare accounts to the 31 December each year. The partnership agreement until 31 October 2009 provides for the following:

	Ronald	**Steven**
	£	£
Salary per annum	60,000	36,000
Capital introduced	150,000	120,000
Interest on capital (rate per annum)	5%	5%
Profit sharing ratio	60%	40%

With effect from 1 November 2009 the new partnership agreement is as follows:

	Ronald	**Steven**
	£	£
Salary per annum	72,000	60,000
Interest on capital (rate per annum)	10%	10%
Profit sharing ratio	50%	50%

The adjusted profit of the partnership after capital allowances for the year ended 31 December 2009 was £295,200.

Required

Allocate the partnership profits for the year ended 31 December 2009 between Ronald and Steven.

a

Answer

	Total	Ronald	Steven
10 months to 31 October 2009	£	£	£
Salary (£60,000 × 10/12 : £36,000 × 10/12)	80,000	50,000	30,000
Interest on capital introduced			
(5% × £150,000 × 10/12 : 5% × £120,000 × 10/12)	11,250	6,250	5,000
Balance of profits (60% : 40%)	154,750	92,850	61,900
Allocation of profits (£295,200 × 10/12)	246,000	149,100	96,900
2 months to 31 December 2009	£	£	£
Salary (£72,000 × 2/12 : £60,000 × 2/12)	22,000	12,000	10,000
Interest on capital introduced			
(10% × £150,000 × 2/12 : 10% × 120,000 × 2/12)	4,500	2,500	2,000
Balance of profits (50% : 50%)	22,700	11,350	11,350
Allocation of profits (£295,200 × 2/12)	49,200	25,850	23,350
12 months to 31 December 2009			
Total allocation of profits	295,200	174,950	120,250

5.4 The calculation of a partner's trading income assessment

The calculation of the trading income assessments for partners is the same as for a sole trader.

Once each partner's profit share has been calculated, the appropriate basis of assessment rules are applied to each partner's share (i.e. opening year, closing year, normal CYB or change of accounting date rules).

5.5 The consequence of a change in the composition of the partnership

The creation of a partnership

When the partnership is originally set up:

- The opening year rules are applied in the normal way to each of the original partner's share of the profits in the opening tax years.
- The overlap profits of each individual partner are calculated separately.

When a new partner joins

If an existing partnership takes on a new partner, or a sole trader takes on a partner and the business becomes a partnership, the following consequences arise:

- The existing partners (or sole trader) continue to be assessed on their share of the profits on a normal current year basis as if there had been no change.

- The new partner is assessed on his share of the profits using the opening year rules and assuming the partner had his own accounting period starting on the date he joined the firm. The overlap profits of that partner are calculated.

The cessation of a partnership

When the partnership business ceases to trade:

- The closing year rules are applied in the normal way to each partner's share of the profits in the closing accounting periods.
- Each partner can deduct his own overlap relief.

When a partner leaves

If a partner leaves the partnership (e.g. retires or dies) and the existing business continues either as a partnership or as a sole trader business, the following consequences arise:

- The continuing partners (or sole trader) are assessed on their share of the profits on a normal current year basis as if there had been no change.
- The partner leaving the firm is assessed on his share of the profits, using the closing year rules and assuming the partner had his own accounting period ending on the date he left the firm. He will use his overlap relief in the final year of assessment.

On a change of accounting date

Where there is a change in the accounting date of the partnership business, the change of accounting date rules are applied separately to each partner's share of profits.

Example

Nicholas and David are partners and have been trading for many years preparing accounts to 30 September each year. They have agreed to share profits in the ratio 55%:45%. On 1 July 2009 Thomas joined the firm on the agreement that the three partners would share profits in the ratio 2:2:1.

The adjusted profits after capital allowances of the partnership are as follows:

	Adjusted profit after capital allowances
	£
Year ended 30 September 2009	428,800
Year ended 30 September 2010	536,000

Required

Calculate the trading income assessments of each partner for 2009/10 and 2010/11 and Thomas' overlap profits.

a Answer

Allocation of profits between partners:

Year ended 30 September 2009	**Total**	**Nicholas**	**David**	**Thomas**
9 months to 30 June 2009	£	£	£	£
Profit share (55%: 45%)	321,600	176,880	144,720	Nil
3 months to 30 September 2009				
Profit share (2/5: 2/5: 1/5)	107,200	42,880	42,880	21,440
Allocation of profits	428,800	219,760	187,600	21,440
Year ended 30 September 2010				
Profit share (2/5: 2/5: 1/5)	536,000	214,400	214,400	107,200

Trading income assessments of existing partners:

			Nicholas	**David**
			£	£
2009/10	CYB	Year ended 30 September 2009	219,760	187,600
2010/11	CYB	Year ended 30 September 2010	214,400	214,400

Thomas' trading income assessment:

		£
Thomas' share of profits:	3 months to 30 September 2009	21,440
	Year ended 30 September 2010	107,200

Thomas started to trade: 1 July 2009 = in tax year 2009/10 = his first tax year

First tax year: Assess Thomas' profits from 1 July 2009 to 5 April 2010

Second tax year = 2010/11. Ask two questions:

Are there accounts which end in the tax year?	Yes = year ended 30 September 2010
Are these accounts 12 months in length?	Yes
Decision	Assess those 12 months' profits

Tax year	**Basis of assessment**	**Basis period**	**Workings (to nearest month)**	**Trading income assessment**
				£
2009/10	Actual	1.7.2009 – 5.4.2010	£21,440 + (6/12 × £107,200)	75,040
2010/11	12 months ending in second year	y/e 30.9.2010		107,200

Thomas' overlap profits:

Overlap period: 1.10.2009 to 5.4.2010.

Overlap profits: (6/12 × £107,200) = £53,600.

5.6 The taxation of a partnership's non-trading income and gains

As mentioned earlier, a partnership is not treated as a separate entity and does not pay income tax itself.

Partners in a partnership are treated as a group of sole traders. Each partner is taxed separately on his share of the partnership income and gains.

As seen above, each partner is assessed on his share of the partnership trading profits as trading income in his own income tax computation. Similarly, each partner is assessed on his share of other partnership income and gains separately as individuals.

However, the allocation of a partnership's non-trading income and gains is different to the allocation of trading profits.

The allocation rules are as follows:

	Basis of assessment	**Allocation according to:**
Non-trading income:		
- received gross (e.g. rental income, gilt-edged security interest)	Amount credited in the accounts in the accounting period	PSR in the **accounting period**
- received net (e.g. bank interest)	Amount received in the tax year	PSR in the **tax year of receipt**
Capital gains	Net gains arising in the tax year	PSR in the **tax year in which the net gains arose**

A partner is assessed to income tax on his share of income and capital gains tax on his share of capital gains.

Each partner claims his income tax loss relief, capital gains rollover relief, gift relief and entrepreneurs' relief in respect of his allocated share separately in his own tax computations.

More detail on partnership capital gains is covered in the capital gains chapters.

CHAPTER

7

Relief for trading losses

Contents

An overview of relief for trading losses at Paper P6

- The calculation of trading losses
- The proforma loss relief computation

1 An overview of relief for trading losses at Paper P6

1.1 The calculation of trading losses

A trading loss occurs when the adjusted profit after capital allowances computation results in a negative figure. If a trading loss occurs, the trading income assessment for the appropriate tax year is £Nil.

Assuming a trading loss is incurred in the year ended 31 August 2009 and the business has been trading for many years, the calculation of the trading loss and the trading income assessment is as follows:

Year ended 31 August 2009	£
Adjusted profit / (loss) before capital allowances	X/(X)
Capital allowances on plant and machinery	(X)
Industrial buildings allowances	(X)
Trading loss for year ended 31 August 2009	(X)
2009/10: Current year basis of assessment	
Trading income assessment	£Nil

1.2 The proforma loss relief computation

This proforma assumes that the trading loss arises in the accounting period which forms the basis of the 2009/10 tax year and the business is continuing to trade.

Income tax computations	**2008/09**	**2009/10**	**2010/11**
	£	£	£
Trading income	X	Nil	X
Less s83 trading losses b/f	-	-	(X)
	X	Nil	X
Other income	X	X	X
Less Allowable interest payments	(X)	(X)	(X)
Net income before loss relief	X	X	X
Less s64 and s72 relief			
- current year claim		(X)	
- carry back claim	(X)		
Net income after loss relief	X	X	X
Less Personal allowance	(X)	(X)	(X)
Taxable income	X	X	X

(W) Record of trading losses

	£	£
Trading loss b/f		X
Set off under s83		(X)
Trading loss in the tax year	X	
Set off under s64/s72/s89		
- in tax year of loss (i.e. 2009/10)	(X)	
- in preceding tax year (i.e. 2008/09)	(X)	
- earlier years: (FIFO) if s72, (LIFO) if s89	(X)	
Trading loss c/f under s83	X	X

Relief for trading losses in the ongoing years

- The reliefs available in the ongoing years
- The rules of s83 ITA 2007
- The rules of s64 ITA 2007
- Additional relief for trading losses incurred in 2009/10
- The rules of s261B TCGA 1992

2 Relief for trading losses in the ongoing years

2.1 The reliefs available in the ongoing years

The following reliefs for trading losses are available to an ongoing unincorporated business:

(1) **Carry forward the trading loss under s83 ITA 2007**:

to set off against the first available profits from the trade that produced the loss

(2) **Make a claim for relief under s64 ITA 2007**:

to set off the trading loss against the total income of the individual:

– in the tax year of the loss, **and/or**

– in the preceding tax year.

(3) Make a claim as in 2 above and then claim additional relief against trading profits of the three preceding tax years. (This additional form of loss relief only applies to losses incurred in 2009/10.)

(4) **Make a claim for relief under s261B TCGA 1992**:

to extend the relief in (2) above to set off the trading loss against the net capital gains of the individual:

– in the tax year of the loss, **and/or**

– in the preceding tax year.

Section numbers in the tax legislation

The loss relief rules are contained in the Income Tax Act 2007 (ITA 2007) and the Taxation of Chargeable Gains Act 1992 (TCGA 1992). Knowledge of the section numbers is not required for the examination. However, using section numbers can be useful in an income tax loss computation, and so they are used in this text. Candidates will not be penalised if section numbers are quoted incorrectly in an examination answer.

2.2 The rules of s83 ITA 2007

Income tax trading losses are **automatically** carried forward under s83 ITA 2007 unless the individual makes an alternative loss relief claim.

Under s83 losses can be carried forward **indefinitely,** but they must be set off against the **first available trading profits of the trade which produced the loss.**

The following rules must therefore be applied:

- The trading loss must be set off in the next tax year if possible.
- The set-off is against trading income assessments only; a loss carried forward cannot be set off against other income or gains.
- The loss carried forward can only be set off against future profits from the activity that produced the loss; it cannot be set off against profits of a different trading activity.
- In each future tax year the maximum amount of trading loss must be set off until relief has been given for the total trading loss.
- The effect of this is that the loss to be relieved in any tax year is the lower of:
  - the loss available
  - the trading profit of the tax year.

The amount of trading loss available to carry forward under s83 must be agreed with HMRC within four years of the end of the tax year in which the loss was incurred (i.e. for a 2009/10 loss, by 5 April 2014).

2.3 The rules of s64 ITA 2007

Under s64 ITA 2007 an individual can make a claim to set off the trading loss against his total income in:

- the tax year of the loss, **and/or**
- the preceding tax year.

A claim can be made in both years in any order, in neither year, or in either year in isolation. However, a making a claim is **optional**.

An individual therefore has five options for utilising an ongoing trading loss:

(1) set off against total income in the current year only (i.e. the tax year of the loss)

(2) set off against total income in the preceding tax year only

(3) set off against total income in the current year first and then set off in the preceding tax year

(4) set off against total income in the preceding tax year first and then set off in the current year

(5) make no specific loss relief claim and the trading losses will be automatically carried forward under s83, as explained earlier.

The following rules apply under s64:

- The trading loss is set off against total income (i.e. all other income **after deducting** allowable interest payments). (Note that the legislation does not actually specify whether the set off should be made before or after any allowable interest payments. However, unrelieved losses can be carried forward, whereas unrelieved interest payments cannot.)

- The claim is optional. However, if the claim is made, the maximum amount must be deducted from total income (it is an 'all or nothing' relief).
- A claim under s64 may reduce the total income to £Nil, so that the relief for personal allowances is lost.
- A claim for relief under s64 must be made within one year of the 31 January following the end of the tax year of the loss (i.e. for a 2009/10 loss, by 31 January 2012).
- If an individual claims relief under s64, any trading losses left unrelieved are **automatically** carried forward under the rules of s83, unless the additional relief for losses incurred in 2009/10 is claimed or a s261B TCGA 1992 claim is made to extend the use of s64 to match against capital gains.

Example

Preston prepares his accounts to 31 July each year and has supplied the following information:

Year ended 31 July	**2008**	**2009**	**2010**
	£	£	£
Trading profit / (loss)	42,600	(38,400)	19,500
Building society interest	1,120	772	1,056
Dividends received from a UK company	324	72	990
Allowable interest payments	1,200	1,200	1,200

Required

(a) Calculate the taxable income for each tax year assuming losses are relieved as soon as possible.

(b) Calculate the unrelieved loss, if any, available to carry forward at 6 April 2011. Assume the 2009/10 personal allowance applies in each year.

Answer

(a) Trading income assessments:

Year ended	**Basis of assessment**	**Tax year of assessment**	**Trading income assessment**
31 July 2008	CYB	2008/09	£42,600
31 July 2009	CYB	2009/10	Nil
31 July 2010	CYB	2010/11	£19,500

2009/10 = tax year of the loss

Preston: Income tax computations	**2008/09**	**2009/10**	**2010/11**
	£	£	£
Trading income	42,600	Nil	19,500
Less s83 trading losses b/f	(Nil)	(Nil)	(Nil)
	42,600	Nil	19,500
Building society interest (× 100/80)	1,400	965	1,320
Dividend income (× 100/90)	360	80	1,100
	44,360	1,045	21,920
Less allowable interest payments	(1,200)	(1,200)	(1,200)
Total income before loss relief	43,160	Nil	20,720
Less s64 loss relief	(38,400)	(Nil)	(Nil)
Total income after loss relief	4,760	Nil	20,720
PA	(4,760)	Wasted	(6,475)
Taxable income	Nil	Nil	14,245

(W) Record of trading loss	**2009/10**
	£
Trading loss in tax year	38,400
s64 loss relief claimed in 2008/09	(38,400)
Trading loss c/f under s83	Nil

There is no loss left to carry forward at 6 April 2011.

Note that the question required relief to be set off as soon as possible. This means that the loss is not carried forward under s83. Instead, a s64 claim is to be made in the preceding year and then in the current year, if possible.

If the requirement had been for losses to be set off in the most tax-efficient manner, the answer would have been the same. This is because:

- there is no total income in the current year (i.e. 2009/10) against which to make a claim
- carrying forward the loss will waste more personal allowances, save tax at a lower rate and the individual has to wait for the tax relief for his loss.

Therefore, even though some personal allowances are lost with a carry back claim, the relief is obtained as soon as possible and saves the individual the largest amount of tax. It may also be possible to avoid the wastage of personal allowances by not claiming full capital allowances (see tax planning section later).

2.4 Additional relief for trading losses incurred in 2009/10

Finance Act 2009 has introduced a temporary extension to the trading loss rules. This extension applies to losses incurred in 2008/09 and 2009/10. However, the examiner has advised that any question involving additional relief will be confined to losses incurred in 2009/10.

The additional relief allows losses to be carried back and set against trading profits of the three preceding tax years. This carry back is on a last-in-first-out (LIFO) basis. It is important to note that the additional relief can only be claimed if the taxpayer makes a claim under s64 first, unless their total income for both the year of the loss and the preceding year is nil. (However, the s64 claim only needs to be made against one of the two possible years, not both.)

There is a limit of £50,000 on the total relief that can be claimed against the two earliest years of set off. (There is, however, no restriction on the amount that can be claimed against 2008/09 income.)

The rules relating to the extended form of loss relief can be summarised as follows:

Rule:	**Explanation:**
Losses incurred in 2009/10	▪ Losses are allocated to tax years in the same way as profits.
Set off against total income first	▪ Before the additional relief may be claimed a normal s64 claim must be made against total income of 2008/09 and/or 2009/10, unless the total income of both years is nil.
Relief against trading profits	▪ Although s64 relief is set against total income, the additional relief can only be set against trading profits.
Relief on LIFO basis	▪ The set off is against profits of the most recent years first, i.e. 2008/09, then 2007/08 and finally 2006/07. ▪ It is not possible to relieve in one or two years only, unless there is insufficient loss to relieve all three years.
Must set off as much as possible in the tax year	▪ It is an all or nothing relief. ▪ The claim is optional. However, if the claim is made, the maximum amount must be deducted from the total income.
Relief restricted to £50,000	▪ The restriction applies only to 2007/08 and 2006/07. ▪ The additional relief for those two tax years is limited to a total of £50,000.

Example

Eric has been trading for many years preparing accounts to 31 January each year. His results for the last few years are as follows:

	Adjusted profit / (loss) after capital allowances
	£
Year ended 31 January 2007	45,000
Year ended 31 January 2008	15,000
Year ended 31 January 2009	8,000
Year ended 31 January 2010	(68,000)

Eric receives rental income of £6,000 each year.

Required

Calculate Eric's taxable income for all tax years affected assuming he claims loss relief in the most beneficial way. Assume the 2009/10 personal allowance applies in all years.

Answer

Step 1: Apply the basis of assessment rules to determine the trading income assessments.

Tax year	Basis of assessment	Basis period	£
2006/07	CYB	Year ended 31 January 2007	45,000
2007/08	CYB	Year ended 31 January 2008	15,000
2008/09	CYB	Year ended 31 January 2009	8,000
2009/10	CYB	Year ended 31 January 2010	Nil

Step 2: Slot the figures of income into the income tax computation and make a s64 set off in either 2008/09 or 2009/10.

Income tax computations	2006/07	2007/08	2008/09	2009/10
	£	£	£	£
Trading income	45,000	15,000	8,000	Nil
Minus: additional loss relief	(?)	(?)	-	Nil
			8,000	Nil
Property income	6,000	6,000	6,000	6,000
			14,000	6,000
Minus: s64 loss relief	-	-	(14,000)	Nil
Total income	16,000	6,000	Nil	6,000
Minus: Personal allowance	(6,475)	(6,475)	wasted	(6,000)
Taxable income			Nil	Nil

Step 3: Carry the remainder of the loss back against trading income on a LIFO basis, being careful to ensure that no more than £50,000 is carried back in total against 2006/07 and 2007/08.

Income tax computations	**2006/07**	**2007/08**	**2008/09**	**2009/10**
	£	£	£	£
Trading income	45,000	15,000	8,000	Nil
Minus: additional loss relief	(35,000)	(15,000)	-	Nil
	10,000	Nil	8,000	Nil
Property income	6,000	6,000	6,000	6,000
	16,000	6,000	14,000	6,000
Minus: s64 loss relief	-	-	(14,000)	-
Total income	16,000	6,000	Nil	6,000
Minus: Personal allowance	(6,475)	(6,000)	wasted	(6,000)
Taxable income	9,525	Nil	Nil	Nil

Working: Record of trading losses	**£**
Loss	68,000
Set off under s64	
- in 2008/09	(14,000)
- additional relief in 2007/08	(15,000)
- additional relief in 2006/07	(35,000)
(restricted to 50,000 – 15,000)	
Carried forward under s83	4,000

Notes

In order to claim the additional relief, Eric must make a s64 claim in either 2008/09 or 2009/10. The above example assumes that the claim has been made in 2008/09 even though this results in the loss of his personal allowance for that year.

Eric could have chosen to make the s64 claim in 2009/10. However, this would have resulted in the loss of his personal allowance for that year instead. The overall result for the four years would have been the same.

2.5 The rules of s261B TCGA 1992

After a s64 claim has been made in a tax year, an individual can make a claim to extend the relief and to set off some of the trading loss against his gains under s261B TCGA 1992.

An individual can make a claim to set off the trading loss against his gains:

- in the tax year of the loss, **and/or**
- in the preceding tax year,

- **but only if** a s64 claim has been made first in the appropriate year.

When setting off the trading loss under s261B in the current or preceding tax year, the following rules apply:

- The trading loss is treated **as if** it is a **current year capital loss:** i.e. s261B losses must be set off against current year gains.
- The claim is optional. However, if the claim is made, the maximum amount must be deducted from current year gains (it is an all or nothing relief).
- An individual cannot restrict the set off to preserve the annual exemption.
- The loss relief claim may reduce the chargeable gains so that the relief for the annual exemption is lost.
- There is a limit on the amount of s261B claim available. This needs to be calculated in a separate working (see below)
- A claim must be made for s261B relief within the same timescale as a s64 claim. This is within one year of the 31 January following the end of the tax year of the loss (i.e. for a 2009/10 loss, by 31 January 2012).
- If an individual claims under s64 and s261B, any trading losses left unrelieved are **automatically** carried forward and set off under the rules of s83 unless the additional relief for losses incurred in 2009/10 is claimed.

The amount of a s261B claim

The amount of a s261B claim is calculated as follows:

		£
Lower of	(i) The unrelieved trading loss **after** the s64 claim has been made	X
	(ii) Total gains for the year	X
	Total capital losses for the year	(X)
	All capital losses brought forward	(X)
	Maximum amount	X

In this calculation the annual exemption is ignored, and **all** capital losses are deducted in full.

Example

Henry prepares accounts to 30 September each year. In the year ended 30 September 2009 he incurred a trading loss of £38,400. He has provided the following information relating to 2009/10:

	£
UK rental income	20,580
Chargeable gains	28,960

Henry also has capital losses of £15,850 brought forward.

Required

Calculate Henry's taxable gains assuming a current year s64 and s261B claim is made. State the amount of any losses remaining unrelieved, if any.

Answer

The amount of s261B claim is the lower of:

		£
(i)	the unrelieved trading loss **after** the s64 claim has been made (£38,400 - £20,580)	17,820
(ii)	Gains for the year	28,960
	Total capital losses for the year	(Nil)
	All capital losses brought forward	(15,850)
	Maximum amount	13,110

Harry - Capital gains tax computation – 2009/10	£
Gains for the year	28,960
S261B claim	(13,110)
Net gains for the year	15,850
Capital losses brought forward (see note)	(5,750)
	10,100
Annual exemption	(10,100)
Taxable gains	Nil

Note

Brought forward capital losses are only set off to the extent necessary to reduce the total net gains to the level of the annual exemption.

Losses remaining unrelieved

Trading losses

	£
Trading loss in tax year	38,400
s64 current year claim	(20,580)
s261B current year claim	(13,110)
Trading loss c/f under s83	4,710

Capital losses

	£
Capital loss brought forward	15,850
Current year set-off	(5,750)
Capital loss c/f	10,100

Relief for trading losses in the opening years

- The rules of s64 in the opening years
- The rules of s72 ITA 2007

3 Relief for trading losses in the opening years

3.1 The rules of s64 in the opening years

The general principles of s64 in the opening years are exactly the same as the rules applying in the ongoing years. However, when applying the opening year rules to a loss-making accounting period, it is possible for one accounting period loss to give rise to two separate losses for s64 relief in different years.

Care must be taken in identifying the tax year of the loss and the amount of relief available under s64.

Where consecutive losses arise, the losses should be dealt with in date order; first loss first, then the second loss. If applicable, any current year loss set off takes priority over losses carried back to that year.

The procedure for opening year loss relief questions

The procedure to adopt in questions involving an opening year loss is as follows:

Step 1: Work out the trading income assessments for each tax year

- The opening year basis of assessment rules (i.e. first year = actual basis, and so on) are applied to both profits and losses in the same way.
- Where an overall net loss arises from applying the rules (i.e. where the calculations give a negative figure), the trading income assessment for that tax year is £Nil.
- If a loss (or part of a loss) is brought into the calculation of an opening year assessment in one tax year, it cannot also be taken into account in the next tax year's calculation. This is because a loss can only be relieved once. **It is not possible to obtain relief for a greater amount than the actual loss incurred.**

Step 2: Work out the amount of loss relief available, the tax year(s) to which the loss(es) relate and identify the options available for relief of the loss(es)

- If an overall net loss is calculated in Step 1, the net loss is the amount available for s64 relief.
- The tax year of the loss is the tax year in which the net loss occurs and the trading assessment is £Nil.

Step 3: Prepare the income tax computations and keep a record of the losses

- In answering an examination question on relief for opening year losses, read the requirement of the question carefully.

- Some questions require losses to be claimed in a specified way; other questions require losses to be utilised in the most tax-efficient manner.
- Tax planning considerations are considered later in this chapter.

Example

Irene started to trade on 1 January 2010 and decided to prepare her accounts to 30 November each year. Her results for the first two periods of trading are as follows:

Period ended	Adjusted profit / (loss) after capital allowances
	£
30 November 2010	(26,400)
30 November 2011	72,000

Required

Calculate Irene's trading income assessments for the first three tax years. State the amount of loss relief available under s64, and identify the years against which a claim can be made.

Answer

Trading starts: 1 January 2010 = in tax year 2009/10 = first tax year

First tax year: Assess from 1 January 2010 to 5 April 2010

Second tax year = 2010/11. Ask two questions:

Are there accounts which end in the tax year?	Yes = period ended 30 November 2010
Are these accounts 12 months in length?	No = less than 12 months
Decision	Assess the first 12 months' profit/(loss)

Third tax year = the 12 months ending in the third tax year (y/e 30.11.2011)

Trading income assessments

Tax year	Basis period	Workings		Assessable
			£	£
2009/10	Actual:			
	1.1.2010 – 5.4.2010	3/11 × £26,400 loss		
		= Net loss	(7,200)	Nil
2010/11	First 12 months:			
	11 months ended 30.11.2010	Loss in the period	(26,400)	
		Loss already used in 2009/10 calculation	7,200	
			(19,200)	
	1 month 31.12.2010	Profit (1/12 × £72,000)	6,000	
		Net loss	(13,200)	Nil
2011/12	12 months ending in 3rd year			
	Year ended 30.11.2011			72,000

Loss relief available

From the £26,400 adjusted loss after capital allowances arising in the 11 month accounting period ended 30 November 2010, the following loss relief is available:

Tax year of loss	Amount of loss	Loss relief available
	£	
2009/10	7,200	s64 relief available against total income in: (i) 2009/10 and/or (ii) 2008/09
2010/11	13,200	S64 relief available against total income in (i) 2010/11 and/or (ii) 2009/10
2010/11	6,000	Relieved automatically by applying opening year rules
Loss left	Nil	Carry forward under s83 to set against 2011/12
	26,400	

3.2 The rules of s72 ITA 2007

For a trading loss incurred in one of the **first four tax years of assessment,** an individual can make a claim under s72 to **carry back the loss against his total income** in the **three preceding tax years** on a first-in-first-out (FIFO) basis.

When setting off the trading loss under s72 the following rules apply:

- The trading loss is set off against total income (i.e. all other income **after deducting** allowable interest payments).
- A s72 claim is a single claim that applies to all three years.
- The claim is optional. However; if the claim is made, the total income of all three years must be relieved as much as possible.
- Relief is given on a FIFO basis (i.e. the earliest year must be relieved first and then the next year and the year after that in date order).
- If the claim is made, the maximum amount must be deducted from total income (it is an all or nothing relief).
- A claim under s72 may reduce the total income to £Nil, so that the relief for personal allowances is lost.
- A claim must be made for relief under s72 within the same time limit as s64, i.e. within one year of the 31 January following the end of the tax year of the loss (i.e. for a 2009/10 loss, by 31 January 2012).

Example

The facts are the same as the previous example involving Irene.

Required

State the amount of loss relief available under s72 and the years against which a claim can be made under s72.

Answer

The trading income assessments are calculated in the same way as in the previous example.

If s72 relief is claimed

From the £26,400 adjusted loss after capital allowances arising in the 11 month accounting period ended 30 November 2010, the following loss relief is available:

Tax year of loss	Amount of loss	Loss relief available
	£	
2009/10	7,200	s72 relief available against total income in: (i) 2006/07 and then (ii) 2007/08 and then (ii) 2008/09 - in that strict order - as much as possible each year
2010/11	13,200	s72 relief available against total income in: (i) 2007/08 and then (ii) 2008/09 and then (ii) 2009/10 - in that strict order - as much as possible each year
2010/11	6,000	Relieved automatically by applying opening year rules
Loss left	Nil	Carry forward under s83 to set against 2011/12
	26,400	

Relief for trading losses in the closing years

- The loss reliefs available
- The rules of s89 ITA 2007

4 Relief for trading losses in the closing years

4.1 The loss reliefs available

An unincorporated business may cease to trade because of:

- the death of the owner
- the cessation and closure of the business
- the sale or gift of the business to another individual
- the sale of the business to an existing company
- the incorporation of the business.

Losses can occur in any of these scenarios and different loss relief options are available.

If the business is in the closing years due to any of the above reasons, trading losses can be relieved in the following ways:

(1) Make a claim under s64 ITA 2007 against total income.

(2) Make a claim as in (1) above and then claim additional relief against trading profits of the three preceding tax years. (This additional form of loss relief only applies to losses incurred in 2009/10.)

(3) Make a claim as in (1) above and then make an extension claim under s261B TCGA 1992 against net gains.

(4) Make a special closing year terminal loss relief claim under s89 ITA 2007.

If the business is incorporating, there is an additional loss relief available:

(5) Carry forward the trading loss under s86 ITA 2007.

The rules for making a claim under items (1) to (3) above are exactly the same as the rules applying in the ongoing years.

The rules for s89 are considered below. The rules for s86 are covered in chapter 18.

4.2 The rules of s89 ITA 2007

Relief is available under s89 if a trading **loss is incurred in the last twelve months of trading.**

An individual can make a claim to set off the loss:

- in the last tax year, and then

- carry back the loss against his **trading profits in the three preceding tax years** on a last-in-first-out (LIFO) basis.

When setting off the trading loss the following rules apply:

- The trading loss is set off against **trading income**
- A s89 claim is a single claim that applies to all three years.
- The claim is optional. However; if the claim is made, as much as possible of the profits of all three years must be relieved.
- Relief is given on a LIFO basis. The most recent year must be relieved first and then the previous year, and so on in reverse date order.
- If the claim is made, the maximum amount must be deducted from available income (it is an all or nothing relief).
- A claim for relief under s89 must be made within four years of the end of the last tax year (i.e. for a 2009/10 cessation loss, by 5 April 2014).

Calculating the terminal loss

The amount of loss which can be relieved under s89 is the **loss of the last twelve months of trading.** The available loss is calculated in three parts as follows:

		£
1.	Overlap profits not yet relieved	X
Last tax year		
2.	Trading loss in the last tax year (i.e. from 6 April before cessation to the date of cessation) (Ignore if a profit)	X
12 months before cessation to 5 April before cessation (the length of this period is 'y')		
3.	Actual trading loss in period 'y' (Ignore if a profit)	X
Terminal loss of the last 12 months trading		X

Note that a loss can only be relieved once. Therefore the terminal loss cannot include a loss that has been relieved under another provision. In other words, losses used in a s64 claim or a s261B claim, if any, must be excluded.

The procedure for closing year loss relief

The procedure to adopt for dealing with a closing year loss is as follows:

Step 1: Identify the last tax year. Work out the trading income assessments for the final year and preceding three tax years

The closing year basis of assessment rules are applied to both profits and losses in the normal way. However, where an overall net loss arises from applying the rules (i.e. the calculations give a negative figure), the trading income assessment for that tax year is £Nil.

Step 2: Set up the income tax loss computations in columnar format, for all the tax years affected

There should be a separate column for each tax year. Insert all the known figures into each column, i.e. the trading income assessments from Step 1, other income, allowable interest payments, personal allowances.

Step 3: Work out the amount of loss relief available, the tax year(s) to which the loss(es) relate, and the options available

If an overall net loss is calculated in Step 1, this net loss is the amount available for s64 relief. Consideration should be given as to whether a s64 and a s261B claim are desirable.

For a decision, look at the income tax computations set up in Step 2 and determine whether a higher rate of relief is obtained by making a s64 and possibly a s261B claim, rather than carrying back the loss under s89.

The terminal loss then needs to be calculated, taking account of s64 and s261B claims to be made, if any. This calculation should be done in a separate working.

Step 4: Complete the income tax computations

Relieve the terminal loss on a LIFO basis, and keep a record of the utilisation of losses for all tax years involved.

Example

Janice has been trading for many years preparing accounts to 31 December each year. On 31 July 2009 she ceased to trade. Her results for the last years are as follows:

	Adjusted profit / (loss) after capital allowances
	£
Year ended 31 December 2006	50,400
Year ended 31 December 2007	16,800
Year ended 31 December 2008	14,400
Seven months ended 31 July 2009	(9,600)

Janice received a dividend of £4,500 from a UK company on 24 June 2008. She has also received rental income of £100 per month since 2005, and paid allowable interest of £1,500 (gross) on 30 June each year.

Her overlap profits not yet relieved total £38,500.

Required

Calculate Janice's taxable income for all tax years affected, assuming losses are carried back under s89 and no other loss relief claim is made. Assume the 2009/10 personal allowance applies in all years.

Answer

Cessation of trade: 31 July 2009 = in tax year 2009/10 = last tax year

Penultimate year: 2008/09 = CYB basis of assessment = y/e 31 December 2008

Last tax year assessment – 2009/10:	£
Profits not yet assessed (1.1.2009 – 31.7.2009)	
Period ended 31 July 2009 - loss	(9,600)
Less Overlap relief	(38,500)
Net loss = loss relief available under s64	(48,100)
Final tax year assessment for 2009/10	Nil

Summary of assessments:

Tax year	**Basis of assessment**	**Basis period**	£
2006/07	CYB	Year ended 31 December 2006	50,400
2007/08	CYB	Year ended 31 December 2007	16,800
2008/09	CYB	Year ended 31 December 2008	14,400
2009/10	as above		Nil

Income tax computations

Set up the income tax computations in columnar form as follows, inserting all known figures. At this stage the terminal loss figures and therefore the final result are not known.

	2006/07	**2007/08**	**2008/09**	**2009/10**
	£	£	£	£
Trading income	50,400	16,800	14,400	Nil
Less s89 terminal loss relief	(?)	(?)	(?)	Nil
				Nil
Rental income (12 × 100)	1,200	1,200	1,200	1,200
Dividend income (× 100/90)	Nil	Nil	5,000	Nil
				1,200
Less Allowable interest payments	(1,500)	(1,500)	(1,500)	(1,500)
Total income				Nil
Less Personal allowance	(6,475)	(6,475)	(6,475)	Wasted
Taxable income				Nil

The final tax year (2009/10) can be completed:

- there will be no s64 claim as there is no net income
- there are £300 of unrelieved interest payments in the last year, and
- the personal allowance is wasted.

The terminal loss calculation

		£	£
1.	Overlap profits not yet relieved		38,500
	Last tax year		
2.	Actual trading loss in last tax year		
	Period 6.4.2009 to 31.7.2009: (4/7 × £9,600 Loss) = £5,486 loss		5,486
12 months before cessation to 5 April before cessation			
1.8.2008 to 5.4.2009 = 8 months			
3.	Actual trading loss in this 8 month period		
	Period 1.8.2008 to 31.12.2008: (5/12 × £14,400) profit	6,000	
	Period 1.1.2009 to 5.4.2009: (3/7 × £9,600 loss) loss	(4,114)	
	Net profit for the period	1,886	Nil
	– ignore profit in loss calculation		
	Terminal loss of the last 12 months trading		43,986

Completed income tax computations

	2006/07	2007/08	2008/09	2009/10
	£	£	£	£
Trading income	50,400	16,800	14,400	Nil
Less s89 terminal loss relief	(12,786)	(16,800)	(14,400)	Nil
	37,614	Nil	Nil	Nil
Rental income (12 × 100)	1,200	1,200	1,200	1,200
Dividend income (× 100/90)	Nil	Nil	5,000	Nil
	38,814	1,200	6,200	1,200
Less Allowable interest payments	(1,500)	(1,200)	(1,500)	(1,500)
Total income	37,314	Nil	4,700	Nil
Less Personal allowance	(6,475)	wasted	(4,700)	Wasted
Taxable income	30,839	Nil	Nil	Nil

Working: Record of trading losses

	£
Terminal loss	43,986
Set off under s89	
- in tax year of loss (2009/10)	Nil
- carry back to 2008/09	(14,400)
- carry back to 2007/08	(16,800)
- carry back to 2006/07	(12,786)
	Nil

Note that as the loss was incurred in 2009/10, a claim for additional relief could also be made. This has the same effect as a terminal loss relief claim except that relief for the earliest two years is restricted to a maximum of £50,000.

Partnership losses

- The loss relief options available to each partner
- Limited liability partnerships

5 Partnership losses

5.1 The loss relief options available to each partner

If a partnership makes a trading loss, it is allocated between the partners in the same way as for profits (i.e. in accordance with the **partnership agreement** in the **accounting period** in which it arises).

The rules for the use of losses by each partner are as follows:

- Each partner can choose to use his share of the loss in the most beneficial way.
- There is no requirement for all partners to utilise their losses in the same way.
- The options available are the same as those available to a sole trader, and the relief is obtained in exactly the same way. The options depend on whether the partner is joining the firm, leaving the firm or is an ongoing partner.

In summary, the options are as follows:

Opening years	**Ongoing years**	**Closing years**
When the partner joins the firm, the first four tax years	The partner is in at least his fifth tax year and continues to be a partner	When the partner leaves the firm
s64 claim (plus additional relief if loss arises in 2009/10)	s64 claim (plus additional relief if loss arises in 2009/10)	s64 claim (plus additional relief if loss arises in 2009/10)
s261B extension claim	s261B extension claim	s261B extension claim
s83 carry forward	s83 carry forward	s86 claim if the business incorporates
s72 claim		s89 claim

Reliefs under s72 and s89 are only available to the partners joining or leaving the firm, not to the continuing partners.

Note that where an individual carries on a trade in a non-active capacity (e.g. is a 'sleeping' partner) the loss relief available under s64 and s72 is restricted to a maximum of £25,000.

An individual is classed as non-active for this purpose if he spends less than 10 hours a week on average on the trading activities of the business.

5.2 Limited liability partnerships

A limited liability partnership (LLP) is a partnership in which the partners' liability to contribute towards the partnership debts and losses is limited in the partnership agreement.

The taxation of these partnerships is as follows:

- A partner in a LLP is taxed in the same way as a partner in a normal partnership.
- Where an individual 'limited partner' has a share of the partnership loss to utilise, the options available for loss relief are the same as for any partner. However, the amount of loss relief available may be restricted.
- The amount of loss which can be relieved against non-partnership income is restricted to the 'total contribution' to the business by that partner by the end of the tax year against which a claim for loss relief is being made.
- The 'total contribution' of a partner is the total capital introduced to the business by him **plus** his share of any profits earned while he has been a partner **less** any drawings by him.
- This restriction affects the amount that a partner can claim under s64, s72, s86 and s261B.
- The restriction does not affect:
  - the ability to carry forward relief under s83 against future partnership income,
  - a s89 terminal loss relief carry-back claim against the trading income from the partnership, or
  - the additional relief for trading losses incurred in 2009/10.

Tax planning with trading losses

- Choosing the optimum loss relief
- Making a reduced capital allowances claim

6 Tax planning with trading losses

6.1 Choosing the optimum loss relief

When using trading losses, the primary aim of an individual is to save the maximum amount of tax.

A secondary aim is to obtain relief as soon as possible, although an individual may be prepared to wait for the relief if he is guaranteed a higher rate of relief by carrying forward.

Key factors in deciding the optimum loss relief

- The rates of tax the individual is likely to pay in each tax year and the personal allowances available, including projected future rates of tax and allowances.
- Cash flow could be an important consideration. An individual may wish for cash flow purposes to claim relief as soon as possible. If so, carrying back losses to obtain a cash repayment, and possibly interest on that repayment, may be more important to the individual than a higher rate of relief at a later date.
- If possible, the individual should not use losses where income is already covered by personal allowances. However, the individual may be prepared to waste personal allowances in order to achieve a higher overall tax saving.
- It may be possible to avoid the wastage of personal allowances by not claiming the maximum capital allowances available.

6.2 Making a reduced capital allowances claim

Loss relief is available for the adjusted loss **including** capital allowances.

It is not possible to treat the adjusted loss and the capital allowances as two separate losses. Therefore, an individual **cannot** set off only the adjusted loss before capital allowances under s64 to maximise the tax savings and also carry forward the unrelieved capital allowances as a separate loss.

However, an individual does not have to claim **all** his capital allowances for an accounting period. He can claim any amount up to the maximum capital allowances available. Therefore, it may be advantageous to reduce a trading loss by not claiming any/all of the capital allowances available.

If a reduced capital allowances claim is made, the actual allowances claimed are deducted from the appropriate columns in the capital allowances computation. The TWDVs carried forward will therefore be higher, resulting in higher capital allowances being available in the future.

CHAPTER

8

The taxation of pensions

Contents

An overview of the taxation of pensions

- The aim of pension schemes
- The taxation relief rules
- Types of pension scheme
- Occupational pension schemes
- Personal pension schemes
- The occasions of taxation relief and charges to tax in relation to pensions

1 An overview of the taxation of pensions

1.1 The aim of pension schemes

A pension scheme is a fund of assets set up with the intention of providing lump sum benefits and a regular income (pension) for the members of the scheme on their retirement and/or benefits for dependants after their death.

An individual usually starts to contribute into a pension scheme early in his working life, with the intention of accumulating sufficient funds to pay for his retirement years.

The Government wishes to encourage individuals to make provision for their retirement. Accordingly, HMRC allow generous tax relief for the provision of pension schemes.

Setting up and contributing into a pension scheme therefore provides all individuals with a very tax efficient long term investment opportunity.

1.2 The taxation relief rules

Tax relief is only available to **registered** pension schemes, and only if the taxpayer:

- is under the age of 75, and
- is a UK resident.

1.3 Types of pension scheme

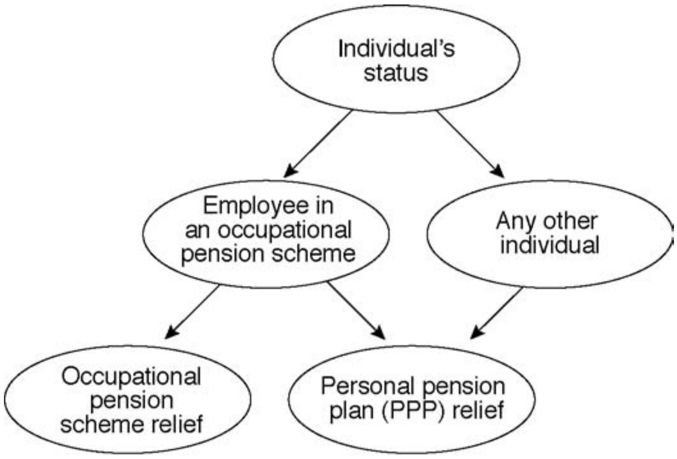
The type of scheme available depends on whether or not the individual is employed.

There are two types of pension schemes which may be **available to an employee**:

- the employer's occupational pension scheme, or
- he can set up his own personal pension plan (PPP).

A **self-employed individual** and **those who are not working** do not have a choice of the type of fund available; they can only set up a PPP. However, there is a wide choice of PPPs available on the market.

In summary:



1.4 Occupational pension schemes

An occupational pension scheme is a scheme established by an employer solely for the benefit of the employees of that business. Therefore an occupational scheme only relates to that employment. If an individual leaves that employment, he will need to set up new pension arrangements.

Employers may use a bank or a life assurance company to set up a pension scheme for their employees, or they may decide to set up their own self-administered pension fund.

Regardless of who manages the scheme, to be a registered scheme, it must be set up as a defined benefit scheme, or a money purchase scheme.

A **defined benefit scheme** means that the benefits received by the employee on retirement are fixed and stated in the pension rules from inception. The benefits received are usually related to the level of earnings of the employee.

A **money purchase scheme** means that the benefits received by the employee on retirement are not fixed. The benefits received are related to the success of the fund and the performance of the assets invested in the scheme.

Occupational schemes may be either contributory or non-contributory.

- If the scheme is a **contributory** scheme, both the employer and the employee must pay contributions into the scheme.
- If the scheme is **non-contributory,** it is only mandatory for employers to contribute into the scheme.

In practice, most occupational pension schemes are **contributory money purchase schemes**. The majority of defined benefit schemes have been converted to money purchase schemes in the last few years.

1.5 Personal pension schemes

A personal pension scheme, or personal pension plan (PPP), (also sometimes referred to as a stakeholder pension):

- is a separate pension fund,
- is usually established by way of a contract between the individual and an approved pension provider (i.e. a financial institution such as a bank or a life assurance company),
- is usually administered by the financial institution who set it up, and
- is usually a money purchase scheme.

PPPs do not relate to a particular job, trade or profession. They are personal to that individual taxpayer and are set up for the duration of his life, regardless of whether he is employed, not working, has periods of self-employment, has several trades or several jobs at different points in time.

PPPs can be set up by **any** individual, whether employed, self-employed or not working. Contributions in to a PPP can be made by:

- the individual, and
- another person on behalf of the individual (for example, the individual's spouse, other relatives or employer).

1.6 The occasions of taxation relief and charges to tax in relation to pensions

Pension schemes are a very tax-efficient investment for an individual as the following taxation reliefs are available:

- **Taxation relief is available for contributions** made into pension schemes.
- Any **income and capital profits** earned by the pension fund from the assets invested in the scheme are **exempt from income tax and capital gains tax**. This means that the fund increases in value tax-free.
- On retirement, a **tax-free lump sum** can be drawn from the pension fund.

However, the taxation relief available is subject to conditions and maximum limits. In addition, it must be remembered that:

- although income earned by the pension fund is tax-free, the tax credit on dividend income is not recoverable, and
- all retirement pensions are taxable income whether from an occupational scheme, personal pension or a state pension. Pension income is treated as normal earned income and taxed accordingly. Only the lump sum payment received on retirement (subject to limits) is tax-free.

The taxation relief for pension contributions

- An overview of the taxation relief available for pension contributions
- The maximum annual contribution eligible for tax relief
- The consequences of exceeding the annual allowance

2 The taxation relief for pension contributions

2.1 An overview of the taxation relief available for pension contributions

Taxation relief is available for contributions made into pension schemes by:

- **an individual taxpayer** into his own scheme,
- **an employer** into an employee's scheme (occupational or PPP), and
- **a third party** on behalf of another individual.

An individual can make any amount of contributions into a number of different schemes if he wishes. There is no restriction on the amount of contributions an individual can make into pension schemes.

However, there are **two key restrictions** which affect the amount of **tax relief** available. There is a restriction on:

- the total amount of contributions for which an individual will be eligible for tax relief, known as the **maximum annual contribution (MAC)**, and
- the total amount of contributions paid into scheme by the individual and by others on behalf of an individual for which tax relief will be given, known as the **annual allowance (AA)**.

2.2 The maximum annual contribution eligible for taxation relief

The maximum annual contribution (MAC) eligible for tax relief is:

Higher of		£
(a)	£3,600	X
(b)	(100% × Relevant earnings chargeable to income tax in the tax year)	X

Relevant earnings for an individual who is employed or self-employed

Relevant earnings are trading profits, employment income and income from furnished holiday lettings. Therefore, if a working individual puts all of his earned income into a pension scheme, he can obtain tax relief for the full amount.

Relevant earnings for an individual not working

If the individual is not working and has no relevant earnings, the maximum amount he can obtain tax relief for is £3,600. This is the maximum *gross* contribution that can be made into a scheme and obtain tax relief.

As contributions are made into a pension scheme *net* of 20% tax, the maximum amount of contributions payable into a scheme by a non-working individual is £2,880 (£3,600 × 80%).

Example

Four individuals provide you with the following information relating to 2009/10:

	Matthew	**Mark**	**Luke**	**John**
	£	£	£	£
Gross pension contributions paid into various pension schemes	85,440	32,040	5,340	2,225
Trading income	66,750	66,750	Nil	Nil

Required

State, with reasons, the amount of pension contributions eligible for tax relief for each individual in 2009/10.

Answer

Matthew - Gross contributions paid > relevant earnings; relief restricted to relevant earnings (i.e. £66,750)

Mark - Gross contributions paid < relevant earnings; relief = gross contributions paid (i.e. £32,040)

Luke - No relevant earnings; relief restricted to £3,600 maximum

John - Relief = gross contributions paid (i.e. £2,225) as this is lower than £3,600

2.3 The consequences of exceeding the annual allowance (AA)

Where the **total pension inputs** (TPI) into a pension scheme exceed the annual allowance (£245,000 for 2009/10), the following consequences arise:

- the individual scheme member is charged 40% income tax on the excess over £245,000, and
- the tax is collected via self assessment.

Total pension inputs (TPI)

Pension inputs can be made by the individual, his employer or anyone else. The amount of TPI into a pension scheme depends on the type of scheme as follows:

Money purchase scheme	**Defined benefit scheme**
TPI =	TPI =
All contributions made by an employer Plus **Contributions made by any individual which have obtained tax relief**	**The increase in the value of the individual's rights** during the year The individual's rights are valued at the beginning and end of the year as = (the pension that would be paid now if the individual became entitled to it) × 10 Plus the lump sum due

Example

Three individuals provide you with the following information relating to 2009/10:

	Janet	**Jill**	**Jenny**
	£	£	£
Gross pension contributions paid into a pension scheme			
- by the individual	105,000	76,000	115,000
- by their employer	145,500	98,000	141,000
Employment income	190,000	190,000	110,000

All three individuals belong to money purchase schemes.

Required

Calculate the income tax charge levied on each individual, if any.

Answer

Step 1: Calculate contributions made by individuals which will obtain tax relief

	Janet	**Jill**	**Jenny**
	£	£	£
Eligible gross contributions =	105,000	76,000	110,000*
* Jenny's relief is limited to her earnings			
Step 2: Calculate TPI			
Eligible gross contributions	105,000	76,000	110,000
Employer contributions	145,500	98,000	141,000
TPI	250,500	174,000	251,000

Step 3: Calculate income tax charge where TPI > £245,000

Income tax charge			
(250,500 – 245,000) × 40%	2,200		
TPI < AA		Nil	
(251,000 – 245,000) × 40%			2,400

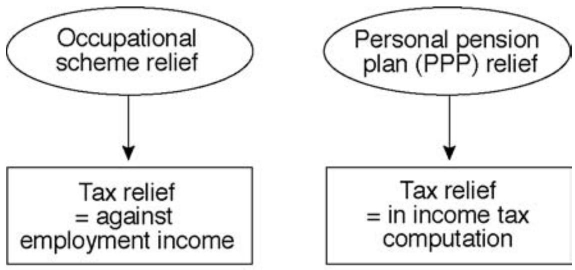
The method of obtaining taxation relief

- An overview of the method of relief
- Personal pension schemes
- Occupational pension schemes

3 The method of obtaining taxation relief

3.1 An overview of the method of relief

The method of obtaining tax relief for pension contributions depends on whether the contributions are paid to an occupational pension scheme (OPS) or a personal pension scheme as follows:



3.2 Personal pension schemes

Tax relief for contributions made into a PPP is given to the person who pays the contributions. An individual pays contributions net of tax and relief is given in the same way as for Gift Aid donations by individuals as follows:

Basic rate taxpayers

Basic rate relief (20%) is **automatically** given at source as pension contributions are paid **net** of 20% tax. Therefore pension contributions are ignored in the individual's income tax computation.

Higher rate taxpayers

Basic rate relief (20%) is **automatically** given at source. The additional 20% relief is obtained by extending the basic rate band by the **gross** amount of the pension contributions.

Example

Mabel is a self-employed individual with trading income in 2009/10 of £48,000. She also received bank interest of £460 and dividends from a UK company of £4,500.

Mabel contributed £5,744 (net) into her personal pension scheme on 31 March 2010.

Required

Calculate Mabel's income tax liability for 2009/10.

Answer

Mabel

Income tax computation: 2009/10

	Total income	Other income	Savings income	Dividend income
	£	£	£	£
Earned income				
Trading income	48,000	48,000		
Savings income				
Bank interest (£460 × 100/80)	575		575	
Dividend income				
UK dividends received (£4,500 × 100/90)	5,000			5,000
Total income	53,575	48,000	575	5,000
Less PA	(6,475)	(6,475)		
Taxable income	47,100	41,525	575	5,000

		£		£
Income tax		£		£
Basic rate band:	Other income	41,525	at 20%	8,305
	Savings income	575	at 20%	115
	Dividend income	2,480	at 10%	248
Extended basic rate band limit *(Note)*		44,580		
Higher rate band:	Dividend income	2,520	at 32.5%	819
Total taxable income		47,100		
Income tax liability				9,487

Note

Mabel is entitled to tax relief on her gross pension payment as it is less than 100% of her earnings. As she is a higher rate taxpayer her basic rate band is extended by the gross pension contributions paid.

The gross pension payment is £7,180 (£5,744 × 100/80). Therefore the extended basic rate band limit is £44,580 (£37,400 + £7,180).

Example

In 2009/10 Andrea had trading income of £542,250. She decided to make a gross contribution into her personal pension scheme of 50% of her trading profits on 3 April 2010. She has no other income.

Required

Calculate Andrea's income tax liability for 2009/10.

a

Answer

Andrea – Income tax computation: 2009/10

			£
Trading income			542,250
Less PA			(6,475)
Taxable income			535,775
Income tax	£		£
Basic rate band: (W1)	308,525	at 20%	61,705
Higher rate band:	227,250	at 40%	90,900
Total taxable income	535,775		
			152,605
Excess pension contributions charge (W2)			10,450
Income tax liability			163,055

Workings

(W1) Extended basic rate band limit

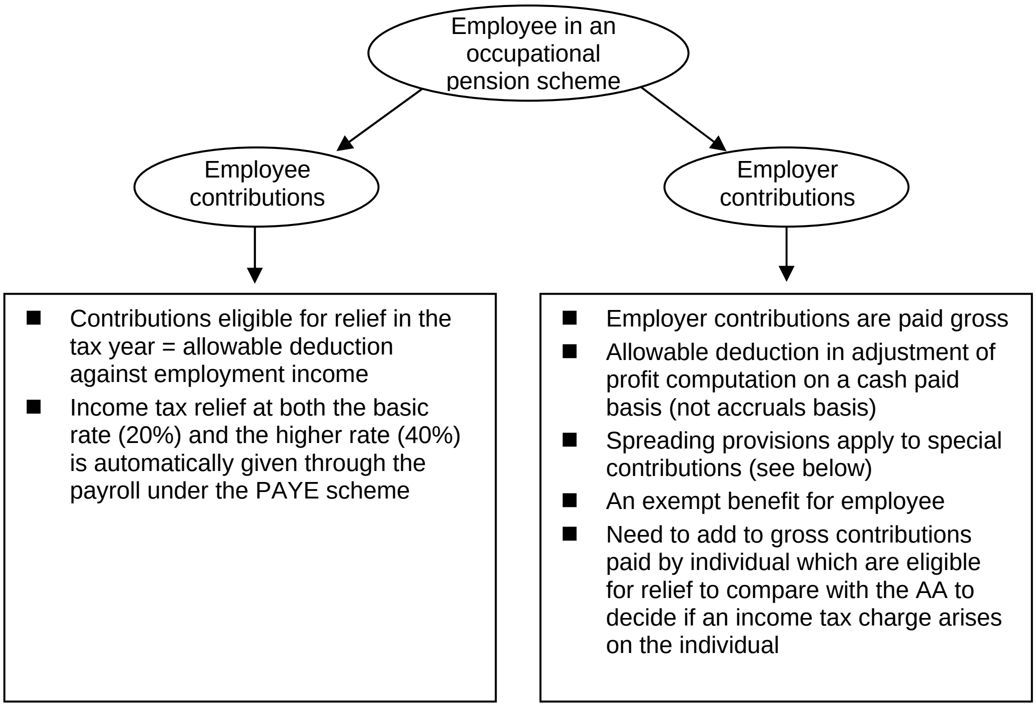
	£
Basic rate band	37,400
Add Gross pension contributions eligible for relief (£542,250 × 50%)	271,125
Extended basic rate band	308,525

(W2) Additional income tax charge

Andrea's gross contribution of £271,125 exceeds the annual allowance of £245,000. She will therefore have an additional income tax liability in 2009/10 of £10,450 (40% × (£271,125 – 245,000)).

3.3 Occupational pension schemes

The tax relief obtained for contributions made into an occupational pension scheme is as follows:



Spreading provisions

If an employer:

- makes special contributions into a scheme in excess of £500,000, and
- there is an increase of over 210% in the level of employer contributions from one period to the next,

HMRC may require the deduction from the company's profits to be spread evenly over a few years as follows:

Special contributions of:	Tax relief to be spread over:
£500,000 to £999,999	2 years
£1,000,000 to 1,999,999	3 years
£2,000,000 or more	4 years

The treatment of additional voluntary contributions

An employee may wish to pay AVCs in order to enhance the retirement benefits arising under the scheme.

Tax relief can be obtained for additional voluntary contributions (AVCs) made by the employee if the total gross contributions made under the scheme rules *plus* any AVCs are less than the maximum annual contribution.

AVCs can be made into the occupational scheme via the payroll, in which case relief is obtained automatically under the PAYE system.

Alternatively a free-standing AVC scheme can be set up by the individual. In this case tax relief for the additional contributions will be obtained in the same way as for PPP relief.

The taxation consequences of retirement

- An overview of the taxation consequences of retirement
- The taxation consequences of exceeding the lifetime allowance
- Retirement benefits drawn during the individual's lifetime

4 The taxation consequences of retirement

4.1 An overview of the taxation consequences of retirement

The normal minimum retirement pension age is:

- 50 years old (if the individual reaches this age by 5 April 2010), or
- 55 years old (if the individual reaches 50 on/after 6 April 2010).

However, retirement at this age is not mandatory. Individuals do not have to draw pension benefits until the age of 75. Individuals can therefore use all or part of the pension fund to draw benefits at any age between 50 and 75, and can continue to work whilst drawing a pension.

On retirement, a **tax-free lump sum** can be drawn from the pension fund and a **taxable** annual pension is usually paid from the scheme for the remainder of the individual's life. On the death of the individual, a **tax-free lump sum** may be available and a **taxable** annual pension may be available for dependants.

However, when the individual becomes entitled to draw benefits from the scheme, the value of the pension fund is reviewed. An excess income tax charge may be levied if the value of the fund exceeds the Lifetime Allowance.

4.2 The taxation consequences of exceeding the lifetime allowance

An individual can make any amount of contributions into a number of different schemes if he wishes. There is no restriction on the amount of contributions an individual can make into pension schemes. Similarly, the individual's employer and any other third party can contribute unlimited amounts into the scheme on behalf of the individual.

As explained earlier, not all contributions will receive tax relief as the maximum annual contribution and the annual allowance restrict the tax relief given for pension contributions each tax year.

Nevertheless, it is possible for unlimited amounts to be invested in a pension scheme to provide future retirement benefits.

Throughout the life of a registered pension fund, any **income and capital profits** earned from the assets invested in the scheme are **exempt from income tax and capital gains tax**. This means that the fund increases in value tax-free.

However, pension funds are not allowed to increase in value excessively. HMRC have set a maximum amount of pension value that can benefit from tax-free growth, known as the lifetime allowance (LA).

The lifetime allowance is checked when the individual becomes entitled to draw benefits from the scheme.

Where the **capital value of the pension fund exceeds the lifetime allowance** (£1,750,000 for 2009/10), the excess fund value is charged to income tax at:

- 55% if the excess is taken as a lump sum on retirement, and
- 25% if the excess fund is used to purchase a pension annuity.

The income tax charge is taken out of the pension scheme assets.

The capital value of the pension fund

The capital value of the pension fund at the relevant date depends on the type of scheme as follows:

Money purchase scheme	Defined benefit scheme
Value =	Value =
Market value of assets in the scheme	**(annual pension entitlement) × 20**

4.3 Retirement benefits drawn during the individual's lifetime

Between the ages of 50 and 75, an individual can start to draw pension benefits from a registered pension fund. However, at 75, the pension fund must be fully utilised to provide pension benefits.

The benefits available are as follows:

Lump sum	Pension income
Tax-free lump sum = Up to 25% of the lower of: (i) the capital value of the fund (ii) the lifetime allowance (£1,750,000 for 2009/10)	Remaining fund **must** be used to provide pension income = either (i) Secured (ii) Unsecured (see below)

Pension income is secured if it is acquired by purchasing a pension annuity. An individual must have a secured pension by the age of 75. An unsecured pension is also known as an income drawdown. Drawdown takes place where an individual takes income from his pension fund without purchasing an annuity. It is subject to a maximum limit and can only take place prior to the age of 75.

Registration
■ The conditions for HMRC approval

5 Registration

5.1 The conditions for HMRC approval

The tax advantages explained above only apply to registered schemes. In order to register a scheme, the scheme administrator must make an application to HMRC. The application must be in the specified form and must contain any information reasonably requested by HMRC.

Schemes can normally only be registered if they are:

- an occupational pension scheme, or
- a scheme established by a financial institution, such as a bank, building society or insurance company.

HMRC can only refuse to register a scheme if they believe the information in the application is incorrect. The scheme administrator can appeal to the general commissioners within 30 days of HMRC's refusal to register the scheme.

CHAPTER

9

National Insurance Contributions

Contents

Class 1 NICs

1 Class 1 NICs

1.1 Introduction: Class 1 National Insurance Contributions

If an **individual is employed** he is personally liable to Class 1 primary contributions. In addition, his employer (whether a sole trader, a partnership or a company) is liable to Class 1 secondary and Class 1A contributions for the individual employee.

1.2 The basis of calculating Class 1 NICs

The key points to remember from Paper F6 are as follows:

- Class 1 NIC liabilities are only payable if the employee is **at least 16 years old.**
- **Employees** are liable to Class 1 **primary** NICs from their 16th birthday until their 60th birthday (women) or 65th birthday (men).
- **Employers** are liable to Class 1 **secondary** NICs from the employee's 16th birthday. There is no upper age limit for secondary contributions.
- The **employer pays** over **all** Class 1 NICs to HMRC under the PAYE system.
- The **due date of payment** for Class 1 primary and secondary NICs is the **19th of every month**.
- Class 1 **secondary contributions** paid by the employer are **allowable deductions in the employer's adjustment of profit computation**.
- Both Class 1 primary and secondary contributions are calculated according to **the week or month in which the cash is paid** to the employee:
  - if paid weekly, NICs are calculated weekly
  - if paid monthly, NICs are calculated monthly.
- Class 1 primary and secondary contributions are **based on** the employee's **cash earnings** which are calculated as follows:

	£
Salary / wages	X
Bonuses / commissions	X
Any other cash receipts and cash benefits (e.g. excess mileage allowance under AMAP)	X
Cash *and* non-cash vouchers *excluding* vouchers exempted under the benefit rules (e.g. childcare vouchers up to £55 per week)	X
Receipts of marketable assets which can be converted into cash (e.g. gold bars, fine wines, shares, diamonds)	X
Cash earnings for Class 1 NICs	X

- The calculation of Class 1 cash earnings excludes:
  - **exempt benefits** per employment income rules
  - **non-cash benefits** (e.g. company car, fuel, living accommodation)
  - **redundancy payments**
  - **pension payments**
  - **business expenses** reimbursed by the employer
  - **tips** from third parties.
- There are **no allowable deductions** in the calculation of Class 1 earnings.

1.3 The calculation of primary and secondary Class 1 NICs

The annual limits and rates for Class 1 NICs are as follows:

Cash earnings	**Employee primary**	**Employer secondary**
	%	%
First £5,715	Nil	Nil
£5,716 - £43,875	11	12.8
Excess over £43,875	1	12.8

- Class 1 primary and secondary contributions are calculated on a weekly basis (if the employee is paid weekly) or a monthly basis (if the employee is paid monthly). The weekly and monthly limits are calculated by dividing the annual limits by 52 weeks or 12 months. However in the examination, calculations should be made using the annual limits and rates unless you are told otherwise.
- The appropriate limits and rates required for the examination question will be given in the tax rates and allowances sheet.

Example

Simon and Sue are both aged 47, employed by Streets Ltd. Their remuneration for 2009/10 is as follows:

	Simon	**Sue**
	£	£
Salary	75,600	30,250
Bonus	9,400	Nil
Car benefit	4,650	Nil
Childcare vouchers	Nil	£60 per week for 36 weeks
Employer's pension scheme contribution	6,700	2,450
Employee's pension scheme contribution	4,200	1,225

Required

Calculate all of the Class 1 NICs payable by the employer to HMRC in respect of Simon and Sue for 2009/10 using the annual limits and rates.

a

Answer

Cash earnings	**Simon**	**Sue**
	£	£
Salary	75,600	30,250
Bonuses	9,400	Nil
Childcare vouchers in excess of £55 per week (£60 - £55) × 36 weeks	Nil	180
Cash earnings for Class 1 NICs	85,000	30,430

- The car benefit is excluded as it is a non-cash benefit.
- The employer's pension contributions are excluded as they are an exempt benefit.
- The employee's pension contributions are ignored as expense deductions are not allowed for NIC purposes.

	Simon	**Sue**	**Total Class 1 NICs payable by Streets Ltd**
	£	£	£
Class 1 primary contributions			
(£43,875 - £5,715) × 11%	4,198		
(£85,000 - £43,875) × 1%	411		
(£30,430 - £5,715) × 11%		2,719	
	4,609	+ 2,719	7,328
Class 1 secondary contributions			
(£85,000 - £5,715) × 12.8%	10,148		
(£30,430 - £5,715) × 12.8%		3,164	
	10,148	+ 3,164	13,312
Total Class 1 NICs payable by Streets Ltd			20,640

1.4 The calculation of directors' Class 1 NICs

The calculation of directors' Class 1 NICs is the same as for other employees except that the NICs are always calculated **assuming an annual earnings period**, regardless of the actual earnings period. Therefore the weekly and monthly rates are never used for directors.

This is because directors are in a position to determine when they will receive their remuneration. Without these special rules, directors could avoid Class 1 NICs by paying themselves a low salary each month and a large bonus in one particular month.

Class 1A NICs

- The basis of calculating Class 1A NICs
- The calculation of Class 1A NICs

2 Class 1A NICs

2.1 The basis of calculating Class 1A NICs

The key points to remember from Paper F6 are as follows:

- Class 1A NICs are payable by **employers only**, not employees.
- Class 1A NICs are charged on the **non-cash benefits** provided by the employer **to P11D employees** (e.g. company cars, private fuel, living accommodation) **excluding** the following:
  - **exempt benefits** (as defined for the employment income rules)
  - **non-cash vouchers** (as these are either specifically exempt or, if not exempt, liable to Class 1 primary and secondary NICs, not Class 1A NICs).
- There is no liability for Class 1A NICs on benefits provided to lower paid employees.
- The **due date of payment** of Class 1A NICs is 19 July following the end of the tax year, i.e. 19 July 2010 for 2009/10.
- Class 1A NICs are allowable deductions in the employer's adjustment of profit computation.

2.2 The calculation of Class 1A NICs

Class 1A NICs are charged at 12.8% on the amount of the benefit, measured using the employment income rules.

Example

Mandeep is employed by Roll Ltd. In 2009/10 he received the following benefits:

(1) A new diesel powered company car costing £26,750 with a list price of £27,950 and CO_2 emissions of 213 g/km. Mandeep contributes £60 per month towards the private use of the car

(2) All fuel for the year 2009/10. Mandeep contributes £55 per month towards the cost of his private fuel.

(3) A nursery place for his daughter at his employer's crèche which costs the company £6,500 per child for the year.

(4) Private medical insurance which cost the company £1,900.

(5) Private use of a laptop from 1 July 2009. The laptop cost the company £300.

Required

Calculate the Class 1A NIC payable by Roll Ltd on 19 July 2010.

a

Answer

Assessable benefits

	£		£
Car benefit:			
Manufacturer's list price × appropriate %	27,950	at 33% (W)	9,224
Less Contribution for the use of the car (£60 × 12)			(720)
			8,504
Private fuel benefit	16,900	at 33% (W)	5,577
(No allowable deduction for contributions towards private fuel)			
Nursery place at workplace = exempt benefit			Nil
Private medical insurance (cost to employer)			1,900
Private use of laptop	300	at 20% × 9/12	45
Total benefits liable to Class 1A NICs			16,026
Class 1A NICs	16,026	at 12.8%	2,051

Working: Appropriate % for car and fuel benefit

	g/km		**Petrol %**
CO_2 emissions (rounded down to nearest 5 g/km)	210		
Base level of CO_2 emissions	(135)		
	75	÷ 5	15
Minimum percentage for diesel car (includes 3% supplement)			18
Appropriate percentage			33

Class 2 NICs and Class 4 NICs

- Introduction
- Class 2 NICs
- The basis of calculating Class 4 NICs
- The calculation of Class 4 NICs

3 Class 2 NICs and Class 4 NICs

3.1 Introduction

A **self-employed individual** (whether a sole trader or a partner) is personally liable to Class 2 and Class 4 contributions.

As both Class 2 and Class 4 NICs are a personal tax on the self-employed individual, they **must be added to profit in the adjustment of profit computation** if they have been accounted for as an expense in the business accounts. This is because they are an appropriation of profit.

3.2 Class 2 NICs

For 2009/10, Class 2 NICs are at a flat rate of £2.40 per week. This rate is given in the tax rate and allowances in the examination. The maximum Class 2 NICs payable in 2009/10 are therefore £125 (£2.40 × 52).

The key points to remember from Paper F6 are as follows:

- Class 2 NICs are **paid by self-employed individuals** (i.e. sole traders and each partner in a partnership) if the individual:
  - has earnings in excess of £5,075, and
  - is aged between 16 – 65 for men, 16 – 60 for women.
- **'Earnings'** is the net profit per the financial accounts (not adjusted for taxation purposes) from 6 April 2009 to 5 April 2010.

  If the self-employed individual does not prepare accounts to 5 April, two years' profit figures need to be time-apportioned to calculate earnings for Class 2 NIC purposes.
- Liability to pay **starts** on the individual's **16th birthday** and **ends** on their **60th birthday** for women and **65th birthday** for men.
- Class 2 NICs are usually **paid monthly by direct debit,** but the individual can ask for quarterly billing if he wishes.

3.3 The basis of calculating Class 4 NICs

The key points to remember from Paper F6 are as follows:

- Class 4 NICs are paid by **self-employed individuals**, in addition to Class 2 NICs.
- Class 4 NICs are **paid** with the individual's income tax liability **under the self assessment system**.
- Self-employed individuals are assessed to Class 4 NICs:
  - based on the profits for a tax year
  - if they are **aged 16 or over at the *start* of the tax year**.
- The liability to pay **ceases** in the **tax year *after* the individual has their 60th birthday** (for women) **or their 65th birthday** (for men).
- Profits for Class 4 purposes are calculated as follows:

	£
Trading income assessment for the tax year	X
Less Trading losses	(X)
Profits for Class 4 purposes	X

3.4 The calculation of Class 4 NICs

The annual limits and rate for Class 4 NICs are as follows:

Profits	**%**
First £5,715	Nil
£5,716 - £43,875	8
Excess over £43,876	1

Example

Aileen is self-employed, aged 59, and has been trading for many years. Her results for the last two years are as follows:

Year ended	**Adjusted profit after capital allowances**
	£
30 September 2009	55,200
30 September 2010	71,750

Aileen has non-trading income of £1,600 (gross) each year.

Required

Calculate the Class 4 NICs Aileen is liable to pay for 2009/10.

Answer

Class 4 NICs – 2009/10

	£
(£43,875 - £5,715) × 8%	3,053
(£55,200 - £43,875) × 1%	113
	3,166

CHAPTER 10

An introduction to capital gains tax

Contents

An overview of capital gains tax

1 An overview of capital gains tax

1.1 The basic charging rules

A **chargeable gain** arises if:

- a **chargeable person** (e.g. an individual, trustee or company)
- makes a **chargeable disposal**
- of a **chargeable asset**.

A **chargeable disposal** is defined as:

- the sale or gift of the whole or part of an asset
- the receipt of a capital sum due to the ownership, loss or destruction of an asset.

A **chargeable asset** is defined as any capital asset (tangible or intangible) except those specifically exempted from tax.

The main **exempt assets** to be aware of are the following:

- cash
- foreign currency acquired for private use
- motor vehicles (including vintage and veteran cars)
- principal private residence (e.g. individual's home) (but see chapter on reliefs)
- shares in an Individual Savings Account (ISA)
- shares in a Venture Capital Trust (VCT)
- qualifying corporate bonds (QCBs) (e.g. company debentures and loan stock)
- gilt-edged securities (e.g. Treasury stock and Exchequer stock)
- certain types of chattels (see next chapter)
- business 'current assets' (i.e. trade debtors, trading stock).

If assets are exempt, they are ignored in the gain/loss computations as:

- any gain on the disposal of an exempt asset is not taxable
- any loss on the disposal of an exempt asset is not allowable.

1.2 The basis of assessment

An individual is charged to capital gains tax (CGT) on his **taxable gains** in respect of **chargeable disposals** made in the **tax year** (i.e. 5 April to 6 April).

Taxable gains are the chargeable gains for the tax year which exceed the annual exemption (£10,100 for 2009/10).

CGT is levied:

- on the disposal of capital assets during the **lifetime** of the individual
- in the tax year in which the asset is disposed of.

The date of disposal is the date on which the purchaser's obligation to pay for the asset becomes unconditional (usually the date on which the contract to sell is made).

However, where a conditional contract exists, the date of disposal will be the date the last condition has been satisfied thereby making the contract legally binding.

For example, when purchasing a house it is customary to make an offer that is subject to surveys being conducted, possibly planning permission obtained and land registry compliance. Until the exchange of contracts the purchase is not legally binding. The exchange date is therefore usually the date of disposal unless further conditions are stated before the completion of the contract.

1.3 Negligible value claims

As a general rule, a chargeable gain or allowable loss can only arise when an asset is disposed of. However, if the value of an asset becomes negligible, the taxpayer can make a claim to treat the asset as if it had been sold and immediately reacquired at its market value. This allows the taxpayer to establish a capital loss without actually having to sell the asset.

The claim can be backdated up to two years, provided the asset was of negligible value at that earlier time.

When the asset is eventually disposed of, it is treated as having been acquired for the negligible value used in the earlier computation.

1.4 Proforma: capital gains tax computation

A summary capital gains tax computation for an individual as follows:

Name of individual	
Capital gains tax computation – 2009/10	£
Asset 1 - Gain after specific reliefs	X
Asset 2 - Gain after specific reliefs	X
Minus capital losses	(X)
Total net chargeable gains	X
Minus annual exemption *(note)*	(10,100)
Taxable gains	X
Tax due at 18%	X
Due date of payment under self assessment: (31 January following the end of the tax year)	31 January 2011

Notes

(i) Where several assets are disposed of, separate computations are required to calculate the gain for each asset disposal and are usually shown as a working to an answer. These computations are covered in detail in the next section.

(ii) If the individual's total net chargeable gains do not exceed £10,100, the unused annual exemption is lost.

(iii) CGT is levied on individuals at a flat rate of 18%, irrespective of the level of the individual's income.

1.5 The payment rules for capital gains tax

Capital gains tax is paid by individuals via the self-assessment return and is due by the 31 January following the end of the tax year (i.e. by 31 January 2011 for 2009/10).

Payment by instalments

CGT can be paid by instalments in the following circumstances:

	Consideration is received in instalments over a period of > 18 months	**The gift of land, unquoted shares and controlling interests of quoted shares where gift relief does not fully cover all of the gain (see chapter 12)**
Instalment period	Spread equally over period consideration is received (but cannot exceed 8 years)	10 equal annual instalments
Interest charge	No interest charge if paid late	Interest charged if paid late on all instalments except the first

1.6 CGT on the death of an individual

CGT is a **lifetime tax.** The transfer of assets due to the death of an individual is not a chargeable disposal**.**

The beneficiaries of a will are deemed to receive the assets at full market value on the date of the individual's death (known as probate value).

CGT is therefore not payable on the increase in value of the asset from the date the deceased purchased it to the date of his death. On the death of an individual there is therefore a tax-free uplift on all of the deceased's assets to market value.

If for example, an individual buys an asset in 1999 for £100 and when he dies in 2007 it is worth £900,000, there is no CGT payable on the capital appreciation of £899,900 (£900,000 - £100). The beneficiary in the will receives the asset at a base cost of £900,000 and only pays CGT on any increase in value from the date of death.

However, although CGT is not payable, there will be an inheritance tax liability on the value of the assets at the date of death (see later chapters).

The disposal of assets other than shares and securities by an individual

- The computation of the gain after specific reliefs
- Disposal proceeds
- Allowable costs
- Transfers to and from trading stock
- The treatment of capital losses

2 The disposal of assets other than shares and securities by an individual

2.1 The computation of the gain after specific reliefs

The proforma computation for an individual is as follows:

Gross sale proceeds or market value		X
Less	Incidental costs of sale	(X)
Net sale proceeds		X
Less	Allowable costs	
	Acquisition cost (including incidental costs)	(X)
	Enhancement expenditure	(X)
Gain / (loss) before specific reliefs		X/(X)
Less	Specific reliefs (see later chapters)	(X)
Gain after specific reliefs / (allowable loss)		X/(X)

2.2 Disposal proceeds

Gross sale proceeds are used as the starting point of the computation where the asset is sold in a commercial arm's length transaction.

Market value is used instead of gross sale proceeds where the asset is gifted, sold for less than market value or disposed of to a connected person (see later).

2.3 Allowable costs

Incidental selling costs and **incidental acquisition costs** include estate agent fees, legal fees, commissions, auctioneers' fees, valuation fees, advertising costs and stamp duty.

Allowable costs consist of:

- the original purchase cost of the asset
- any incidental acquisition costs
- any enhancement expenditure (i.e. costs incurred in improving/enhancing the value of the capital asset).

Enhancement expenditure is only allowable if it:

- is capital expenditure (and not revenue expenditure, such as repairs)
- improves the value of the asset (for example, extensions, additions), and
- is reflected in the state of the asset sold.

For example, if an extension to a property is built but later demolished, on the sale of the property the cost of the extension is not allowable as the sale proceeds received relate to the property being sold without an extension.

2.4 Transfers to and from trading stock

When a taxpayer acquires a chargeable capital asset and then transfers it to trading stock, he is treated as making a disposal at market value at the date of the transfer. He will therefore have a chargeable gain or allowable loss, and the asset will be treated for income tax purposes as if it was acquired at market value at the date of the transfer.

The taxpayer can, however, elect to have the cost for income tax purposes reduced by the gain. This will avoid the chargeable gain that would otherwise arise at the time of the transfer.

When a taxpayer transfers an item of trading stock to his capital assets, his trading profits are treated as if he had sold the asset for its market value. The same market value becomes the base cost for capital gains tax purposes.

2.5 The treatment of capital losses

The rules for capital losses can be summarised as follows:

Type of capital loss:	Explanation:
Current year losses	■ Must be set off against current year gains. ■ An individual cannot restrict the set off to preserve the annual CGT exemption. ■ If current year losses reduce the chargeable gains below the annual exemption, the unused annual exemption is lost. ■ If current year losses exceed current year gains, the net losses are carried forward and set off against future gains.
Losses brought forward	■ Set-off against net gains **after** current year losses have been set off. ■ Must be set off against the **first available** future gains. ■ The set off is restricted to the amount that brings the total gains of the individual down to the annual exemption. Total net gains means the total of the gains **after** deducting current period losses.

Type of capital loss:	Explanation:
Losses in the year of death	■ Can be **carried back** to set against gains of the **preceding three years** on a **LIFO** basis. ■ The set off is restricted to preserve the annual exemption.
Losses on disposals to connected persons	■ Can only be set against gains from disposals to the **same connected person.** ■ The definition of a connected person is covered in the next chapter.
Relief of trading losses against capital gains under s261B TCGA 1992	■ s261B trading losses are treated **as if they are current year capital losses.** ■ The detail on s261B relief has been covered in chapter 7.

Example

Wallace realised a gain of £26,580 in 2009/10. He has a current year loss of £8,500 and brought forward losses of £11,000.

Required

Calculate Wallace's taxable gains for 2009/10.

Answer

Wallace

Capital gains tax computation – 2009/10	£
Gain	26,580
Minus current year capital losses	(8,500)
Minus capital losses brought forward	(7,980)
Total net chargeable gains	10,100
Minus annual exemption *(note)*	(10,100)
Taxable gains	Nil

Notes

Wallace has capital losses of £3,020 (£11,000 - £7,980) available to carry forward as the set off of brought forward capital losses is restricted to make use of the annual exemption.

The disposal of shares and securities by an individual

- Shares and securities that are chargeable to CGT
- The share identification rules for individuals
- Same day or 30 day acquisitions
- Acquisitions in the pool
- The treatment of bonus issues
- The treatment of rights issues
- The treatment of takeovers
- The treatment of reorganisations

3 The disposal of shares and securities by an individual

3.1 Shares and securities that are chargeable to CGT

All quoted and unquoted shares and securities are chargeable assets for CGT purposes with the exception of the following securities:

- Qualifying Corporate Bonds (QCBs), and
- Gilt-edged securities (gilts).

Disposals of QCBs and gilts by an **individual** are exempt from CGT. If QCBs are exchanged for shares, the new shares are treated as acquired for market value at the date of the exchange.

QCBs are defined as corporate securities issued after 13 March 1984 which represent a normal commercial loan that is expressed in sterling and cannot be converted into any other currency.

In the examination, company debentures and loan stock are assumed to satisfy these conditions and are therefore treated as QCBs unless it is clearly stated otherwise.

Gilts are government securities, quoted on the Stock Exchange, which are usually called Treasury stock or Exchequer stock.

3.2 The share identification rules for individuals

When purchasing shares, an individual must keep separate records for each different type and class of shares that he has purchased.

The tax legislation deems shares to be disposed of by an individual in the following order:

(1) Acquisitions on the same day as the disposal
(2) Acquisitions in the next 30 days on a first-in-first-out (FIFO) basis
(3) Shares in the pool.

3.3 Same day or 30 day acquisitions

A separate capital gain computation must be produced for each matching.

The gain or loss on the disposal of these shares is calculated simply as the difference between the disposal proceeds and cost.

3.4 Acquisitions in the pool

An individual with many investments in other companies will need to construct a pool **for each company and each class of share**.

For individuals, each pool contains all acquisitions of that class of share from 6 April **1982**. (Acquisitions prior to 6 April 1982 are not examinable).

These shares are pooled and treated as a single source of shares, disposed of at their average cost.

Proforma: pool for individuals

	Number of shares	**Original Cost**
		£
Acquisition A	X	X
Acquisition B	X	X
Pool balance	X	X
Sale of shares (see *note* below)	(X)	(X)
Pool balance c/f	X	X

Note
The appropriate proportion of cost to deduct from the cost column is calculated using the average cost principle, as follows:

$$\text{Total cost to date} \times \frac{\text{Number of shares disposed of}}{\text{Number of shares held (before the disposal)}}$$

The chargeable gain on the disposal of pool shares

The gain on the disposal of pool shares is calculated as follows:

		£
Gross sale proceeds (see note)		X
Less	Incidental costs of sale (e.g. stockbrokers' commission)	(X)
Net sale proceeds		X
Less	Allowable costs	
	The cost deducted from the cost column in the pool	(X)
Gain / (allowable loss)		X/(X)

Notes

Special rules apply to the valuation of quoted shares and securities if market value is needed. These rules are as follows:

Lower of:	pence
(i) the quarter up rule	
Lower quoted price	X
Plus ¼ × (higher quoted price *less* lower quoted price)	X
	X
(ii) the average of the highest & lowest marked bargains of that day	
½ × (highest marked bargain + lowest marked bargain)	X

Example

Janet held 7,000 shares in K Ltd, an unquoted trading company. The shares were held in the pool and had a cost of £48,500.

On 13 March 2010 Janet sold 5,500 of the shares in K Ltd for £52,800.

Required

Calculate the chargeable gain arising on the sale of Janet's shares in K Ltd.

Answer

Chargeable gain computation

	£
Gross sale proceeds	52,800
Less Cost (from pool working)	(38,107)
Gain	14,693

Pool working	**Number of shares**	**Original Cost**
Pool balance	7,000	48,500
Sale of shares (see note below)	(5,500)	(38,107)
Pool balance c/f	1,500	10,393

Note

Shares sold from the pool are removed at average cost:
£48,500 × 5,500/7,000 = £38,107

3.5 The treatment of bonus issues

Bonus shares are treated **as if** they were acquired on the same day as the original shares to which they relate.

Bonus shares are therefore added to the number of shares acquired at each acquisition date before applying the matching rules.

Example

On 13 September 1998 David purchased 6,000 ordinary shares in X plc for £90,000.

On 10 April 2007 X plc made a 1 for 3 bonus issue. On 31 January 2010 David disposed of 7,500 of his shares in X plc for £120,000. He bought another 4,800 shares on 4 February 2010 for £57,600.

Required

Calculate the chargeable gains arising on the disposal of the shares.

Answer

Matching rules

	Number of shares held	Disposal 31 January 2010	Remaining shares
1. Acquisitions in the following 30 days			
February 2010	4,800	(4,800)	Nil
2. Pool shares	6,000		
Bonus issue (1 for 3)	2,000		
	8,000	(2,700)	5,300
	12,800	(7,500)	5,300

Chargeable gain on the disposal of shares acquired on 4 February 2010 (4,800 shares)

	£
Gross sale proceeds (£120,000/7,500) × 4,800	76,800
Less Cost	(57,600)
Gain	19,200

Working: Pool

	Number of shares	Original Cost
		£
Pool balance (6,000 + 2,000)	8,000	90,000
Sale of shares (see note below)	(2,700)	(30,375)
Pool balance c/f	5,300	59,625

Note

Shares sold from the pool are removed at average cost:

£90,000 × 2,700/8,000 = £30,375

Chargeable gain on the disposal of shares in the pool (2,700 shares)

	£
Gross sale proceeds (£120,000/7,500) × 2,700	43,200
Less Cost	(30,375)
Gain	12,825

3.6 The treatment of rights issues

A rights issue takes place when a company makes an offer of new shares to its existing shareholders, giving them the opportunity to purchase shares in the company in proportion to the number of shares already held for less than the current market value.

A rights issue can be:

- taken up (i.e. the additional shares are purchased), or
- the right to purchase the additional shares can be sold to another person. This is known as the sale of rights nil paid.

If the rights issue is taken up by the individual

Rights shares are treated **as if** they were acquired on the same day as the original shares to which they relate.

Rights shares are therefore added to the number of shares acquired at each acquisition date before applying the matching rules.

The sale of rights nil paid

The treatment for tax purposes is as follows:

- If the sale proceeds are:

  (i) ≤ 5% of the value of the shares on which the rights are offered, **or**

  (ii) ≤ £3,000

  no chargeable gain arises on the sale of rights nil paid.

  However, the sale proceeds received must be deducted from the original cost of the shares.

- If the sale proceeds are:

  (i) > 5% of the value of the shares on which the rights are offered, **and**

  (ii) > £3,000

  a chargeable gain arises.

  The gain is calculated in the same way as the gain on a takeover where cash consideration is received (see next section).

3.7 The treatment of takeovers

Where an individual holds shares in a company which is subsequently taken over by another company, the treatment of this event for tax purposes depends on the type of consideration received in exchange for the old shares.

Different treatment applies if the consideration is received:

- wholly in the form of cash
- wholly in the form of shares
- partly in the form of cash and partly in the form of other consideration such as shares and/or securities (i.e. mixed consideration).

A summary of the treatment for each types of consideration received is as follows:

(1) Consideration received wholly in the form of cash

- A **chargeable gain arises**, calculated applying the normal rules.

(2) Consideration received wholly in the form of shares

- This is a paper-for-paper exchange and is **not a chargeable disposal** for CGT purposes **provided:**
  - (i) Advance clearance for the transaction to be treated as such is obtained by either company from HMRC, and
  - (ii) The exchange of shares or debentures is undertaken for a genuine commercial reason and is not part of a scheme to avoid paying tax, and
  - (iii) One of the following conditions is satisfied:
    - The takeover company must make an offer to all of the existing shareholders of the target company which, if accepted, would result in the takeover company obtaining a controlling interest, or
    - As a result of the takeover offer, the takeover company obtains a > 25% interest in the target company's ordinary share capital, or
    - The takeover company can exercise > 50% of the voting power in the target company.
- Provided the above conditions are satisfied, the **new shares** received are deemed to be:
  - **acquired on the same day** as the original shares, and
  - **for the same cost as the original shares**.
- Therefore, at the time of the take-over, no chargeable gain or allowable loss arises. However, a base cost of the new shares needs to be established for the purposes of calculating future gains when the new shares are sold.
- The **original cost** of the old shares is **allocated** to the new shares received **in proportion to the market values of the consideration** received.
- New records and pools for the new shares are set up (one pool for each class of share received as consideration).

(3) Mixed consideration received

Mixed consideration is where the consideration received is partly in the form of cash and partly in the form of shares or securities (for example, company debentures or loan stock).

At the time of the takeover

- If the cash consideration is:
  - (i) ≤ 5% of the total consideration, **or**
  - (ii) ≤ £3,000

  no chargeable gain arises on the receipt of cash.

  However, the cash received must be deducted from the original cost of the shares.
- If the cash consideration is:
  - (i) > 5% of the total consideration, **and**
  - (ii) > £3,000

a **chargeable gain arises** in respect of cash consideration received.

This gain is taxed in the year of the takeover.

- No chargeable gain arises in respect of the share consideration received.
- A chargeable gain is calculated in respect of the securities (QCBs) received, but is frozen and not taxed until the subsequent disposal of the securities.
- To calculate the above gains and establish the base cost of the new shares received, the original cost of the old shares is allocated to the cash, the new shares and the securities received in proportion to the market values of the consideration received at the time of the takeover.
- The **chargeable gains** arising in respect of the **cash consideration** and the **securities (QCBs)** received are calculated as follows:

	Cash	**QCBs**
	£	£
Cash consideration received	X	
Market value (MV) of the securities received		X
Deemed cost	(X)	
(Cost of original shares) x $\frac{\text{Cash consideration}}{\text{Total consideration}}$		
(Cost of original shares) x $\frac{\text{MV of the securities received}}{\text{Total consideration}}$		(X)
Gain	X	X

The chargeable gain in relation to the cash received is taxed immediately in the tax year of the takeover.

The chargeable gain in relation to the QCBs received is not taxed at the time of the takeover. It is frozen and becomes chargeable on the future disposal of the QCBs.

The future disposal of the new shares

- New pools are set up for the new shares received at the time of the takeover to establish the base cost for future gain computations when the shares are sold.
- The gains arising on the future disposal of the new shares are therefore calculated applying the normal rules.

The future disposal of the new securities

- New pools and records are not set up for the securities received as company debentures and loan stock are exempt assets for CGT purposes.
- On the disposal of the securities, no chargeable gain arises on the increase in value of the securities as the gain is exempt.
- However, on the disposal of the securities, the frozen gain on the disposal of the original shareholding which relates to the securities received becomes chargeable.

Example

In June 2003 Wilson acquired 6,000 £1 ordinary shares in Gray Ltd, an unquoted trading company, for £6,000.

Gray Ltd was taken over by Peach plc in July 2009. The terms of the takeover were that for every 2 £1 ordinary shares held, existing shareholders would receive the following:

- £5 in cash
- £3 of debentures, valued at par immediately after the takeover
- 7 ordinary shares in Peach plc, quoted at £3.50 per share immediately after the takeover

Wilson plans to sell his debentures in Peach plc in May 2010 and expects to receive £12,000 for them.

Required

Calculate the chargeable gains arising as a result of the takeover and state the base cost of the new Peach plc shares.

Answer

Takeover consideration received by Wilson

		£
Cash	(6,000/2) × £5	15,000
Debentures	(6,000/2) × £3	9,000
Ordinary shares	(6,000/2) × 7 × £3.50	73,500
		97,500

Allocation of original cost of Gray Ltd shares to the takeover consideration

		£
Cash	(15,000/97,500) × £6,000	923
Debentures	(9,000/97,500) × £6,000	554
Ordinary shares	(73,500/97,500) × £6,000	4,523
		6,000

The new Peach plc shares are deemed to have been acquired in June 2003 for £4,523.

The chargeable gains calculated at the time of the takeover

	Re cash received	Re debentures received
	£	£
MV of consideration received	15,000	9,000
Less Deemed cost (above)	(923)	(554)
Gain	14,077	8,446

The £14,077 chargeable gain arising in relation to the cash consideration is taxed in the year of the takeover, i.e. 2009/10.

The chargeable gain arising in relation to the debentures received is frozen at £8,446 and is not taxed until Wilson disposes of the debentures. It will become chargeable in 2010/11 if the debentures are sold in May 2010.

There is no gain arising on the increase in value of the debentures of £3,000 (£12,000 - £9,000) as they are QCBs and are exempt from capital gains tax.

3.8 The treatment of reorganisations

A reorganisation occurs where a company reorganises its equity capital and debt ratio by exchanging existing shares and securities for another class of share or security in the same company.

As with takeovers:

- No chargeable gain arises unless cash consideration is received by the shareholders.
- The cost of the original shares must be allocated to the new shares (see below).
- The shareholder is deemed to acquire the new shares on the same date as the original shares for the deemed allocated cost.

The allocation of the original cost of the original shares depends on whether the shares are quoted or unquoted as follows:

Basis of apportionment of original cost =	
MV of new shares	on the date of the:
Quoted shares	Reorganisation
Unquoted shares	First disposal

CHAPTER 11

Adjustments to the basic capital gain computation

Contents

Disposals to connected persons

1 Disposals to connected persons

1.1 The definition of connected persons

An individual is connected to the following persons:

- spouse
- direct relatives (brothers, sisters, ancestors and lineal descendants) and their spouses
- spouse's direct relatives and their spouses
- business partners and their spouses and direct relatives.

The term spouse includes civil partner (i.e. a same sex partner recognised by a civil ceremony under the Civil Partnership Act).

1.2 Disposals to connected persons

Where an asset is disposed of to a connected person (other than the individual's spouse or civil partner), the gross sale proceeds are replaced with the full market value of the asset at the date of disposal.

Gross Disposal Consideration (GDC) = Full market value of the asset

If a disposal results in an allowable loss, it can only be set against gains from disposals in the current or future years to the **same connected person.**

1.3 Inter-spouse transfers

Although an individual is connected to his spouse (or civil partner), the general rule for connected person disposals outlined above does not apply.

The computation for a disposal to an individual's spouse (or civil partner) is fixed so that at the time of the transfer no gain arises on the disposal and there is no allowable loss. Inter-spouse transfers are therefore referred to as 'nil gain/nil loss' transfers (abbreviated to NGNL transfer).

Disposal consideration = Allowable Cost (AC)	X

On the subsequent disposal of the asset by the spouse, the deemed acquisition cost is equal to the deemed disposal consideration at the time of the inter-spouse transfer.

Example

Michelle bought some land in September 1994 for £30,000 as an investment. She gave the land to Andy, her husband, in December 2006 when it was worth £78,000.

In January 2010 Andy sold the land to an unconnected person for £125,000.

Required

Calculate the chargeable gains arising on the transfer to Andy and on the sale by Andy.

Answer

Inter-spouse transfer

	£
Deemed disposal consideration (Cost)	30,000
Less Cost of asset (September 1994)	(30,000)
Gain / (loss)	Nil

Subsequent disposal by Andy in January 2010

	£
Sale proceeds	125,000
Less Deemed acquisition cost	(30,000)
Gain	95,000

1.4 Partnership gains

Any gain (or loss) made by a partnership is shared between the partners in their capital profit sharing ratio. Each partner can make their own decision as to whether to claim reliefs, such as rollover relief, against their share of the gain.

When assets are revalued there is no chargeable gain or allowable loss, provided there is no change in the profit sharing ratio.

If there is a change in the profit sharing ratio, each partner is treated as disposing of (or acquiring) a share of the partnership assets. For example, if A and B share profits 50:50 and then decide to change the ratio to 60:40, B is treated as disposing of 10% of the partnership assets and A acquires that 10%.

In such a situation, the assets are deemed to be disposed of for their current **balance sheet** values. If the assets have not been revalued in the balance sheet, their cost and deemed disposal proceeds will be equal and so no chargeable gain will arise. However, if the assets have been revalued, the partners reducing their profit share will have chargeable gains based on the increase in the value of the asset multiplied by the percentage fall in their profit sharing ratio.

Part disposals

- The problem with part disposals
- The allowable cost
- Small part disposals of land

2 Part disposals

2.1 The problem with part disposals

Where only part of an asset is disposed of, it is necessary to allocate the allowable cost (AC) relating to the whole asset between:

- the part of the asset that is being disposed of, and
- the part of the asset that is being retained.

The same allocation is required where a set of assets is purchased and only part of the set is disposed of.

It is only the allowable costs incurred prior to the sale that need to be allocated. Costs relating wholly to the part that is sold (for example, incidental selling expenses) are allowable in full on the part disposal.

2.2 The allowable cost

When calculating the allowable cost:

- All allowable costs incurred before the part disposal that **relate to the whole asset** (including incidental acquisition expenses and enhancement expenditure) are allocated between the two parts on the basis of market values at the date of the part disposal as follows:

$$\text{AC for the part disposal} = \text{AC} \times \frac{\text{MV of part disposed of}}{\text{MV of part disposed of} + \text{MV of part retained}}$$

$$\text{AC for the part retained} = (\text{AC less AC re - part disposed of})$$

The market value of the part disposed of is usually the gross sale proceeds received. The market value of the part retained will be given in the examination question and is usually referred to as the market value of the remainder.

- Any allowable costs that **relate only to the part disposed of** can be deducted **in full** in the **part disposal** computation.
- Any allowable costs that **relate only to the part retained** can be deducted **in full** in the **subsequent disposal** computation.

Example

Penelope acquired an asset in July 1985 for £29,600. Incidental costs of acquisition totalled £530. The asset was enhanced in July 1999 at a cost of £14,200.

On 11 September 2009 Penelope sold a one-third interest in the asset to an unconnected person for £48,000. Incidental selling expenses amounted to £900. At that time the value of the remaining two-thirds was £105,000.

On 31 March 2010 Penelope sold the remaining two-thirds interest for £147,500. Incidental selling expenses amounted to £2,300.

Required

Calculate the chargeable gains arising in 2009/10.

Answer

Part disposal	**Sept 2009**
	£
Gross sale proceeds	48,000
Less Incidental selling expenses	(900)
Net sale proceeds	47,100
Less Allowable cost	
$(£29,600+£530 + 14,200) \times \dfrac{48,000}{48,000+105,000}$	(13,907)
Gain	33,193

Subsequent disposal	**Mar 2010**
	£
Gross sale proceeds	147,500
Less Incidental selling expenses	(2,300)
Net sale proceeds	145,200
Less Allowable cost	
((£29,600 + £530 + 14,200) – £13,907)	(30,423)
Gain	114,777

2.3 Small part disposals of land

The taxpayer can elect for no chargeable gain to arise on small part disposals of land. The gain is deferred until the subsequent disposal of the land.

To defer the gain, the sale proceeds received on the part disposal must be deducted from the original cost of the land and therefore reduce the allowable cost in the subsequent disposal computation.

A disposal of land is deemed to be small if:

- the sale proceeds from this part disposal of land are ≤ 20% of the value of the land before disposal, **and**
- the total sale proceeds from all land sales in the tax year is ≤ £20,000.

Wasting assets and chattels

- The definition of wasting assets and chattels
- The disposal of chattels
- The disposal of plant and machinery
- The disposal of wasting assets

3 Wasting assets and chattels

3.1 The definition of wasting assets and chattels

A **wasting asset** is an asset with an expected useful life of 50 years or less.

A **chattel** is tangible moveable property (for example, most things you would put into a removal van if you were to move house).

A **wasting chattel** is therefore tangible moveable property with an expected life of 50 years or less. Examples include a caravan, boat, dishwasher, cooker, greyhound, horse.

A **non-wasting chattel** is tangible moveable property with an expected life of more than 50 years. Examples include antiques, jewellery, paintings.

3.2 The disposal of chattels

Chattels are treated as follows:

- **Wasting chattels** are **exempt** from capital gains tax.
- **Non-wasting chattels** are chargeable. Special rules apply where the cost or sale proceeds are less than £6,000. However, these are not examinable.

3.3 The disposal of plant and machinery

Items of plant and machinery are always deemed to have a life of less than 50 years and are therefore **wasting assets**.

As most items of plant and machinery are tangible and moveable, they are classed as **wasting chattels** and are therefore exempt from capital gains tax.

However, if the plant and machinery is used in a trade and capital allowances can be claimed on them:

- they are chargeable assets
- no allowable loss arises if sold at a loss.

3.4 The disposal of wasting assets

Wasting assets which are chattels (i.e. tangible, moveable property) are exempt assets as explained above.

Wasting assets which are not chattels (i.e. not tangible or moveable) are chargeable assets, but special rules apply in the calculation of the gain.

As wasting assets usually decline in value over time, they are often referred to as depreciating assets. A wasting asset purchased with an expected life of 40 years will be worth considerably more at the time of purchase than it will be when it is sold (say) ten years later with an expected 30 year remaining life.

If the sale proceeds received are compared with the original cost in the normal way, a capital loss will always arise on the disposal of a wasting asset. Instead, the computation must compare like with like. Therefore, if selling an asset with a 30 year life, the sale proceeds received should be compared with the deemed cost of an asset with a 30 year life.

To obtain the allowable cost of the asset, its anticipated net cost must be depreciated on a straight line basis as follows:

$$\textbf{Net cost} \times \frac{\textbf{Length of ownership by the seller (months)}}{\textbf{Expected life of the asset (months)}}$$

The net cost of the asset is the original cost of the asset less any anticipated scrap value at the end of the life of the asset.

Leases

- The different types of lease
- Assignment of a lease

4 Leases

4.1 The different types of leases

A lease is a legal document which gives the holder a right to occupy property. It is an intangible capital asset which can be bought and sold.

There are two types of leases for capital gains tax purposes:

- Long leases (i.e. leases with a life of more than 50 years to run), and
- Short leases (i.e. leases with a life of 50 years or less to run).

The length of a lease is determined when the lease is created and is usually clearly stated in the lease agreement. However, where there are clauses which allow the earlier termination of the lease by the landlord, or a significant change in the terms of the lease at a future date which may result in an early termination, the lease is deemed to run up to the earliest possible termination date.

The disposal of a lease can occur in one of two ways, a lease can be:

- assigned, or
- granted.

The assignment of a lease is the complete disposal of the leasehold interest.

The granting of a lease is the disposal of the right to use the property for a set period of time, but the property reverts back to the owner at the end of the lease period.

Only the capital gains tax implications of the assignment of a lease interest are examinable.

To determine whether the assignment is of a long or short lease, and therefore how the gain is to be calculated, the length of the lease remaining at the date of the disposal (not the length of the lease on its creation) is the deciding factor.

4.2 Assignment of a lease

Assignment of a long lease

The assignment of a long lease is treated as a normal disposal of an asset. The gain or allowable loss arising is calculated applying the normal rules with no variations.

Assignment of a short lease

Short leases are chargeable wasting assets. However, they do not depreciate on a straight line basis like other wasting assets. Short leases depreciate in value on a curvilinear basis. They depreciate slowly in the first few years of the life of the lease and more rapidly in the last few years in the life of the lease.

The tax legislation contains depreciation tables for short leases. These need to be applied when calculating the gain on the assignment of a short lease. The depreciation tables are expressed as percentages and aim to replicate the actual depreciated value of the lease at the end of each year of its life.

The appropriate lease percentages will be provided in the examination question if required. For the purposes of this text, the full table of depreciation percentages is included at the end of the tax rates and allowances section.

The depreciated cost of a short lease is calculated as:

$$\textbf{Depreciated cost = Cost of original lease} \times \frac{\textbf{\% relating to the length of lease left at date of sale}}{\textbf{\% relating to the length of lease left at date of acquisition}}$$

Example

Linda acquired a 45 year lease in May 1990 for £48,000. In May 2009 she assigned (i.e. sold) the lease to an unconnected person for £46,000.

Required

Calculate the chargeable gain arising in 2009/10.

Answer

	£
Gross sale proceeds (May 2009) (26 year lease)	46,000
Less Depreciated cost	
$£48{,}000 \times \frac{\text{\% for 26 years}}{\text{\% for 45 years}} = £48{,}000 \times \frac{82.496}{98.059}$	(40,382)
Gain	5,618

Where the length of the lease left at the date of sale or date of acquisition is not a whole number of years, the percentage must be calculated to the nearest month. This is achieved by assuming straight line depreciation between one year and the next. The difference between the percentages for the nearest whole number of years above and below is time apportioned.

Assuming the length of the lease is 13 years and 9 months, the appropriate percentage is calculated as follows:

% for (13 years 9 months) =	% for 13 years	56.167
	Plus 9/12 × (% for 14 years **Less** % for 13 years)	2.103
	9/12 × (58.971 – 56.167)	
		58.270

Insurance and compensation

- The receipt of a capital sum due to the ownership of an asset
- Assets totally destroyed or lost
- Assets damaged but not totally destroyed

5 Insurance and compensation

5.1 The receipt of a capital sum due to the ownership of an asset

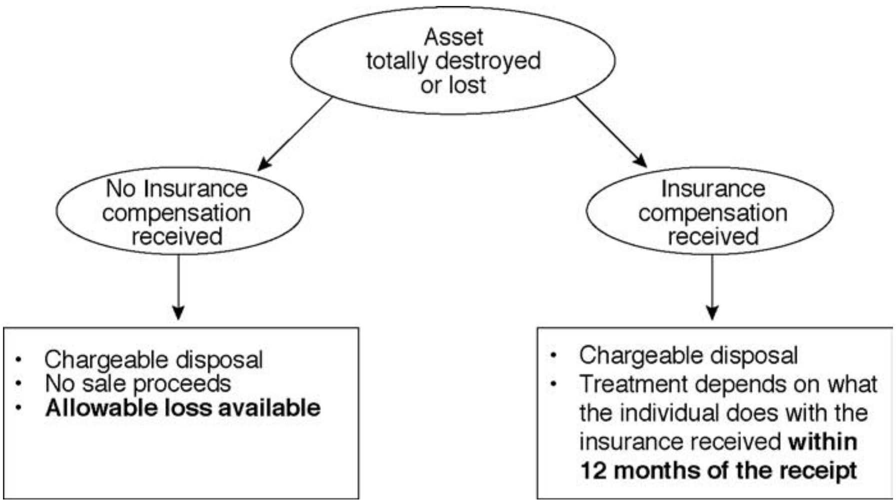
The receipt of a capital sum due to the ownership of an asset is a chargeable disposal for capital gains tax purposes. The receipt of compensation or insurance on making a claim due to the loss, destruction or damage to a capital asset is therefore a chargeable event.

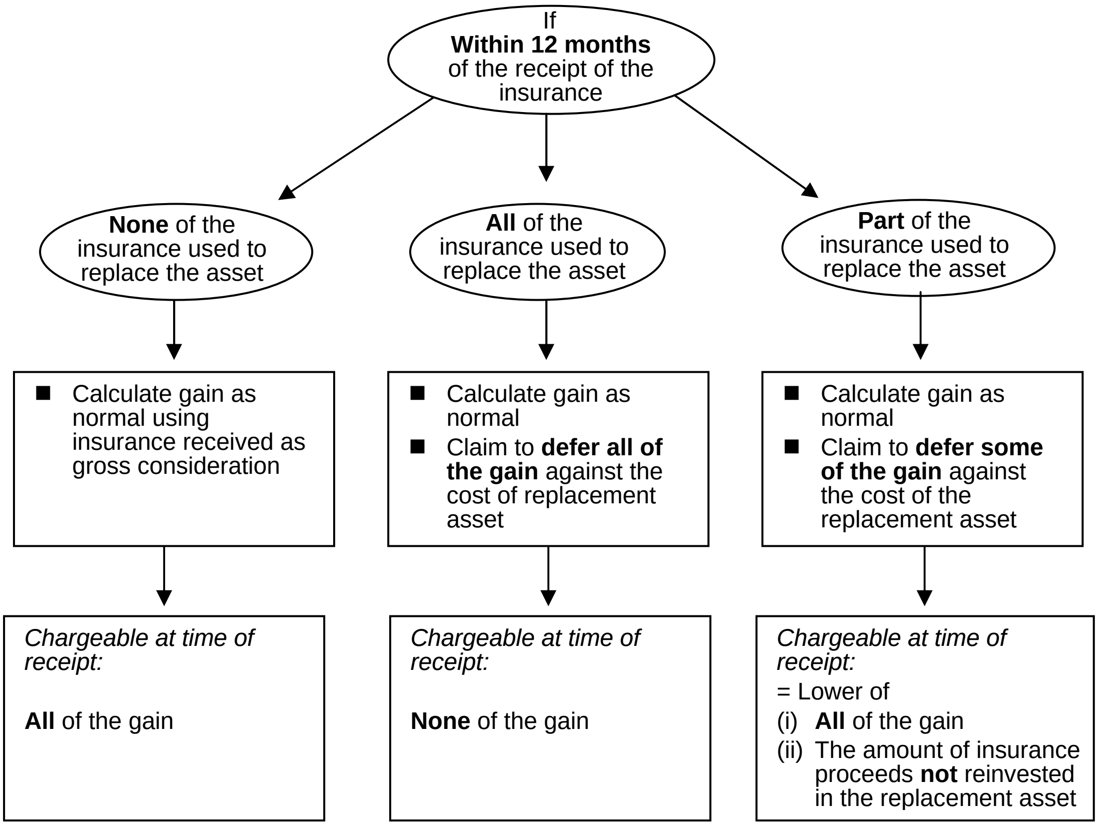
The treatment of the receipt depends on whether the asset is:

- totally destroyed/lost – i.e. a disposal of the asset, or
- damaged but not totally destroyed – i.e. a part disposal of the asset.

5.2 Assets totally destroyed or lost

Where an asset is totally destroyed or lost, the treatment for capital gains tax can be summarised as follows:





Example

Diane bought a painting for £280,000 in August 1999. In November 2009 the painting was destroyed in a fire. The insurance company settled a claim for £600,000 in January 2010. In May 2010 Diane replaced the painting.

Required

Calculate the chargeable gain arising in 2009/10 and the base cost of the replacement painting assuming the replacement painting cost:

(a) £650,000

(b) £480,000

Answer

	£
Insurance proceeds (January 2010)	600,000
Less Allowable cost (August 1999)	(280,000)
Gain	320,000

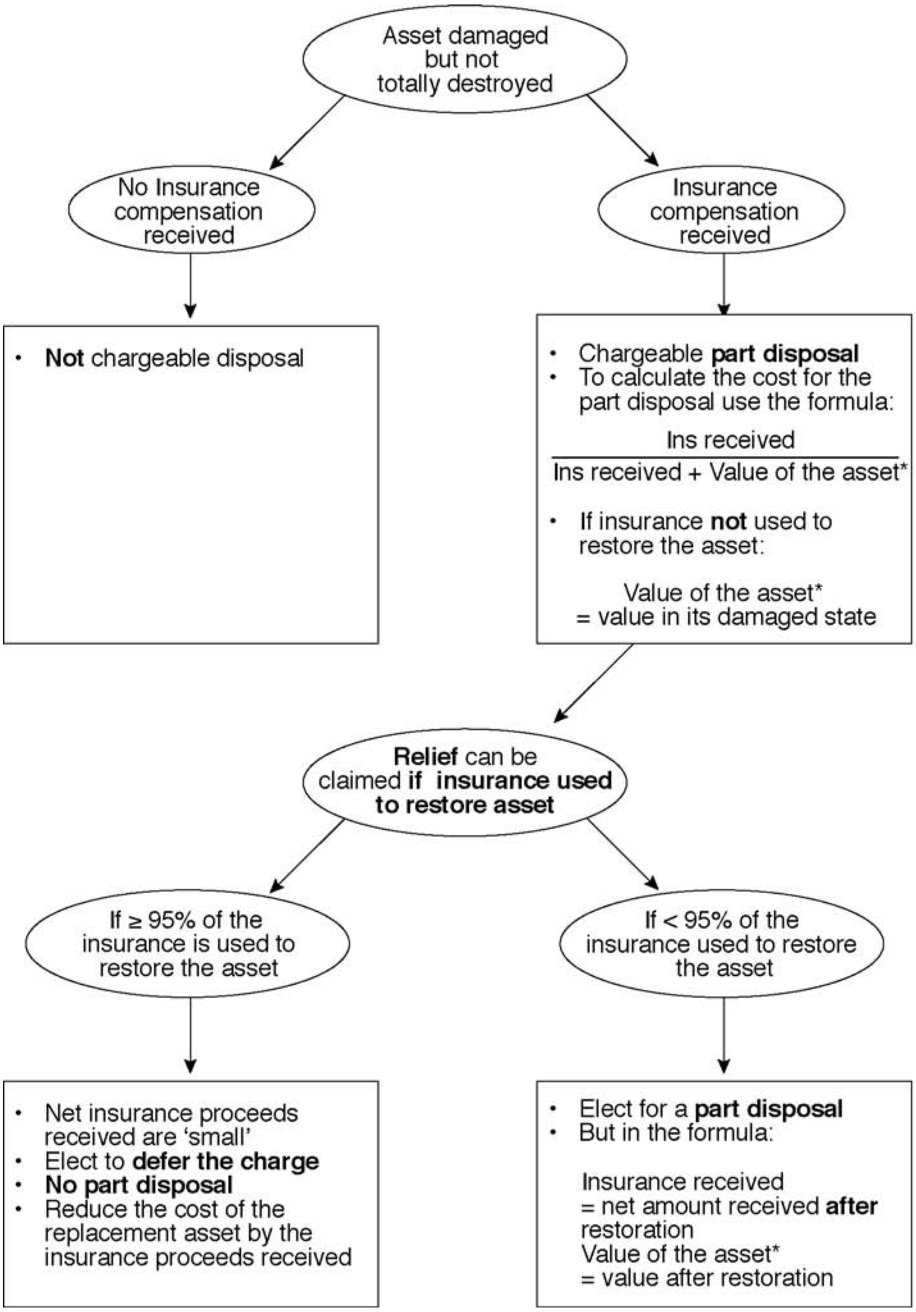
(a) If replacement cost £650,000		**(b) If replacement cost £480,000**	
Gain in 2009/10	£Nil	Gain in 2009/10	
		= Lower of	
		all of the gain	£320,000
		insurance not reinvested	£120,000
As all of the insurance proceeds are reinvested in a replacement painting, all of the gain can be deferred until the later disposal of the replacement painting		*Note:* The chargeable gain is assessed in 2009/10 (the tax year of the receipt of insurance, not the date of the destruction of the asset)	

Base cost of replacement painting:

	£		£
Cost	650,000	Cost	480,000
Less Deferred gain	(320,000)	Less Deferred gain	
		(£320,000 – £120,000)	(200,000)
Base cost	330,000	Base cost	280,000

5.3 Assets damaged but not totally destroyed

Where an asset is damaged but not totally destroyed, the treatment for capital gains tax can be summarised as follows:



Note

The net insurance proceeds are also deemed to be small if they are < £3,000.

Example

Ian bought an antique vase in August 1999 for £79,200. In August 2009 the vase was damaged and in December 2009 Ian received £40,000 compensation from his insurance company. The value of the vase in its damaged state is £105,600.

Required

(i) Calculate the chargeable gain arising in 2009/10 and the base cost of the vase assuming none of the compensation is used to restore the asset.

(ii) Explain the capital gains consequences of restoring the asset with the compensation.

Answer

(a) Part disposal at the time of the receipt of the compensation

	£
Insurance proceeds (December 2009)	40,000
Less Allowable cost	
$(£79,200) \times \frac{40,000}{40,000 + 105,600}$	(21,758)
Gain	18,242
Base cost of the vase:	
Original cost	79,200
Used in the part disposal computation	(21,758)
	57,442
Restoration costs	Nil
Base cost	57,442

(b) Consequences of restoring the vase

The insurance proceeds received = £40,000

95% of the insurance proceeds = £38,000

If £38,000 or more is spent on restoration:

- If no election is made the consequences are as explained above.
- If an election is made to defer the charge to CGT, no part disposal occurs, no CGT charge arises.
- The base cost of the vase is adjusted:
  - reduced by the insurance proceeds received, and
  - increased by the restoration costs which are treated as enhancement expenditure.

If less than £38,000 is spent on restoration:

- If no election is made the consequences are as explained above, but an election can be made to compute a different part disposal computation based on:
  - the insurance proceeds received **after** deducting any restoration costs, and
  - looking at the value of the asset **after** restoration.

CHAPTER 12

Capital gains tax reliefs

Contents

Rollover relief

- An overview of rollover relief for individuals
- Qualifying business assets for individuals
- The mechanics of rollover relief for individuals
- Assets not used wholly for the purposes of the trade
- Multiple disposals and reinvestments
- Reinvestment in a non-depreciating asset during the hold-over period

1 Rollover relief

1.1 An overview of rollover relief for individuals

A capital gain is usually taxed in the tax year of disposal. However, if conditions are satisfied, the gain may be deferred to a later tax year if a rollover relief claim is made.

Rollover relief is a relief to encourage businesses to reinvest in capital assets and continue in business. The relief is **optional** but, if required, it must be claimed. It is not given automatically.

Rollover relief is available **if:**

- the sale proceeds received from the **disposal of a qualifying business asset** (QBA) are used to **purchase any type of replacement QBA**,
- both assets are used **wholly and exclusively for the purposes of the trade**,
- the replacement purchase takes place in the **qualifying time period** running from 12 months before, to three years after the date of disposal, and
- a claim for relief is made within four years from the end of the tax year in which the disposal takes place.

1.2 Qualifying business assets for individuals

The following assets are the main examinable assets eligible for rollover relief for individuals:

- Land and buildings used for the purposes of the trade

  (i.e. **any** property used for the purposes of the trade, both for industrial and non-industrial purposes, **including** the land)

  Examples include factories, warehouses, shops, showrooms and offices etc.
- Fixed plant and machinery

  (but not moveable plant and machinery such as fork lift trucks).
- Goodwill

  (but only for individuals. Goodwill is not a qualifying asset for companies).

It is important to note that shares are never a qualifying asset for rollover relief purposes.

1.3 The mechanics of rollover relief for individuals

Where rollover relief is claimed, all or part of the gain arising on the disposal of the chargeable asset is deferred and becomes taxable at a later date.

Calculating the amount of a rollover relief claim

The gain can be deferred in one of two ways, depending on the type of replacement QBA purchased. However, regardless of the deferral method, the calculation of **the amount of rollover relief available is the same** and is calculated as follows:

If **all** of the sale proceeds are reinvested in QBAs	▪ Defer **all** of the gain ▪ No gain taxable immediately
If all of the sale proceeds are **not** reinvested in QBAs	▪ Taxable immediately = lower of: (i) all of the gain, or (ii) the sale proceeds **not** reinvested in QBAs ▪ Defer the rest of the gain

Methods of deferring the gain with a rollover relief claim

The gain can be deferred under rollover relief in one of two ways as follows:

- By deduction from the cost of the replacement asset, or
- By keeping a separate record of the gain still to be charged.

A summary of when each method of deferral should be used and the implications of claiming rollover relief are as follows:

Type of QBAs purchased:	**Non-depreciating QBAs**	**Depreciating QBAs**
Definition	Expected life of more than 60 years	Expected life of 60 years or less
Examples	Freehold land and buildings. Leasehold land and buildings with more than 60 years left on lease.	Fixed plant and machinery. Goodwill. Leasehold land and buildings with up to 60 years left on lease.
Treatment of rollover relief (regardless of the type of asset purchased)	▪ Rollover relief = deducted from the gain ▪ Only the remaining gain (if any) is chargeable in the tax year of disposal	

Mechanics of the deferral	■ The gain to be deferred is deducted from the cost of the new asset to calculate the base cost of the replacement asset (i.e. cost less rollover relief) ■ On the subsequent disposal of the replacement asset, the new base cost is used to calculate the gain instead of the original cost - thus increasing the gain on this disposal ■ The original gain has therefore been rolled over (i.e. deferred) until the disposal of the replacement asset.	■ The gain to be deferred is not deducted from the cost of replacement asset ■ A separate record of the deferred gain is kept ■ The deferred gain is taxed 10 years after the date the replacement asset was acquired **unless** ■ within the 10 year period, the replacement asset is either sold, or ceases to be used in the trade ■ When the replacement asset is sold, the gain is calculated normally using the original cost.

- Rollover relief is an all or nothing relief (i.e. it is optional, but if claimed, the maximum amount of gain allowed by the legislation must be deferred.)
- On the disposal of the replacement asset, the deferred gain becomes taxable, unless a further rollover relief claim is made because the rollover relief conditions are satisfied for the subsequent disposal.
- With good tax planning, gains on QBAs can be deferred potentially indefinitely, provided the conditions are satisfied at each disposal date.

Example

Debbie is a self employed individual. She prepares her accounts to 31 March each year. On 30 April 2009 she sold a freehold warehouse for £330,000, which was purchased in August 1995 and gave rise to a gain (before considering reliefs) of £185,000.

On 24 October 2010 Debbie purchased a 68 year lease on a new warehouse for £318,000. She anticipates that the warehouse will be sold on 30 November 2011 for £750,000.

Required

Calculate Debbie's chargeable gains arising in 2009/10 and 2011/12.

Explain the difference in treatment if the replacement warehouse were a 48 year leasehold interest.

Answer

Is the asset a QBA for rollover relief purposes?	Yes
Has it been replaced with a QBA?	Yes
Has it been replaced in the four year qualifying period? (30 April 2008 – 30 April 2012)	Yes
Have all the sale proceeds been reinvested in a QBA?	No

Gain arising in 2009/10

Lower of:	
- all of the gain £185,000	
- the sale proceeds **not** reinvested in QBAs (£330,000 - £318,000) =	12,000

	£
Rollover relief = the rest of the gain (£185,000 - £12,000)	173,000
Base cost of replacement 68 year leasehold interest	
Cost	318,000
Less Rollover relief	(173,000)
Base cost	145,000

Chargeable gain arising in 2011/12	£
Sale proceeds	750,000
Base cost	(145,000)
Gain	605,000

If the replacement had been in a 48 year leasehold interest

A 48 year leasehold interest is a QBA, but is a depreciating asset. The calculation of the amount of rollover relief and the chargeable gain arising in 2009/10 would be the same as above. However, the amount relieved with a rollover relief claim is not deducted from the cost of the replacement asset.

The following treatment applies instead:

- A record of the amount of rollover relief is kept and that amount is deferred for 10 years from the date of disposal of the original warehouse. However, as the replacement asset is disposed of before 10 years have elapsed, the deferred gain becomes chargeable in 2011/12 on the disposal of the asset.
- In addition to the deferred gain becoming chargeable, a chargeable gain arises on the disposal of the replacement asset itself. The gain is calculated as normal, using the actual cost of the leasehold interest with no rollover relief deduction.

1.4 Assets not used wholly for the purposes of the trade

To be eligible for rollover relief, both the original and replacement assets must be used wholly and exclusively for the purposes of the trade.

If part of the asset is not used for trade purposes (e.g. a factory extension or part of a building is let to another business), rollover relief is only available in relation to the business proportion of the gain.

The non-business proportion of the gain is chargeable immediately.

The rollover relief available on the business proportion of the gain is calculated in the normal way. However, to calculate the amount of relief, the amount of sale proceeds received relating to the business use of the asset is compared to the amount reinvested in QBAs.

Example

Yolanda owns a secretarial recruitment agency business which prepares its accounts to the 31 January each year. She owned a three-storey building which she purchased in December 1989 for £40,000 and sold on 24 October 2009 for £250,000.

Yolanda used the first two floors for the purposes of her trade, but throughout her period of ownership she never occupied the top floor. She let out the top floor to another unincorporated business for use in their trade.

In October 2009 Yolanda relocated to a new business centre. She purchased a new building for £148,000 on 1 September 2009 and plans to use it exclusively for the purposes of her trade.

Required

Calculate the chargeable gain arising in 2009/10 and the base cost of the new building.

Answer

	£
Gross sale proceeds (October 2009)	250,000
Cost (December 1989)	(40,000)
Gain	210,000
Is the asset a QBA for rollover relief purposes?	Yes
Has it been replaced with a QBA?	Yes
Has it been replaced in the four year qualifying period? (24 October 2008 – 24 October 2012)	Yes
Have all of the sale proceeds been reinvested in a QBA?	No

As part of the asset is not used for the purposes of Yolanda's business, rollover relief is only available on the business portion of the gain.

Split of gain before rollover relief:		**Business**	**Non-business**
	£	£	£
Gain before rollover relief (2/3:1/3)		140,000	70,000
Sale proceeds re the business proportion of the gain (£250,000 × 2/3)	166,667		
less amount reinvested in QBAs for the business (£148,000 × 100%)	(148,000)		
	18,667	(18,667)	
Rollover relief (the rest of the business gain)		121,333	
Gains arising		18,667	70,000
Total gains in 2009/10		£88,667	

Base cost of replacement building	
Cost	148,000
Less Rollover relief	(121,333)
Base cost	26,667

1.5 Multiple disposals and reinvestments

If an individual disposes of more than one QBA and reinvests the sale proceeds in a single QBA, all of the gains can be deferred into the new purchase provided all of the sale proceeds have been reinvested. Where not all of the sale proceeds have been reinvested, the individual can choose which gain(s) are to be deferred.

If an individual disposes of one (or more) QBAs and reinvests the sale proceeds in more than one QBA, the gain(s) can be deferred into several purchases. At least £1 of gain must be deferred into each purchase to be able to claim that the sale proceeds have been reinvested in that asset, however the gain can be deferred in whatever proportion the individual wishes.

As a result, it is usually preferable to defer the majority of the gain against purchases of non-depreciating QBAs rather than depreciating QBAs. This is because the deferral of gains on non-depreciating assets is until the replacement asset is disposed of, whereas with depreciating assets the gain will crystallise in ten years time (or possibly earlier).

1.6 Reinvestment in a non-depreciating asset during the hold-over period

Where an individual reinvests in a depreciating QBA, the gain is deferred for a maximum of ten years.

If during this period the individual purchases a non-depreciating QBA, a claim can be made to link the original disposal with the new non-depreciating asset instead of the depreciating asset. The gain is then deferred against the new non-depreciating asset and deducted from the base cost of the asset in the normal way, instead of being deferred with respect to the depreciating asset.

As a result, the gain will not crystallise in ten years time. The gain is deferred until the new replacement non-depreciating QBA is disposed of.

The claim therefore extends the reinvestment time period for rollover relief.

Indefinite deferral against a non-depreciating QBA is therefore possible if a purchase is made **up to thirteen years after the original disposal**, provided there is a purchase and a **temporary claim is made within three years of the disposal against a depreciating QBA**.

Gift relief

- An overview of gift relief
- Qualifying assets for gift relief
- The mechanics of gift relief
- Sales at undervaluation
- Assets not used wholly for the purposes of the trade

2 Gift relief

2.1 An overview of gift relief

The lifetime gift of an asset is a chargeable disposal at full market value for capital gains tax purposes. However, if conditions are satisfied, the gain arising on the gift may be deferred if a gift relief claim is made.

The key points to remember are as follows:

- Gift relief is an **optional relief** but, if required, it must be claimed. It is not given automatically.
- A **joint claim** is required and must be signed by both the **donor** (i.e. the person making the gift) and the **donee** (i.e. the recipient of the gift).
- Gift relief is available **if:**
  - an individual makes a **disposal of a QBA** which is **used wholly and exclusively for the purposes of the trade**,
  - by way of an **outright gift**, or
  - **sale for less than its full market valuation**, and
  - a claim for relief is made within four years from the end of the tax year in which the disposal takes place.

2.2 Qualifying assets for gift relief

Qualifying assets for gift relief purposes are defined as follows:

- Assets used in a business carried on by the donor or by his personal company
- Unquoted trading company shares or securities
- Shares or securities in the donor's personal trading company
- Agricultural property provided the conditions for inheritance tax agricultural property relief are satisfied
- Any asset put into a relevant property trust as there is an immediate charge to inheritance tax (note that gift relief is available even if no inheritance tax is actually payable).

A personal company in this context means a company in which the individual has at least 5% of the voting rights.

Note that this definition of QBA is **not** the same as the definition used for rollover relief purposes.

2.3 The mechanics of gift relief

Where there is an **outright gift of a QBA** and gift relief is claimed:

- **all** of the gain arising on the gift is deferred (i.e. no gain arises and therefore no tax is payable by the donor at the time of the gift)
- the gain is deferred by deduction from the deemed acquisition cost of the asset acquired by the donee as follows:

	£
Full market value of the asset at the date of the gift	X
Less Gift relief = gain deferred (sometimes referred to as the gain held over)	(X)
Deemed acquisition cost (also referred to as the base cost)	X

- Gift relief is an all or nothing relief (i.e. it is optional, but if claimed, the maximum amount of gain allowed by the legislation must be deferred).

2.4 Sales at undervaluation

Where a qualifying business asset is sold for less than its full market value, the gain must be calculated using the full market value of the asset. Gift relief is available, but may be restricted depending on the amount of sale proceeds received as follows:

If the sale proceeds received are:	Treatment:
less than the original cost of the asset	Full gift relief is available, i.e. **all of the gain** can be deferred as if an outright gift
more than the original cost of the asset	■ The excess sale proceeds received are treated as a gain for the donor, arising at the time of the disposal. ■ The rest of the gain can be deferred with a gift relief claim.

Example

On 4 November 2009 Sheenagh gave a business asset to her son which was worth £264,000. She bought the asset in August 1989 for £16,200. Her son sold the asset in 31 May 2010 for £315,000. The asset qualifies as a business asset for gift relief purposes.

Required

(a) Calculate the chargeable gains arising on the disposals, with and without a gift relief claim. State whether a gift relief claim is advisable.

(b) Calculate the chargeable gain arising if Sheenagh sold the asset to her son for £65,000.

a

Answer

	(a) No sale proceeds No claim	(a) No sale proceeds With claim	(b) Sale for £65,000 With claim	Notes
November 2009 - gift to son	£	£	£	
Market value at date of gift	264,000	264,000	264,000	(1)
Less Cost	(16,200)	(16,200)	(16,200)	
Gain	247,800	247,800	247,800	
Less Gift relief	(Nil)	(247,800)	(199,000)	(2)
Gain after specific reliefs	247,800	Nil	48,800	

Notes for sale at undervaluation part (b)

(1) In the sale at undervaluation, ignore the actual sale proceeds received in the gain computation. The full market value must be used as the consideration.

(2) To calculate the gift relief, first calculate the gain at the time of the sale. The gift relief is the rest of the gain, calculated as follows:

	£
Actual sale proceeds received	65,000
Original cost	(16,200)
Gain at the time of the sale	48,800

Note: the gain arising at the time of the sale is the difference between the original capital cost and the sale proceeds actually received.

Gift relief = (£247,800 - £48,800)	199,000

	(a) No sale proceeds No claim	(a) No sale proceeds With claim	(b) Sale With claim
Deemed acquisition cost for the son		£	£
Market value at date of gift	264,000	264,000	264,000
Less Gift relief	(Nil)	(247,800)	(199,000)
Base cost of the asset	264,000	16,200	65,000
May 2010 – sale of asset by the son			
Sale proceeds	315,000	315,000	315,000
Less Base cost	(264,000)	(16,200)	(65,000)
Gain	51,000	298,800	250,000
Summary of chargeable gains			
November 2009	247,800	Nil	48,800
May 2010	51,000	298,800	250,000
Total chargeable gains	298,800	298,800	298,800

Advice

The total gain chargeable is the same irrespective of whether gift relief is claimed. However, the claim defers the tax liability until the second disposal. This is advantageous for cash flow purposes.

As CGT is payable at a flat rate of 18%, the decision may depend on the availability of the annual exemption and any capital losses held by the donor and donee.

2.5 Assets not used wholly for the purposes of the trade

The amount of gift relief available is restricted if the asset has not been used wholly for the purposes of the trade.

The restrictions are applied as follows:

Where the asset gifted:	
(1) has been used partly for business and partly for non-business use (i.e. 75% of a building used by the business and 25% not)	■ Only the business proportion of the gain is eligible for gift relief
(2) has been used wholly for business use for but only for some of the period of ownership (i.e. for 10 out of 12 years)	■ The gain eligible for gift relief is time apportioned
(3) is a shareholding in the donor's personal company and the company has investment assets	■ The gain eligible for gift relief is calculated as explained below

For shares in a personal trading company, the gain eligible for gift relief is calculated using the market values (MV) of assets owned by the personal trading company at the date of the gift of the shares by the donor as follows:

$$\text{Gain} \times \frac{\text{MV of the chargeable business assets (CBAs) in the company}}{\text{MV of the chargeable assets (CAs) in the company}}$$

CAs are the capital assets owned by the company which are chargeable assets for capital gains purposes (e.g. land and buildings, shares held in other companies, investment properties but not exempt assets such as goodwill, motor cars, stock, debtors etc).

CBAs are those CAs which are used for the purposes of the trade (e.g. land and buildings, but not investment assets such as shares held in other companies and investment properties).

Entrepreneurs' relief

- Overview of entrepreneurs' relief
- Conditions
- Associated disposals

3 Entrepreneurs' relief

3.1 Overview of entrepreneurs' relief

Entrepreneurs' relief is a relief that is available to an individual who disposes of a business or part of a business.

The relief covers the first £1 million of qualifying gains that an individual makes **during their lifetime**. The qualifying gains are reduced by a factor of 4/9ths. This results in an effective capital gains tax rate of only 10% (18% x 5/9) on those gains.

Gains in excess of £1 million are taxed at the normal CGT rate of 18%.

e

Example

Jan has qualifying gains of £1.2 million from the disposal of her business.

Required

Calculate the amount of capital gains tax payable by Jan, assuming this is her only disposal in 2009/10.

a

Answer

The first £1 million of gains qualifies for relief. The balance is taxable at the normal rate of CGT:

	£
Total qualifying gains	1,200,000
Less Entrepreneur's relief: £1,000,000 × 4/9	(444,444)
Chargeable gain	755,556
Less Annual exemption	(10,100)
Taxable gain	745,456
CGT at 18%	134,182

3.2 Conditions

Relief is available for disposals of the following:

- The whole or part of a business run by a sole trader or a partnership. However, the relief only applies to gains arising from the disposal of assets used in the business; it does not apply to gains arising from the disposal of investments.
- The disposal of shares in a trading company, provided the individual:
  - has a 5% shareholding in the company, and
  - is an employee of the company.

The company itself may hold investments without it affecting the availability of the relief.

Note that a mere disposal of assets used in a business is insufficient to qualify for entrepreneurs' relief; the relief requires the disposal of all or part of a business **as a going concern**. In addition, in order to qualify for relief, the business must have been owned throughout the year leading up to the date of disposal.

The relief is not given automatically. It must be claimed within one year of the 31 January following the end of tax year in which the disposal takes place (i.e. the 31 January immediately prior to the second anniversary of the end of the tax year).

Example

On 1 August 2009, Agnes sold a business that she had operated as a sole trader for ten years.

The disposal resulted in the following gains:

	£
Goodwill	100,000
Freehold premises (used by the business)	500,000
Freehold premises (held as an investment)	200,000

Required

Calculate the capital gains tax payable by Agnes on the disposal of her business.

Answer

	£
Total gains	800,000
Less Entrepreneur's relief: £600,000 × 4/9	(266,667)
Chargeable gain	533,333
Less Annual exemption	(10,100)
Taxable gain	523,233
CGT at 18%	94,182

Notes

1 The gain on the investment property does not qualify for relief.

2 The remaining £400,000 of entrepreneurs' relief (£1,000,000 – 600,000) is available to set against any future qualifying gains.

3.3 Associated disposals

Entrepreneurs' relief is also available in respect of associated disposals.

Associated disposals are disposals of assets:

- owned by an individual but used by his personal trading company or a partnership in which he is a partner,
- which take place at the same time as the sale of the partnership/company.

In order for full relief to be available for associated disposals, the individual must not have charged rent to the business for the use of the assets.

Principal private residence and letting relief

4 Principal private residence and letting relief

4.1 An overview of principal private residence relief

Where an individual disposes of his only or main residence and grounds of up to half a hectare, the gain is completely exempt from CGT provided the individual:

- occupied the property as his principal private residence (PPR) (i.e. main home) throughout the whole period of ownership, or
- was prevented from living in the house because he was required to live in job-related accommodation (as defined in chapter 4).

If these conditions are not met, only part of the gain may be exempt.

In addition to PPR relief, letting relief is available if:

- the property has been the individual's PPR, and
- some of the gain remains chargeable after PPR relief, and
- during the period of ownership part or all of the house was let to tenants.

4.2 Choice of principal private residence

Where an individual owns and lives in more than one residence, it is necessary to determine which property is to be treated as his PPR for CGT purposes. This is because an individual may only have one PPR at any one time. Note also that a married couple (or civil partners) can similarly only have one PPR between them at any one time.

The PPR of an individual is usually the property he lives in the most. However, as long as the individual lives in the property at some time, he may choose the property he wishes to be treated as his PPR. It therefore is advantageous to choose the property likely to have the highest chargeable gain arising on its disposal, so that the highest gain is exempted.

The election to choose the PPR must be:

- made within two years of the acquisition of the second property, and
- signed by all parties, if the property is jointly owned.

If an election is not made, HMRC will choose the property to be treated as the PPR based on the facts of actual occupation (i.e. the property most used as the main residence).

4.3 Actual and deemed occupation

PPR relief is given for periods of actual and deemed occupation and is calculated as follows:

$$\text{Gain} \times \frac{\text{Period of actual and deemed occupation since 31 March 1982}}{\text{Period of ownership since 31 March 1982}}$$

Calculations are made to the nearest month in the examination.

Deemed occupation

HMRC will exempt the following periods of deemed occupation:

	Provided the property has been the individual's PPR at some time	Provided additional conditions are satisfied (see below)
Exempt periods	Last 36 months of ownership	Any period(s) of absence while working overseas
		Maximum total of four years absence while working elsewhere in the UK
		Maximum total of three years for any other reason

There are two additional conditions, both of which must be satisfied, to allow the periods other than the last 36 months of ownership. They are as follows:

- During the period of absence this property must be elected as the **individual's PPR at that time**, and
- **at some time both before and after the period of absence** there is a period of actual occupation by the owner.

However, there is an extra-statutory concession which will allow the periods of absence while working overseas or in the UK to be exempt even if the property is not reoccupied by the owner after the period of absence.

This concession applies only to the work-related absences and only if the reason the individual does not reoccupy the house is because the terms of his employment prevent him from being able to reoccupy.

4.4 The mechanics of principal private residence relief

If the property has not been occupied as an individual's PPR throughout the period of ownership and the individual was not required to live in job-related accommodation, a chargeable gain arises as follows:

- The gain on the disposal of the property is calculated in the normal way.
- Periods of actual and deemed occupation since 31 March 1982 are determined and PPR relief is deducted from the gain.
- If the property has been let, letting relief is calculated and deducted from the remaining gain.

4.5 Proforma gain computation: disposal of a principal private residence

	£
Gain (calculated as normal)	X
Less PPR relief (based on periods since 31 March 1982)	
$\text{Gain} \times \dfrac{\text{Period of actual and deemed occupation}}{\text{Period of ownership}}$	(X)
Gain after PPR	X
Less Letting relief (see below)	(X)
Chargeable gain	X

Example

Barbara sold her house on 16 March 2010 for £850,000. She purchased the house on 16 April 1997 for £205,000.

She occupied the property as her home until 16 April 2001 when she went to live with her invalid mother for two years. She reoccupied the house following her mother's death on 16 April 2003. She lived there until 16 October 2005 when she moved into her boyfriend's house and put her house up for sale.

The property remained empty and was not let during her periods of absence.

Required

Calculate the chargeable gain arising on the sale of Barbara's home.

a

Answer

		£
Gross sale proceeds (March 2010)		850,000
Less	Cost (April 1997)	(205,000)
Gain		645,000
Less	PPR relief (W)	
	£645,000 × (138/155)	(574,258)
Gain after PPR		70,742
Less	Letting relief	(Nil)
Gain after PPR and letting relief		70,742

Working: PPR relief

		Notes	Total (mths)	Exempt (mths)	Chargeable (mths)
16.04.1997 to 16.04.2001	Owner occupied		48	48	
16.04.2001 to 16.04 2003	Empty	(1)	24	24	
16.04.2003 to 16.10.2005	Owner occupied		30	30	
16.10.2005 to 16.03.2010	Empty	(2)	53	36	17
			155	138	17

Notes

(1) As the property is Barbara's PPR and she actually occupied the property at some time both before and after the period of absence, these 24 months are exempt under the three years for any reason rule.

(2) The last 36 months of ownership are always exempt, provided the property has been Barbara's PPR at some time.

The remaining amount of the three years for any reason is not allowed as Barbara does not reoccupy the property at some time after the period of absence.

4.6 Letting relief

Letting relief may be available if the property:

- has been let to tenants as residential accommodation, and
- qualifies for PPR relief, but not all of the gain is exempted under the PPR rules.

The amount of letting relief available is the lowest of:

(i) PPR relief

(ii) That part of the remaining gain (after PPR relief) which relates to a period of letting

(iii) Maximum of £40,000.

Example

Judith purchased a house for £69,379 on 1 April 1988.

She occupied the property as her home until 1 April 1992 when she went to work overseas. She let the property to tenants.

On 1 January 2002 she returned to the UK and was required by her employers to work in a different city. On 1 March 2003 she returned to her home town but lived with relatives until 1 July 2003 when she could reoccupy her house on the termination of the tenancy agreement.

On 1 January 2006 Judith purchased another house and elected for it to be her PPR from that date. She let her original house to tenants until it was sold on 31 March 2010 for £384,000.

Required

Calculate the chargeable gain arising on the disposal of Judith's house.

Answer

			£
Gross sale proceeds (March 2010)			384,000
Less	Cost (March 1988)		(69,379)
Gain			314,621
Less	PPR relief (W1)		
	£314,621 × (249/264)		(296,745)
Gain after PPR			17,876
Less	Letting relief (W2)		(17,876)
Gain after PPR and letting relief			Nil
Chargeable gain			Nil

Working

(1) PPR relief

	Notes	Total (mths)	Exempt (mths)	Chargeable (mths)	Let (mths)
01.04.1988 – 01.04.1992	(1)	48	48		
01.04.1992 – 01.01.2002	(2)	117	117		
01.01.2002 – 01.03.2003	(3)	14	14		
01.03.2003 – 01.07.2003	(4)	4	4		
01.07.2003 – 01.01.2006	(5)	30	30		
01.01.2006 – 31.03.2010	(6)	51	36	15	15
		264	249	15	15

Notes

(1) Owner occupied.

(2) Working overseas – unlimited periods of working overseas are exempt as this property is Judith's PPR at that time and she did actually occupy the property **at some time before and after** this period of absence.

(3) Working elsewhere in the UK – periods totalling up to 4 years are exempt for working elsewhere in the UK by reason of employment as this property is Judith's PPR at that time and she did actually occupy the property **at some time before and after** this period of absence.

(4) In home town but living with relatives – periods totalling up to three years are exempt for any other reason as the property is Judith's PPR and she actually occupied the property both at some time both before and after the period of absence.

(Note that letting relief is not given for periods (2) to (4) as these periods are exempt under the PPR rules.)

(5) Owner occupied.

(6) The last 36 months are always exempt if the property has been the PPR at some time. The remaining period of 15 months cannot be covered by the three years for any other reason rule as the property is not Judith's PPR at that time and she does not reoccupy it after the period of absence. Therefore the remaining 15 months are chargeable under the PPR rules. However, during this period the property is let to tenants and therefore letting relief is available for this period.

(2) Letting relief

Lower of:		£
(i)	PPR relief	296,745
(ii)	That part of the remaining gain (after PPR relief) which relates to a period of letting (W1) £314,621 × (15/264)	17,876
(iii)	Maximum	40,000

4.7 Restriction of relief for business use

PPR relief is not available to exempt the portion of the gain relating to exclusive business use.

The portion of the gain relating to exclusive business use is calculated as follows:

Situation		Apportionment
(1)	Where the whole of the house is used for business purposes for part of the period of ownership	Time apportionment
(2)	Where part of the house is used for business purposes for the whole period of ownership. The individual lives in the remaining part.	Usually based on percentage of floor space

Situation		Apportionment
(3)	Where part of the house is used for business purposes for part of the period of ownership. The individual lives in the whole house for part of the period of ownership and in the non-business part only for the remaining period of ownership.	Usually based on time apportionment and percentage of floor space

Note that the periods of deemed occupation are not allowed against the business portion of the gain.

However, the last 36 months exemption will apply to the whole property if the business part of the property was at some time used as the individual's main residence (i.e. situations (1) and (3) above).

e

Example

Michelle purchased a three storey Victorian house on 1 August 1999 as her main residence and sold it on 31 October 2009, giving rise to a gain on the whole property before PPR relief of £295,000.

Required

Calculate the business portion of the gain which becomes chargeable assuming:

(a) Michelle used the top floor for business purposes throughout the entire period of ownership

(b) Michelle used the top floor for business purposes from 1 August 2003 to the date of sale.

a

Answer

(a) Top floor used for business purposes throughout the entire period of ownership

Business use of a third of the building for the whole period, therefore the last 36 months are not exempt

Business portion of the gain = (£295,000 × 1/3) = £98,333

(b) Top floor used for business purposes for part of the period of ownership

Length of ownership (01.08.1999 – 31.10.2009) = 123 months

Business use (01.08.2003 – 31.10.2009) = 75 months

Business use of a third of the building for part of the period of ownership, but the top floor was **used as Michelle's main residence at some time,** therefore the last 36 months are exempt.

Chargeable business use = (75 – 36) = 39 months

Business portion of the gain = (£295,000 × 1/3) × (39/123) = £31,179

It is therefore advisable to ensure that all of the property is at some time used for residential purposes.

CHAPTER 13

Inheritance tax and lifetime gifts

Contents

An overview of inheritance tax

- The principles of inheritance tax
- The scope of inheritance tax
- A transfer of value
- Excluded property
- The occasions of charge

1 An overview of inheritance tax

1.1 The principles of inheritance tax

An individual is taxed on the value of the net assets he leaves in his estate when he dies. However, in addition, **some lifetime gifts attract an immediate IHT charge**, and a **further tax charge** may be due on certain lifetime gifts **on the event of death**.

IHT is essentially **a donor-based tax**. This means that for all charges to IHT:

- the calculations of the amounts of tax payable are based on the circumstances of the individual making the gift (the donor), and
- the donor is primarily responsible for paying any IHT due.

1.2 The scope of inheritance tax

IHT taxes **chargeable transfers of value.** An IHT liability therefore arises if:

- a **chargeable person**
- makes a **transfer of value**
- of capital assets which are not **excluded property.**

Individuals are chargeable to IHT as follows:

Status of the individual:	Liable to IHT on transfers of:
Domiciled in the UK	Worldwide capital assets
Not domiciled in the UK	UK capital assets only

The term 'domicile' is a legal term that means the permanent home of an individual. An individual can only have one domicile at any point in time.

On birth an individual acquires a domicile of origin which means that he inherits the domicile of his father (i.e. the permanent home of his father becomes his domicile). The actual place of birth is not relevant in determining domicile.

From the age of 16 an individual can acquire a domicile of choice.

To lose UK domicile status, an individual must prove to HMRC that he has:

- disassociated himself from the UK (for example, by selling his UK home, resigning from clubs, not making regular visits back to the UK), and
- made another country his **permanent** home (for example, by purchasing a home, joining clubs, legally changing nationality/citizenship).

The domicile of an individual is important in determining the individual's liability to all of the personal taxes (i.e. income tax, capital gains tax and inheritance tax). However, for IHT purposes **only**, the term domicile is extended and also includes the concept of **deemed domicile.**

An individual is deemed to be domiciled in the UK if:

(1) He has been resident in the UK for at least 17 out of the preceding 20 tax years (including the tax year in which the transfer is made), or

(2) He was UK domiciled but legally changed his domicile to another country within the preceding three years.

1.3 A transfer of value

A **transfer of value** means any gratuitous disposition of wealth. A transfer of value occurs where an individual transfers a capital asset and his estate decreases in value as a result of the transfer.

Transfers of value can occur during an individual's lifetime or on death (via a will or under the rules of intestacy).

For the transfer to be caught by the IHT regime, there must be gratuitous intent (i.e. it must be a gift). A genuine commercial transaction or bad bargain (i.e. the unintentional sale of an asset for less than it is worth) would not be a transfer of value for IHT purposes. Similarly, expenditure on family maintenance is not considered to be a transfer of value.

The concept of the fall in value as a result of a gift, or the **diminution in value concept**, is the fundamental starting point of all IHT calculations.

The diminution in the value of the estate is usually the open market value of the capital asset that is gifted. However, special valuation rules apply to the gifts of certain assets. These are considered later.

1.4 Excluded property

There are very few types of property which are excluded from a charge to IHT. The main type of excluded property is foreign assets owned by a non-UK domiciled individual.

1.5 The occasions of charge

There are three key occasions of charge to IHT as follows:

Timing of the event:	IHT charged on:	
During the individual donor's lifetime	(1)	Chargeable lifetime transfers (CLTs), **at the time the gift is made**
On the death of the individual	(2)	Chargeable Lifetime Transfers (CLTs), and Potentially Exempt Transfers (PETs) **if the gift is within seven years of death**
	(3)	The value of the individual's estate on the date of death

The two IHT charges on lifetime gifts are covered in this chapter. The next chapter covers the third IHT charge on the value of an individual's estate.

Lifetime gifts

- The three types of lifetime gifts
- Exempt gifts
- Potentially exempt transfers (PETs)
- Chargeable lifetime transfers (CLTs)
- Valuation rules

2 Lifetime gifts

2.1 The three types of lifetime gifts

For IHT purposes an individual may make the following three types of gifts during his lifetime:

(1) Exempt gifts

(2) Potentially exempt transfers (PETs), and

(3) Chargeable lifetime transfers (CLTs).

2.2 Exempt gifts

The following lifetime gifts are exempt from IHT:

- **Gifts to a spouse or civil partner**

  Gifts to spouses and civil partners are exempt regardless of the amount of the gift **unless** the recipient is non-UK domiciled. In this case there is a total lifetime maximum exemption of £55,000.

- **Gifts to a charity**

  Gifts to charities are exempt regardless of the amount of the gift, provided the charity is recognised by HMRC.

- **Gifts to a qualifying political party**

  A qualifying political party is a party that following the last General Election has:

  – at least two elected MPs, or

  – one elected MP and at least 150,000 votes cast for that political party.

- **Gifts for the public benefit**

  This exemption covers gifts of land, buildings and works of art with national historic interest and/or outstanding beauty to non-profit making organisations such as the National Trust, approved museums, libraries and art galleries.

- **Gifts which represent normal expenditure out of income**

  To prove that a gift is an item of normal expenditure, HMRC would expect the expenditure to be regular payments out of income (not capital) and the payments not to affect the standard of living of the individual donor (for example, Christmas and birthday presents).

- **Small gifts**

  Gifts **to individuals of £250 or less** per recipient per tax year are exempt. If a gift exceeds £250, or the total gifts to the same person in a tax year exceed £250, the full amount of the gift is chargeable.

- **Wedding gifts**

  Wedding presents are exempt, subject to monetary limits as follows:

Relationship of the donor to one of the couple:	**Limit**
	£
Parent	5,000
Grandparent	2,500
One of the couple to the other	2,500
Anyone else	1,000

  If the gift exceeds the limit, only the excess is chargeable. Note that these limits are not given in the examination.

- **Gifts covered by the annual exemption**

  In each tax year an individual has an annual exemption (AE) of £3,000.

  The AE is allocated in strict chronological date order irrespective of whether a gift is a PET or a CLT. It is deducted after other specific exemptions, such as the marriage exemption.

  Any unused AE may be carried forward and set off in the following year. However, the carry forward of unused AE is for one year only and can only be utilised after the current year AE has been set off.

The IHT consequences of exempt gifts

There is no IHT to pay at any time on exempt gifts.

2.3 Potentially exempt transfers (PETs)

A **potentially exempt transfer** (PET) is a gift **by** an individual (the donor) **to** another individual (the donee).

The IHT consequences of PETs

- There is **no IHT** to pay on PETs **at the time of the gift**.
- A PET is potentially exempt. Therefore, it may never become chargeable.
- A PET will only become chargeable if the donor dies within seven years of making the gift.

The gross chargeable value of a PET

Despite the fact that a PET does not become chargeable until the event of death, the value of a PET is fixed at the time of the gift and is calculated as follows:

			£
Value of the estate before the gift			X
Value of the estate after the gift			(X)
Transfer of value (or diminution in value)			X
Less:	Reliefs if applicable (see later)		(X)
Less:	Exemptions (e.g.)		
	Marriage exemption		(X)
	Annual exemption	– current tax year	(X)
		– preceding tax year (if unused)	(X)
Gross chargeable amount			X

2.4 Chargeable lifetime transfers (CLTs)

A **chargeable lifetime transfer** (CLT) is a gift which is not a PET and is not exempt.

The main example of a CLT is a gift into a relevant property trust (RPT).

The IHT consequences of CLTs

- A CLT is taxed **at the time of the gift**. CLTs are the only lifetime gifts by a donor which are immediately chargeable to IHT.
- There is a choice of who pays the lifetime tax, the donor or donee.
- A CLT becomes chargeable again if the donor dies within seven years of making the transfer.

The gross chargeable value of a CLT

The gross chargeable value of a CLT is calculated in a same way as the gross value of a PET, if the donee agrees to pay the lifetime tax. However, it is slightly different if the donor agrees to pay the lifetime tax.

The detailed computations of lifetime IHT on CLTs is covered in the next section of this chapter.

Example

Lucy and her husband are UK domiciled individuals. Lucy made the following lifetime cash gifts:

		£
10 July 2008	To her son	55,000
16 November 2008	To Save the Children Fund (a charity)	90,000
8 April 2009	To her husband	43,000
25 May 2009	To a friend	245
12 June 2009	To her grandson on the occasion of his marriage	4,500
30 September 2009	To a relevant property trust (the trustees are to pay any lifetime IHT)	100,000

Required

(a) State whether each gift is an exempt gift, a PET or CLT.

(b) Calculate the gross chargeable value of each gift.

a **Answer**

Date:	Gift to:				£
10.7.2008	Son	PET	Transfer of value = cash		55,000
			Less	AE for 2008/09	(3,000)
				AE for 2007/08	(3,000)
			Value of PET		49,000
16.11.2008	Charity	Exempt – unlimited amount			Nil
8.4.2009	Spouse	Exempt – unlimited amount			Nil
25.5.2009	Friend	PET	Transfer of value = cash		245
			Less	Small gift exemption	(245)
			Value of PET		Nil
12.6.2009	Grandson	PET	Transfer of value = cash		4,500
			Less	Marriage exemption	(2,500)
				AE for 2009/10	(2,000)
			Value of PET		Nil
30.9.2009	RPT	CLT	Transfer of value = cash		100,000
			Less	AEs	
				– 2009/10 - balance	(1,000)
				– 2008/09 - already used	(Nil)
			Value of CLT		99,000

2.5 Valuation rules

The diminution in the value of the estate is usually the open market value of the capital asset that is gifted. For example, in the above example all of the gifts were of cash and the transfer of value was the amount of cash gifted.

However, special valuation rules apply where the asset gifted consists of shares or related property.

Quoted shares and securities

Quoted shares and securities are usually traded on the stock exchange within a range of quoted prices. Any notable transactions or recorded bargains for the day are also sometimes quoted in the financial press.

For IHT purposes, the value of quoted shares and securities is calculated as the lower of:

- the quarter-up rule, or
- the mid-bargain price.

The quarter-up valuation is calculated by adding a quarter of the difference in the range of quoted prices to the lower value in the range.

The mid-bargain price is the average of the highest and lowest marked bargains of the day.

Example

Mandy gave her entire holding of 2,000 £1 ordinary shares in ABC plc to her daughter. The shares were quoted at 310p-318p per share. There were three marked bargains for the day quoted at 306p, 307p and 314p.

John gave away his £30,000 12% debentures 2012 to his son. The debentures were quoted at 96p-98p per £1.

Required

Calculate the transfer of value of Mandy's shares and John's securities for IHT purposes.

Answer

Mandy's shares

Lower of:

(i) Quarter-up rule

$310 + (318 – 310) \times ¼ = 312p$

(ii) Mid-bargain price

$(306 + 314) \times ½ = 310p$

Value of 2,000 shares = 2,000 × 310p = £6,200

John's shares

If there are no marked bargains, the valuation is the quarter-up rule.

Quarter-up rule = 96p + ((98 – 96) × ¼) = 96½p per £1 of debenture stock

Value of £30,000 debentures = 30,000 × 96½p = £28,950

Unit trusts

For IHT purposes, units in a unit trust are valued at the manager's bid price which will be the lower of the two published prices.

Unquoted shares and securities

As unquoted shares are not readily marketable assets on a stock exchange, a professional valuation of the business, and therefore the shares, has to be obtained. In practice the valuation has to be agreed with HMRC's Share Valuation Division.

However, in the examination the appropriate value to use will be given in the question.

Related property

Property is deemed to be related to an individual's property if it is property of a similar kind held by:

- that individual's spouse (or civil partner), or
- a charity or other exempt body (such as a political party) as a result of a gift by that individual or his spouse.

In the last case, the property is deemed to be related for as long as the exempt body owns the assets and for a further five years after it disposes of the asset.

Special valuation rules apply to related property mainly to prevent couples artificially splitting up valuable sets of assets between them to try to avoid IHT by reducing the value of both of their estates. This is because an asset that is part of a set of similar assets is usually worth more than an asset owned in isolation.

For example, the value of three Chippendale chairs held by an individual on their own will be much less than the value of three chairs that are part of a set of six owned by the individual and his spouse.

Similarly, if a husband and wife each own a 45% interest in an unquoted company, the valuation of each interest should not be taken as a minority interest holding of 45%. Clearly the couple have a controlling interest over the company and the valuation of each spouse's shareholding should take account of this fact.

The related property valuation is calculated as follows:

$$\text{Value of the whole set of similar assets} \times \frac{A}{A+B}$$

Where:

	Assets other than shares	Shares
A =	The value of the donor's assets	The number of shares held by the donor
B =	The value of the related parties' assets	The number of shares held by the related parties

In the case of shares, a short cut to the above formula can be used. The combined percentage of the company held by a married couple (or civil partners) can be used to determine the price per share. This price is then applied to the number of shares held by the donor.

e 1

Example 1

Kerry owns a plot of land worth £30,000. Her husband, Brian, owns the adjacent plot of land which is worth £40,000. The combined plots of land are worth £110,000.

On 28 October 2009 Kerry gifts her plot of land to her son, Edward, on the occasion of his marriage. She has made no previous lifetime gift.

Required

Calculate the gross chargeable value of the PET to Edward.

a

Answer

		£
Transfer of value 110,000 × $\frac{30,000}{30,000 + 40,000}$		47,143
Less	Marriage exemption	(5,000)
	AEs – 2009/10	(3,000)
	– 2008/09	(3,000)
Gross chargeable value of PET		36,143

Note

Once the land has passed to the son it is no longer 'related' for the purposes of IHT.

e 2

Example 2

Larry gifted 2,000 of his shares in XYZ Ltd to his daughter, Sally, on 25 December 2009. Larry has made no previous lifetime gifts and the shares are not eligible for any reliefs.

XYZ Ltd is an unquoted investment company with an issued share capital of £1 ordinary shares owned before the transfer as follows:

	Number of shares
Larry	9,500
Mavis (Larry's wife)	4,000
Nigel (Larry's son)	6,000
Other unconnected persons	5,500
	25,000

XYZ Ltd shares are valued on 25 December 2009 as follows:

	Price per share
	£
0 – 25%	12
26 – 50%	18
51 – 75%	30
76 – 100%	42

Required

Calculate the gross chargeable value of the PET to Sally.

Answer

	Before the gift	After the gift
	No. of shares	No. of shares
Larry	9,500	7,500
Mavis – related property	4,000	4,000
	13,500	11,500
	54%	46%

		£
Value of estate before the gift (9,500 × £30)		285,000
Value of estate after the gift (7,500 × £18)		(135,000)
Transfer of value		150,000
Less	AEs – 2009/10	(3,000)
	– 2008/09	(3,000)
Gross chargeable value of PET		144,000

Associated operations

Two or more transactions affecting the same property (directly or indirectly) are known as associated operations. All associated operations are treated as one disposition made at the time of the last one of the associated operations.

The calculation of lifetime tax on chargeable lifetime transfers (CLTs)

- The procedure for calculating lifetime IHT
- The chargeable amount
- The nil rate band available
- The seven year cumulation period
- The lifetime rate of tax
- The proforma computation for lifetime IHT

3 The calculation of lifetime tax on chargeable lifetime transfers (CLTs)

3.1 The procedure for calculating lifetime IHT

Lifetime IHT is payable on CLTs at the time of the gift.

The procedure to adopt for calculating lifetime IHT is as follows:

Step 1: Deal with gifts in strict chronological date order and calculate **the chargeable amount** of any CLTs **and** PETs

Although there is no lifetime tax payable on PETs, the gross chargeable amount of the PETs needs to be calculated in order to decide whether the annual exemptions have been utilised

Step 2: Calculate the lifetime tax on each CLT separately starting with the earliest (ignore the PETs at this stage) and take into account:

- the **available nil rate band**, and
- **who has agreed to pay the tax**

Step 3: If required, state the **due date for payment** of the lifetime tax.

3.2 The chargeable amount

The IHT payable on CLTs can be paid by either:

- the donor of the gift, or
- the donee (i.e. the recipient of the gift).

As the main example of a CLT is a gift into a relevant property trust, the donee will be the trustee(s) of the relevant property trust fund.

As mentioned earlier, the gross chargeable value of a CLT is calculated in the same way as the gross value of a PET if the donee (i.e. trustee) agrees to pay the lifetime tax. However, it is slightly different if the donor agrees to pay the lifetime tax.

If the trustee (the **donee**) agrees to pay the tax:

- The gift is known as a **gross gift**.
- This means that the value of the gift is the total (gross) amount that the donor is gifting out of his estate.

However, if the **donor** agrees to pay the tax:

- The gift is known as a **net gift.**
- This means that the donor is not only gifting the value of the asset but is paying the associated tax bill. Therefore, the value of the gift **plus** the associated lifetime IHT payable is the total (gross) amount that the donor is gifting out of his estate.

IHT is principally a donor-based tax. Therefore, if an examination question does not state who has agreed to pay the lifetime tax, always assume that it is a net gift and the donor will pay the tax.

3.3 The nil rate band available

There is a nil rate band available for IHT transfers. The nil rate band available usually changes each tax year and is announced in the Budget.

To calculate the lifetime IHT due on a CLT, the nil rate band applicable at the time of the transfer should be used. However, for the Paper P6 examination, the examiner has said that the current nil rate band of £325,000 should always be used.

3.4 The seven year cumulation period

The nil rate band covers a 'cumulation period' of seven years.

Lifetime IHT is only payable if the CLT **plus** any other gross chargeable transfers in the preceding seven years exceed the nil rate band of £325,000.

This means that when calculating the IHT payable on a CLT, it is necessary to look back seven years **before the gift** and to work out the total value of any other gross **chargeable** transfers in that period. This step is important to find out whether or not there is any nil rate band left available to match against the latest CLT.

Note that **only CLTs are cumulated** in lifetime IHT calculations. Exempt gifts are ignored as they never become chargeable and all PETs are ignored as they do not become chargeable until the donor dies.

3.5 The lifetime rate of tax

The rate of lifetime IHT payable on the excess over the available nil rate band is calculated as follows:

Type of gift:	**The payer of the lifetime IHT:**	**Rate:**
Gross CLT	The trustees of the relevant property trust	20%
Net CLT	The donor	20/80 or 25%

3.6 The proforma computation for lifetime IHT

Step 1: The chargeable amount of a CLT or PET is calculated as follows

			£
Value of the estate before the gift			X
Value of the estate after the gift			(X)
Transfer of value (or diminution in value)			X
Less: Reliefs if applicable (see later)			(X)
Less: Exemptions (e.g.)			
	Marriage exemption		(X)
	Annual exemption	– current tax year	(X)
		– preceding tax year (if unused)	(X)
Chargeable amount			X

= gross chargeable amount if a PET or a CLT where the trustees agree to pay the IHT
= net chargeable amount if a CLT and the donor agrees to pay the IHT

Step 2: The lifetime IHT is calculated as follows

	£	£
Chargeable amount		X
Nil rate band (NRB)	325,000	
Gross CLTs in the seven years before this gift	(X)	
Nil rate band available		(X)
Taxable amount		X
Lifetime IHT at 20% (if gross gift) or 25% (if net gift)		X

If the CLT is a net gift, the lifetime IHT must be added to the net chargeable amount to calculate the correct figure of gross chargeable transfers in the previous seven years when calculating the IHT on the next gift.

	£
Net chargeable amount	X
Add: Lifetime IHT	X
Gross chargeable amount to carry forward for future calculations	X

If there are only a few gifts, adopting a columnar form layout with two columns for each gift (as in the example below) will save time in the examination.

Step 3: State the due date of payment of the IHT and who has agreed to pay the tax

- The donor and the donee can choose who is to pay the lifetime IHT.
- The date of payment depends on when the CLT occurs in the tax year as follows:

Date of CLT:	Due date:
6 April to 30 September	30 April in the following year
1 October to 5 April	Six months after the end of the month in which the CLT is made

Example

Michael made the following lifetime gifts:

Date of gift	Recipient of the gift	£
13 February 2002	Daughter's relevant property trust	200,000
24 May 2006	Nephew	140,000
29 September 2007	Son's relevant property trust	175,000
9 December 2009	Daughter's relevant property trust	171,000

The trustees of the daughter's relevant property trust agreed to pay the lifetime IHT in respect of the gifts into that trust. Otherwise Michael paid any tax due.

Required

Calculate the lifetime IHT due on these gifts and state the due date for payment.

Answer

The gift on 24 May 2006 to the nephew is a PET. There is no lifetime IHT payable on PETs.

This gift is ignored when calculating the lifetime tax on the other CLTs, except that the annual exemption for 2006/07 and 2005/06 will be matched against this PET. Therefore the 2006/07 annual exemption is not available to match against CLT 2 as shown on the next page.

	CLT 1 13.2.2002		PET 24.5.2006	CLT 2 29.9.2007		CLT 3 9.12.2009	
	£	£	£	£	£	£	£
Transfer of value		200,000	140,000		175,000		171,000
Less AE							
2001/02		(3,000)					
2000/01 b/f		(3,000)					
2006/07			(3,000)				
2005/06 b/f			(3,000)				
2007/08					(3,000)		
2009/10							(3,000)
2008/09 b/f							(3,000)
Chargeable amount		194,000	134,000		172,000		165,000
NRB	325,000			325,000		325,000	
Gross CLTs in 7 yrs before the gift							
13.2.95 – 13.2.02	(Nil)						
29.9.00 – 29.9.07 (*ignore the PET*)				(194,000)			
9.12.02 – 9.12.09 (*first gift drops out, ignore PET, bring in gross amount of CLT2*)						(182,250)	
NRB available		(325,000)			(131,000)		(142,750)
Taxable amount		Nil			41,000		22,250
		Gross gift			**Net gift**		**Gross gift**
Lifetime IHT							
Covered by NRB		Nil					
No IHT = PET			Nil				
41,000 × 25%					10,250		
22,250 × 20%							4,450
Paid by					Michael		Trustees
Due date					30.4.08		30.6.10
Gross CLT c/f to next gift calculation:							
Gross CLT		194,000					
Net CLT + tax (172,000 + 10,250)					182,250		
Gross CLT							165,000

The calculation of death tax on lifetime gifts

- The procedure for calculating death tax on lifetime gifts
- The gross chargeable amount on death
- The nil rate band available
- The seven year cumulation period
- The death rate of tax
- Taper relief
- Lifetime IHT paid
- The proforma computation for death tax on lifetime gifts

4 The calculation of death tax on lifetime gifts

4.1 The procedure for calculating death tax on lifetime gifts

On the death of an individual IHT is payable on both CLTs and PETs at the death rates of tax, but only if the gifts are within seven years of the date of death.

The procedure to adopt for calculating IHT payable on death is as follows:

Step 1: Deal with the gifts in strict chronological date order and calculate the **gross chargeable amount** of any CLTs **and** PETs

Step 2: Calculate the death tax on each gift if it is within seven years of the date of death starting with the earliest and taking into account:

- the **available nil rate band**,
- **the death rates of tax**,
- **taper relief**, and
- **lifetime IHT paid** (if any)

Step 3: If required, state the **due date for payment** of the death tax.

4.2 The gross chargeable amount on death

The amount chargeable on death is the **gross chargeable amount** calculated when computing the lifetime IHT calculations.

Therefore, in the previous example, if Michael were to die on 31 December 2009, the gross chargeable amounts that would become taxable on death would be:

			Gross chargeable amount on death
			£
13.2.02	CLT 1	More than seven years before death	Nil
24.5.06	PET	Becomes chargeable for the first time	134,000
29.9.07	CLT 2	Becomes chargeable again on death	182,250
9.12.09	CLT 3	Becomes chargeable again on death	165,000

4.3 The nil rate band available

The nil rate band is matched against lifetime gifts first, before computing the IHT on the value of the individual's estate at the date of death. Therefore the death tax on lifetime gifts must be calculated before the death tax due on the estate.

4.4 The seven year accumulation period

As in the lifetime calculations, in death calculations the nil rate band covers a cumulation period of seven years **before the date of the gift**.

Death IHT is payable on a lifetime gift if:

- the gross chargeable amount **plus**
- the total gross amount of gifts in the preceding seven years

exceed the nil rate band of £325,000.

This means that when calculating the IHT payable on a CLT or PET which has become chargeable on death, it is necessary to look back seven years **before the gift** and to work out the value of any other **gross chargeable transfers** in that period.

However, when looking back seven years from the date of the gift in death calculations:

- **all** CLTs must be totalled together with
- any PETs which are **within seven years of death**.

In the death calculations the only gifts that can be ignored are exempt gifts and PETs which are more than seven years before the date of death.

4.5 The death rate of tax

The death rate of IHT is 40% on the excess over the nil rate band.

The death tax due on lifetime gifts can be reduced by:

- taper relief, and
- any lifetime IHT paid in respect of that gift.

4.6 Taper relief

Taper relief is available if the lifetime gift was made more than three years before the date of death.

The rate of taper relief is as follows:

Years between the date of the gift and the date of death		
More than	**Not more than**	**Taper relief %**
0	3	Nil
3	4	20
4	5	40
5	6	60
6	7	80

The taper relief table above should be learned as it is not given in the examination.

4.7 Lifetime IHT paid

If the gift is a CLT some lifetime IHT may have been paid. If so, it can be deducted from the death tax calculated and only the excess is paid on death. Credit is given for the lifetime tax paid irrespective of whether it was paid by the donor or donee.

If the lifetime IHT paid exceeds the death tax due, there is **no repayment** of lifetime IHT.

4.8 The proforma computation for death tax on lifetime gifts

Step 1: Start with the gross chargeable amount of any CLTs and PETs per the lifetime tax calculations.

Step 2: The death IHT is calculated for each gift as follows

	£	£
Gross CLT or PET per lifetime calculations		X
Nil rate band (NRB)	325,000	
Gross chargeable transfers in the seven years before this gift	(X)	
Nil rate band available		(X)
Taxable amount		X
Death IHT at 40%		X
Less Taper relief		(X)
Lifetime IHT paid (if any)		(X)
IHT payable on death		X

Step 3: State the due date of payment of the IHT and who pays the tax

- Death tax on lifetime gifts is **always** paid by the recipient of the gift.
- Death tax is due six months after the end of the month of death.

Example

Assume that Michael in the previous example died on 31 December 2009.

Required

Calculate the death tax arising on the lifetime gifts as a result of Michael's death. State the due date for payment and who will pay the tax.

Answer

Date of death: 31 December 2009
Seven years before: 31 December 2002

There is no further tax due in respect of CLT 1 on 13 February 2002 as it is more than seven years before the date of death.

There is death tax to calculate in respect of the PET and the other two CLTs.

	PET 24.5.2006		**CLT 2 29.9.2007**		**CLT 3 9.12.2009**	
	£	£	£	£	£	£
Gross chargeable amount per lifetime		134,000		182,250		165,000
NRB	325,000		325,000		325,000	
Gross CLTs in 7 yrs before the gift						
24.5.1999 – 24.5.2006 *(include CLT 1)*	(194,000)					
29.9.2000 – 29.9.2007 *(include CLT1 and the PET)* (194,000 + 134,000)			(328,000)			
9.12.2002 – 9.12.2009 *(first gift drops out, include PET and gross amount of CLT 2)* (134,000 + 182,250)					(316,250)	
NRB available		(131,000)		(Nil)		(8,750)
Taxable amount		3,000		182,250		156,250

			PET 24.5.2006	**CLT 2 29.9.2007**	**CLT 3 9.12.2009**
			£	£	£
IHT at death rates at 40%			1,200	72,900	62,500
Less	Taper relief				
	24.5.06 – 31.12.09 = 3 – 4 yrs	20%	(240)		
	29.9.07 – 31.12.09 = less than 3 yrs			(Nil)	
	9.12.09 – 31.12.09 = less than 3 years				(Nil)
			960	72,900	62,500
Less	Lifetime IHT paid		(Nil)	(10,250)	(4,450)
IHT payable on death			960	62,650	58,050
Paid by			Nephew	Trustees	Trustees
Due date			30.6.10	30.6.10	30.6.10

Relief for the fall in value of a lifetime gift
■ Fall in value relief

5 Relief for the fall in value of a lifetime gift

5.1 Fall in value relief

The chargeable value of a CLT or a PET is calculated at the date of the gift. If the donor subsequently dies within seven years, the gross chargeable amount calculated at the time of the gift normally becomes chargeable at the death rates of tax.

However, where the asset gifted has fallen in value between the date of the gift and the date of death, relief is available for the fall in value.

The rules for this relief are as follows:

- The relief affects the calculation of the death tax payable by the donee on **this one gift only**.
- There is no impact on the lifetime tax already paid, if any.
- There is no impact on the death tax on subsequent gifts or on the death estate (i.e. the **original** gross chargeable amount of the gift is cumulated and carried forward, not the revised value after claiming fall in value relief).
- The fall in value is calculated from the donee's point of view (i.e. the extent of the decline in value of the asset to the donee is allowable), and related property concepts are ignored.
- The relief is available for assets that would normally be expected to appreciate in value, but happen to have fallen in value since the date of the gift. Therefore, no relief is available for assets that are normally expected to fall in value such as plant and machinery or wasting assets (i.e. assets with a useful life of less than 50 years).
- If the donee sold the asset before the donor died, fall in value relief is still available but only for the fall in value from the date of the gift to the date of sale, not to the date of death.

CHAPTER 14

Inheritance tax on the value of an estate

Contents

Inheritance tax on the death of an individual

- The charges to inheritance tax on death
- The calculation of IHT on a deceased individual's estate

1 Inheritance tax on the death of an individual

1.1 The charges to inheritance tax on death

On the death of an individual there are two key charges to IHT:

(1) the IHT arising on lifetime gifts (PETs and CLTs) as a result of the death of the donor

(2) the IHT payable on the value of the individual's estate on the date of death.

The IHT arising on lifetime gifts must be calculated first. This is because an individual's nil rate band must be utilised against lifetime gifts before considering the death estate.

This chapter covers the last IHT charge to be calculated, i.e. the IHT arising on a deceased individual's estate.

1.2 The calculation of IHT on a deceased individual's estate

The procedure to adopt for calculating IHT on a death estate is as follows:

Step 1 Calculate the **gross chargeable value** of the deceased individual's estate at the date of death and take into account:

- the **status of the individual** (e.g. domiciled or not domiciled in the UK)
- the **special valuation rules** (e.g. related property provisions, share valuations)
- **business property and agricultural property relief**
- the **terms of the will** (e.g. whether any specific gifts are left to an exempt person).

Step 2 Calculate the death tax payable and take into account:

- the **available nil rate band**
- the **death rates of tax**
- the **terms of the will** (e.g. whether the residue of the estate is left to an exempt person)
- the **tax credit reliefs.**

Step 3 If required in an examination question:

- state the **due date for payment** of the death tax
- **allocate the amount payable** between those responsible for making the payment
- discuss the **instalment option** available, if applicable.

The valuation of a deceased individual's estate

- An overview of an estate computation
- The location of assets
- Special valuation rules
- A proforma estate computation

2 The valuation of a deceased individual's estate

2.1 An overview of an estate computation

The gross chargeable value of an estate is:

	£
Value of assets legally owned by the deceased at the date of death	X
Assets acquired on death (e.g. lump sums payable on death)	X
Less: Value of liabilities due at the date of death	(X)
Net asset value	X
Less: Allowable expenditure	(X)
	X
Less: Exempt legacies (= gifts in the will to exempt persons)	(X)
Total free estate (see below)	X
Gifts with reservation (GWR) (see below)	X
Gross chargeable estate	X

The term 'free estate' means the net assets over which the individual has an absolute free choice with regard to whom he bequeaths the assets. Gifts with reservation have special rules which are covered in the next chapter.

Assets are usually brought into the estate computation at their **probate value**. This means the **open market value** of the asset at the date of death.

The open market value is the value that an individual may reasonably expect to obtain for the sale of the asset on that date assuming:

- the transaction is at arm's length with an unconnected person, and
- the value is not affected by the fact that all of the assets are being sold on the same day.

The open market value is usually given in an examination question.

In deciding **which assets** to bring into the estate on death, consideration must be given to the status of the individual. This is because the scope of IHT depends on whether the individual is domiciled or deemed domiciled in the UK as follows:

Status of the individual:	Liable to IHT on transfers of:
Domiciled in the UK	Worldwide capital assets
Not domiciled in the UK	UK capital assets only

Therefore, if the individual is not UK domiciled, overseas assets are **excluded property,** and only UK assets are brought into the estate computation.

2.2 The location of assets

In most cases it is obvious where an asset is located; therefore deciding which assets are UK assets and which are foreign assets is clear-cut.

However, special rules are required to decide the location of some assets as follows:

Asset	Location rule
Land and buildings (including interests in land such as timeshares, leases and mortgage interests)	Where the land is physically located
Registered shares and securities	Where the shares or securities are registered or normally traded
Bearer shares and securities	Where the document of title is kept
An unincorporated business or interest in a partnership	Where the business is carried on
Chattels (i.e. tangible movable property)	Where the chattel is situated at the date of death
Debts owed to the deceased	Where the debtor lives at the date of death
Bank accounts (whether denominated in sterling or overseas currencies)	Where the branch of the bank that holds the account is located

2.3 Special valuation rules

Special valuation rules apply to the following assets:

Quoted shares and securities

Quoted shares and securities in an estate computation are valued in the same way as for lifetime gifts (i.e. at the lower of the quarter-up rule and the mid-bargain price).

However, further rules apply when valuing an estate if the shares are quoted 'ex-dividend' or the securities are quoted 'ex-interest'.

Shares quoted 'ex-dividend'

Quoted shares are usually quoted 'cum dividend'. This means that they are valued at the price they would fetch on the open market if sold with the right to the next dividend payment.

Occasionally shares are quoted 'ex-dividend'. This usually occurs for a few days after a dividend has been declared, as the company organises the payment of the dividend to the shareholders who owned the shares on the day the dividend was declared.

The quoted ex-dividend price reflects the fact that if the shares were sold on that day, the person buying the shares would not receive the dividend which is declared and paid shortly afterwards.

For IHT estate purposes, shares quoted ex-dividend are valued as follows:

- using the quoted ex-dividend prices apply the normal valuation rules, then
- **add** the full value of the next net dividend payment.

Remember that dividends are always quoted net.

Securities quoted 'ex-interest'

Securities in both quoted and unquoted companies (such as debentures, loan stock and gilt-edged securities) are similarly valued at a reduced 'ex interest' price shortly after an interest payment has been announced and due to be paid to the owner of the security.

For IHT estate purposes, securities quoted ex-interest are valued as follows:

- using the quoted ex-interest prices apply the normal quarter-up method, then
- **add** the full value of the next interest payment.

If the interest is normally received gross (for example, gilt-edged security interest) the gross amount of the next interest payment is added.

If the interest is normally received net of income tax deducted at source (for example, debentures) the net amount is added.

Remember that interest rate percentages are always quoted gross. Therefore 80% of the interest received will be added.

Example

Mandeep died on 31 May 2009. He owned 2,000 £1 ordinary shares in ABC plc. On 31 May 2009 the shares were quoted at 310p-318p ex-div. A dividend of 10p per share was announced on 28 May 2009 and is paid on 6 June 2009.

Required

Calculate the value of Mandeep's shares to be included in his death estate.

a

Answer

There are no marked bargains, therefore the valuation is calculated using the quarter-up rule.

Quarter-up rule = 310 + ((318 – 310) × ¼) = 312p

Value of 2,000 shares

	£
Ex-dividend valuation (2,000 × 312p)	6,240
Plus Net dividend payment (2,000 × 10p)	200
Value to include in the estate	6,440

Unit trusts, unquoted shares and securities, related property

These are valued in the same way as for lifetime gifts (see previous chapter).

An unincorporated business

To value a sole trader business or a share in a partnership, a professional valuation of the business needs to be obtained. However, in the examination the appropriate value to use will be given in the question.

Overseas property

If the individual is UK domiciled, worldwide assets must be brought into the estate computation. Overseas assets are valued in the same way as UK assets.

However, the following additional rules apply when valuing overseas assets:

- If valued in an overseas currency, the value must be **converted into sterling** using the relevant exchange rate applicable on the date of death.
- If a range of exchange rates is quoted, the rate giving the **lowest sterling valuation** can be used.
- Any **additional expenses** incurred by the executors in realising or managing property **because the property is situated overseas** (for example costs of translating legal documents and complying with overseas legal rules) can be deducted from the sterling valuation.
- The **maximum expenses** that can be deducted is **5% of the probate value.**
- Overseas death tax suffered is not an allowable deduction in calculating the value of the estate on death. If both UK and overseas death taxes are suffered double taxation relief (DTR) is given against the UK IHT liability, but not in the valuation of the estate. DTR is considered in more detail later.

e

Example

Giselle, a UK domiciled individual, died on 31 March 2010. She owned a property in France which was valued at 300,000 Euros. On 31 March 2010 the exchange rate was 1.40 – 1.47 Euros per £1.
The executors sold the property after her death and incurred £19,300 professional expenses, of which £14,500 related to additional costs due to the property being overseas. The executors also incurred £60,000 French death duties.

Required

Calculate the value of the French property to be included in Giselle's estate computation.

a

Answer

	£
Market value of property (300,000 ÷ 1.47)	204,082
Less: Additional expenses incurred in realising the property = £14,500 but restricted to £10,204 (£204,082 × 5%)	(10,204)
Value to include in the estate	193,878

Overseas death duties are not an allowable deduction in the estate; however, DTR will be available against the UK IHT liability.

2.4 A proforma estate computation

Free estate	Notes	£	£
Freehold property			X
Less: Repayment mortgage	1		(X)
			X
Leasehold property			X
Unincorporated business	2		X
Shares	2	X	
Add: Next dividend if quoted ex-dividend		X	X
Securities	2	X	
Add: Next interest if quoted ex-interest		X	X
Motor cars	3		X
Personal chattels			X
Debts due to the deceased			X
Interest and rental income accrued to the date of death			X
Insurance policy proceeds	4		X
ISAs	3		X
Cash at bank and on deposit	3		X
Foreign assets (if UK domiciled)		X	
Less: Additional expenses (subject to a max of 5% of probate value)		(X)	
			X
			X
Less: Allowable deductions:	5		
Funeral expenses		X	
Legally enforceable debts		X	
Outstanding other taxes (e.g. income tax, CGT, VAT, NICs)		X	
			(X)
			X
Less: Exempt legacies (e.g. to spouse or civil partner, charity, political party)	6		(X)

Free estate	Notes	£	£
Net free estate			X
Gift with reservation (GWR)			
Market value of capital assets gifted subject to a reservation at the date of death			X
Gross chargeable estate			X

Notes

(1) Mortgages

The estate value must include assets owned by the individual **net of any outstanding liabilities.**

Any outstanding repayment mortgage at the date of death must be deducted in the estate valuation as the mortgage will have to be repaid from the estate funds on death.

However, an endowment mortgage is not deducted from the estate value as an endowment policy arrangement includes an element of life assurance.

On the death of the individual, an endowment policy should generate a lump sum sufficient to repay the mortgage loan on death. An endowment mortgage is therefore not an outstanding liability on death.

(2) Business property relief

An unincorporated business, shares and securities and other business assets may be eligible for business property relief (BPR) if conditions are satisfied.

The rules for BPR are considered in more detail later.

(3) Exempt assets for CGT

Motor cars, ISAs and cash balances are exempt assets for CGT purposes. However, they are not exempt for IHT and must be brought into the estate computation.

(4) Insurance policy proceeds

Proceeds from life assurance policies must be brought into the estate value except where:

- the policy was taken out by the deceased for the benefit of a named beneficiary (for example, the spouse or children) and the policy deed is written under a declaration of trust
- the policy is taken out by someone other than the deceased based on the death of the deceased (i.e. the policy ends and pays out a lump sum on the death of the deceased to another person during his lifetime).

In both of these cases the lump sum received on death bypasses the deceased's estate and escapes IHT.

However, where life assurance policy proceeds are to be included in the estate, the amount of the proceeds received is taxable (not the surrender value).

(5) Allowable expenses

Reasonable funeral expenses and legally enforceable debts are allowable deductions in the estate computation. However, gambling and other debts which are not legally enforceable are not allowable deductions.

General executors' expenses incurred in administrating the estate are not allowable deductions in the estate computation.

Other outstanding tax bills are allowable deductions. It is common in an examination question to have to calculate the individual's IT and CGT liability in the year of death before calculating the IHT on the estate value at death.

(6) Exempt legacies

In the death estate there are only three types of exempt legacies:

- To the spouse or civil partner

  The inter-spouse (or civil partner) exemption is unlimited in amount **unless** the recipient is non-UK domiciled. In this case there is a total maximum exemption of £55,000.
- To a recognised charity
- To a qualifying political party.

Example

Rachel owned the following assets when she died on 24 July 2009:

(1) A flat in Basingstoke which is valued at £210,000. She bought the flat in 2001 with the help of a £180,000 endowment mortgage.

(2) A cottage in Germany which is valued at £120,000. The cottage is to be sold and the executors envisage additional expenses of £4,000 will be incurred in realising the property.

(3) Personal chattels in the UK flat and a motor car worth £45,000, and personal chattels and a bicycle in the German cottage worth £10,200.

(4) 3,000 £1 ordinary shares in DEF plc, a company quoted on the UK stock exchange. On 24 July 2009 the shares were quoted at 412p-428p per share.

(5) £12,000 4% Treasury stock 2014, quoted at 90-94p ex-interest. The interest is paid half yearly on 31 July and 31 January each year.

(6) An ISA worth £14,500 and a bank account with a balance of £560.

Rachel was owed £250 by a friend who lives in Basingstoke and £1,000 by another friend who lives in the cottage next door in Germany. Rachel owed £2,300 income tax to HMRC and £1,650 to a credit card company.

The executors received a £25,000 life assurance lump sum in August 2009 and spent £3,500 on her funeral.

Under the terms of her will Rachel left £35,000 to the Imperial Cancer Fund, a registered charity, and the residue of her estate to her niece.

Required

Calculate the gross value of Rachel's estate assuming:

(i) she is UK domiciled

(ii) she is not UK domiciled.

Answer

		UK domiciled	Not UK domiciled
Free estate	£	£	£
Flat in Basingstoke (W1)		210,000	210,000
Cottage in Germany	120,000		
Less: Additional expenses (not restricted)	(4,000)		
		116,000	Excluded
Personal chattels and motor car in UK		45,000	45,000
Personal chattels and bicycle in Germany		10,200	Excluded
Shares in DEF Ltd (W2)		12,480	12,480
Treasury stock (W3)	10,920		
Add: Next interest (£12,000 × 4% × ½)	240		
		11,160	11,160
ISA		14,500	14,500
Bank account		560	560
Debts from UK friend		250	250
Debts from German friend		1,000	Excluded
Life assurance policy proceeds		25,000	25,000
		446,150	318,950
Less: Funeral expenses		(3,500)	(3,500)
Credit card outstanding		(1,650)	(1,650)
Income tax		(2,300)	(2,300)
		438,700	311,500
Less: Exempt legacies to charity		(35,000)	(35,000)
Gross chargeable estate		403,700	276,500

Workings

(1) The endowment mortgage is not deducted as the endowment element will generate a lump sum to pay off the mortgage loan.

(2) Shares in DEF Ltd valuation = 3,000 shares × [412 + ((428 – 412) × ¼)] = £12,480

(3) Treasury stock valuation = £12,000 × (90 + ((94 – 90) × ¼)) = £10,920

The calculation of IHT on a deceased individual's estate

- The nil rate band available
- The proforma computation for death tax on the death estate
- The due date of payment and who pays the tax
- Grossing up on death

3 The calculation of IHT on a deceased individual's estate

3.1 The nil rate band available

On the death of an individual, IHT is payable on the gross chargeable value of the estate at the death rates of tax. The nil rate band of £325,000 is available, but must be matched against lifetime gifts before computing the IHT on the estate.

As in the lifetime calculations, the nil rate band covers a cumulation period of seven years. For the death estate it is necessary to look back seven years **before the date of death** and to work out the value of any lifetime **gross chargeable transfers (**both CLTs and PETs) in that period.

3.2 The proforma computation for death tax on death estate

The death IHT is calculated as follows:

	£	£
Gross chargeable estate		X
Nil rate band (NRB)	325,000	
Gross chargeable transfers in the seven years before death	(X)	
Nil rate band available		(X)
Taxable amount		X
IHT on the taxable amount at 40%		X
Less: Quick succession relief (QSR)		(X)
		X
Less: Double taxation relief (DTR)		(X)
IHT payable on estate		X

3.3 The due date of payment and who pays the tax

- All death tax is due six months after the end of the month of death unless the instalment option is available (see later).

- The IHT payable is allocated to those responsible for paying the tax at the average rate of tax on the whole estate after QSR (if applicable).

  The average rate is calculated as:

$$\frac{\text{IHT payable on the estate } \textbf{after QSR}}{\text{Gross chargeable estate}} \times 100$$

- The person responsible for paying the IHT and the person who suffers the tax on the estate depends on the make-up of the estate as follows:

	Paid by	Suffered by
UK assets specifically gifted	The executors pay out of the estate fund	The residual legatee (i.e. the person who is left 'the rest of the assets' in the will) **unless** the will states otherwise
Overseas assets specifically gifted	The specific legatee (i.e. the person who is left the overseas asset)	The specific legatee (all of the benefit of DTR goes to this person)
The rest of the free estate	The executors pay out of the estate fund	The residual legatee
Gift with reservation (GWR)	The donee who received the gift	The donee who received the gift

Note that specific legatees of UK assets from a will do not suffer any IHT on the gift to them. The tax on their gift is suffered by the residual legatee.

Therefore, if an individual is left £200,000 in a will, he will receive exactly £200,000. The associated tax on that gift is suffered by the person who is bequeathed the rest of the estate.

Example

Grace died on 12 January 2010 leaving the following estate:

Free estate	£
House in Nottingham	454,500
Apartment in Spain (no Spanish death duties payable)	79,000
Shares in XYZ plc (a 3% interest in the company)	16,000
House, personal chattels, motor car and bank accounts	36,700
	586,200
Less: Allowable deductions	(34,700)
Gross chargeable estate	551,500

In her will Grace leaves the apartment in Spain to her niece, the shares in XYZ plc to her nephew and the rest of her estate to her daughter.

Grace's only lifetime gift was a gross chargeable transfer of £258,000 into a relevant property trust in June 2008. No lifetime IHT was payable.

Required

Calculate the IHT payable on Grace's death estate. State who is liable to pay the tax, who will suffer the tax and the due date of payment.

Answer

The CLT is within seven years of death but is covered by the nil rate band of £325,000; therefore no death tax is due on this gift.

IHT on the death estate

	£	£
Gross chargeable estate		551,500
Nil rate band (NRB)	325,000	
Gross chargeable transfers in the seven years before death	(258,000)	
Nil rate band available		(67,000)
Taxable amount		484,500
IHT payable on estate at 40%		193,800
Due date of payment	31 July 2010	

Average rate of IHT on estate: 193,800 ÷ 551,500 × 100 = 35.141%

Allocation of the IHT payable

		£	**Paid by**	**Suffered by**
Apartment in Spain	£79,000 × 35.141%	27,761	Niece	Niece
Shares in XYZ plc	£16,000 × 35.141%	5,622	Executors	Daughter (*note*)
Rest of free estate	£456,500 × 35.141%	160,418	Executors	Daughter
		193,801		

Note

The shares are left in the will to the nephew but he does not bear the tax on the gift, the tax is borne by the daughter (i.e. the residual legatee).

3.4 Grossing up on death

The death rate of IHT on the estate is usually 40% on the excess over the nil rate band. However, the exception to this rule is when grossing up on death is required.

Grossing up on death is required where:

- specific assets are gifted in the will, and
- part or all of the residue of the estate is left to an exempt person (i.e. a spouse, civil partner, charity or political party).

A problem arises in this situation as the specific legacies of UK assets are chargeable to IHT. However, the IHT is paid out of the estate fund and is suffered by the exempt person (i.e. the residual legatee) not the specific legatee.

The total of the specific legacies in the will is therefore the net chargeable estate value and the net death tax rate has to be used to calculate the tax liability.

The gross death rate is 40% on the excess over the nil rate band. The net death rate is therefore 40/60 (or 2/3rds) on the excess over the nil rate band.

The residue of the estate which goes to the exempt person is the balancing figure.

e

Example

Sarah died on 15 August 2009 leaving an estate worth £1,000,000. She had made no lifetime gifts.

The terms of her will were as follows:

- To her son, £220,000 cash
- To her daughter, some UK quoted shares worth £240,000
- To her husband, the rest of the estate.

Required

Calculate the IHT payable by the executors and the value of the legacy to the husband.

a

Answer

IHT on the death estate

Free estate	£
Value of estate on death	1,000,000
Less: Exempt legacy to husband = balancing figure (see working)	(450,000)
Gross chargeable estate (see working)	550,000
IHT payable on estate (see working)	90,000

Working

	£	£
Net chargeable estate (£220,000 + £240,000)		460,000
Nil rate band (NRB)	325,000	
Gross chargeable transfers in the seven years before death	(Nil)	
Nil rate band available		(325,000)
Net taxable amount		135,000
IHT payable on estate at 2/3		90,000
Gross chargeable estate (460,000 + 90,000)		550,000

Reliefs available to reduce the estate value

- Business property relief (BPR)
- Agricultural property relief (APR)
- The impact of BPR and APR on lifetime gifts

4 Reliefs available to reduce the estate value

4.1 Business property relief (BPR)

Business property relief (BPR) is a very important relief in practice and therefore a very popular relief in examination questions.

Without the relief there could be substantial IHT liabilities arising on the transfer of a family business, which may require the sale of assets (and possible closure of the business) in order to afford the IHT. Therefore, to ensure that a business does not suffer unduly as a result of the death of an individual, BPR is available.

BPR is available if an individual transfers business property by way of a lifetime gift or in his will on death. The relief does not have to be claimed; it is given **automatically** provided the conditions are satisfied.

The key rules and conditions to be eligible for BPR are as follows:

- The property transferred must be relevant business property.
- There is no monetary limit on the amount of BPR available.
- The relief is available on transfers of worldwide business property.
- For lifetime gifts, the relief is deducted from the transfer of value before deducting lifetime exemptions.
- In the estate computation, the relief is deducted from the value of the property before inclusion in the total estate.

Relevant business property

The key categories of relevant business property and the appropriate rates of BPR are as follows:

	%
An unincorporated business or interest in a partnership	100
Unquoted trading company shares	100
Unquoted trading company securities (such as debentures, loan stock) provided the donor has a controlling interest based on share ownership immediately before the gift	100
Quoted trading company shares and securities provided the donor has a controlling interest immediately before the gift	50

	%
Land, buildings and items of plant and machinery which are used for the purposes of a trade in: ■ a partnership in which the individual is a partner ■ a company in which the individual has a controlling interest	50

To determine whether the donor has a controlling interest in a company, account must be taken of both the donor's shareholding and that of any related party.

For the purposes of BPR, the term 'unquoted shares' includes shares quoted on the Alternative Investment Market (AIM).

No relief is available for a business involved wholly or mainly in the making, holding or dealing in investments.

Example

Steven has owned the following assets for more than two years:

(1) 10% interest in the ordinary shares of A Ltd, an unquoted trading company.

(2) 10% interest in the ordinary share capital of B plc, a quoted trading company.

(3) 10% interest in the debentures of C Ltd, an unquoted trading company.

(4) 40% interest in shares of D plc, a quoted trading company in which his wife has a 5% interest and his son a 10% interest. The remaining shares are owned by members of the public.

(5) 40% interest in the ordinary shares of E Ltd, an unquoted company whose main activity is the letting of land and buildings.

(6) A share in a partnership in which he works one day a week on a consultancy basis.

(7) An office block which he lets the partnership use for the business.

Required

State which of the assets are eligible for BPR and at what rate.

Answer

	Eligible for BPR?	Rate
(1)	Yes – A Ltd is an unquoted trading company; the size of the interest is not important	100%
(2)	No – B plc is a quoted trading company and Steven does not have a controlling interest.	Nil
(3)	No – Steven's interest in C Ltd is in securities only (he has no shares). Whether quoted or unquoted, BPR is only available if Steven has a controlling interest based on shares.	Nil

	Eligible for BPR?	Rate
(4)	No – D plc is a quoted trading company. Steven does not have a controlling interest on his own or when considering related property (40% + wife's 5% = 45%). The shares held by Steven's son are not 'related' for IHT purposes.	Nil
(5)	No – E Ltd is a company involved mainly in the holding of investment assets.	Nil
(6)	Yes – Steven is a partner; the fact that he does not work full-time is not important.	100%
(7)	Yes – land and buildings owned personally but used by his partnership are eligible.	50%

No BPR is available if the asset is subject to a binding contract of sale at the date of the chargeable event (i.e. lifetime gift or death). However, the existence of an option to sell does not preclude BPR.

Therefore, if the partnership agreement in which Steven is a partner has a clause which **requires** his partnership share to be sold to the other partners, BPR will not be available. However, if there is an **option** for the other partners to have first refusal on buying Steven's share, BPR will not be denied.

The minimum period of ownership

To qualify for BPR the property must be owned for a minimum period of **two years.**

The period of ownership will start from the following dates:

Method of acquisition:	Ownership starts from:
Purchase	Date of purchase
Gift	Date of gift
Inheritance	Date of death of the donor
Gift or inheritance from spouse (or civil partner)	Date the spouse (or civil partner) acquired the asset

Exceptions to the minimum period of ownership rule

It is possible in two cases to fail the two year ownership test but still qualify for BPR. These cases are as follows:

(1) Replacement property provisions

BPR is still available if:

- the business property replaced other relevant business property, and
- the donor has owned some type of relevant business property for a combined period of at least two out of the previous five years.

However, the amount of BPR given cannot exceed that which would have been obtained had the original business property been retained.

(2) Successive transfers

BPR is still available if:

- the property was acquired within the preceding two years as a result of death and was eligible for BPR at that time, or
- the property was acquired within the preceding two years as a result of a lifetime gift, was eligible for BPR at that time, and is now chargeable as a result of death.

Excepted assets

BPR is not available if the business or company is involved mainly in the making, dealing or holding of investments. BPR is restricted where the business is a trading business but it holds some excepted assets.

An excepted asset is an asset that:

- is not currently used for the purposes of the trade
- has not been used for the purposes of the trade in the previous two years, and
- is not likely to be required to be used for the purposes of the trade in the foreseeable future.

Excepted assets are essentially investment assets, such as investments in property which is let, shares and securities, and substantial excess cash deposits.

BPR is only available on the business proportion of the value of the relevant business property gifted. For shares it is therefore necessary to calculate the BPR as follows:

$$\text{Value of the shares} \times \frac{\text{Value of the company's assets } \textbf{less} \text{ value of the excepted assets}}{\text{Value of the company's assets}}$$

Example

Hugh owned 10,000 50p ordinary shares in FG Ltd worth £560,000. On 31 December 2009 Hugh died. At that time the value of FG Ltd's assets was as follows:

	£
Land and buildings	1,000,000
Plant and machinery	260,000
Motor cars	105,000
Investments in KJ plc	100,000
Inventories	20,000
Receivables	10,000
Bank and cash	5,000
	1,500,000

Required

Show how the shares will be valued in Hugh's estate computation.

a

Answer

	£
Shares in FG Ltd	560,000
Less: BPR	
$£560{,}000 \times \frac{1{,}500{,}000 - 100{,}000}{1{,}500{,}000}$	(522,667)
Value to include in the estate	37,333

4.2 Agricultural property relief (APR)

Agricultural property relief (APR) works in a similar way to BPR in that it reduces the value of agricultural property transfers by 100%.

The relief is given **automatically** provided the conditions are satisfied. The key rules and conditions to be eligible for APR are as follows:

- The relief is available on transfers of agricultural property in the UK, the Channel Islands, the Isle of Man or the European Economic Area (but **not worldwide** agricultural property).
- For lifetime gifts, the relief is deducted from the transfer of value before deducting lifetime exemptions.
- In the estate computation, the relief is deducted from the value of the property before inclusion in the total estate.
- It is possible for a farm to be eligible for both APR and BPR. If so, APR is given before BPR.
- There is no monetary limit on the amount of APR available.

Agricultural property

Agricultural property is any land and buildings relating to the farm, including:

- the farm house
- tied cottages
- fields and fencing
- pig sheds, cowsheds, stables, barns, hay lofts etc.

APR is not available on farming plant and machinery, equipment, stocks of animals and harvested crops.

Agricultural value

The agricultural value of a farm is the value that would be placed on the land and buildings assuming there is a perpetual covenant attached to the land that prohibits any use of the land and buildings other than for agricultural purposes.

A farm may be sold for £1,000,000 on the open market, but its agricultural value may be considerably less, say £600,000. The difference of £400,000 in the valuation reflects the 'development value' of the land.

This means that a purchaser may be prepared to pay £1 million for the farm as he can potentially realise the development value. By using the land for purposes other than agriculture (such as developing the land, building houses on it and selling off the land) will make the farm more attractive to buy.

APR is only available on the agricultural value of the land. However, BPR may be available on the development value if the land is used for the purposes of the business carried on by the owner at the farm.

The minimum period of ownership / occupation

The minimum period of ownership depends on whether the agricultural property is owner occupied or tenanted as follows:

	Minimum period
Owner occupied farm	Two years
Tenanted farm	Owned by the donor and occupied by someone else for the purposes of agriculture for seven years

Exceptions to the minimum period rule

The same two exceptions apply to APR as they do to BPR, namely the successive transfers exception and the replacement property provisions. However, the time period for replacement property provisions is different for APR.

APR is still available if the donor owned some type of agricultural property for the following combined time period:

	Combined period of ownership / occupation
Owner occupied farm	Two years out of the previous five years (as for BPR)
Tenanted farm	Seven years out of the previous ten years

Example

Ruben owned the following assets when he died on 24 August 2009:

(1) A house in Bristol which is valued at £610,000. He bought the house in 2000 with the help of a £280,000 repayment mortgage.

(2) A share in a partnership worth £360,000.

(3) A farm worth £700,000 with an agricultural value of £530,000. Ruben bought the farm in 1998. He immediately let the farm to a tenant farmer on a 15 year lease.

(4) Personal chattels and a motor car worth £76,000.

(5) 3,000 £1 ordinary shares in GHI Ltd, an unquoted UK trading company worth £25,000. The company has assets worth £600,000, of which £30,000 relates to a surplus office block let to another business.

(6) Bank accounts with a total balance of £24,600.

Ruben owed HMRC £4,300 capital gains tax and a credit card company £530. His funeral cost £8,700.

As his wife is independently wealthy, under the terms of his will Ruben left all of his estate equally to his six children.

Required

Calculate the gross chargeable value of Ruben's estate.

Answer

	£	£
House in Bristol		610,000
Less: Repayment mortgage		(280,000)
		330,000
Share in partnership	360,000	
Less: BPR (100%)	(360,000)	
		Nil
Farm	700,000	
Less: APR (100%)	(530,000)	
BPR (not available as the farm is tenanted)	(Nil)	
		170,000
Personal chattels and motor car		76,000
Shares in GHI Ltd	25,000	
Less: BPR (100% × 25,000 × 570,000/600,000)	(23,750)	
		1,250
Bank accounts		24,600
		601,850
Less: Allowable deductions		
Funeral expenses		(8,700)
Credit card bill		(530)
Outstanding CGT		(4,300)
		588,320
Less: Exempt legacies		(Nil)
Gross chargeable estate		588,320

4.3 The impact of BPR and APR on lifetime gifts

For lifetime gifts, BPR and APR are deducted from the transfer of value before considering specific exemptions (such as the annual exemption).

As long as the conditions remain satisfied, BPR and APR are available in both:

- the calculation of the lifetime tax due, and
- the calculation of death tax due on lifetime gifts.

To qualify for relief on a lifetime transfer, the conditions for the relief must be satisfied at the date of the gift.

However, to qualify for the relief in the calculation of death tax, the following two additional conditions must be satisfied at the date of death:

(1) the donee must still own the asset gifted (or replacement relevant property) at
   - the date of the donor's death, or
   - the date of the donee's death, if he predeceases the donor

(2) the property must be relevant business (or agricultural) property at the date of the donor's death (or donee's death if earlier).

If these conditions are not satisfied:

- the lifetime IHT calculations are unaffected: BPR (or APR) is available as normal
- BPR (or APR) will be clawed back (i.e. will not be allowed) in the death calculations and is added to the gross chargeable lifetime amount.

Example

Mabel died on 14 December 2009. During her lifetime she made the following lifetime gifts:

Date	To	Asset gifted	Market value
13.6.2005	Relevant property trust	Business property - eligible for 50% relief	£674,000
28.8.2007	Daughter	Business property - eligible for 100% relief	£250,000

Mabel agreed to pay any lifetime IHT due. The trustees sold the business property without replacement in 2008 but the daughter still owned her asset which qualified as relevant business property on 14 December 2009.

Required

(a) Calculate the lifetime IHT due and the IHT due as a result of Mabel's death.

(b) Explain what would have happened had the daughter also sold her business asset before Mabel died.

Answer

(a)

Lifetime IHT		**CLT 13.6.2005**	**PET 28.8.2007**
	£	£	£
Transfer of value		674,000	250,000
Less: BPR		(337,000)	(250,000)
Less: AE			
2005/06		(3,000)	
2004/05 b/f		(3,000)	
Chargeable amount		331,000	Nil
NRB	325,000		
Gross CLTs in 7 yrs before the gift 13.6.1998 – 13.6.2005	(Nil)		
NRB available		(325,000)	
Taxable amount		6,000	

Lifetime IHT		**CLT 13.6.2005**	**PET 28.8.2007**
	£	£	£
		Net gift	
Lifetime IHT			
£6,000 × 25%		1,500	Nil
Gross amount to carry forward			
(£331,000 + £1,500)		332,500	

IHT on Mabel's death

		CLT 13.6.2005	**PET 28.8.2007**
	£	£	£
Gross chargeable amount per lifetime		332,500	Nil
Add: BPR claw back		337,000	Nil
Revised chargeable amount on death		669,500	Nil
NRB	325,000		
Gross CLTs in 7 yrs before the gift 13.6.1998 – 13.6.2005	(Nil)		
NRB available		(325,000)	
Taxable amount		344,500	
IHT at death rates at 40%		137,800	
Less: Taper relief 13.6.2005 – 14.12.2009 = 4 – 5 yrs	40%	(55,120)	
		82,680	
Less: Lifetime IHT paid		(1,500)	
IHT payable on death		81,180	Nil

(b) If the daughter had also sold her business asset before Mabel's death

There would be no IHT payable at the time of the gift as the gift is a PET. However, on death BPR would not be available. The IHT due would be calculated as follows:

		PET 28.8.2007
	£	£
Gross chargeable amount per lifetime		Nil
Add: BPR claw back		250,000
Less: AEs not previously used		
2007/08		(3,000)
2006/07 b/f		(3,000)
Revised chargeable amount on death		244,000

		PET 28.8.2007
	£	£
NRB available (used by CLT)		(Nil)
Taxable amount		244,000
IHT at death rates at 40%		97,600
Less: Taper relief 28.8.2007 – 14.12.2009 = less than 3 years		(Nil)
		97,600
Less: Lifetime IHT paid		(Nil)
IHT payable on death		97,600

Tax credit reliefs

- An overview of the tax credit reliefs
- Quick succession relief (QSR)
- Double taxation relief (DTR)

5 Tax credit reliefs

5.1 An overview of the tax credit reliefs

There are two tax credit reliefs that may be deducted from the IHT payable on the death estate: quick succession relief (QSR) and double taxation relief (DTR).

QSR benefits all of the beneficiaries of the will. Therefore it **must be calculated and deducted first** as it affects the average rate of tax on the whole estate.

The **IHT after QSR is then allocated** between those who pay and suffer the tax.

If there is an overseas asset in the estate that has suffered foreign death tax, DTR is available and all of the benefit of DTR is given to the person who is left the overseas asset in the will.

The IHT payable on the estate is therefore presented as follows:

	£
IHT on the taxable amount of the gross chargeable estate at 40%	X
Less: Quick succession relief (QSR)	(X)
	X
Less: Double taxation relief (DTR)	(X)
IHT payable on estate	X

5.2 Quick succession relief (QSR)

QSR is available where an asset is charged to IHT more than once in a five year period. Therefore, QSR is available where an individual:

- receives a lifetime gift, or a legacy in a will, on which IHT is payable
- in the last five years of his life.

There is no requirement for the deceased to own the asset at the date of his death. QSR is available **automatically,** no claim is required.

The amount of QSR is based on the amount of IHT charged on the first transfer. The QSR is calculated as follows:

Appropriate percentage × Tax charged on the earlier legacy

The **appropriate percentage** depends on the length of time between the date the deceased received the first gift and the date of his death as follows:

Years between the date of first gift and the date of death		QSR %
More than	**Not more than**	
0	1	100
1	2	80
2	3	60
3	4	40
4	5	20
More than 5 years before death		Nil

These rates are not provided in the examination.

Example

Ben died on 18 May 2009 leaving an estate of £392,000. He had made no lifetime transfers.

Ben had inherited a cottage in the UK on the death of his sister, Kate, on 4 March 2005. The cottage was valued at £120,000. Kate's total estate was worth £450,000 and £108,000 IHT was payable on the estate. Ben sold the asset for £160,000 on 1 December 2006.

Required

Calculate the IHT payable on Bill's estate.

Answer

IHT on the death estate

	£	£
Gross chargeable estate		392,000
Nil rate band (NRB)	325,000	
Gross chargeable transfers in the seven years before death	(Nil)	
Nil rate band available		(325,000)
Taxable amount		67,000
IHT at 40%		26,800
Less: QSR (see working)		
(20% × £28,800)		(5,760)
IHT payable on the estate		21,040

Working - QSR

Appropriate percentage: 4.3.2005 to 18.5.2009 = 4 to 5 years = 20%

Tax charged on earlier transfer:

- Average rate of tax on Kate's estate = 108,000 ÷ 450,000 × 100 = 24%
- Tax on cottage = £120,000 × 24% = £28,800

Note

The fact that Ben had sold the cottage before his death is not important. Although the cottage itself is not charged to IHT twice, the cottage will have been sold for cash and the cash (or some other assets bought with the cash) will be reflected in the estate value on death; therefore QSR is still available.

5.3 Double taxation relief (DTR)

As shown earlier, any **additional expenses** incurred by the executors in realising or managing property **because the property is situated overseas** can be deducted from the sterling valuation. However, the **maximum expense** that can be deducted is **5% of the probate value.**

Overseas death tax suffered is not an allowable deduction in calculating the value of the estate on death. However, if both UK and overseas death taxes are suffered, double taxation relief (DTR) is given against the UK IHT liability.

DTR is the lower of:

(i) overseas death duties suffered

(ii) UK IHT attributable to the foreign asset.

The UK IHT attributable is calculated as:

$$\text{Average rate of IHT payable after QSR} \times \text{Value of the foreign asset brought into the estate (after deducting expenses)}$$

Example

George dies on 3 December 2009 leaving the following estate:

	£
Assets in the UK	308,000
Foreign villa	99,000
Asset gifted to his grandson with a reservation attached	45,000

The executors incurred additional expenses of £5,500 in selling the foreign villa. In addition overseas death duties of £9,500 have been paid.

In his will George left £12,000 to the Conservative Party, the foreign villa to his daughter and the residue of his estate to his son. George had made no lifetime gifts.

Required

Calculate the IHT payable on George's estate. State who is liable to pay the tax, who will suffer the tax, and the due date of payment.

a

Answer

Free estate	£	£
Assets in UK		308,000
Foreign villa	99,000	
Less: Additional expenses (£5,500, restricted to 5% × £99,000)	(4,950)	
		94,050
		402,050
Less: Exempt legacies – political party		(12,000)
Net free estate		390,050
Gift with reservation (GWR)		45,000
Gross chargeable estate		435,050
Nil rate band (NRB)	325,000	
Gross chargeable transfers in the seven years before death	(Nil)	
Nil rate band available		(325,000)
Taxable amount		110,050
IHT at 40%		44,020
Less: QSR		(Nil)
IHT after QSR		44,020
Less: DTR		
Lower of (i) Overseas death tax suffered = £9,500		(9,500)
(ii) UK IHT attributable to foreign asset		
£94,050 × 10.118% (Working) = £9,516		
IHT payable on the estate		34,520
Due date of payment	30 June 2010	

Allocation of the IHT payable

		£	**Paid by**	**Suffered by**
Foreign villa	£94,050 × 10.118%	9,516	Daughter	Daughter
	Less: DTR	(9,500)		
		16		
Assets in UK	£296,000 × 10.118%	29,950	Executors	Son
GWR	£45,000 × 10.118%	4,554	Grandson	Grandson
		34,520		

Working – average rate of IHT

44,020 ÷ 435,050 × 100 = 10.118%

CHAPTER 15

Further aspects of IHT

Contents

Deeds of variation

- The purpose of a deed of variation
- The conditions for making a valid deed of variation
- The tax consequences of entering into a deed of variation
- Tax planning opportunities

1 Deeds of variation

1.1 The purpose of a deed of variation

A deed of variation (also known as a deed of family arrangement) is a formal legal instrument which rewrites the provisions of the deceased's will after his death.

Many individuals make a will without detailed knowledge of inheritance tax. They often leave their assets to relatives and friends on a compassionate basis without regard to the taxation implications.

As a result:

- substantial inheritance tax liabilities can arise unnecessarily on death, or
- assets are left to children who already have sufficient independent wealth, but there are living grandchildren.

In addition, as a result of a dispute with relatives and friends, the provisions of a will may be considered to be unjust by the family members.

It may be therefore be desirable to enter into a deed of variation in order to:

- save inheritance tax
- miss a generation charge to IHT
- redistribute assets on a fairer basis.

A deed of variation is therefore an important tax planning tool which can be entered into by the beneficiaries of a deceased's estate.

However, it is important to draft the deed carefully as only one deed of variation is allowed post death and the provisions of the deed can not be subsequently changed.

1.2 The conditions for making a deed of variation

To be effective for tax purposes, a deed of variation must:

- be a formal written instrument
- be entered into voluntarily for no valuable consideration
- be signed by all of the beneficiaries of the original estate
- be executed within 2 years of the date of death, and
- contain a statement that it is to be effective for IHT (and/or CGT).

1.3 The tax consequences of entering into a deed of variation

Without a deed of variation, if a beneficiary wishes to gift his share of the estate personally to another person, the gift of each asset would be treated as:

- a PET for IHT purposes, and
- a chargeable disposal for CGT purposes.

By entering into a deed of variation, a beneficiary can gift his share of the estate by renouncing his right to his inheritance and either:

- allowing the assets to pass to the other beneficiaries in the will (known as a disclaimer), or
- deciding who is to inherit the assets instead (known as a variation).

As a result of entering in to a deed of variation, the provisions of the new deed are treated as if they were the original provisions of the will of the deceased.

Therefore, the gift of a share in an estate by the original beneficiary will avoid a PET for IHT and a chargeable CGT disposal arising. In addition, there is no stamp duty payable on the execution of the deed of variation.

Even though the deed can be entered into up to 2 years after the date of death, the new beneficiaries will be deemed to acquire the assets at the date of the deceased's death at probate value.

However, the deed is not effective for backdating the right to income for income tax purposes. Any income received after the date of death up to the date of the deed will go to the original beneficiary. The income will not be reallocated to the new beneficiaries.

In summary, a deed of variation is:

- a very tax effective planning tool for the capital taxes (i.e. IHT and CGT)
- not effective for income tax
- exempt from stamp duty.

1.4 Tax planning opportunities

The tax planning opportunities available depend on whether or not the individual dies leaving a spouse.

Individual dies leaving a spouse

If the individual dies leaving a spouse, IHT on the estate can be completely avoided and the use of the deceased's nil rate band maximised as follows:

- *Gift assets in the will to friends and relatives to the value of the remaining nil rate band*

  For example, if there are no lifetime gifts in the previous 7 years, the deceased's will should gift up to £325,000 to chargeable beneficiaries (e.g. the children, grandchildren). No IHT will be payable as the gifts are covered by the nil rate band.
- *Gift the rest of the estate to the spouse*

  No IHT is payable as this is an exempt gift.

In the future, the spouse may wish to gift more of the assets to the other relatives during their lifetime. These gifts will have further IHT consequences, however any potential IHT payable will be likely to be less than the IHT payable on the deceased's estate.

This is because the gifts by the spouse would have the following consequences:

- these gifts will be PETs, valued at the time of the gift, but annual exemptions may be available to reduce the value
- if the spouse lives for 7 years, the gifts are exempt and no IHT is payable
- if the spouse dies after 3 years of the gift, IHT is payable on the PET but at a reduced amount due to taper relief.

Individual dies without leaving a spouse

If the individual dies and does not leave a spouse, no immediate IHT can be saved on the deceased's estate unless gifts are made to charities and political parties.

However, if the deceased left assets to his children who are independently wealthy and there are living grandchildren, a deed of variation can be tax-effectively used to by-pass a generation charge to IHT.

Without a deed of variation, when the son (or daughter) dies, the assets will be taxed again in his estate when he leaves the assets to his children.

It is common therefore in this situation to enter into a deed of variation to rewrite the will to by-pass a generation.

In the deed, the son (or daughter) will ensure the gift of his share of his parent's estate either:

- passes directly to the grandchildren, or
- is put into a trust for the benefit of the grandchildren.

As a result, the IHT liability on the inherited assets in the son's estate will be avoided.

Gifts with reservation and pre-owned asset transfers

- The purpose of the gifts with reservation rules
- The tax consequences of gifts with reservation
- The purpose of the pre-owned asset transfer rules
- The tax consequences of pre-owned asset transfers

2 Gifts with reservation and pre-owned asset transfers

2.1 The purpose of the gifts with reservation rules

A gift with reservation (GWR) is a gift of the legal ownership of an asset, however the donor retains some interest or continues to enjoy some benefit from the asset in the future.

The most common examples of gifts with reservation are where the donor gifts:

- the freehold interest in a house but still lives in the property
- shares but retains the right to receive the dividend income
- assets into a trust fund but names himself as one of the beneficiaries of the trust.

Without special rules for GWR

If these gifts were treated as normal gifts:

- the first two examples would be PETs and therefore exempt from IHT if the donor lives for 7 years after the gift
- the third example would be a CLT, but lifetime tax is only payable at the lifetime rates if the gift is in excess of the nil rate band.

As a result, an individual could gift these assets at a relatively young age and therefore exclude the assets from their estate on death.

As a person's house is usually their most valuable asset, and the asset which makes them liable to pay IHT on death, most individuals could avoid paying IHT on their estates by ensuring that they give away their house more than 7 years before they die.

Their remaining assets would be likely to be below the nil rate band threshold and therefore no IHT would be payable on death. In addition, there would be no adverse effects as they would continue to live in the house until they died, rent-free.

Special rules for GWR

To prevent the avoidance of tax in this way, special anti-avoidance GWR rules apply to such gifts.

However, the special rules do **not apply** where:

- only a minimal benefit is derived from the asset (for example, the gift of a holiday home and the donor takes a two week annual vacation at the property)
- the donor pays full consideration for the benefit received from the asset (for example, the donor lives in the house but pays a market rent for the use of the house).

2.2 The tax consequences of gifts with reservation

At the time of the GWR, the gift is treated as a normal gift (i.e. a PET or CLT). This original gift will become chargeable if the donor dies within 7 years.

However, the asset is still treated as an asset of the donor for IHT purposes. A further charge to IHT is therefore levied on the death of the donor.

The subsequent charge on the donor depends on whether or not the donor ceases to retain an interest or enjoy a benefit from the asset before he dies.

If the individual retains an interest or benefit until his death

On the death of the individual the value of the GWR asset at the date of death is included in the donor's estate computation, as if the asset had never been gifted.

If the original gift was within 7 years of death, the original lifetime gift also becomes chargeable.

However, to prevent a double charge to tax, HMRC will only collect the **higher** of the tax on:

(1) the original gift becoming chargeable, and

(2) the asset being included in the estate.

As most assets (particularly houses) increase in value over time, and annual exemptions are not available in the estate computation, it is likely that including the asset in the estate will give the higher IHT charge.

If the individual does not retain an interest or benefit until his death

When the individual ceases to retain an interest or enjoy a benefit from the asset (i.e. the reservation is removed), for IHT purposes, there is another deemed PET. The value of this deemed PET is the value of the asset at that time, with no allowable annual exemption deductions.

If the donor then lives for 7 years, both the original and deemed PET will be exempt. However, if the donor dies within 7 years of the original PET, both the original and deemed PET become chargeable.

However, to prevent a double charge to tax, HMRC will only collect the **higher** of the tax on:

(1) the original gift becoming chargeable, and

(2) the deemed PET becoming chargeable.

As most assets (particularly houses) increase in value over time, and annual exemptions are not available on the deemed PET, it is likely that taxing the deemed PET will give the higher IHT charge.

2.3 The purpose of the pre-owned asset transfer rules

In recent years, many complicated schemes have been devised to get around the GWR rules. The pre-owned asset rules have therefore been introduced to catch schemes which allow individuals to give up ownership of valuable assets (such as land and chattels) without falling under the GWR rules.

To illustrate the point simply:

- if a father gifts cash to his son, then
- the son uses the cash to buy the father's house, and
- the son allows the father to continue to live in the house

this is technically not a GWR. This is because the reservation of living in the house does not apply to the asset which is gifted (i.e. the cash).

The pre-owned asset rules therefore apply where:

- the donor gifts property, continues to enjoy a benefit, but avoids the GWR rules, or
- within the previous 7 years, the donor provides cash to another person for them to acquire an asset from the donor, which the donor still uses.

The rules do not apply:

- to gifts to a spouse or civil partner
- where the value of the pre-owned asset is £5,000 or less.

2.4 The tax consequences of pre-owned asset transfers

An annual **income tax** charge arises on the donor for the benefit derived from the use of the asset, which is taxed in a similar way to an employment benefit charge.

The value of the benefit depends on the nature of the asset and is calculated as follows:

- For property = the market rent
- Chattels and other assets = (official rate of interest × market value of the asset)

Alternatively, the donor can opt out of the annual income tax charge and instead include the asset within his IHT estate computation on death, applying the rules the same way as the GWR rules.

The donor must elect to opt out of the annual income tax charge by 31 January following the end of the tax year in which the scheme commenced.

Administration of inheritance tax

- Delivering an account for inheritance tax
- The assessment and appeals procedure
- Payment dates
- Interest payments

3 Administration of inheritance tax

3.1 Delivering an account for inheritance tax

An individual must deliver an account to HMRC when either a lifetime or death transfer of value occurs. The due date for the delivery of an account is as follows:

	Deliver by	**Person responsible**
CLTs during lifetime	12 months following the end of the month of the CLT	Donor
CLTs and PETs on death	12 months following the end of the month of death	Donee
Estate on death	Later of: ■ 12 months following the end of the month of death, or ■ 3 months from the date of appointment	Executors

When the executors deliver the account for the deceased's estate, they must detail all property forming part of the estate and all lifetime gifts made by the deceased in the preceding seven years.

3.2 The assessment and appeals procedure

Following the submission of an account, HMRC will issue an assessment (known as a notice of determination) where IHT is payable.

An individual may make a written appeal against the assessment within 30 days of the date of the determination notice, stating the grounds for appeal.

Appeals are normally heard by the Special Commissioners, but further appeals can be made to the courts, as for the other personal taxes, but only on a point of law.

3.3 Payment dates

The due date of payment of **lifetime IHT** depends on when the CLT occurs in the tax year as follows:

Date of CLT:	**Due date:**
6 April to 30 September	30 April in the following year
1 October to 5 April	Six months after the end of the month in which the CLT is made

The due date of payment of **death tax on lifetime gifts** is six months after the end of the month of death.

The due date of payment of **death tax on the estate** is also six months after the end of the month of death, unless the instalment option is available.

The instalment option

If an election is made, the IHT payable in respect of some assets can be paid in ten equal annual instalments starting on the normal due date (i.e. for death tax, six months after the end of the month of death).

The assets qualifying for the instalment option include the following:

- Land and buildings anywhere in the world
- Quoted shares or securities where the donor has a controlling interest in the company
- Unquoted shares or securities where certain qualifying conditions are met
- An unincorporated business or share in a partnership.

However, in practice there is usually no IHT payable in respect of the last two categories of assets as they qualify for 100% BPR.

If at any time in the ten year instalment period the asset is sold, the sale proceeds must be used immediately to pay the remaining IHT liability on that asset.

Example

Grace died on 12 January 2010 leaving the following estate:

Free estate	**£**
House in Nottingham	454,500
Apartment in Spain (no Spanish death duties payable)	79,000
Shares in XYZ plc (a 3% interest in the company)	16,000
House, personal chattels, motor car and bank accounts	36,700
	586,200
Less: Allowable deduction	(34,700)
Gross chargeable estate	551,500

The average rate of IHT on the estate was 36.0834%.

In her will Grace left the apartment in Spain to her niece and the rest of the estate to her daughter.

Required

Calculate the allocation of the estate, and state how much of the IHT payable can be paid by instalments.

a

Answer

Allocation of the IHT payable

Payable in instalments:		**£**	**Paid by**	**Suffered by**
House in Nottingham	£454,500 × 36.0834%	163,999	Executors	Daughter
Apartment in Spain	£79,000 × 36.0834%	28,506	Niece	Niece
		192,505		
Payable in one lump sum:				
Shares in XYZ plc	£16,000 × 36.0834%	5,773	Executors	Daughter
Rest of free estate	£2,000 × 36.0834%	722	Executors	Daughter
		199,000		

The executors will pay £16,400 on 31 July 2010 and every 31 July for the next nine years.

The niece will pay £2,851 on 31 July 2010 and every 31 July for the next nine years.

Interest will accrue on the outstanding amounts from 31 July 2010.

3.4 Interest payments

Interest on overdue IHT runs **from** the due date of payment **to** the day before the date the tax is actually paid to HMRC.

Note that the normal due date of payment for death tax is 6 months after the end of the month of death, however, the delivery of account is not required until 12 months after the end of the month of death.

If the tax is not paid until the account is delivered, interest will be charged. It is therefore beneficial for the executors to deliver the account, and pay the tax, on or before the due date of payment.

Where IHT is paid by instalments on land and buildings, interest will accrue on the IHT outstanding from the date of the first instalment.

Where IHT is paid by instalments on other assets, interest will only accrue if instalments are paid late.

Interest on overpaid IHT runs from the date of the overpayment to the day before the date the tax is repaid by HMRC.

CHAPTER 16

The taxation of trusts

Contents

An overview of the taxation of trusts

1 An overview of the taxation of trusts

1.1 An overview of the syllabus for trusts

This chapter considers the different types of trust that exist and the inheritance tax and capital gains tax implications of setting up and operating those trusts. The income tax position of the beneficiaries was covered in chapter 2.

The computation of income tax, capital gains tax and inheritance tax payable by the trustees of any trust is excluded from the P6 syllabus.

Students tend to find trusts quite difficult. However, you should bear in mind that trusts are only a small part of the syllabus and many of the rules are the same as those that apply in a non-trust situation.

1.2 An overview of trust arrangements

A trust (also known as a settlement) is an arrangement laid down in a formal legal trust deed whereby:

- a group of persons (known as the **trustees**)
- are given the duty and responsibility
- to hold and administer **assets** put into a fund
- by a person (known as the **settlor**)
- for the benefit of other persons (known as the **beneficiaries**).

The settlor can set up the trust either during his lifetime or on his death under the provisions of his will.

A trust arrangement enables an individual to gift the legal ownership of assets, but retain some control over the property, via the provisions of the trust deed. It is also possible for the settlor to be one of the trustees of the fund if the trust is set up during his lifetime.

The trustees act in a representative capacity and administer the trust fund according to the wishes of the settlor. The powers and duties of the trustees and the wishes of the settlor are laid out in the trust deed.

1.3 Why use a trust?

A trust enables the benefits arising out of owning property to be enjoyed by someone other than the legal owner. For example, if a property is put into a trust, the legal owner of the property will be the trustees as it is their name that is on the title deeds. However, any rental income earned from the property could be enjoyed by the beneficiary, who is the beneficial owner of the property.

This separation of legal ownership from beneficial ownership has the following advantages:

- It enables the benefits of owning property to be transferred to a minor whilst control of the property remains with the trustees.
- It enables income to be enjoyed by one person, while the capital is preserved for another.
- It enables assets to be removed from the settlor's estate and thereby reduce the settlor's exposure to IHT.

1.4 Types of trust

For the purpose of the examination, you are required to be aware of the following types of trust arrangements:

- Immediate post-death interests
- Relevant property trusts (also known as mainstream trusts).

Immediate post-death interests

These are trusts whereby an interest in possession, or life interest, is created **on someone's death** in their will or via intestacy. (The terms 'interest in possession' and 'life interest' are explained below).

Relevant property trusts

From 22 March 2006, a relevant property trust (RPT) is any trust which is **not** an immediate post-death interest trust.

Relevant property trusts therefore include:

- discretionary trusts
- interest in possession (life interest) trusts, and
- accumulation and maintenance trusts. These were a special type of discretionary trust that could be created prior to 22 March 2006. A&M trusts had certain advantages for inheritance tax purposes.

1.5 Interest in possession trusts

An interest in possession trust (IIP trust) is an arrangement whereby:

Settlor

The **settlor** transfers legal ownership of property to a trust for the benefit of a person or persons (known as the '**life tenant'**) for the rest of their life, or for a set period of time.

During this time, the life tenant has an '**interest in possession**' (IIP), also referred to as a '**life interest**'.

This means that the life tenant is legally **entitled** to an interest in the trust property. The interest may be the right to receive the income generated by the assets in the trust fund (but not the capital assets), or the right to use a trust asset (for example, the right to live in a house belonging to the trust).

An IIP will end where the life tenant dies or the set period of time specified in the trust deed elapses.

Life tenant

When an IIP ends, the capital assets in the fund are given to the ultimate beneficiary or beneficiaries of the trust (known as the '**remainderman**').

The remainderman has an absolute **entitlement** to receive the capital assets when the life interest ends.

This means he has a '**reversionary interest**' in the capital assets.

Remainderman

When is an IIP trust used?

An IIP trust is often used in a will where there is a surviving spouse and children. The surviving spouse has the life interest; the children are the remaindermen. This ensures that the capital is preserved for the children in the event of the spouse remarrying.

A life tenant's interest

A life tenant is not strictly the owner of the trust property, but they have the right of enjoyment of the trust capital during their lifetime. An example could be income from the letting of a trust property, or investment income from the capital being invested in stocks, shares etc.

Termination of the life interest

The life interest usually ends on the death of the life tenant.

When this happens, the value of the trust property is included in the death estate of the life tenant and is therefore subject to IHT. In other words, for IHT purposes the life tenant is treated as if they owned the trust property.

When can an IIP trust be created?

An IIP trust can be created during the settlor's lifetime or on his death:

- If created on death, it is an immediate post-death interest (IPDI) trust.
- If created during lifetime, it is a relevant property trust.

1.6 Discretionary trusts

A discretionary trust (DT) is an arrangement whereby:

Settlor

The **settlor** transfers legal ownership of property to a trust for the benefit of a person or persons (known as the '**beneficiaries**').

No person has an interest in possession or reversionary interest.

During the life of the trust, the beneficiaries have no legal right to receive any income or capital from the trust fund.

Any payment of income or capital out of the trust fund is at the **discretion** of the trustees, and subject only to the powers and duties specified in the trust deed.

Beneficiaries

When is a discretionary trust used?

A discretionary trust enables a settlor to make general provision for the future needs of the beneficiaries, but in a flexible manner.

Inheritance tax and trusts

- An overview of the capital taxes and trusts
- The gifting of capital assets into a trust
- The distribution of capital assets to the beneficiaries

2 Inheritance tax and trusts

2.1 An overview of the capital taxes and trusts

It is important to understand that there can be both IHT and CGT implications arising from the creation of a trust by the settlor and the subsequent management of the trust assets by the trustees. Remember, however, that CGT is only payable in respect of **lifetime** transfers of capital assets.

The tax implications may differ depending on the date on which the trust was created. Trusts created prior to 22 March 2006 are dealt with under the old rules; trusts created after that date are dealt with under the new rules.

2.2 The gifting of capital assets into a trust

Assets can be gifted into a trust by a settlor during his lifetime or on his death under the provisions of his will.

Transfers during the settlor's lifetime – old rules

- The lifetime transfer of any asset into an **IIP** or an **accumulation and maintenance** trust was a **PET** for IHT purposes. No IHT was therefore payable unless the settlor died within seven years of the date of the transfer.
- The lifetime transfer of any asset into a **discretionary trust** was a **CLT** for IHT purposes.
- Lifetime IHT at the rate of 20% of the gross gift was payable at the time of the gift and the settlor was primarily responsible for the tax. However, an agreement could be made for the trustees to pay the tax.
- No further IHT was payable unless the settlor died within seven years of the gift.
- The death rates of IHT were payable by the trustees if the CLT became chargeable on the settlor's death. However, credit was given for any lifetime tax paid and taper relief was available if the settlor's death was more than three years after the gift.

Transfers during the settlor's lifetime – new rules

- The lifetime transfer of any asset into a **relevant property trust** is a **CLT** for IHT purposes. The rules are as explained above.

- It is not possible to make a lifetime transfer into an IPDI trust as such a trust can only be created on the death of the settlor.

Transfers on death

IHT is paid on the estate of the settlor, as usual, and the funds then go into the trust. This applies irrespective of the type of trust used or the date on which it was created.

If the transfer is made to an IIP trust and the surviving spouse/civil partner is the beneficiary, the transfer into the trust will be covered by the spouse exemption and will therefore be exempt from IHT.

2.3 The distribution of capital assets to the beneficiaries

The inheritance tax implications of the distribution of capital assets to the beneficiaries depend on whether the trust is:

- an IIP trust, or
- a discretionary trust/relevant property trust.

Trusts with an interest in possession

For IHT purposes, the life tenant is treated as if they own the trust property.

The life interest usually ends on the death of the life tenant. When this happens, the value of the trust property is included in the death estate of the life tenant and is therefore subject to IHT.

If property is distributed to beneficiaries other than on the death of the life tenant:

- There is no IHT if the property passes to the life tenant. (This is because the life tenant is already treated as owning the property.)
- The transfer is treated as a PET by the life tenant if the property passes to an individual, or a CLT if the property passes to someone other than an individual.

Discretionary trusts/relevant property trusts

During the life of a discretionary trust/relevant property trust, there are two occasions of charge to IHT:

Exit charge	■ This arises when capital assets are distributed out of the trust to the beneficiaries. ■ The charge is based on the value of the assets in the trust at the time of distribution.
Principal charge (also known as the 10 year charge)	■ This arises every ten years starting on the 10th anniversary of the creation of the trust.

The effective rate of IHT on these charges can vary between 0 – 6% (maximum).The computation of ten year charges and exit charges is not examinable. Therefore, only an awareness of the above principles is required.

Capital gains tax and trusts

- The gifting of capital assets into a trust
- The distribution of capital assets to the beneficiaries

3 Capital gains tax and trusts

3.1 The gifting of capital assets into a trust

Transfers during the settlor's lifetime

A chargeable gain arises if the settlor gifts a chargeable asset into a relevant property trust. The asset is deemed to be disposed of for a consideration equal to its full **market value** on the date of the gift.

Gift relief can be claimed on the gift of **any** chargeable asset into a relevant property trust as there is an immediate charge to IHT. Any gift relief claim is made by the settlor only; the trustees' consent is not necessary.

(Remember that assets cannot be gifted to an IPDI trust during the settlor's lifetime.)

Transfer at the time of the settlor's death

CGT is a lifetime tax. Therefore, no CGT liability arises if the settlor gifts assets to a trust on his death under the provisions of his will.

For CGT purposes, the assets of the deceased are transferred to the trustees of the trust at their full **market value** at the date of the settlor's death. This is known as probate value.

3.2 The distribution of capital assets to the beneficiaries

A chargeable gain arises on the distribution of chargeable assets to the beneficiaries by the trustees, unless the assets are passing due to the death of the life tenant.

The distribution is a chargeable disposal for consideration equal to the full **market value** on the date of the distribution. Gift relief can be claimed if:

- the asset is a qualifying business asset, or
- the transfer is immediately subject to IHT.

If a gift relief claim is made, the gain is deferred to the beneficiary receiving the asset. The claim must therefore be made jointly by both the trustees and the beneficiary.

Summary

- A summary of the capital taxes and relevant property trusts
- A summary of the capital taxes and IPDI trusts

4 Summary

4.1 A summary of the capital taxes and relevant property trusts

	IHT	CGT
Lifetime gifts into a RPT by the settlor	■ CLT ■ Lifetime IHT of 20% payable by settlor or trustees ■ Further tax may be payable if settlor dies within 7 years	■ Chargeable disposal at full MV ■ Payable by settlor ■ Gift relief available irrespective of type of asset
Gifts into a RPT on the death of the settlor	■ Assets included in estate ■ Estate taxed in the normal way ■ Post-tax assets put into trust	■ No CGT payable ■ Trustees acquire assets at probate value
Distribution of assets to beneficiaries	■ Exit charge arises ■ IHT = (Max 6% × Transfer of value) ■ Payable by the trustees	■ Chargeable disposal at MV ■ Payable by trustees ■ Gift relief available
Other charges to capital taxes	■ Principal charge every 10 years ■ IHT = (Max 6% × MV of trust assets) ■ Payable by the trustees	■ No further charges

4.2 A summary of the capital taxes and IPDI trusts

	IHT	CGT
Lifetime gifts into an IPDI trust	■ Lifetime gifts are not possible as an IPDI trust can only be created on death	■ Lifetime gifts are not possibe as an IPDI trust can only be created on death
Gifts into an IPDI Trust on the death of the settlor	■ Assets included in estate ■ Estate taxed in the normal way ■ Post-tax assets put into trust	■ No CGT payable ■ Trustees acquire assets at probate value

	IHT	CGT
Distribution of assets to beneficiaries	■ No IHT if assets pass to life tenant ■ If pass due to death of life tenant, include in life tenant's estate ■ Otherwise treat as PET or CLT by the life tenant	■ No CGT if pass due to death of life tenant ■ Otherwise, chargeable disposal at MV ■ Gift relief available if qualifying business asset or immediate charge to IHT

CHAPTER 17

Overseas aspects of personal tax

Contents

Residence, ordinary residence and domicile

- An overview of the syllabus for overseas aspects of personal tax
- The importance of the status of an individual for taxation purposes
- Residence
- Ordinary residence
- Domicile

1 Residence, ordinary residence and domicile

1.1 An overview of the syllabus for overseas aspects of personal tax

Paper P6 examination questions bring many topics together and often expect an appreciation of the overseas implications of **all** of the personal taxes, usually in the scenario of an individual either coming to or leaving the UK.

This chapter looks at the detailed overseas aspects of income tax and capital gains tax. The overseas aspects of inheritance tax have been covered in chapters 13 and 14.

A multi-tax summary of the common examination scenarios is given at the end of the chapter.

1.2 The importance of the status of an individual for taxation purposes

In order to determine the liability of an individual to income tax, capital gains tax and inheritance tax, it is necessary to know whether or not an individual is:

- resident,
- ordinarily resident, and/or
- domiciled in the UK.

There are no formal definitions of 'residence' and 'ordinary residence' in the tax legislation. However, case law has established a set of rules which are applied to determine the tax status of an individual. In addition, HMRC publish a booklet (HMRC 6) that explains their understanding of the legislation.

1.3 Residence

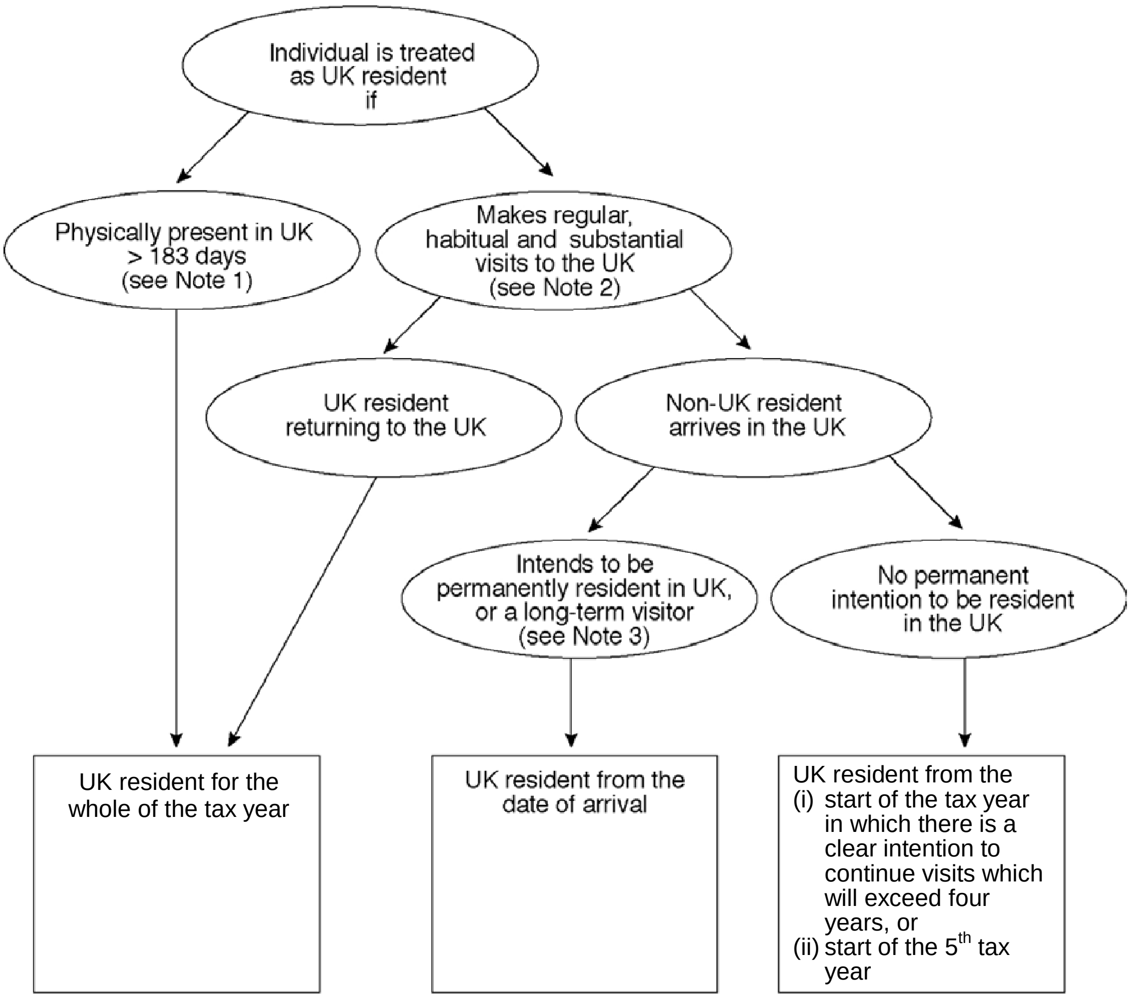
To be classed as resident in the UK, an individual must normally be physically present in the UK at some time in the tax year.

In most cases, an individual is treated as resident (or not resident) in the UK for a full tax year.

However, in some circumstances, an individual may be treated as resident in the UK for only part of a tax year.

Individual coming into the UK

For an individual coming in to the UK, the key rules for acquiring UK residency status can be summarised as follows:



Notes

(1) An individual is regarded as being physically present in the UK if they are still in the UK at midnight at the end of that day. (There is an exception for passengers who are in transit between two places outside the UK.)

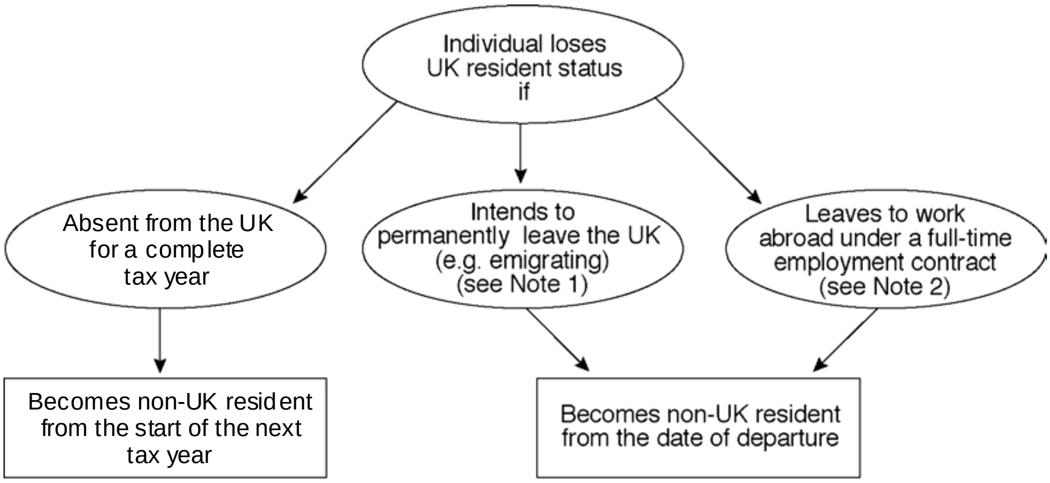
(2) The expression 'regular, habitual and substantial visits' is taken to mean that the individual has visited the UK, on average, for at least 91 days per tax year for four consecutive years. Any days spent in the UK for exceptional circumstances beyond their control are ignored (for example, due to illness).

(3) A long-term visitor is an individual intending to stay in the UK for at least two years. For example, an individual with an employment contract to work here for at least two years.

Individual leaving the UK

A UK resident individual leaving the UK will normally remain UK resident until he has been abroad for a period which includes one complete tax year (6 April to 5 April). However, there are exceptions to the rule.

The key rules for losing UK residency status can be summarised as follows:



Notes

(1) Permanently leaving the UK is taken to mean that the individual intends to leave the UK for at least three years.

(2) Where an individual leaves the UK under a full time contract of employment and satisfies certain conditions, he will be treated as non-UK resident from the day after the date of departure. Details of this extra-statutory concession are covered in the income tax section of this chapter.

1.4 Ordinary residence

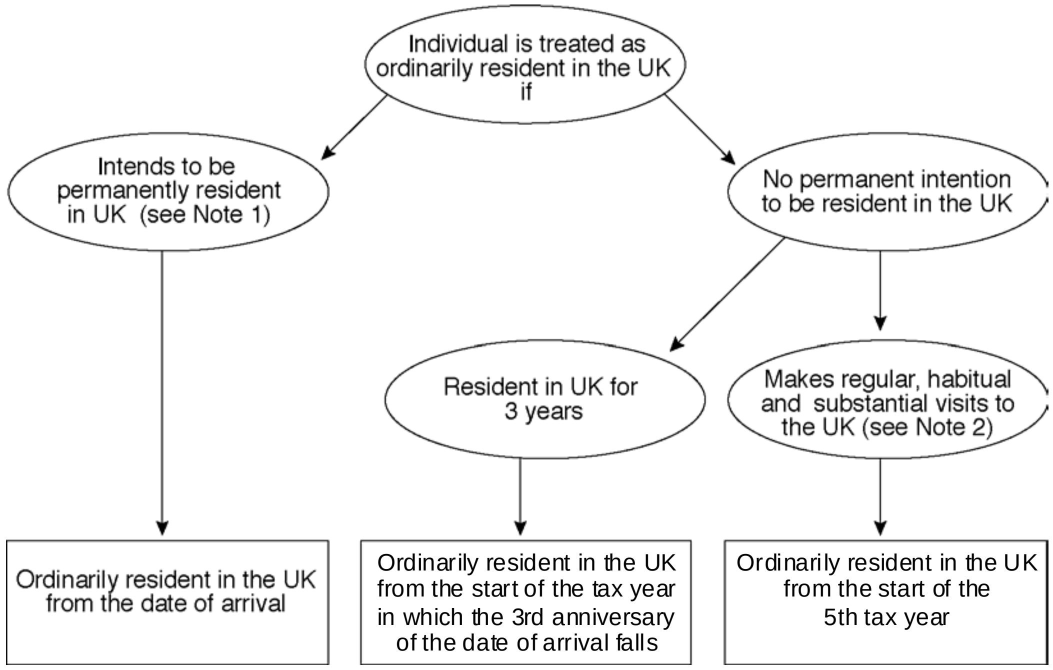
The ordinary residence of an individual is his habitual residence. This means the country in which the individual would say he normally lives.

For example, a French man may be physically present in the UK for 183 days or more in 2009/10 and would therefore be treated as UK resident in that year. However, if asked, he would say that he normally lives in France, which is his ordinary residence.

It is therefore possible for an individual to be resident, but not ordinarily resident in the UK.

Individual coming into the UK

For an individual coming in to the UK, the key rules for acquiring ordinary residence status in the UK can be summarised as follows:



Notes

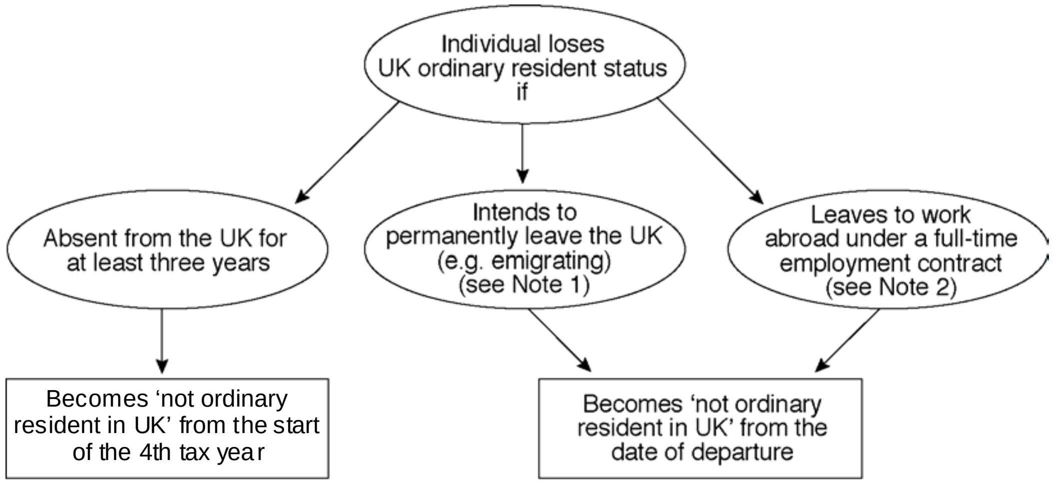
(1) Intending to be permanently resident in the UK is taken to mean that the individual intends to reside here for at least three years.

(2) The expression 'regular, habitual and substantial visits' is taken to mean the same as for residence status.

Individual leaving the UK

A UK resident individual leaving the UK will normally remain ordinarily resident in the UK until he has been abroad for a period of at least three years. However, there are exceptions to the rule.

The key rules for losing UK ordinary residence status can be summarised as follows:



Notes: As for residency status:

(1) Permanently leaving the UK is taken to mean that the individual intends to leave for at least three years.

(2) Where an individual leaves the UK under a full time contract of employment and satisfies certain conditions, he will be treated as not ordinarily resident in the UK from the day after the date of departure. Details of this extra-statutory concession are covered in the income tax section of this chapter.

1.5 Domicile

As mentioned in chapter 13, the term 'domicile' is a legal term which is defined as the country in which the individual has his permanent home. You should refer back to chapter 13 for the detailed rules on how to determine domicile.

For inheritance tax purposes, the definition of domicile for an individual is extended to include the concept of 'deemed domicile'. Deemed domicile is unique to IHT.

Example

Tiger is an American who spent from 2 May 2009 to 12 January 2010 in the UK visiting the tourist sights.

In August 2009, Tiger stayed in a hotel in Devon and met a German student, Bernard. Bernard was working as a waiter in the hotel. It is the second time Bernard has been to the UK. He has a five year agreement, which started in June 2008, to work in the hotel in the period from 15 June to 30 September each year.

The owner of the hotel, Colin, has lived in Devon all his life. Towards the end of the holiday season, on 10 September 2009, he left the UK to travel abroad and see the world. He returned to the UK on 18 May 2010.

Required

Explain whether Tiger, Bernard and Colin are resident, ordinarily resident and domiciled in the UK in 2009/10.

Answer

Tiger

Domicile	= USA USA is his permanent home
Residence	= UK Physically present in UK for ≥ 183 days in 2009/10
Ordinary residence	= USA No permanent intention to reside in UK Not been in UK for three years, and Not making regular visits
Tax status	Not UK domiciled. Resident but not ordinarily resident in the UK

Bernard

Domicile	= Germany Germany is his permanent home
Residence	= UK Physically present in UK for < 183 days in 2009/10 but present for > 91 days and clear intention from the first visit to return to the UK for > 91 days on average over a period exceeding 4 years
Ordinary residence	= Germany No permanent intention to reside in UK Not been in UK for three years, and Making regular visits but 2009/10 = the second year
Tax status	Not UK domiciled. Resident but not ordinarily resident in the UK

Colin

Domicile	= UK UK is his permanent home
Residence	= UK UK citizen physically present in UK for < 183 days in 2009/10 But do not lose residency status unless: - permanently leaving - have a full-time working contract abroad - absent for a complete tax year None of these situations apply
Ordinary residence	= UK UK citizen Do not lose ordinary residence status unless: - permanently leaving - have a full-time working contract abroad - absent for three years None of these situations apply
Tax status	UK domiciled Resident and ordinarily resident in the UK

Overseas aspects of income tax

- The taxation of overseas income
- The availability of personal allowances
- The special rules for employment income
- Overseas travel and subsistence expenses
- Double taxation relief
- Interaction of double taxation relief with the dividend tax credit

2 Overseas aspects of income tax

2.1 The taxation of overseas income

All income arising in the UK is subject to UK income tax regardless of the status of the individual.

If the individual is not UK domiciled or not ordinarily resident in the UK, overseas income may be assessed only if remitted into the UK. Income is remitted to the UK if it is brought into the UK, e.g. interest is remitted from an overseas bank account if it is withdrawn from the account and spent in the UK.

The following table summarises the detailed rules to determine the liability of an individual to UK income tax:

Status (Note)	UK income	Overseas income
R, OR and D in the UK	All taxable	All taxable Exception: Overseas pension income = 90% taxable
R but NOR in UK or R but ND in UK	All taxable	Taxable if remitted to the UK Note: Remittances of overseas pension income = 100% taxable
NR in UK	All taxable	Overseas income = exempt

Note
The abbreviations used are as follows:

R	= Resident	NR	= Not resident
OR	= Ordinarily resident	NOR	= Not ordinarily resident
D	= Domiciled	ND	= Not domiciled

2.2 The availability of personal allowances

Personal allowances are usually not available to individuals unless they are resident in the UK. However, the following non-resident individuals may claim personal allowances to deduct from any income that is taxable in the UK:

- Nationals of the European Economic Area

- Residents of the Channel Islands or the Isle of Man
- Former UK residents who have left the UK for health reasons (their own health or that of another family member)
- Employees or former employees of the Crown, and their widows or widowers
- Individuals employed in the service of any territory under Her Majesty's protection.

Up until 6 April 2010, the list also included Commonwealth citizens. However, from that date Commonwealth citizens lose their entitlement to a personal allowance unless they qualify under one of the other headings.

Note that non-domiciled or non-ordinarily resident individuals who claim the remittance basis of assessment in respect of their overseas income are not entitled to a personal allowance. However, individuals to whom the remittance basis automatically applies retain entitlement to a personal allowance.

2.3 The special rules for employment income

The assessment of employment income depends on two key factors:

- the individual's tax status (as above), **and**
- where the duties of employment are actually performed
  (i.e. the source of the employment income).

The following table summarises the position in respect of employment income:

	Duties performed in the UK	**Duties performed abroad**
R and OR in the UK	All earnings = actual receipts basis	All earnings = actual receipts basis
R but NOR in UK	All earnings = actual receipts basis	All earnings remitted to UK = remittance basis
NR in UK	All earnings = actual receipts basis	All earnings = exempt

Finally, where a **non-UK domiciled employee** is employed by **a non-UK resident employer**, the individual's employment income is known as 'foreign emoluments' and is taxed on a remittance basis.

Extra-statutory concession

By concession from HMRC, if an individual leaves the UK and satisfies certain conditions, he will be treated as not resident and not ordinarily resident in the UK from the date of departure to the date of return.

The effect of satisfying the concession is that all overseas income, including overseas earnings, will be exempt from UK income tax.

The extra-statutory concession applies where an individual leaves the UK:

- on a full-time contract of employment
- which spans a complete tax year, and
- where all of the duties are to be performed outside the UK, and
- visits to the UK do not satisfy the normal residency rules (i.e. do not exceed 182 days in a tax year and are not regular, substantial, habitual visits).

(This treatment will also apply to any accompanying spouse/civil partner.)

Example

Veronica has been offered two 15 month contracts of employment to work abroad in South Africa. All of the duties will be performed abroad and the remuneration package will be identical. The only difference is the start date of the contract as follows:

Offer 1	1 June 2009 to 31 August 2010
Offer 2	1 February 2009 to 30 April 2010

Required

Discuss the treatment of the employment income received from each contract in 2009/10.

Answer

Offer 1

Veronica is working abroad for more than a year, however the period of absence does not span a complete tax year.

She is not leaving the UK permanently and does not satisfy the conditions of the extra-statutory concession. She therefore remains UK resident and ordinarily resident in the UK for the whole of the period abroad.

As a result she will be subject to UK income tax on all of her overseas earnings on an actual receipts basis.

DTR will be available.

Offer 2

Veronica satisfies the conditions of the extra-statutory concession. She is therefore treated as not resident and not ordinarily resident in the UK from the date of departure to the date of return (i.e. 1 February 2009 to 30 April 2010).

As a result, for the whole of 2009/10 her overseas income will be exempt but she will still be assessed on any UK income. She can claim personal allowances to offset against the UK taxable income for the tax year.

However, in 2008/09 and in 2010/11, the tax year will be split into two periods.

From 6 April 2008 to 1 February 2009, and from 1 May 2010 to 5 April 2011: she will be assessed on her worldwide income.

From 2 February 2009 to 5 April 2009, and from 6 April 2010 to 30 April 2010, her overseas income will be exempt but she will still be assessed on any UK income. She can claim personal allowances to offset against the UK taxable income for each tax year. (Remember that the personal allowance is never time apportioned).

2.4 Overseas travel and subsistence expenses

Where an employee works under a contract of employment for a non-UK resident employer:

- travel costs from the individual's UK home to place of work abroad
- at the beginning and end of the employment, and
- overseas subsistence costs (for example, board and lodgings whilst abroad)

are treated as:

- an allowable deduction from employment income, if paid by the employee, or
- a tax exempt benefit, if paid by the employer.

Additional travel costs incurred for the employee to make any number of return visits to the UK are treated as a tax exempt benefit where:

- the employment duties can only be performed abroad, and
- the costs are incurred by the employer.

This tax exemption is available regardless of the number of days spent working abroad.

Additional travel costs (from UK home) incurred for the spouse (or civil partner) and/or the employee's children (under 18 at the start of the outward journey) to visit the employee are also treated as a tax exempt benefit where:

- the individual has worked overseas for at least 60 consecutive days, and
- the costs are incurred by the employer.

Up to two return trips per tax year per person are allowable.

Similar provisions exist to allow overseas travelling and subsistence expenses incurred by a self-employed individual as a deduction against trading profits.

However, the relief is only available to individuals who carry on a trade, profession or vocation wholly overseas. This is an unlikely examination scenario.

2.5 Double taxation relief

Overseas income may be liable to both UK income tax and tax in the overseas country according to the tax rules in that country. Where this is the case, double taxation relief (DTR) is available.

To avoid a double charge to tax, a deduction is allowed for the tax charged in one country against the tax charge in the other country.

The two most important methods of obtaining relief for double taxation are:

- Treaty relief
- Unilateral relief.

Treaty relief

In practice, treaty relief is usually available under the provisions of a specific double taxation treaty agreement drawn up between governments of two countries.

Treaty agreements are usually large complicated legal documents which cover all possible eventualities and sources of income. The detail of any particular treaty relief is not examinable, but awareness is required of how treaty relief is given.

Typically, a DTR treaty will contain the following:

- exemption clauses, whereby some income is taxable in one country but exempt in the other: so that there is no double taxation of income
- an agreement on the level of taxation to be applied to some types of income in both countries, and
- a credit relief clause, whereby overseas tax suffered is deducted from the domestic liability to tax, usually under the unilateral relief provisions.

In an examination answer, as the detailed provisions of a particular treaty will not be examined, DTR is to be given under the unilateral relief provisions.

Unilateral relief

DTR is a deduction from the UK income tax liability of the lower of the:

(i) Overseas income tax suffered on the overseas income
(ii) UK income tax suffered on the overseas income.

Overseas income is treated as the top slice of each source of income.

UK income tax is therefore calculated in the following order:

(1) UK 'other income'

(2) Overseas 'other income'

(3) UK savings income

(4) Overseas savings income

(5) UK dividends

(6) Overseas dividends

The UK income tax suffered on a particular source of income is calculated as:

	£
UK income tax liability including the overseas source of income	X
UK income tax liability excluding that source of income	(X)
UK income tax suffered on a source of overseas income	X

Example

Susan is resident, ordinarily resident and domiciled in the UK. In 2009/10 she received the following income:

	£
Employment income (gross amount)	38,000
Overseas rental profits from a property in Marbella	4,410

The overseas rental profits were received net of 30% withholding tax.

Required

Calculate Susan's income tax liability for 2009/10.

Answer

Susan: Income tax computation: 2009/10

	Total income £	*UK income* £	*Overseas income* £
Employment income	38,000	38,000	
Overseas property income (£4,410 × 100/70)	6,300		6,300
Total income	44,300	38,000	6,300
Less PA	(6,475)	(6,475)	
Taxable income	37,825	31,525	6,300

Income tax		£		£
Basic rate band:	Other income (UK)	31,525	at 20%	6,305
	Other income (Overseas)	5,875	at 20%	1,175
		37,400		
Higher rate band:	Other income (Overseas)	425	at 40%	170
Total taxable income		37,825		
				7,650
Less Double taxation relief				
(i) Overseas income tax suffered	(£6,300 × 30%) =	1,890		
(ii) UK income tax on overseas income	(£1,175 + £170) =	1,345		(1,345)
Income tax liability				6,305

Notes:

(1) In principle, at best, DTR can only eliminate the UK tax liability in respect of the overseas income. Any excess overseas tax suffered can not be carried forward or carried back.

(2) In this example, it is easy to calculate the amount of UK income tax on the source of overseas income. However, care must be taken to calculate DTR where there are other sources of income involved, as shown in the next example.

Example

Suzie is resident, ordinarily resident and domiciled in the UK. In 2009/10 she received the following income:

	£
Employment income (gross amount)	38,000
Overseas rental profits from a property in Marbella	4,410
UK bank interest received	1,200

The overseas rental profits were received net of 30% withholding tax.

Required

Calculate Suzie's income tax liability for 2009/10.

Answer

Suzie: Income tax computation: 2009/10	**Total income** £	**Other income** £	**Savings income** £
Earned income			
Employment income	38,000	38,000	
Savings income			
Bank interest (£1,200 × 100/80)	1,500		1,500
Other investment income			
Overseas property income (£4,410 × 100/70)	6,300	6,300	
Total income	45,800	44,300	1,500
Less PA	(6,475)	(6,475)	
Taxable income	39,325	37,825	1,500

		£		£
Income tax				
Basic rate band:	Other income (UK)	31,525	at 20%	6,305
	Other income (Overseas)	5,875	at 20%	1,175
		37,400		
Higher rate band:	Other income (Overseas)	425	at 40%	170
		37,825		
	Savings income (UK)	1,500	at 40%	600
Total taxable income		39,325		
				8,250

Less Double taxation relief			
(i) Overseas income tax suffered	(£6,300 × 30%) =	1,890	
(ii) UK income tax on overseas income			
(see W1 and Note to answer below)		1,645	(1,645)
Income tax liability			6,605

Workings:

(W1) DTR

	£
UK liability **including** the overseas rental profits	8,250
UK liability **excluding** the overseas rental profits (W2)	(6,605)
UK income tax suffered on the overseas rental profits	1,645

(W2) UK liability excluding the overseas rental profits

Income tax		£		£
Basic rate band:	Other income (UK)	31,525	at 20%	6,305
	Savings income (UK)	1,500	at 20%	300
		33,025		
UK liability excluding the overseas rental profits				6,605

Note: Alternative short cut calculation of UK income tax suffered:

		£
UK income tax on overseas income in IT computation	(£1,175 + £170)	1,345
Plus		
Reduction in tax on other sources of income		
if overseas income is not included in the computation:		
Savings income [£1,500 × (40% - 20%)]		300
UK income tax suffered on the overseas rental profits		1,645

DTR where there is more than one source of overseas income

Where there is more than one source of overseas income suffering different rates of overseas tax, DTR for each source of overseas income is calculated separately.

To maximise DTR, the source suffering the highest rate of overseas tax is considered first.

Example

Michael is resident, ordinarily resident and domiciled in the UK. In 2009/10 he received the following income:

	£
Trading income	38,000
Overseas rental profits from a property in Florida	4,095
UK bank interest	1,200
Overseas interest income	810

The overseas rental profits were received net of 35% withholding tax, and the overseas interest was received net of 10% withholding tax.

Required

Calculate Michael's income tax liability for 2009/10.

a

Income tax computation: 2009/10	*Total income* £	*Other income* £	*Savings income* £
Earned income			
Trading income	38,000	38,000	
Savings income			
Bank interest (£1,200 × 100/80)	1,500		1,500
Overseas interest (£810 × 100/90)	900		900
Other investment income			
Overseas property income (£4,095 × 100/65)	6,300	6,300	
Total income	46,700	44,300	2,400
Less PA	(6,475)	(6,475)	
Taxable income	40,225	37,825	2,400

Income tax		£		£
Basic rate band:	Other income (UK)	31,525	at 20%	6,305
	Other income (Overseas)	5,875	at 20%	1,175
		37,400		
Higher rate band:	Other income (Overseas)	425	at 40%	170
		37,825		
	Savings income (UK)	1,500	at 40%	600
	Savings income (Overseas)	900	at 40%	360
Total taxable income		40,225		
				8,610
Less Double taxation relief (£1,825 + £180) (W1) (W4)				(2,005)
Income tax liability				6,605

Workings

(W1) DTR on overseas rental income

As the overseas rental income suffers the highest rate of overseas tax, DTR on this source of income is calculated first as follows:

Lower of:

(i) Overseas income tax suffered on the overseas income (£6,300 × 35%) = £2,205

(ii) UK income tax suffered on the overseas income (W2) = £1,825

(W2) DTR on overseas rental income

	£
UK liability **including** the overseas rental profits	8,610
UK liability **excluding** the overseas rental profits (W3)	(6,785)
UK income tax suffered on the overseas rental profits	1,825

(W3) UK liability excluding the overseas rental profits

Income tax		£		£
Basic rate band:	Other income (UK)	31,525	at 20%	6,305
	Savings income (UK)	1,500	at 20%	300
	Savings income (Overseas)	900	at 20%	180
Taxable income		33,925		
Income tax liability excluding overseas rental income				6,785

(W4) DTR on overseas interest income

As the overseas interest income suffers the lowest rate of overseas tax, DTR on this source of income is calculated last as follows:

Lower of

(i) Overseas income tax suffered on the overseas income (£900 × 10%) = £90

(ii) UK income tax suffered on the overseas income (W5) = £180

(W5) DTR on overseas interest income

	£
UK liability **including** the overseas interest income (but excluding the overseas rental income) (W3)	6,785
UK liability **excluding** the overseas interest income (and excluding the overseas rental income) (W6)	(6,605)
UK income tax suffered on the overseas interest income	180

(W6) UK liability excluding all overseas income

Income tax	£		£
Basic rate band: Other income (UK)	31,525	at 20%	6,305
Savings income (UK)	1,500	at 20%	300
Taxable income	33,025		
Income tax liability (excluding all overseas income)			6,605

Notes:

Alternative calculation of UK income tax suffered on overseas rental income:

		£
UK income tax on overseas income in IT computation	(£1,175 + £170)	1,345
Plus		
Reduction in tax on other sources of income		
if overseas income is not included in the computation:		
Savings income [£1,500 × (40% - 20%)]		300
Overseas savings income [£900 × (40% - 20%)]		180
UK income tax suffered on the overseas rental profits		1,825

2.6 Interaction of double taxation relief with the dividend tax credit

As stated in chapter 2, UK resident individuals in receipt of overseas dividends are usually entitled to a 10% tax credit.

Where the overseas dividend has suffered tax in the overseas country, double taxation relief will be available. The procedure to adopt is as follows:

Step one - Gross up the overseas dividend in respect of the overseas tax.

Step two – Gross up the dividend again for the 10% tax credit (i.e. figure from step one x 100/90).

Step three – Calculate the UK income tax due at 10% or 32.5% depending on the individual's taxable income. Remember that overseas dividends are regarded as the top slice of income.

Step four – Calculate the double taxation relief due. This will be the lower of two figures:

(1) Overseas tax suffered – figure from step one x overseas tax rate.

(2) UK tax on that source of income – UK tax at 10% or 32.5% less the 10% tax credit.

Example

Mariam is resident, ordinarily resident and domiciled in the UK. In 2009/10 she received the following income:

	£
Trading income	48,000
Overseas dividends	648

The overseas dividends were received net of 20% withholding tax.

Required

Calculate Mariam's income tax liability for 2009/10.

a

Income tax computation: 2009/10		*Total income*	*Other income*	*Dividend income*
		£	£	£
Earned income				
Trading income		48,000	48,000	
Dividend income				
Overseas dividend				
(£648 x 100/80 = £810 × 100/90)		900		900
Total income		48,900	48,000	900
Less PA		(6,475)	(6,475)	
Taxable income		42,425	41,525	900

Income tax		£		£
Basic rate band:	Other income (UK)	37,400	at 20%	7,480
Higher rate band:	Other income (UK)	4,125	at 40%	1,650
		41,525		
	Dividend income (Overseas)	900	at 32.5%	292
Total taxable income		42,425		
				9,422
Less Double taxation relief (W1)				(162)
Income tax liability				9,260

Workings

(W1) DTR on overseas dividend income

DTR on the overseas dividend income is calculated as follows:

Lower of:

(i) Overseas income tax suffered on the overseas income (£810 × 20%) = £162

(ii) UK income tax suffered on the overseas income £900 x (32.5% - 10%) = £202

The overseas aspects of capital gains tax

- The taxation of overseas capital gains
- Temporary absence abroad
- Double taxation relief
- Capital losses

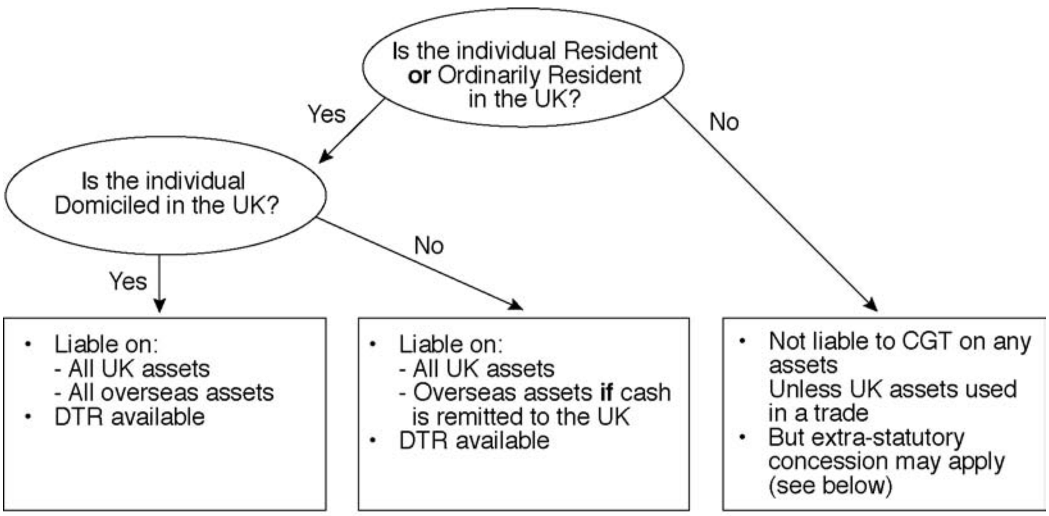
3 The overseas aspects of capital gains tax

3.1 The taxation of overseas capital gains

The residence and ordinary residence status of an individual primarily determines their liability to capital gains tax.

If the individual is not UK domiciled, they may be able to use the remittance basis of assessment. However, individuals who claim the remittance basis are not entitled to the capital gains tax annual exemption. (The remittance basis of assessment is covered later.)

The following flowchart summarises the liability to capital gains tax:



As can be seen above, if an individual is not resident and not ordinarily resident in the UK:

- domicile is not important, and
- there is unlikely to be any liability to UK CGT.

In the income tax section, it was explained that where an individual takes up full-time employment abroad which spans one complete tax year, he will be treated as not resident and not ordinarily resident in the UK. As a result, he will be exempt from income tax on overseas income from the date of departure to the date of return.

However, this exemption applies to income tax only. This is because it was considered to be too generous to allow an individual to avoid capital gains tax on **both** his UK and overseas assets by leaving the UK for only one complete tax year.

3.2 Temporary absence abroad

Despite being classed as not resident and not ordinarily resident in the UK, individuals will remain liable to UK capital gains tax on disposals of assets while they are abroad **if**:

- the individual was UK resident for 4 out of the 7 years prior to leaving the UK, **and**
- the assets were owned by the individual before leaving the UK, **and**
- the period spent abroad is less than five complete **tax** years.

The liability to capital gains tax operates as follows:

Tax year	Rules
Year of departure	Liable on any disposals in the tax year
	(both before and after the date of departure)
Years abroad	Not liable on any disposals
Year of return	If return within five complete tax years liable on:
	All disposals whilst abroad (see note), and
(known as the	Any disposals in the tax year since the date of return
re-entry charge)	
	If return after five complete tax years liable on:
	Any disposals since the date of return only
	All disposals whilst abroad = exempt

Note: The individual is only liable to capital gains tax on the disposal of assets owned before leaving the UK. Assets which are both acquired and then sold whilst the individual is abroad are not liable to capital gains tax.

3.3 Double taxation relief

Where gains are assessed to both UK capital gains tax and overseas tax, double taxation relief is available. This is calculated in the same manner as for income tax.

3.4 Capital losses

Capital losses realised by non-UK domiciled individuals in respect of assets situated overseas are available for relief provided they have arisen in a year where the individual is taxed on the arising basis. Individuals who do not claimed the remittance basis will obtain relief for such losses automatically; individuals who claim the remittance basis will be required to make an election in order to claim relief. The election is irrevocable and must be made in the first year in which the remittance basis is claimed.

The remittance basis rules

4 The remittance basis rules

4.1 When does the remittance basis apply?

Individuals who are **non-ordinary resident or non-domiciled** in the UK are eligible to be taxed on their overseas income on the remittance basis.

Chargeable gains realised on assets situated overseas by UK resident or ordinarily resident individuals who are **not UK domiciled** may also be taxed on the remittance basis.

The remittance basis applies **automatically** to those individuals who:

(1) Have unremitted income and gains totalling less than £2,000, or

(2) Have no UK income and gains (investment income of less than £100 is ignored), make no remittances of foreign income or gains, and either:

- Are under the age of 18 throughout the tax year, or
- Have been resident in the UK for no more than six out of the last nine years.

Non-domiciled individuals who do not meet the above conditions **must make a claim** if they wish to use the remittance basis. Such individuals are known as 'remittance basis users' (RBUs). They are required to pay a £30,000 charge for using the remittance basis and also lose their entitlement to the personal allowance and annual exemption.

4.2 The £30,000 charge

An individual who has been UK resident for at least seven of the nine previous tax years must pay a **tax charge of £30,000 on their unremitted income/gains** in order to claim the remittance basis. This charge is payable **in addition to** the tax due on any amounts remitted to the UK.

Individuals will therefore need to choose **each year** whether to:

- pay the £30,000 charge and claim the remittance basis or
- pay tax on their worldwide income and capital gains.

If the remittance basis is claimed

Individuals who claim the remittance basis must pay the £30,000 charge.

They are not entitled to the income tax personal allowance or the capital gains tax annual exemption.

Any overseas income remitted to the UK is taxed as 'other income'. It is therefore taxed at 20% or 40% irrespective of its source.

If the remittance basis is not claimed

Individuals who do not claim the remittance basis do not have to pay the £30,000 charge.

They retain their entitlement to the income tax personal allowance and the capital gains tax annual exemption.

All of their overseas income is taxable. The tax rates depend on the source of income.

If the remittance basis applies automatically

Any income remitted to the UK is taxable as 'other income' (i.e. at 20% or 40%).

Such individuals do not have to pay the £30,000 charge and retain their entitlement to the personal allowance and annual exemption.

It was originally assumed that these individuals would wish to take advantage of the remittance basis and so it was applied automatically. However, if an individual wishes to be taxed on the arising basis instead, he can choose to do so (i.e. he can opt out of the remittance basis.)

4.3 Exemptions to the remittance rules

Untaxed overseas income will be regarded as remitted to the UK where it is used to purchase goods or services which are subsequently brought into the UK. There are a number of exemptions to this rule including:

- personal items, such as clothes, shoes, jewellery and watches
- items imported for a short period of time or for repair, and
- items costing less than £1,000.

Example

Sanjeev has been resident and ordinarily resident in the UK since March 2001. He is domiciled in India. In 2009/10 he received the following income:

	£
Employment income	130,000
UK bank interest	12,000
Overseas bank interest (net)	24,000

The overseas bank interest was received net of 25% withholding tax. Sanjeev remitted £1,800 of the interest to the UK.

Sanjeev also incurred a chargeable gain of £72,000 on the disposal of an overseas asset. No overseas tax has been paid on this disposal and none of the gain has been remitted to the UK.

Required

Calculate Sanjeev's income tax and capital gains tax liability for 2009/10 and advise him whether a claim for the remittance basis should be made.

Answer

As Sanjeev is non-domiciled in the UK, he can claim for his overseas income and gains to be assessed using the remittance basis.

However, as Sanjeev has been resident in the UK for eight tax years prior to 2009/10, he will be liable to the £30,000 additional charge if he claims the remittance basis.

If Sanjeev claims the remittance basis his tax liability will be as follows:

Sanjeev
Income tax computation: 2009/10

	Total income £	*Other income* £	*Savings income* £
Earned income			
Trading income	130,000	130,000	
Savings income			
Bank interest (£12,000 × 100/80)	15,000		15,000
Other investment income			
Overseas bank interest remitted (£1,800 × 100/75)	2,400		2,400
Total Income	147,400	130,000	17,400
Less PA (none as remittance basis claimed)	(Nil)	(Nil)	
Taxable income	147,400	130,000	17,400

Income tax		£		£
Basic rate band:	Other income (UK)	37,400	at 20%	7,480
Higher rate band:	Other income (UK)	92,600	at 40%	37,040
		130,000		
	Savings income (UK)	15,000	at 40%	6,000
	Savings (Overseas)	2,400	at 40%	960
Total taxable income		147,400		
				51,480
Less Double taxation relief (W1)				(600)
Income tax liability				50,880

Total tax liability: 2009/10	£
UK income tax liability	50,880
Additional tax charge for claiming remittance basis	30,000
CGT liability (none of the gain has been remitted)	Nil
Total UK tax liability assuming remittance basis claimed	80,880

If Sanjeev does not claim the remittance basis, he will be taxed on his worldwide income and gains as follows:

Sanjeev
Income tax computation: 2009/10

	Total income £	*Other income* £	*Savings income* £
Earned income			
Trading income	130,000	130,000	
Savings income			
Bank interest (£12,000 × 100/80)	15,000		15,000
Other investment income			
Overseas bank interest remitted (£24,000 × 100/75)	32,000		32,000
Total Income	177,000	130,000	47,000
Less PA	(6,475)	(6,475)	
Taxable income	170,525	123,525	47,000

Income tax		£		£
Basic rate band:	Other income (UK)	37,400	at 20%	7,480
Higher rate band:	Other income (UK)	86,125	at 40%	34,450
		123,525		
	Savings income (UK)	15,000	at 40%	6,000
	Savings (Overseas)	32,000	at 40%	12,800
Total taxable income		170,525		
				60,730
Less Double taxation relief (W2)				(8,000)
Income tax liability				52,730

Capital gains tax	£
Chargeable gain	72,000
Annual exemption	(10,100)
Taxable gain	61,900
CGT at 18%	11,142

Total tax liability: 2009/10	£
UK income tax liability	52,730
Additional tax charge – none as remittance basis not claimed	Nil
CGT liability	11,142
Total UK tax liability assuming remittance basis is not claimed	63,872

Conclusion

Sanjeev's total tax liability is £80,880 if he claims the remittance basis, but only £63,872 if he does not. He will therefore be better off by £17,008 by **not** claiming the remittance basis for 2009/10.

Workings

(W1) DTR on overseas bank interest – remittance basis

Lower of:

(i) Overseas income tax suffered on the overseas income (£2,400 × 25%) = £600

(ii) UK income tax suffered on the overseas income (£2,400 × 40%) = £960

(W2) DTR on overseas bank interest – worldwide income

Lower of:

(i) Overseas income tax suffered on the overseas income (£32,000 × 25%) = £8,000

(ii) UK income tax suffered on the overseas income (£32,000 × 40%) = £12,800

A summary of common examination scenarios

- An individual coming to work in the UK
- An individual leaving the UK to work abroad

5 A summary of common examination scenarios

5.1 An individual coming to work in the UK

When an individual comes to the UK to take up full-time employment, he will usually retain his foreign domicile.

However, his UK residence and ordinary residence position will depend on his physical presence in the UK and on his intentions when arriving in the UK.

- If he is physically present in the UK for more than 182 days in a tax year, he will be treated as UK resident for the whole of that tax year.
- If he intends to stay in the UK for at least **two years** when he arrives, he will be treated as UK resident from the date of arrival to the date of departure.
- If he intends to stay in the UK for at least **three years** when he arrives, he will be treated as ordinarily resident in the UK from the date of arrival to the date of departure. (Note, however, that the ordinary residence position will not affect his personal tax liability).

The following table summarises the personal tax issues which should be considered to determine his liability to tax.

Individual coming to the UK to work

	ND in the UK **R in the UK**	**ND in the UK** **NR in the UK**
Income tax	All UK income assessable on arising basis Overseas income (earnings and other income) eligible for remittance basis (either automatically/if claimed) Personal allowance available, unless remittance basis is claimed All earnings relating to duties performed in the UK are assessable Earnings relating to duties performed abroad may be assessable on a remittance basis	UK income assessable on arising basis No personal allowance available (unless a British subject or member of EEA country) Overseas income (earnings and other income) = exempt

	ND in the UK R in the UK	ND in the UK NR in the UK
CGT	Liable on all UK gains Overseas gains may be assessed on remittance basis, but annual exemption lost if remittance basis claimed	Normally, both UK and overseas assets = exempt Not liable to CGT on any assets (unless UK assets used in a trade)
IHT	Liable on UK assets only	Liable on UK assets only

5.2 An individual leaving the UK to work abroad

When an individual leaves the UK to take up full-time employment, he will usually retain his UK domicile.

However, his UK residence and ordinary residence position will depend on his intentions when leaving the UK and whether he satisfies the extra-statutory concession rules.

If he intends to leave the UK permanently (i.e. for at least three years) or satisfies the extra-statutory concession rules, he will be treated as not UK resident and not ordinarily resident in the UK from the day after the date of departure.

If he does not intend to leave the UK for at least three years and does not satisfy the extra-statutory concession rules, he will be treated as:

- not UK resident from the start of the tax year following his departure, and
- not ordinarily resident in the UK from the start of the tax year after he has been abroad for three years.

The following table summarises the personal tax issues which should be considered to determine the liability to tax.

Individual leaving the UK to work abroad

	D in the UK NR and NOR in the UK	D in UK R and OR in the UK
Income tax	Liable on: All UK income only No personal allowance available (unless a British subject or member of EEA country) Overseas income (earnings and other income) = exempt	Liable on: All UK income All overseas income (earnings and other income) Personal allowance available All earnings are assessable regardless of where duties are performed

	D in the UK **NR and NOR in the UK**	**D in UK** **R and OR in the UK**
CGT	If return within 5 complete tax years liable on: All UK disposals All disposals whilst abroad (taxed in the year of return) If return after 5 complete tax years liable on: All UK disposals only All disposals whilst abroad = exempt	Liable on: All UK gains All overseas gains
IHT	Liable on: All UK assets All overseas assets	Liable on: All UK assets All overseas assets

CHAPTER 18

Tax planning for the individual

Contents

An overview of effective tax planning for an individual

- An overview of the importance of tax planning at Paper P6
- General tax planning points for an individual

1 An overview of tax planning for an individual

1.1 An overview of the importance of tax planning at Paper P6

The aim of the Paper P6 syllabus is:

'To apply relevant knowledge and skills and exercise professional judgement in providing relevant information and advice to individuals and businesses on the impact of the major taxes on financial decisions and situations'.

Therefore, examination questions at Paper P6 are usually scenario based and frequently require elements of tax planning and the interaction of taxes.

Questions often examine tax planning elements in the form of writing a letter or report.

To answer these types of questions well, it is important to be able to:

- apply common sense and technical knowledge
- ensure the answer refers to the scenario given and the facts provided
- write in a clear and concise manner
- discuss issues, draw conclusions, express an opinion, and recommend any tax planning opportunities available, if required.

This chapter aims to help with tax planning type questions by:

- selecting some frequently tested examination scenarios,
- considering all the relevant taxes and topics applicable, and
- summarising the key points to consider when giving tax planning advice.

Much of the content of this chapter should be a familiar revision of facts given in earlier chapters in this manual.

1.2 General tax planning points for an individual

Tax planning is defined as the use of tax knowledge to develop strategies to minimise the amount of tax payable.

The primary aim of effective tax planning is to:

- minimise the cash flow cost, or
- maximise the cash flow benefit

resulting from the tax consequences of a transaction.

To achieve this, the customary basic tax planning advice given is to:

- maximise the benefits of:
  - exemptions,
  - allowances, and
  - reliefs
- try to minimise the rate of tax payable, or
- try to maximise the rate at which tax is repayable (for example, when utilising tax losses).

Note that if tax cannot be saved, deferring a tax liability is often good advice for cash flow management.

In giving tax planning advice, an accountant must always take into account:

- the key objectives of the taxpayer
- the family relationships involved
- the timing of the transaction(s)
- alternative ways of structuring the transaction(s)
- other non-tax factors influencing the decision.

It is important to appreciate that good tax planning advice is just one variable in an individual's decision making process. Strategies should not be based purely on the taxation consequences.

Other financial and commercial planning considerations of any suggested proposals should also be considered, such as:

- the personal circumstances of the individual (for example, the individual may be about to get married or start a family, about to retire, buy a house, be concerned about the possibility of being made redundant, suffering from ill health)
- the individual's objectives and future goals in life
- the individual's current and anticipated financial commitments
- the importance of cash flow to the individual
- the individual's attitude to financial risk.

These issues and the consideration of giving personal financial management advice are considered in more detail in chapter 19.

The rest of this chapter just addresses the consideration of giving tax planning advice.

Tax planning opportunities for a married couple and civil partners

- The objective of tax planning for a married couple
- Income tax planning points
- Capital gains tax planning points
- Inheritance tax planning points
- Unmarried couples

2 Tax planning opportunities for a married couple and civil partners

2.1 The objective of tax planning for a married couple

A married couple can take advantage of the inter-spouse exemption rules to ensure that they arrange their affairs to minimise the couple's overall total tax liabilities.

For simplicity, the text in this section will refer to married couples, spouses and husband and wife scenarios. However, it is important to appreciate that the same rules covered in this section apply to civil partners (i.e. same-sex couples who have acquired legal status for their relationship under the Civil Partnership Act 2004).

2.2 Income tax planning points

A married couple are treated as two separate individuals for income tax purposes.

Therefore, a married couple should ensure that each spouse fully utilises their own:

- personal allowance, and
- basic rate band

before either of them pay income tax at the higher rate.

If one spouse is paying tax at the higher rate and the other spouse has not fully utilised their allowance and basic rate band, tax planning advice should be given to:

- reduce the taxable income of the spouse paying the higher rate of tax, and
- increase the taxable income of the other spouse by an equivalent amount.

To achieve this, the following tax planning advice can be given:

- Gift income-producing assets from one spouse to the other spouse (see notes below)
- Put assets into joint names so that the taxable income is taxed on the basis of a 50:50 split between the spouses
- If the spouse paying the higher rate of tax has an unincorporated business:
  - employ the spouse, or
  - take the spouse on as a partner (see later section)

- Ensure that if any allowable interest payments or Gift Aid donations are made, they are paid by the spouse paying the higher rate of tax as relief is available at 40%.

Notes:

(1) To be effective for income tax purposes, if income-producing assets are gifted from one spouse to the other spouse, the gift must be an outright gift of the legal ownership of the capital asset which gives rise to the source of income. The original spouse can not retain any legal right to the asset or income in the future.

(2) The gift of capital assets from one spouse to another as suggested above is tax effective because:

– it achieves an income tax saving, and

– such inter-spouse gifts are not chargeable to capital gains tax (see next section).

Note that this tax advice can not apply retrospectively, it will only affect the treatment of future income generated.

A common tax planning examination question therefore gives a scenario and requires a discussion of the tax planning opportunities available to the couple, followed by a requirement to comment on the most tax efficient advice and/or a calculation of the tax savings that could have been achieved had the advice been given earlier (typically, at the start of the tax year).

Note that the potential tax savings achieved by transferring taxable income from the higher rate band of one spouse to the basic rate band of the other spouse are as follows:

		Rate of tax saving
Dividend income	(32½% - 10%)	22½%
Savings income	(40% - 20%)	20%
Other income	(40% - 20%)	20%

2.3 Capital gains tax planning points

A married couple are treated as two separate individuals for CGT purposes.

A married couple should ensure that each spouse fully utilises their:

- annual exemption, and
- available capital losses.

If one spouse is likely to have to pay CGT and the other spouse:

- will not fully utilise their annual exemption, and/or
- has capital losses available

tax planning advice should be given to:

- reduce the taxable gains of the spouse likely to pay CGT, and

- increase the taxable gains of the other spouse.

To achieve this, the following tax planning advice should be given:

- gift the chargeable assets which will give rise to taxable gains to the other spouse, and
- the other spouse disposes of the asset to a third party.

As a result, the recipient spouse will be treated as having made the gain, and can match any capital losses against the gain before deducting the annual exemption.

The gift of chargeable capital assets from one spouse to another is tax effective because inter-spouse gifts are treated as a nil gain / nil loss disposals. However, a gift will not be regarded as effective for CGT purposes if there is a prior agreement for the recipient to return the sale proceeds once the asset is disposed of.

2.4 Inheritance tax planning points

Inheritance tax planning advice can be separated into three main types:

- planning during the individual's lifetime to maximise available exemptions and reliefs
- planning to mitigate the IHT liability on death
- post-death tax planning.

Lifetime IHT planning

A married couple are treated as two separate individuals for IHT purposes. Therefore tax planning advice is the same advice that can be given to any individual.

Each individual should firstly ensure that each year they fully utilise their:

- annual exemption
- small gifts exemption
- wedding gifts exemption
- normal expenditure out of income exemption.

Lifetime gifts in excess of the IHT exemptions will be treated as PETs (or CLTs if put into a relevant property trust) for IHT purposes.

Even so, it is advantageous for an individual to make lifetime gifts in excess of these exempt amounts as early as possible.

Lifetime gifts of the following assets are recommended:

- cash (as cash is an exempt asset for CGT purposes)
- other assets exempt from CGT (for example, chattels, cars)
- appreciating assets which will not give rise to a significant CGT liability.

Care should be taken if other assets are gifted as there could be potential IHT and CGT implications of making lifetime gifts (see later section).

However, note that there is no tax advantage in making lifetime gifts of assets covered by 100% BPR or APR as they will be exempt from IHT whether gifted during the individual's lifetime or on death. They could also give rise to a CGT liability which may not be deferred with a CGT relief.

Gifting appreciating assets to another individual as early as possible during the donor's lifetime is good tax planning advice because:

- there is no IHT payable at the time of the gift
- the value of a PET is calculated as the market value of the asset at the time of the gift less any reliefs and exemptions available
- the value of a PET is therefore frozen at the time of the gift
- the PET will be completely exempt if the donor lives for 7 years
- even if the PET becomes chargeable, it may be covered by the nil rate band
- if IHT is payable, taper relief is available to reduce the amount of IHT payable arising if the gift is more than 3 years before the date of death.

A summary of the interaction of IHT and CGT in relation to lifetime gifts and legacies on death is covered in more detail in the next section of this chapter.

A married couple should ensure that each spouse fully utilises their:

- exemptions, and
- nil rate band.

If one spouse is likely to have to pay IHT and the other spouse:

- will not fully utilise their exemptions, and/or
- nil rate band

tax planning advice should be given to:

- gift assets to the other spouse, and
- the other spouse gifts the asset to a third party.

As a result, the recipient spouse will be treated as having the PET or CLT.

The gift of capital assets from one spouse to another is tax effective because inter-spouse gifts are exempt.

However, it is important to remember that if the spouse gifts some of, but not all of his assets of a particular type, the property gifted to the spouse is deemed to be related property for IHT purposes and will therefore affect the valuation of future gifts of that property by either spouse.

IHT planning to mitigate the liability on death

Every individual has an IHT nil rate band of £325,000.

However, where a surviving spouse dies after 8 October 2007, their nil rate band can be increased by the proportion of the nil rate band that was unused at the time the first spouse died. (Note that the date the first spouse died is irrelevant).

Example

Brian and Mavis were married for 30 years. Brian died in 2006. Half of his nil rate band was unused.

Required

Calculate the nil rate band available to Mavis.

Answer

Mavis will be entitled to her own nil rate band of £325,000 plus an additional £162,500 (£325,000 x ½) as this proportion was unused at the date of Brian's death.

Post-death tax planning

Deeds of variation

If an individual dies without leaving a will, or leaves a will with provisions which are not tax efficient or inequitable, the beneficiaries should be advised to enter into a deed of variation.

The detailed rules for entering into a deed of variation are covered in chapter 15.

2.5 Unmarried couples

The taxation consequences detailed above only apply to couples who are legally married or in a civil partnership. Couples who are unmarried should note the following points:

- Gifts from one individual to another will be classed as chargeable disposals for capital gains tax purposes if they consist of chargeable assets. The transfer will be deemed to take place at market value.
- For inheritance tax purposes, a gift to an unmarried partner has the same inheritance tax implications as a gift to any other individual. This means that a lifetime transfer will be treated as a PET; a transfer on death will not benefit from the spouse exemption.

Lifetime giving versus leaving legacies in a will

3 Lifetime giving versus leaving legacies in a will

3.1 The interaction of IHT and CGT

Lifetime gifts have both IHT and CGT consequences. However, the liability to tax is calculated in completely different ways.

A common examination scenario is to consider both the IHT and CGT implications of proposed lifetime gifts and to discuss whether gifts should be made during an individual's lifetime or on his death in his will.

3.2 A summary of the capital tax implications of lifetime gifts

The following tables summarise the key points to bear in mind when considering lifetime gifts:

Inheritance Tax

Assessed on gifts of:	■ any capital asset (there are no exempt assets for IHT) ■ to any other person (only exceptions = gifts to spouse, charity or qualifying political party)
Taxable amount:	■ Diminution in the value of the estate = Value of estate before the gift less Value of the estate after the gift (Beware of special valuation rules and related property) ■ Less BPR/APR (if relevant property and/or replacement property held for minimum period of ownership) (Beware of related property) ■ Less specific exemptions (small gifts, wedding gifts) ■ Less annual exemptions £3,000 (current year, then previous year, if available)

Rate of tax:	■ If a PET – no lifetime IHT ■ If a CLT – lifetime tax to pay – at 20% or 25% – on excess over nil rate band ■ If within 7 years of death – gross amount of both PETs and CLTs taxed – at 40% on excess over nil rate band of £325,000 – deduct taper relief (if between 3 – 7 years before death) – deduct any amounts paid in lifetime (if a CLT) (Beware of – claw back of BPR, if property not owned by donee at date of donor's death, and – fall in value relief)
Due date for 2009/10	■ If a PET – no lifetime IHT ■ If a CLT – first half of tax year: = 30 April 2011 – second half of tax year: = 6 months after end of month of gift

Capital Gains Tax

Assessed on gifts of:	■ chargeable assets only (not exempt assets e.g. cash, cars, PPR) ■ to any other person (main exception = gifts to spouse)
Taxable amount:	■ MV of asset actually gifted (no such thing as related property) ■ Less Original cost and enhancement expenditure ■ Less specific reliefs (if qualifying business assets: gift relief, rollover relief, entrepreneurs' relief) ■ Less capital losses available (all of current year, then brought forward but can restrict offset) ■ Less annual exemption £10,100
Rate of tax:	■ 18% tax
Due date for 2009/10	■ 31 January 2011

3.3 The capital tax consequences of common lifetime gifts

The following table highlights key points to bear in mind when considering lifetime gifts to other individuals which often feature as part of an examination question:

	IHT	CGT
Cash or Motor car	■ PET ■ No BPR	■ Exempt asset
Chattels	■ PET ■ No BPR	■ Chargeable disposal (unless cost and sale proceeds below £6,000) ■ No gift relief
PPR	■ PET ■ May be a GWR ■ No BPR	■ Chargeable disposal ■ PPR and letting relief available ■ No gift relief
Unincorporated business	■ PET ■ 100% BPR ■ (only if owned for at least 2 years and a trading business) ■ (restrict for excepted assets)	■ Separate gains on all of the chargeable assets in the business ■ Gift relief available
Unquoted shares	■ PET = diminution in value ■ Take account of related property, if applicable ■ 100% BPR (only if owned for at least 2 years and a trading business) (restrict for excepted assets)	■ Chargeable disposal = MV of shares gifted ■ Gift relief available (regardless of size of holding, but may be restricted by CBA/CA if hold at least 5% interest)
Quoted shares	■ PET ■ 50% BPR (only if donor has controlling interest, owned for at least 2 years and a trading business) (restrict for excepted assets)	■ Chargeable disposal = MV of shares gifted ■ Gift relief available (only if own at least 5% of voting power, may be restricted by CBA/CA)

3.4 A summary of the capital tax implications of legacies on death

The following tables summarise the key points to bear in mind when considering legacies in a will on death:

Inheritance Tax

Assessed on:	■ Lifetime PETs and CLTs within 7 years of death (as above) ■ Value of the estate on death
Taxable amount of estate:	■ Probate value (i.e. market value) of all assets owned at date of death (Beware of special valuation rules, GWR, APR, BPR and related property) ■ Less legally enforceable liabilities ■ Less funeral expenses ■ Less exempt legacies ■ (gifts to spouse, charity or qualifying political party)
Rate of tax:	■ at 40% on excess over nil rate band of £325,000 ■ deduct DTR and QSR, if applicable
Due date	■ 6 months after end of month of death

Capital Gains Tax

Assessed on:	■ No CGT payable on gifts due to the death of an individual ■ Beneficiaries acquire assets at probate value

Employed versus self-employed

- The consequences of employment versus self-employment
- The consequences of taking on a partner versus employing an individual

4 Employed versus self-employed

4.1 The consequences of employment versus self-employment

The distinction between employment and self-employment is very important because there are legal obligations and rights attached to employment which do not apply to the self-employed (for example, the right to sick pay and holiday pay).

The key tax advantages of self-employment compared with employment are that:

- the total income tax and NICs payable are usually lower
- there are more expenses allowable for tax purposes, and
- the due dates for payment of tax and NICs are later.

The following table summarises the main taxation consequences arising from being deemed to be employed or self-employed.

	Employed	**Self-employed**
Income assessed	Employment income = Salary + bonuses + benefits less Allowable deductions (e.g. occupational pension contributions, professional subscriptions)	Trading income = Adjusted trading profits Less Capital allowances (e.g. plant and machinery, IBAs)
Basis of assessment	Actual receipts basis	Current year basis Special opening and closing year rules

Table continues

	Employed	Self-employed
Allowable expenses	Those expenses incurred: ■ wholly ■ exclusively, and ■ necessarily in the performance of duties	Those expenses incurred: ■ wholly, and ■ exclusively, for the purposes of the trade
Private use of assets	Assessed as: ■ an employment benefit (e.g. company cars) ■ but some benefits are exempt (e.g. mobile phones)	Assessed by: ■ adding back to profit the private use proportion of related expenses ■ not allowing capital allowances for the private use element
Pension contributions	Amount of relief = Higher of (i) £3,600 and (ii) 100% of employment income Method of relief = ■ through PAYE if paid into occupational scheme	Amount of relief = Higher of (i) £3,600 and (ii) 100% of trading income Method of relief = ■ Basic rate relief at source ■ Higher rate relief by extension of basic rate band
Payment dates for income tax for 2009/10	Monthly via PAYE system	Payable under self-assessment: ■ POA 1: 31 January 2010 ■ POA 2: 31 July 2010 ■ Balancing payment: 31 January 2011
National Insurance	Class 1 primary contributions = Maximum £4,198 plus 1% on cash earnings in excess of £43,875	Class 2 contributions = Maximum £125 Class 4 contributions = Maximum £3,053 plus 1% on trading profits in excess of £43,875
Payment dates for NICs for 2009/10	Monthly via PAYE system	Class 2 = Monthly direct debit, or Quarterly billing Class 4 = Payable under self-assessment with income tax (as above)

4.2 The consequences of taking on a partner versus employing an individual

Taking on a partner

The following table summarises the taxation consequences of taking on a partner from the point of view of the business, the sole trader and the new partner.

Business	Sole trader	New partner
Adjustment of profit *Partners' salaries* = an appropriation of profit and not an allowable deduction against trading profits *Capital allowances* = available for the partners' cars and other private use assets, but private use restrictions apply *Motor expenses associated with partners' cars* = an allowable deduction against trading profits, but private use restrictions apply	*Income tax - Basis of assessment* The sole trader becomes a partner and is assessed to income tax and NICs on his share of the partnership profits The sole trader will continue to be assessed to income tax on a current year basis	*Income tax - Basis of assessment* A partner joining the business is assessed to income tax and NICs based on his share of the partnership profits: ■ from the date they join ■ as if they were a sole trader starting to trade (i.e. the opening year rules apply) ■ overlap profits will arise and will be carried forward as normal
NICs The business does not pay any NICs	*NICs* Class 2 and Class 4 NICs payable	*NICs* Class 2 and Class 4 NICs payable
Payment of tax The business does not pay any income tax and NICs	*Payment of tax* The sole trader is responsible for paying his own income tax and NICs on his share of the profits	*Payment of tax* The new partner is responsible for paying his own income tax and NICs on his share of the profits

Taking on an employee

The following table summarises the taxation consequences of taking on an employee, from the point of view of the business, the sole trader and the new employee.

Business	Sole trader	New employee
Adjustment of profit *Employee's remuneration and associated NICs* = allowable deductions against trading profits *Capital allowances* = available in full for the employee's car and other private use assets; no private use restrictions apply *Motor expenses associated with employee's car* = all costs are an allowable deduction in full against trading profits; no private use restrictions apply	*Income tax - Basis of assessment* The sole trader is assessed to income tax and NICs on all of the taxable trading profits of the business The sole trader will continue to be assessed to income tax on a current year basis	*Income tax - Basis of assessment* The employee is assessed on his employment income, including benefits Taxed on an actual receipts basis of assessment *Company car* = Assessed using the employment benefit rules based on the list price and CO_2 emissions, and fuel benefit if private fuel provided
NICs Class 1 secondary NICs payable in respect of employee's cash earnings Class 1A NICs payable in respect of benefits provided to the employee	*NICs* Class 2 and Class 4 NICs payable	*NICs* Class 1 primary NICs payable
Payment of tax The business is responsible for accounting to HMRC for: ■ the employee's income tax and Class 1 NICs via PAYE and ■ Class 1A NICs by 19 July following the end of the tax year	*Payment of tax* The sole trader is responsible for paying his own income tax and NICs	*Payment of tax* The employee's income tax and NICs are deducted from his gross salary via PAYE

The same factors need to be considered where the individual to be taken on to help in the business is the individual's spouse. However, in this scenario, the impact on the couple's total tax position needs to be considered.

Where one spouse is a sole trader and the level of profits is such that he is paying the higher rate of tax, but the spouse is a basic rate taxpayer, it may be advantageous to take on the spouse as a partner or an employee.

It is often more advantageous to take on the spouse as a partner because:

- the partnership profits can be shared in any proportion regardless of the duties performed by the spouse. It is therefore possible to ensure that each spouse utilises their basic rate band and the minimum amount of income tax is paid on the trading profits. However, if employed, remuneration is only allowable if it represents reasonable pay for the service provided to the business.
- the total NIC burden is usually lower.

However, this may not always be the case and to decide on the optimum route, a comparison of the overall net income for the couple, after all taxes, needs to be produced.

Tax consequences of incorporation

5 Tax consequences of incorporation

5.1 Overview of the consequences of incorporation

The key factor in an incorporation scenario is that the individual owner of the unincorporated business retains his interest in the business, but in a different form. He becomes a director/shareholder in a separate legal entity, the company, with an interest in the shares of the company. (If the individual did not remain involved in the business, there would be a disposal of the business, and the tax rules for incorporation would not apply.)

5.2 Summary of the main taxation consequences of incorporation

The main tax rules arising when a business is incorporated are as follows.

Capital gains tax

On incorporation, an individual is usually transferring his unincorporated business to a company in return for shares and other consideration (such as cash or debentures) which have the same value as the value of the unincorporated business.

A separate chargeable gains computation must be made in respect of **each** chargeable asset disposed of to the company:

- using the rules applicable to individuals, and
- taking as the disposal consideration the full market value of the assets at the date of incorporation.

Incorporation relief is available to defer the gains on the disposal of the unincorporated business until the individual disposes of the shares he acquires in the company (see below)

Income tax

The trade ceases and the closing year basis of assessment rules are applied.

The final capital allowances computation has no WDA. Balancing charges and/or allowances arise, assuming the assets are disposed of for their full market value at the date of incorporation.

An exception to this rule applies when the newly-incorporated company is controlled by the previous owner of the business and an election is made to transfer the assets to the company at their tax written down values. This is known as a 'succession election' and was covered in chapter 6

Terminal loss relief and incorporation loss relief may be available, if applicable. Terminal loss relief was covered in chapter 7. Incorporation loss relief is covered below.

VAT

No VAT consequences arise as the business is transferred as a going concern, (see chapter 25).

Taxation of the individual

The individual will be liable to income tax on employment income and dividends in the future, not to income tax on trading income.

If an employee, the individual will also be liable to Class 1 primary NICs, not Class 2 and 4 NICs.

Taxation of the profits of the business

The business will now be liable to corporation tax and not income tax.

The company can claim capital allowances on the assets transferred, based on their transfer value (i.e. market value at the date of incorporation or TWDV if the succession election is made).

5.3 Unrelieved trading losses

Where an unincorporated business ceases to trade because it becomes incorporated (i.e. it is converted into a company), loss relief may be available under s86 ITA 2007 for any unrelieved losses.

For s86 relief to be available the following conditions must be satisfied:

- The business is ceasing because it is being transferred as a going concern to a company.
- The consideration is **wholly or mainly** in the form of shares.
- The company continues to carry on the business of the previous owner.
- The previous owner of the business retains the shares throughout the tax year in which loss relief is being claimed.

'Mainly' in this context is taken to mean at least 80% of the consideration is in the form of shares.

Section 86 allows the **unrelieved** trading losses to be **carried forward indefinitely** and set off against the **first available income derived from the new company**.
The rules for the relief are as follows:

- The trading loss must be set off in the next tax year if possible.
- The set-off is against any employment income, interest and dividend income received by the previous owner from the company. The trading loss cannot be set off against other income or gains.
- In each future tax year, the maximum amount of trading loss must be set off until relief has been given for the total trading loss.
- The loss cannot be transferred to, and utilised by, the company. Under s86 the loss can only be relieved against the future **personal income** received by the individual from the company.

5.4 Incorporation relief for capital gains

Incorporation relief is an automatic relief which defers the net gains arising on incorporation where the following conditions are satisfied:

- The transfer must be of a business as a going concern.
- All the assets in the business must be transferred. (The only exception is that the owner is allowed to retain the cash in the unincorporated business.)
- The consideration received from the company must be wholly or partly in the form of shares.

The mechanics of incorporation relief

If the consideration for the business is received **wholly** in the form of shares:

- all the gains are deferred against the base cost of the shares acquired
- no chargeable gains arise at the time of incorporation
- the gain crystallises when the individual disposes of the shares in the future.

If the consideration for the business is received **only partly** in the form of shares, the amount of gain deferred against the base cost of the shares is calculated as follows:

$$\text{Gains to be deferred} = \text{Gains} \times \frac{\text{Market value of shares acquired}}{\text{Market value of total consideration}}$$

$$\text{Gains to be taxed on incorporation} = \text{Gains} \times \frac{\text{Market value of non-share consideration}}{\text{Market value of total consideration}}$$

Any deferred gain is deducted from the base cost of the shares as follows:

	£
Market value of the shares issued on incorporation	X
Minus: Gains deferred	(X)
Base cost of shares	X

Incorporation relief is automatic if the conditions are satisfied, therefore no claim is required. However, the relief can be dis-applied if the taxpayer prefers (for example if he wishes to make use of entrepreneurs'relief, capital losses or his annual exemption).

The election to dis-apply incorporation relief must be made within two years of 31 January following the end of the tax year in which the business is transferred.

Example

On 23 March 2010 Poppy sells her business to TY Ltd for £140,000, realising gains of £45,000 on her chargeable business assets which she has held for many years. She will become a director/shareholder of TY Ltd.

Required

Calculate the chargeable gains arising in 2009/10 and the base cost of the shares acquired in TY Ltd assuming the following alternative amounts of consideration are received:

(a) 80,000 £1 ordinary shares

(b) Cash of £40,000 and 50,000 £1 ordinary shares in TY Ltd.

a

Answer

(a) Consideration received wholly in the form of shares

No chargeable gain arises in 2009/10.

Base cost of the 80,000 £1 ordinary shares received:

	£
Market value of the shares issued on incorporation	140,000
Minus Gains deferred	(45,000)
Base cost of shares	95,000

(b) Consideration partly in the form of shares and partly cash

	£
Total consideration = market value of business	140,000
Minus Cash received	(40,000)
Value of shares	100,000

$$\text{Gains to be deferred} = £45{,}000 \times \frac{£100{,}000}{£140{,}000} = £32{,}143$$

$$\text{Gain to be taxed on incorporation} = £45{,}000 \times \frac{£40{,}000}{£140{,}000} = £12{,}857$$

Base cost of the 50,000 £1 ordinary shares received:

	£
Market value of the shares issued on incorporation	100,000
Minus: Gains deferred	(32,143)
Base cost of shares	67,857

CHAPTER 19

Personal financial planning

Contents

Sources of finance

- Sources of finance available to individuals
- Mortgage products
- Tax treatment of borrowing

1 Sources of finance

1.1 Sources of finance available to individuals

The main sources of finance available to an individual are:

- **Bank overdrafts** - These should always be agreed with the bank in advance otherwise a higher rate of interest and charges may be incurred. Overdrafts are repayable on demand and should only therefore be used as a short-term source of finance.
- **Loans** - These may be secured or unsecured. Secured loans tend to be cheaper but, as they are usually secured on the individual's home, borrowers who default run the risk of being made homeless.
- **Credit cards** - Interest rates vary widely. Some have an introductory rate of 0%, but this tends to be for a limited period. A very expensive way of borrowing in the long-term, especially if the borrower only repays the minimum amount every month.
- **Store cards** - Similar to credit cards, but usually only valid in one particular store or group of stores. Interest rates tend to be extremely high. As a result, it is not advisable to view them as a source of finance.
- **Mortgages** - Usually the cheapest form of finance available to an individual. However, as the loan is secured on the property, a borrower who defaults on the repayments may have their property repossessed by the lender.

1.2 Mortgage products

For most people, the biggest purchase they will ever make will be their own home. Few people can afford to purchase a house outright with their available funds, so a mortgage will be a necessity.

Most mortgages are for a fixed term, typically 25 years. There are numerous different products available, the most common in terms of the way in which they charge interest are:

- **Fixed rate mortgage** - Under this type of mortgage, the interest rate is fixed at the outset. The fixed rate will usually only last for the first few years of the mortgage. It is possible to fix the rate for the full term, but this is fairly unusual.
- **Variable rate mortgage** - The interest rate on this type of mortgage will go up or down depending on the movement in the Bank of England base rate. The actual movement in the rate is usually determined by the lender, although it is possible to arrange a deal whereby the interest rate will track the movement in the Bank of England base rate.

- **Offset mortgage** - This type of product is most suitable for people who have a high level of savings. The mortgage typically comes with a linked savings account. The balance on the savings account is offset against the balance still owing on the mortgage and the mortgage interest is then calculated on the net balance. The individual benefits from this arrangement because the interest rate payable on savings accounts is usually less than that charged on a mortgage. In addition, as the individual is benefiting from a reduction in the mortgage interest they have to pay (rather than receiving interest on their savings) there is the added bonus of no income tax liability on their savings.

In addition to paying the interest on the sum borrowed, the individual will have to eventually repay the capital. Again there are a number of different options:

- **Repayment mortgage** - This is the most common type of mortgage. A repayment of capital is made every month. In the early life of the mortgage, the repayment will consist mainly of interest with only a small amount of capital. In the later stages, it will consist mainly of capital with only a small amount of interest.
- **Endowment mortgage** - With this type of mortgage, the borrower only pays interest. A separate savings policy is taken out with a life assurance policy. The amount paid in to the savings policy, together with the income and capital growth generated by the policy, is designed to ensure that the investment grows into a sum sufficient to repay the capital at the end of the mortgage term. Endowment policies were very popular in the 1980s when interest rates and capital growth were high. However, in more recent years, they have fallen out of favour as many policies have performed poorly and left borrowers needing to find other sources to repay their mortgages.
- **ISA or pension mortgages** - These are a variation on the endowment mortgage. The borrower pays into an ISA or pension plan with the aim that the funds generated will be sufficient to repay the mortgage at the end of its term.

1.3 Tax treatment of borrowing

The interest paid in respect of borrowing is not an allowable deduction for income tax purposes unless it is **for a qualifying purpose**. All qualifying loan interest is paid gross.

If the loan is taken out to finance expenditure which is wholly and exclusively for the purposes of a trade, the interest is treated as a trading expense and is an allowable deduction in the trading income computation.

Interest on loans taken out **for the following qualifying purposes** will receive relief by deduction from total income as outlined in chapter 2:

- Loans to buy a share in, increase capital to, make a loan to, or purchase plant or machinery for use in a partnership in which the individual is a partner
- Loans to buy plant or machinery for use in the individual's employment
- Loans to buy ordinary shares in an employee controlled company in which the individual is a full-time employee and the company is a UK resident unquoted trading company
- Loans to buy ordinary shares in, or make a loan to, a close company (see later chapter).

Tax efficient investments

- The characteristics of key investment opportunities
- The tax advantages of key investment opportunities
- Choosing a suitable investment

2 Tax efficient investments

2.1 The characteristics of key investment opportunities

There are many investment opportunities available on the market for an individual to use any surplus funds/savings:

- Land and buildings
- Chattels and works of art
- Shares and securities
- Pension funds
- Cash based investments (such as bank and building society accounts, National Savings Certificates, premium bonds).

Each investment has different characteristics:

- **Liquidity**

  Some investments are easy to access and can be immediately converted into cash. Other investments may require notice, incur penalties to access within certain time periods (for example, certain deposit accounts) and/or may take considerable time to convert into cash (for example, property).

- **Yield**

  Some investments yield high income levels and offer low capital growth. Other investments yield a low income but give high capital growth.

- **Financial risk**

  Some investments are risky in that the investor may lose the capital invested. Others are less risky and the investor may only risk losing interest earned.

- **Tax advantages**

  Some investments are exempt from tax and some benefit from tax reliefs.

2.2 The tax advantages of key investment opportunities

The taxation treatment of the main types of investment income was covered in chapter 3. The following table summarises key investment products which give the individual tax advantages:

Investment	**Tax advantages**
Principal Private Residence	Usually yields a capital gain on disposal. Only yields income if the property is let Exempt from CGT on disposal for periods of actual and deemed occupation under PPR relief rules Maximum £40,000 of gain exempt from CGT under letting relief rules, if PPR is let to residential tenants Maximum £4,250 p.a. rental income exempt from income tax under rent-a-room relief where accommodation is in the taxpayer's main residence
Chattels	May yield a capital gain on disposal, unlikely to yield any income Exempt from CGT if bought and sold for no more than £6,000
Gilts and QCBs	Fixed interest security Exempt from CGT on disposal Annual interest is assessed to income tax in normal way
National Savings Certificates	Deposit based investment Usually yield interest which is accumulated until the certificate is cashed in, no capital gain on disposal Exempt from income tax
Premium Bonds	May yield cash winnings, no capital gain on disposal Exempt from income tax
Cash ISA	Deposit based investment Usually yield annual interest, no capital gain on disposal Exempt from income tax, but maximum annual investment is £3,600 (or £5,100 if investor aged 50 or more) As regards the tax incentives, there is no minimum investment period, no minimum contribution and no penalty for withdrawal of capital (however, the bank or building society with which the money is deposited may set its own conditions)
Stocks and shares ISA	Usually yield dividends/interest and capital gains on the disposal of shares Exempt from income tax and CGT, but maximum annual investment is £7,200 (or £10,200 if investor aged 50 or more) No minimum investment period, no minimum contribution and no penalty for withdrawal of capital

Investment	Tax advantages
EIS shares	Usually yield dividends and capital gains on the disposal of shares 20% income tax investment relief available when individual subscribes for the shares but maximum annual investment rules (£500,000) apply Can defer the gain on any asset if proceeds reinvested in qualifying EIS shares under the reinvestment relief rules Exempt from CGT on disposal if shares held for at least three years Relief is available for capital losses Income tax relief is not clawed back if shares held for at least three years However, dividends are assessed to income tax in normal way
VCT shares	Usually yield dividends and capital gains on the disposal of shares 30% income tax investment relief available when individual subscribes for the shares but maximum annual investment rules (£200,000) apply No reinvestment relief available for VCT shares Exempt from CGT regardless of the length of ownership Income tax relief is not clawed back if shares held for at least five years Dividends are exempt from income tax
Pension funds	The fund usually yields dividends/interest and capital gains on the disposal of assets each year The individual usually receives a lump sum and stream of pension income on retirement Income tax relief available at highest marginal rate of tax when the individual contributes into the scheme - but maximum annual contribution rules (higher of £3,600 or 100% of earnings) apply, and - additional 40% income tax charge applies if total contributions exceed the annual allowance (£245,000) The fund is exempt from income tax and CGT On retirement: - exempt lump sum can be drawn up to a maximum of (25% × lifetime allowance of £1,750,000) - pension income is assessed to income tax in the normal way - additional charge to income tax if the fund exceeds the lifetime allowance

Note that tax exemptions and reliefs may not cover all of the income generated from an investment and all of the capital gains arising on its disposal.

If an amount of income is taxable after exemptions and reliefs, in recommending an investment, it is important to remember that the rate of income tax which applies to the source of income generated from the investment is as follows:

Dividend income	10% / 32½%
Savings income	10% / 20% / 40%
Other income (e.g. rental income)	20% / 40%

2.3 Choosing a suitable investment

An exam question on this topic will usually give you a few facts about an individual and then require you to suggest suitable investments for them. Here are some indications of what you should look out for:

- If the individual needs access to their money within a short period of time, say within a year, suggest deposit-based investments such as banks and building society accounts, gilts or cash ISAs. Equity-based investments are not a suitable short term investment as they do not have time to grow and the dealing costs may exceed any gains.
- If the individual is cautious and does not want to risk their capital, again suggest deposit based investments. These offer virtually no risk to the investor's capital. Do not suggest equity-based investments as these can go down in value as well as up.
- If the individual is happy to accept a moderate amount of risk and is able to leave their money invested for five years or more, suggest equity investments such as stocks and shares ISAs or unit trusts. These could go down in value, but over the long-term they do tend to rise.
- If the individual is prepared to accept a high degree of risk, suggest investment in unquoted securities. Ideally, investment should be made through the EIS or VCT schemes as the tax breaks available help to cushion any potential fall in value.
- If the individual wants income, for example because they are a pensioner, suggest deposit-based investment and gilts. These pay interest regularly and the amount is fairly predictable. Equity-based investments might pay dividends, but there is no guarantee of this. A company may decide not to pay a dividend in a year in which profits are low or if it has no available cash.
- If the individual is a higher rate taxpayer, capital growth will be more suitable than income. Equity-based investments should therefore be suggested.

Giving investment advice

- Authorisation
- Penalties for carrying on unauthorised investment business

3 Giving investment advice

3.1 Authorisation

In order to carry out investment business (which includes giving investment advice), an individual or firm:

- must have obtained an appropriate qualification, such as the Financial Planning Certificate, and
- must be authorised by the Financial Services Authority or a designated professional body, such as the ACCA.

Authorisation is not needed to give general information about the tax implications of an investment. However, authorisation is needed to give specific advice as to which particular product to invest in.

3.2 Penalties for carrying on unauthorised investment business

A person who carries on investment business without being authorised to do so commits a criminal offence. The penalty is a maximum two years in prison and/or an unlimited fine.

There are also civil penalties:

- Any agreement entered into by an unauthorised person is unenforceable by that person.
- The customer may take civil action in the courts to recover any money paid and may seek compensation for any losses suffered. The adviser should have adequate professional indemnity insurance to cover this type of claim.

CHAPTER 20

Introduction to corporation tax

Contents

The scope of corporation tax

- The basic charging rules
- Determining the residence status of a company

1 The scope of corporation tax

1.1 The basic charging rules

A company is liable to pay UK corporation tax on its profits chargeable to corporation tax (PCTCT) for a chargeable accounting period (CAP). Both public limited companies and private limited companies are liable to corporation tax on their profits.

To calculate the corporation tax liability, it is first of all necessary to calculate the amount of the profits chargeable to corporation tax. To determine a company's PCTCT, it is important to establish whether or not the company is resident in the UK. The residence status of a company is important because:

- A UK resident company is liable to UK corporation tax on all of its profits, generated anywhere in the world (worldwide PCTCT).
- A non-UK resident company is only liable to UK corporation tax on profits that have been generated in the UK through a permanent establishment situated in the UK (for example, profits earned by a branch or an agency). Its foreign income (profit earned in other countries) is not taxable in the UK.

1.2 Determining the residence status of a company

A company is UK resident, and therefore liable to UK corporation tax on its worldwide PCTCT, if one of the following conditions applies:

- it is incorporated in the UK, or
- it is not incorporated in the UK, but its centre of management and control is situated in the UK.

To determine where the centre of management and control for a company is situated, HMRC will look at where the directors hold their regular board meetings.

Overview of a corporation tax computation

- The profits chargeable to corporation tax
- Determining the accounting period which is chargeable to corporation tax
- Winding up

2 Overview of a corporation tax computation

2.1 The profits chargeable to corporation tax

The figure of profits chargeable to corporation tax (PCTCT) consists of:

- taxable income generated from all sources, **plus**
- capital gains from the disposal of chargeable capital assets, **after deducting**
- gift aid donations.

2.2 Determining the accounting period which is chargeable to corporation tax

The chargeable accounting period (CAP) for corporation tax purposes is usually the same as the period of account, i.e. the period for which the company prepares its financial accounts.

- A CAP commences on:
  - the commencement of trade
  - the date the profits of the company first become liable to corporation tax
  - the day following the end of the previous CAP.
- A CAP ends on the earliest of:
  - 12 months after the beginning of the CAP
  - the end of the company's period of account
  - the date the company ceases to trade.

It is important to note that **a CAP cannot exceed 12 months in length**. The treatment of a long period of account is covered later.

2.3 Winding up

An accounting period ends when a winding up begins and a new accounting period commences. Thereafter, accounting periods end on the anniversary of the start of winding up. The final accounting period ends when the winding up ends.

Distributions made after the commencement of winding up are not treated as income in the hands of the shareholders. Instead, they treated as part disposals of the shares for capital gains tax purposes.

The statement of profits chargeable to corporation tax (PCTCT)

- Overview of the PCTCT statement
- Trading income
- Property income
- Foreign income
- Interest income
- Dividends
- Gift aid donations

3 The statement of profits chargeable to corporation tax (PCTCT)

3.1 Overview of the PCTCT statement

The first step in preparing a corporation tax computation is to produce a list of the sources of income and chargeable gains which are taxable.

The list should be presented as follows.

Name of company

Corporation tax computation – year ended dd.mm.yy	**£**
Income	
Trading income (adjusted profits less capital allowances)	X
Interest income	X
UK property income	X
Foreign income	X
Capital gains	
Net chargeable gains (chargeable gains less allowable losses)	X
	X
Gift Aid donations	(X)
Profits chargeable to corporation tax (PCTCT)	X

It is important to list each source of income separately. This is because the rules for determining the amount of income that is chargeable to corporation tax are different for each source of income. The detailed computations to calculate the amounts of assessable income and chargeable gains are explained later.

3.2 Trading income

Trading income is usually the primary source of income for a company. It is computed in the same way as for income tax purposes, however, there is no adjustment for private expenditure. Thus if the company provides a car for the use of a director or employee all of the expenditure, including that relating to private mileage, is deductible. Similarly, capital allowances are not restricted in respect of private use.

3.3 Property income

Property income is calculated in the same way as for income tax purposes. Note, however, that any interest paid is allowed as a deduction in calculating the company's interest income, as opposed to its property income.

The treatment of property business losses is covered in the next chapter.

3.4 Foreign income

If a company is UK resident, it is liable to UK corporation tax on its worldwide profits. Therefore any foreign income, such as overseas rental income or foreign interest, must be brought into the PCTCT statement and taxed.

Foreign income must be brought into the PCTCT statement gross of any foreign tax suffered in the foreign country.

e

Example

N Ltd received rental income of £46,750 from a property in Spain, after overseas tax of 15% had been deducted at source.

Required

Calculate the foreign income to include in the PCTCT statement for N Ltd.

a

Answer

	£
Net income received	46,750
Overseas tax suffered (= £46,750 × 15/85)	8,250
Gross foreign income	55,000

Alternative calculation: £46,750 × 100/85 = £55,000

3.5 Interest income

A loan relationship occurs where the company is either:

- lending money

  (for example, purchases a debt instrument such as debentures or loan stock in another company, or purchases gilt-edged securities from the Government such as Treasury stock or Exchequer stock), or

- borrowing money

  (for example, borrows from a bank or building society, or issues its own corporate debt instruments such as debentures or loan stock).

The loan relationship rules apply to any amounts charged/credited to the profit and loss account in respect of the loan, for example, loan arrangement fees as well as interest.

Lending and borrowing money can be undertaken either:

- for the purposes of the trade, for example to provide working capital for the business or to buy plant and machinery, or
- for non-trading purposes, for example investing surplus cash in a bank deposit account.

Interest receivable

In the examination, all interest **receivable** should be treated as **non-trading income**. It is therefore taxed as interest income, rather than as a part of trading income.

All interest received by companies, such as bank interest, building society interest, debenture interest and interest received from HMRC on overpaid tax, is received gross.

Interest income is taxed on an accruals basis. This means that the gross amounts of interest income credited in the financial accounts for the CAP (i.e. amounts received and receivable) must be brought into the PCTCT statement.

Interest payable

Non-trading interest payable and trading interest payable are both allowable expenses, but they are treated differently.

Non-trading interest payable includes items such as interest payable in respect of a loan to purchase an investment property or an investment in shares in another company, and interest payable to HMRC on underpaid tax. Non-trading interest payable is an allowable deduction against **interest income**.

Trading interest payable is treated as an allowable trading expense against **trading income** and is not deducted from interest income.

In the examination, interest payable on the company's debentures and loan stock, hire purchase interest payable and interest payable on a loan to purchase plant and machinery, are all deemed to be interest payable for a trading purpose.

Proforma interest income computation

To calculate the interest income assessment for a PCTCT statement, it is often necessary to prepare a separate working, as follows:

Interest income		**£**
Interest receivable		X
Minus:	Interest payable to purchase investment property	(X)
	Interest payable to purchase shares	(X)
	Interest on underpaid corporation tax	(X)
	Non-trade loan written off	(X)
Interest income		X

Notes

(1) Debenture and loan stock interest **payable** is usually treated as allowable trading interest and is therefore not deducted in this working.

(2) If this working produces a negative figure, the interest income assessment in the PCTCT statement is £0. The loss that arises can be utilised in a variety ways. This is covered in a later chapter.

Example

K plc has given you the following information in respect of the year ended 31 December 2009:

	Received/ paid	**Credited/charged in the accounts**
	£	£
Bank interest received / receivable	4,800	5,500
Interest received / receivable on £100,000 10% loan stock purchased in X Ltd	12,000	10,000
Interest paid / payable on £50,000 12% debentures K plc issued last year	6,600	6,000
Interest paid / payable on a loan taken out to buy shares in a Z Inc, a foreign company	2,300	2,300

Required

Calculate the interest income to be included in K plc's PCTCT statement for the year ended 31 December 2009.

Answer

K plc – Interest income	**£**
Bank interest receivable	5,500
Loan stock interest receivable	10,000
	15,500
Minus: Interest payable to purchase shares	(2,300)
Interest income	13,200

Note: The debenture interest **payable** of £6,000 is treated as allowable deduction against trading income and is therefore not deducted from interest income.

3.6 Dividends

Dividends received from non-associated companies

For the purpose of the P6 examination, dividends from both UK and overseas companies are ignored in computing PCTCT. However, dividends from non-associated companies are classed as franked investment income and are therefore taken into account in determining the recipient company's 'profits' (see later).

A company is associated with another if one controls the other or both are under the control of the same person. (Associated companies will be covered in more detail later in this chapter.)

Dividends received from associated companies

Dividends received from associated companies are classed as 'group income'. They are not taken into account in determining the recipient company's 'profits'.

Dividends paid

Dividends paid by the company to its own shareholders are excluded from the PCTCT statement.

3.7 Gift Aid donations

Companies make payments to charities under the Gift Aid scheme gross. The gross amount paid in the CAP is deducted in computing PCTCT.

Note that the amount charged in the financial accounts in respect of Gift Aid payments is calculated on an accruals basis (i.e. amounts paid and payable in the CAP) but only the gross amount actually paid is an allowable deduction for corporation tax purposes.

Chargeable gains

- Net chargeable gains: overview
- The indexation allowance
- Shares and securities
- Substantial shareholdings

4 Chargeable gains

4.1 Net chargeable gains: overview

A company pays corporation tax not only on its income but also on capital gains arising from the disposal of chargeable capital assets.

The PCTCT statement includes the net chargeable gains of a company. These consist of:

- chargeable gains arising in the CAP, minus
- allowable capital losses arising in the CAP, and minus
- any capital losses brought forward from an earlier CAP.

The calculation of gains for companies is similar to the calculation of gains for individuals. However, there are some important differences:

- companies receive an indexation allowance
- companies do not receive an annual exemption.

4.2 The indexation allowance

The indexation allowance (IA) eliminates any inflationary gains. As a result, a company is only taxed on the real growth in value of any capital assets it sells.

The IA is based on the movement in the retail prices index (RPI). It is given from the date the expenditure is incurred to the date of disposal and is **calculated separately for each element of allowable expenditure**.

The indexation allowance is calculated as follows:

IA = Cost × **Indexation factor**

$$\text{Factor} = \frac{\text{RPI for month of disposal - RPI for month of expenditure}}{\text{RPI for month of expenditure}}$$

Examples in this text use the appropriate RPIs shown in the Tax Rates and Allowances pages. In the examination, the appropriate RPIs (if required) will be given in the question, not as part of the tax rates and allowances information sheet.

However, some past examination questions have provided the relevant information in other ways:

- by giving the indexation factor to be used, or
- by giving the indexation allowance as a monetary amount, or
- by stating that the cost given in the question is the indexed cost (i.e. it already includes indexation allowance).

If the IA needs to be calculated, the tax legislation states that **the indexation factor must be rounded to three decimal places** before multiplying by the allowable cost.

If there is **enhancement expenditure**, a separate IA calculation is needed, based on the RPI from the month of enhancement to the month of disposal.

The IA cannot create nor increase an allowable loss. At best, the IA brings the gain down to £Nil.

Example

G Ltd purchased an investment property in June 1990 for £42,000. Estate agents' and solicitors' fees totalled £2,500. In August 2000 an extension costing £36,000 was added, and the whole property was redecorated at a cost of £5,500.

G Ltd sold the property on 25 June 2009. The estate agents' and solicitors' fees were arranged at a fixed price and totalled £4,800.

Required

Calculate the chargeable gain/(allowable loss) assuming the property is sold for each of the following alternative amounts:

(a) £150,000

(b) £110,000

(c) £ 70,000

Answer

	(a)	(b)	(c)
	£	£	£
Gross sale proceeds (June 2009)	150,000	110,000	70,000
Minus Incidental selling expenses	(4,800)	(4,800)	(4,800)
Net sale proceeds	145,200	105,200	65,200
Original cost (June 1990)			
(including incidental acquisition costs)	(44,500)	(44,500)	(44,500)
Cost of extension (August 2000)	(36,000)	(36,000)	(36,000)
Unindexed gain / (loss)	64,700	24,700	(15,300)
IA on original cost			
From June 1990 to June 2009			
$\frac{213.4 - 126.7}{126.7} = 0.684 \times £44,500$	(30,438)	(24,700)	0

IA on extension From August 2000 to June 2009 $\frac{213.4 - 170.5}{170.5} = 0.252 \times £36{,}000$	(9,072)	0	0
Chargeable gain / (Allowable loss)	25,190	0	(15,300)

Notes

(1) Redecoration costs are not capital expenditure and are therefore not allowable in the capital gain computation.

(2) Indexation allowance cannot create or increase a loss. In scenario (b) the IA is restricted to the amount where the net chargeable gain is £0. In scenario (c) no IA is available as a loss arises before the application of indexation.

4.3 Shares and securities

The matching rules for companies are slightly different to those for individuals.

Sales are matched against acquisitions in the following order:

- shares acquired on the same day as the sale
- shares acquired in the nine days before the sale
- shares in the pool.

Shares in the first two categories never enter the pool and no indexation is available on their disposal.

The pool is computed in a slightly different way to the pool used for acquisitions made by individuals as it includes the indexation allowance:

- before recording any acquisition that changes the pool cost, the indexation allowance (IA) available up to that purchase date has to be calculated for the shares already in the pool. This IA is added to the indexed cost column.
- before recording a sale, the IA available up to the date of the sale has to be calculated and added to the indexed cost column.

The IA is based on the indexed cost to date, and is calculated in the normal way for gains on chargeable assets **except** that the indexation factor is **not** rounded to three decimal places.

The working for a share pool should be presented as shown in the proforma below:

	Number of shares	Original cost	Indexed cost
		£	£
First operative event (e.g. purchase). Original cost = indexed cost.	X	X	X
Second operative event (e.g. purchase)			
(i) Indexation allowance:			
Balance in the Indexed cost column × Indexation factor (notes 1 & 2)			X
(ii) Purchase of shares	X	X	X
	X	X	X
Third operative event (e.g. sale)			
(i) Indexation allowance:			
Balance in the Indexed cost column × Indexation factor (notes 1 & 2)			X
			X
(ii) Sale of shares (see note 3)	(X)	(X)	(X)
Pool balance carried forward	X	X	X

Notes

(1) The indexation factor is calculated as follows:

$$\frac{\text{RPI for month of this operative event} - \text{RPI for month of last operative event}}{\text{RPI for month of last operative event}}$$

(2) Do **not** round the indexation factor to three decimal places.

(3) The appropriate proportion of cost and indexed cost to deduct from each column when shares are sold is calculated as follows:

$$\text{Total cost to date, or Total indexed cost to date} \times \frac{\text{Number of shares disposed of}}{\text{Number of shares held (before the disposal)}}$$

Example

J plc purchased shares in K Ltd as follows:

		Cost
		£
16 May 1995	5,000 shares	34,500
27 September 2003	6,500 shares	37,700

On 13 March 2010, J plc sold 10,000 of the shares in K Ltd for £96,000.

Required

Calculate the chargeable gain arising from the disposal of these shares.

a

Answer

Pool	Number of shares	Original cost	Indexed cost
		£	£
16 May 1995: Initial purchase	5,000	34,500	34,500
27 September 2003: subsequent purchase			
(i) IA: from May 1995 to September 2003 $\frac{182.5 - 149.6}{149.6} \times £34,500$ (Do not round this indexation factor)			7,587
(ii) Purchase of shares	6,500	37,700	37,700
	11,500	72,200	79,787
13 March 2009: sale of shares			
(i) IA: from September 2003 to March 2010 $\frac{216.3 - 182.5}{182.5} \times £79,787$ (Do not round the indexation factor)			14,777
			94,564
(ii) Sale of shares (see note below)	(10,000)	(62,783)	(82,230)
Pool balance c/f	1,500	9,417	12,334

	£
Gross sale proceeds	96,000
Minus Cost (from the working for the pool)	(62,783)
Unindexed gain	33,217
Minus IA (from the pool working) (£82,230 - £62,783)	(19,447)
Chargeable gain	13,770

Notes

(1) Shares sold from the pool are removed at average cost. This applies to both the original cost and the indexed cost column in the pool calculation.

Original cost: £72,200 × 10,000/11,500 = £62,783

Indexed cost: £94,564 × 10,000/11,500 = £82,230

(2) The IA must be shown separately because the IA deduction cannot create nor increase an allowable loss.

4.4 Substantial shareholdings

Disposals of all or part of a substantial shareholding are exempt. Any losses are not allowable. The conditions are as follows:

- the company making the disposal must be a trading company or a member of a trading group

- the shares must relate to a trading company or the holding company of a trading group or sub group.

A substantial shareholding is one where the company making the disposal is entitled to:

- at least 10% of the profits available for distribution to equity shareholders, and
- at least 10% of the assets available for distribution to equity shareholders on a winding up.

Shareholdings held by other group members may be taken into account in determining whether the 10% test is met.

The 10% tests must have been met for at least 12 months out of the 24 months immediately prior to the disposal. This rule enables part disposals of substantial shareholdings to qualify for relief even after the vendor company has ceased to meet the 10% requirement.

Where there has been a qualifying share-for-share exchange, the holding period of the original shares is amalgamated with the holding period of the replacement shares in order to determine whether the 12 month rule has been satisfied.

Example

Alpha Ltd purchased 12% of the shares of Beta Ltd on 1 April 2008. Both companies are trading companies. Alpha Ltd sold an 8% shareholding on 1 May 2009 and the remaining 4% on 1 February 2010.

Required

Explain whether these disposals will qualify for the substantial shareholding exemption.

Answer

At the time of the disposal on 1 May 2009, Alpha Ltd has owned a shareholding in Beta Ltd of more than 10% for more than 12 months. This first disposal therefore clearly qualifies for the exemption.

At the time of the second disposal, Alpha Ltd only held a 4% shareholding in Beta Ltd. However, the 10% test is applied by looking back at the previous two years. Within the period 1 February 2008 to 1 February 2010, Alpha Ltd owned a shareholding of more than 10% for more than 12 months therefore the second disposal also qualifies for the exemption.

Goodwill and intangible fixed assets

5 Goodwill and intangible fixed assets

5.1 Overview

The tax treatment of expenditure and receipts in respect of goodwill and other intangible fixed assets has been brought into line with FRS 10. Such assets are therefore removed from the charge to corporation tax on chargeable gains (and are therefore not classed as qualifying business assets for the purpose of rollover relief). The regime applies only to companies and only to assets acquired or created on or after 1 April 2002.

As the corporation tax treatment is in line with the normal accounting treatment, no adjustment to the net profit should be needed when computing trading profits for corporation tax purposes.

5.2 Relief for expenditure

Revenue expenditure on intangible assets, such as patent royalties, is an allowable deduction in calculating trading profits. Similarly, expenditure relating to writing down capitalised intangible assets, such as goodwill, is an allowable deduction in calculating trading profits.

However, an election can be made to disallow any amortisation charged in the accounts and instead write off the cost of a capitalised intangible asset at a rate of 4% per annum. The election is irrevocable and must be made in writing within two years of the end of the accounting period in which the asset was acquired.

5.3 Relief for disposals

When an intangible asset is sold, a form of rollover relief is available if the intangible asset is sold for more than it originally cost and other intangible assets are acquired in the period 12 months prior to and up to 36 months after the disposal.

Where full reinvestment takes place, the relief will be the excess of proceeds over the original cost. Where the amount reinvested is less than the proceeds received, the relief is restricted to the amount by which the reinvestment exceeds the cost of the asset.

The relief is deducted from the tax cost of the replacement asset.

e

Example

Omega Ltd makes up its accounts to 31 March annually. It purchased an intangible asset for £100,000 on 1 October 2007. It amortised the cost at the rate of 2% per annum.
The asset was sold on 1 April 2010 for £110,000 and replaced on the same date with an intangible asset costing £130,000.

Required

What relief is available in respect of the cost of the first intangible asset and what are the tax implications arising from its disposal?

a

Answer

In its accounting period ended 31 March 2008, Omega Ltd will be able to obtain relief for any amortisation charged in its accounts. Alternatively, Omega Ltd can make an irrevocable election to write down the asset at 4% per annum. This will give relief of £100,000 × 4% × 6/12 = £2,000.

Assuming the election has been made, the relief available for the years ended 31 March 2009 and 31 March 2010 will be £100,000 × 4% = £4,000 per annum.

As at 31 March 2010, the asset has a tax written down value of £100,000 - £2,000 - £4,000 - £4,000 = £90,000. The disposal of the asset will give rise to a taxable credit of £110,000 - £90,000 = £20,000.

As Omega Ltd has purchased a new intangible asset, it may claim a form of rollover relief. The relief is restricted to £10,000 as this is the sum by which the proceeds exceed the asset's original cost (£110,000 - £100,000). The remaining credit of £10,000 will be taxable.

The relief will reduce the tax cost of the replacement asset to £120,000 (£130,000 - £10,000). Therefore annual write downs in respect of this asset will be £4,800 (£120,000 × 4%).

Reasearch and development
■ Qualifying expenditure ■ Relief for SMEs ■ Relief for large companies

6 Research and development

6.1 Qualifying expenditure

Revenue expenditure incurred on research and development may qualify for enhanced relief if it meets certain conditions:

- The company must spend at least £10,000 on qualifying R & D during a 12 month accounting period. (This amount is scaled down for short accounting periods.)
- The R & D must relate to staff costs, software or consumables (such as fuel) and/or subcontracted expenditure of the same type.

6.2 Relief for SMEs

Small or medium sized enterprises may claim 175% of their qualifying expenditure as a deduction in computing their taxable trading income.

A company is classed as small or medium sized if it has:

- no more than 500 employees, and
- either revenue of no more than €100 million or total assets of no more than €86 million.

Questions in the exam will state whether or not a company is an SME for the purposes of research and development.

Alternatively, if the company has made a trading loss, it may prefer an immediate repayment. It can achieve this by surrendering the R & D relief for a repayable tax credit of 14%. However, the tax credit is restricted to the amount of PAYE and NICs payable by the company for the accounting period.

6.3 Relief for large companies

Large companies may claim 130% of their qualifying expenditure as a deduction in computing their taxable trading income. They cannot convert their relief into a repayable tax credit.

The corporation tax liability

- The rate of corporation tax
- The Financial Year
- The level of profits
- Determining the appropriate rate of corporation tax
- Marginal relief

7 The corporation tax liability

7.1 The rate of corporation tax

A company pays corporation tax on its PCTCT for a CAP.

The rate of corporation tax applicable to a company depends on two factors:

- the Financial Year(s) into which the CAP falls, and
- the amount of the company's profits.

7.2 The Financial Year

A Financial Year (FY) runs from 1 April in one year to the following 31 March.

Financial Years are referred to using the calendar year in which they start. For example, FY2009 means the period from 1 April 2009 to 31 March 2010.

7.3 The level of profits

The rate of tax applied to the PCTCT is determined according to the level of the company's profits. Profits are defined as follows:

	£
PCTCT	X
Franked Investment Income (FII)	X
(Dividends received × 100/90)	
Profits	X

The definition of profits for the purpose of establishing the rate of corporation tax includes Franked Investment Income (FII). This means that, in some cases, the amount of dividends received by a company can affect the rate of tax that it pays on its PCTCT.

A company is deemed to receive dividends after the deduction of 10% tax at source. FII is the term used for the grossed up amount of dividends received. In other words, **FII is the amount of dividends received multiplied by a factor of 100/90** (i.e. FII = dividends received × 100/90).

In an examination question, the amount of **cash dividends received** will probably be given. This cash amount should be grossed up to calculate the FII for inclusion in the profits computation.

Intra-group dividends are not FII. Therefore, where a company receives dividends from a subsidiary (i.e. it owns more than 50% of the shares in the company paying the dividend), these dividends are ignored and are not treated as FII. The group implications of corporation tax are considered in more detail in a later chapter.

Example

For the year ended 31 March 2010 B Ltd has trading income of £200,000, property income of £6,000 and gross interest received of £3,500. B Ltd also received cash dividends of £7,200 from an unconnected UK company.

Required

Calculate the profits of B Ltd for the purpose of determining the appropriate rate of corporation tax.

Answer

B Ltd - Corporation tax computation – year ended 31 March 2010

	£
Trading income	200,000
UK property income	6,000
Interest income (gross)	3,500
PCTCT	209,500
FII (£7,200 × 100/90)	8,000
'Profits' for determining the rate of corporation tax	217,500

Note: Dividends are ignored in calculating PCTCT as they are not taxable. However, they are grossed up and brought into the calculation of profits.

7.4 Determining the appropriate rate of corporation tax

To determine the appropriate rate of tax to apply to PCTCT, profits (for a 12-month period) are compared to annual statutory limits as shown in the table below.

If the profits of the company are…	Statutory limits	Corporation tax rate
At or below the small companies rate lower limit	£300,000	Small
Between the small companies rate lower and upper limits	£300,000 – £1,500,000	Full rate minus marginal relief
Above the small companies rate upper limit	£1,500,000 +	Full rate

The following rates of corporation tax will be provided in the examination (within a list of tax rates and allowances).

Financial year	2007	2008	2009
Small companies rate	20%	21%	21%
Full rate	30%	28%	28%

Example

Continuing with the above example, state the rate of tax applicable for B Ltd for the year ended 31 March 2010.

Answer

The profits of the company lie below the small companies' rate lower limit. Therefore the appropriate rate of corporation tax for B Ltd = 21%.

Note that this rate is applied to PCTCT. Therefore, the corporation tax liability of B Ltd for the year ended 31 March 2010 is £43,995 (£209,500 × 21%).

Do not make the mistake of applying the rate of tax to the profits figure. Remember that a company does not pay tax on dividends received. FII is only included in the computation to determine the rate of tax applicable to the PCTCT.

7.5 Marginal relief

If profits fall into the marginal band of £300,000 – £1,500,000, the corporation tax on PCTCT is initially calculated at the full rate. Marginal relief (sometimes referred to as tapering relief) is then calculated and deducted.

Marginal relief is calculated using the following statutory formula:

$$(M - P) \times \frac{I}{P} \times (\text{Marginal relief fraction})$$

Where

M = Upper limit of £1,500,000

P = Profits

I = PCTCT

This formula will be provided in the examination, together with the following information:

Financial year	2007	2008	2009
Small companies rate:			
lower limit	300,000	300,000	300,000
upper limit	1,500,000	1,500,000	1,500,000
Marginal relief fraction:			
Small companies rate	1/40	7/400	7/400

Example

The following information relates to three different companies, each with a 31 March 2010 year end:

	E Ltd	F Ltd	G Ltd
	£	£	£
PCTCT	228,000	750,000	1,405,000
Dividends received	54,000	63,000	90,000

Required

Calculate the corporation tax liability for each company.

Answer

	E Ltd	F Ltd	G Ltd
	£	£	£
PCTCT	228,000	750,000	1,405,000
FII	60,000	70,000	100,000
'Profits'	288,000	820,000	1,505,000

Note: FII = dividends × 100/90.

Decision: tax rate	E Ltd 21%	F Ltd 28% less marginal relief (MR)	G Ltd 28%
	£	£	£
Corporation tax liability on PCTCT			
£228,000 × 21%	47,880		
£750,000 × 28%		210,000	
Minus MR (see below)		(10,884)	
		199,116	
£1,405,000 × 28%			393,400

Marginal relief: working

(1,500,000 – 820,000) × 750,000/820,000 × 7/400

Special rules applying to the corporation tax liability

- Short chargeable accounting periods
- Associated companies
- Accounting periods straddling 31 March
- Comprehensive example

8 Special rules applying to the corporation tax liability

8.1 Short chargeable accounting periods

The statutory limits are annual limits. Therefore if a company has a CAP of less than 12 months (i.e. a short CAP) the annual statutory limits must be time-apportioned before comparing with the profits of the CAP, to determine the appropriate rate of corporation tax.

Example

H Ltd produced accounts for the 7-month period ended 31 October 2009. Its PCTCT totalled £268,500 and it received dividends of £2,700 from an unconnected company on 14 June 2009.

Required

Calculate the corporation tax liability of H Ltd for the 7-month period.

Answer

H Ltd – corporation tax liability computation – 7-month period ending 31 October 2009

			£
PCTCT			268,500
FII: (£2,700 × 100/90)			3,000
Profits			271,500
Small companies rate	Lower limit	300,000 × 7/12	175,000
	Upper limit	1,500,000 × 7/12	875,000
Decision: 28% minus marginal relief			

Corporation tax liability	**£**
£268,500 × 28%	75,180
Minus Marginal relief (875,000 – 271,500) × 268,500/271,500 × 7/400	(10,445)
Corporation tax liability	64,735

8.2 Associated companies

The statutory annual limits apply to a single company operating on its own.

If the company is associated with other companies, the statutory annual limits must be divided equally between the number of associated companies.

Companies are associated if:

- one company is under the control of another, or
- two or more companies are under the common control of another person: this other person may be another company, an individual or a partnership.

A person has control of a company if they have an interest in the company's shares exceeding 50%. The full definition of these terms and the consequences for corporation tax are dealt with in more detail in a later chapter.

8.3 Accounting periods straddling 31 March

When a company's CAP straddles 31 March, it falls into two financial years. The corporation tax liability must be calculated in two parts if either the corporation tax rate or the fraction for marginal relief changes between the two financial years. For example, the small companies' rate of corporation tax was increased from 20% (FY07) to 21% (FY08) and the small companies' marginal relief fraction changed from 1/40 to 7/400.

Note that it is only the corporation tax liability that is affected. The calculation of profits chargeable to corporation tax remains unchanged.

Example

J Ltd has the following results for the year ended 31 December 2008:

	£
Trading income	400,000
Interest income	40,000
Gift Aid donation	3,000
Dividends from UK companies (amount received 1 November 2008)	72,000

Required
Calculate the corporation tax liability for the year.

a **Answer**

J Ltd – corporation tax liability computation – year ended 31 December 2008

Step 1 Calculate the PCTCT and 'profits' for the year.

	£
Trading income	400,000
Interest income	40,000
	440,000
Less: Gift aid payment	(3,000)
PCTCT	437,000
FII (£72,000 × 100/90)	80,000
'Profits'	517,000

Step 2 The 'profits' figure falls between the upper and lower limits, therefore marginal relief applies.

Step 3 The chargeable accounting period is the year ended 31 December 2008; three months falls into FY 2007, and nine months into FY 2008.

Step 4 Calculate the corporation tax payable:

	£
FY 2007 (3 months)	
Corporation tax at 30% on £437,000 × $^3/_{12}$	32,775
Less: Marginal relief:	
$^1/_{40} \times (£1{,}500{,}000 - 517{,}000) \times \frac{437{,}000}{517{,}000} \times {^3/_{12}}$	(5,193)
	27,582
FY 2008 (9 months)	
Corporation tax at 28% on £437,000 × $^9/_{12}$	91,770
Less: Marginal relief:	
$^7/_{400} \times (1{,}500{,}000 - 517{,}000) \times \frac{437{,}000}{517{,}000} \times {^9/_{12}}$	(10,905)
Corporation tax payable	108,447

As an alternative it is possible to arrive at the same result by time-apportioning the statutory limits, the PCTCT and the figure of profits into the respective financial years and then calculating the corporation tax (i.e. as if there were two separate short accounting periods).

8.4 Comprehensive example

Example

O Ltd provides you with the following information in respect of the year ended 31 March 2010:

	£
Income	
Rental income from letting an empty factory in Manchester	12,000
Dividends from a French company	3,600
Profits from the trade	1,304,800
Bank deposit interest	7,800
Dividends from a UK company	32,400
Debenture interest from a UK company	151,000
Expenditure	
Estate agent management fees	1,200
Repairs to factory in Manchester	17,500
Interest payable on a loan taken out to purchase shares	33,750
Gift Aid donation paid	24,000
Dividends paid to shareholders	105,500

O Ltd disposed of one capital asset which gave rise to a chargeable gain of £100,000 and another capital asset which gave rise to an allowable loss of £24,000. It has capital losses of £10,000 brought forward from previous years.

Required

Prepare the PCTCT statement for O Ltd and calculate its corporation tax liability for the year ended 31 March 2010.

Answer

O Ltd: Corporation tax computation – year ended 31 March 2010

	£
Trading income	1,304,800
Interest income (W1))	125,050
UK property income (W2) (see note below)	(6,700)
Net chargeable gains (W3)	66,000
	1,489,150
Gift Aid donation	(24,000)
PCTCT	1,465,150

Note

Property income losses are first set against other income in the CAP. The inclusion of a negative assessment will ensure relief is given in this way, and is an acceptable method in the examination.

	£
PCTCT	1,465,150
FII (£32,400 + £3,600) × 100/90	40,000
Profits	1,505,150
Profits exceed £1,500,000, therefore the full rate of corporation tax applies.	
Corporation tax liability (= £1,465,150 × 28%)	£410,242

Workings

(W1) Interest income		**£**
Bank interest receivable		7,800
Debenture interest receivable		151,000
		158,800
Minus:	Interest payable to purchase shares	(33,750)
Interest income		125,050

(W2) UK property income		**£**
Rents accrued in CAP		12,000
Minus	Agents' management fees	(1,200)
	Repairs	(17,500)
Property income assessment		(6,700)

(W3) Net chargeable gains		**£**
Chargeable gains in the CAP		100,000
Minus	Allowable losses in the CAP	(24,000)
	Allowable losses brought forward	(10,000)
Net chargeable gain		66,000

Long periods of account

- The treatment of long periods of account
- The allocation of income, gains and Gift Aid donations between CAPs

9 Long periods of account

9.1 The treatment of long periods of account

A company is entitled to produce financial accounts for periods in excess of 12 months. However, if it does so, the CAP for corporation tax purposes will not be the same as the period of account. In these circumstances two corporation tax computations must be produced from the one set of financial accounts.

A long period of account must be split into two CAPs using the following rules:

- CAP 1: The first 12 months of the long period of account.
- CAP 2: The remaining period (the balance period).

Example

A company prepares a 17-month set of accounts from 1 June 2009 to 31 October 2010.

Required

State how the 17-month set of accounts will be assessed to corporation tax.

Answer

For corporation tax purposes, the 17-month financial accounting period would be split into two CAPs as follows:

- CAP 1: 12-month period ended 31 May 2010
- CAP 2: 5-month period ended 31 October 2010

For each CAP the following must then be produced:

- A separate PCTCT statement allocating the income, gains and Gift Aid donations generated in the long period of account
- Separate computations of profits to determine the appropriate rate of tax for each CAP. (Note that it is possible for the company to have different rates of tax applying in the different CAPs.)
- Separate corporation tax liability computations, as each CAP has a different due date of payment.

9.2 The allocation of income, gains and Gift Aid donations between CAPs

The tax legislation requires income, gains and Gift Aid donations in a long period of account to be allocated to the separate CAPs as follows:

	Allocation method
Adjusted profit **before** capital allowances	Produce one adjustment of profit computation for the long period, ignoring capital allowances. Then time-apportion between the two CAPs.
Capital allowances	Produce a separate computation for each CAP, bringing in the appropriate additions and disposals according to the dates of acquisition and disposal.
Interest income	Allocate on an accruals basis to each CAP.
Property income	Produce one property income assessment for the long period, then time-apportion.
Net chargeable gains	Allocate gains and losses according to the date of disposal of the capital asset.
Gift Aid donations	Allocate between CAPs according to the dates of payment of donations.
FII	Allocate between CAPs according to the dates the dividends are received.

Example

P Ltd decided to change its accounting date and prepared a 17-month set of accounts to 31 August 2009. The following information relates to the 17-month period:

	£
Income	
Adjusted profit before capital allowances	1,530,000
Interest received on £200,000 12% debentures on 31 March 2009	24,000
Dividends received from a UK company on 31 January 2009	56,700
Rental income	51,000
Expenditure	
Gift Aid donation paid on 30 June each year	16,000
Dividends paid to shareholders on 30 April 2008	96,000

P Ltd disposed of one capital asset which gave rise to an allowable loss of £34,000 on 30 September 2008 and another capital asset which gave rise to a chargeable gain of £125,000 on 30 June 2009. It has capital losses of £18,000 brought forward from previous years.

Capital allowances are calculated as £35,000 for the first CAP and £23,000 for the second CAP.

Required

Calculate the corporation tax liabilities of P Ltd for the 17 months ended 31 August 2009 and state the due dates for payment.

Answer

P Ltd: Corporation tax computations	**12 months ending 31 March 2009**	**5 months ending 31 August 2009**
	£	£
Adjusted profit before capital allowances		
(£1,530,000 × 12/17 : £1,530,000 × 5/17)	1,080,000	450,000
Capital allowances	(35,000)	(23,000)
Trading income	1,045,000	427,000
Interest income		
(£200,000 × 12% : £200,000 × 12% × 5/12)	24,000	10,000
UK property income		
(£51,000 × 12/17 : £51,000 × 5/17)	36,000	15,000
Net chargeable gains		
(no gain in first CAP : £125,000 - £52,000 b/f losses)	Nil	73,000
	1,105,000	525,000
Gift Aid donation	(16,000)	(16,000)
PCTCT	1,089,000	509,000

To determine the rate of corporation tax to apply	**12 months ended 31 March 2009**	**5 months ended 31 August 2009**
	£	£
PCTCT	1,089,000	509,000
FII (£56,700 × 100/90)	63,000	Nil
Profits	1,152,000	509,000
Small companies rate		
Upper limit (full limit : full limit × 5/12)	1,500,000	625,000
Lower limit (full limit : full limit × 5/12)	300,000	125,000
Decision: The rate to apply in both CAPs = full rate of tax less marginal relief		

Corporation tax liabilities	**£**	**£**
£1,089,000 × 28%	304,920	
£509,000 × 28%		142,520
Less Marginal relief		
(1,500,000 – 1,152,000) × 1,089,000/1,152,000 × 7/400	(5,757)	
(625,000 – 509,000) × 7/400		(2,030)
Corporation tax liability	299,163	140,490
Due dates for payment	1 Jan 2010	1 June 2010

Note: Due date for payment is 9 months and 1 day after the end of the CAP (except for large companies).

Corporate venturing scheme

10 Corporate venturing scheme

10.1 Overview

The corporate venturing scheme is similar to the Enterprise Investment Scheme and Venture Capital Trusts that are available to individuals. It allows companies to claim relief for the cost of investing in unquoted trading companies.

The company in which the investment is made:

- must be an unquoted trading company
- must have fewer than 50 employees
- must have gross assets of no more than £7 million before the investment or £8 million afterwards
- must raise no more than £2 million under the scheme in a 12-month period.

The investing company must not have a material interest (over 30% of the ordinary share capital) in the issuing company. At least 20% of the shares in the issuing company must be held by independent individuals. Directors, employees and their relatives are not classed as independent individuals.

10.2 Investment relief

The investing company is entitled to a tax credit of 20% in respect of the amount of cash subscribed. Relief is given in the accounting period in which the shares are issued. Relief is restricted to the amount of corporation tax liability, if lower. The relief is withdrawn if the company disposes of the shares within three years.

10.3 Gains and losses

Gains arising on the disposal of CVS shares can be deferred if reinvested in new CVS shares within the period one year before to three years after the disposal.

The amount of gain that may be deferred is the lowest of:

- the gain
- the amount subscribed
- the amount specified in the claim.

Losses arising on the disposal of CVS shares can be claimed against income of the same accounting period, unless the substantial shareholding exemption applies. Any remaining loss can be carried back against profits of the previous 12 months.

CHAPTER 21

Company trading losses

Contents

The calculation of trading losses

- When does a trading loss occur?
- Section numbers

1 The calculation of trading losses

1.1 When does a trading loss occur?

A trading loss occurs when a company has:

- an adjusted trading loss before capital allowances which is increased by the addition of capital allowances, or
- an adjusted trading profit before capital allowances which becomes a loss when capital allowances are deducted.

If a trading loss occurs, the trading income assessment in the PCTCT statement for the CAP is £0. This is shown in the table below:

	£
Adjusted profit / (loss) before capital allowances	X/(X)
Capital allowances on plant and machinery	(X)
Industrial buildings allowances	(X)
Trading loss (negative figure)	(X)
Trading income assessment in the PCTCT statement	£Nil

Although the trading income assessment for the CAP is £Nil, the company is able to obtain relief for the trading loss. Several options are available. The company needs to consider the options available and choose the one that gives it the optimum use of its trading loss.

1.2 Section numbers

The rules for relieving trading losses are contained in the Income and Corporation Taxes Act 1988. This is abbreviated to ICTA 1988.

Knowledge of section numbers is not required or even expected in answers to examination questions. Candidates will not even be penalised for quoting a section number incorrectly in their answer.

However, section numbers serve as useful abbreviations in a corporation tax loss computation, and are a way of identifying the particular tax rules. Section numbers are therefore used in this part of the text.

The carry forward of trading losses

- The rules of s393(1) ICTA 1988

2 The carry forward of trading losses

2.1 The rules of s393(1) ICTA 1988

Trading losses can be carried forward and set off against the first available trading profits from the trade that produced the loss. The losses can be carried forward indefinitely. However, they **must** be set off against the first available trading profits:

- If the trading losses carried forward are less than the available trading profit, the losses must be set off in full.
- If the trading losses carried forward are more than the available trading profit, the losses must be set off up to the amount of the trading profit, and the unrelieved balance should be carried forward to the next CAP.

Trading losses will be carried forward automatically and relieved in this way if the company does not claim relief against total profits under s393A ICTA. (This alternative option is explained later.)

Example

S Ltd prepares its accounts to 31 March each year and has supplied the following information:

Year ended 31 March	2008	2009	2010
	£	£	£
Trading profit / (loss)	(125,000)	28,000	803,500
Interest income	20,000	20,000	20,000
Net chargeable gains	Nil	135,000	Nil

There were no unrelieved trading losses at 1 April 2007.

Required

(a) Calculate the PCTCT for each year, assuming the losses are carried forward.

(b) Calculate the amount of loss, if any, that is unrelieved at 31 March 2010.

Answer

S Ltd: Corporation tax computations

Year ended 31 March	**2008**	**2009**	**2010**
	£	£	£
Trading income	0	28,000	803,500
Minus s393 (1) trading losses b/f (see working)	0	(28,000)	(97,000)
	0	0	706,500
Interest income	20,000	20,000	20,000
Net chargeable gains	0	135,000	0
PCTCT	20,000	155,000	726,500

(W) Record of trading losses

Trading loss b/f	125,000	97,000
Set off under s393(1)	(28,000)	(97,000)
Trading loss c/f under s393(1)	97,000	0

Notes

(1) Losses brought forward can only be set against trading profits. The maximum amount possible must be deducted each year.

(2) A better rate of tax saving would probably be achieved if all the loss could be set off in the year ended 31 March 2010. (This is because the profits put the company into a higher tax band.) However, losses brought forward must be set against the first available future trading profits (in this example, y/e 31 March 2009). It is not possible to skip a year.

Relief for trading losses against total profits

- Claiming relief for losses against total profits under s393A ICTA 1988
- The temporary extension of relief
- The effect of a short CAP in the 12-month carry back period
- Terminal loss relief

3 Relief for trading losses against total profits

3.1 Claiming relief for losses against total profits under s393A ICTA 1988

A company can make a claim, within two years of the end of the loss making CAP, to set off the trading loss against its total profits:

- in the loss-making CAP only (i.e. make a claim for the current period), or
- in the loss-making CAP first, and then carry back the unrelieved loss to the previous 12 months (i.e. make a current year **and** carry back claim).

A carry back claim cannot be made unless the current loss making period is relieved first.

When setting off the trading loss in the current or previous CAPs, the following rules apply:

- The option to claim loss relief under s393A is optional.
- If relief is claimed under s393A, as much as possible of the loss is set off against total profits in the current CAP. Any loss that cannot be relieved against total profits in the current CAP may be carried back 12 months.
- If a company claims s393A, **any trading losses left unrelieved are automatically carried forward** and set off under the rules of s393(1).

These rules are explained in some further detail in the table below.

Rule:	Explanation
■ Set off against total profits	■ Total profits are all other income plus net chargeable gains, but before deducting gift aid payments.
■ Must set off as much as possible in the CAP	■ It is an all or nothing relief. ■ The claim is optional. However if the claim is made, the maximum amount of trading loss must be deducted from total profits of the CAP. ■ The loss relief may reduce the total profits to nil, so that relief for gift aid payments is lost. ■ The gift aid payments cannot be carried forward, or carried back; they are wasted/lost.

The following proforma should be used for computations involving loss relief under s393A. In this proforma, it is assumed that a trading loss occurs in CAP 2.

Name of company:

Corporation tax computations	**Assuming the loss occurs in CAP 2**		
	CAP 1	**CAP 2**	**CAP 3**
	£	£	£
Trading income	X	Nil	X
Minus: s393 (1) trading losses b/f	-	-	(X)
	X	Nil	X
Other income	X	X	X
Net chargeable gains	X	X	X
	X	X	X
Minus: s393A claim			
- current loss making CAP		(X)	
- carry back to previous 12 months	(X)		
	X	Nil	X
Minus: - Gift Aid	(X)	lost/ wasted	(X)
PCTCT	X	X	X

Working

Record of trading losses

		CAP 2	CAP 3
Trading loss b/f			X
Set off under s393(1)			(X)
Trading loss in CAP 2		X	
Set off under s393A:			
- in loss-making CAP		(X)	
- in carry back CAP		(X)	
Trading loss c/f under s393(1)		X	X

Example

T Ltd prepares its accounts to 31 August each year and has supplied the following information:

Year ended 31 August	**2008**	**2009**	**2010**
	£	£	£
Trading profit / (loss)	58,500	(323,000)	164,250
UK property income	14,000	15,000	16,000
Net chargeable gains / (loss)	(5,000)	45,000	0
Gift Aid donation	(1,000)	(1,000)	(1,000)

Required

(a) Calculate the PCTCT for each year assuming losses are relieved as soon as possible.

(b) Calculate the loss available to carry forward, if any, at 31 August 2010.

a

Answer

(a)

T Ltd: Corporation tax computations

Year ended 31 August	**2008**	**2009**	**2010**
	£	£	£
Trading income	58,500	0	164,250
Minus: s393 (1) trading losses b/f	0	0	(164,250)
	58,500	0	0
UK property income	14,000	15,000	16,000
Net chargeable gains (see note 1)	0	40,000	0
'Total profits'	72,500	55,000	16,000
Minus s393A claim			
- current loss making CAP		(55,000)	
- carry back to previous 12 months	(72,500)		
	0	0	16,000
Minus Gift Aid (see note 2)	Lost	Lost	(1,000)
PCTCT	0	0	15,000

Working

Record of trading losses

Trading loss b/f			195,500
Set off under s393(1)			(164,250)
Trading loss in CAP		323,000	
Set off under s393A	- in loss-making CAP	(55,000)	
	- in carry-back CAP	(72,500)	
Trading loss c/f under s393(1)		195,500	31,250

(b) The loss available to carry forward at 31 August 2010 is £31,250.

Notes

(1) **Capital losses** must be carried forward and set against the first available future chargeable gains. They cannot be set against other profits in the CAP. Net chargeable gains in the year to 31 August 2009 are therefore £45,000 - £5,000 loss brought forward = £40,000.

(2) If as a result of loss relief there are no profits against which to set off Gift Aid donations, the benefit of Gift Aid is lost.

3.2 The temporary extension of relief

Finance Act 2009 has introduced a temporary extension to the trading loss rules.

Losses incurred in CAPs ending between 24 November 2008 and 23 November 2010 can be carried back against total profits generated in the 36 months before the start of the loss-making CAP. The carry back is on a last-in-first-out (LIFO) basis.
The extended loss relief is restricted to a maximum of:

- £50,000 for losses incurred in CAPs ending between 24 November 2008 and 23 November 2009 and
- £50,000 for losses incurred in CAPs ending between 24 November 2009 and 23 November 2010.

Where the CAP in which the loss is incurred is less than 12 months, the £50,000 limit is apportioned.

A claim for the extended carry back must be made within two years of the end of the loss making accounting period.

These rules are explained in further detail in the table below.

Rule:	**Explanation:**
Losses incurred in CAPs ending between 24 November 2008 and 23 November 2010	▪ The extended loss relief depends on the date on which the loss making accounting period **ends**.
Set off against total profits.	▪ Before the extended relief may be claimed a normal s393A claim must be made against total profits of the current year and the 12 months prior to the current year.
Relief on LIFO basis	▪ The set off is against profits of the most recent years first.
Must set off as much as possible in the tax year	▪ It is an all or nothing relief. ▪ The claim is optional. However, if the claim is made, the maximum amount must be deducted from the total profits.
Relief restricted to £50,000	▪ The restriction applies only to the two earliest years of set off. ▪ The additional relief for those two tax years is limited to a total of £50,000. ▪ The £50,000 limit is apportioned if the loss making accounting period is less than 12 months long.

Example

T Ltd prepares its accounts to 31 August each year and has supplied the following information:

Year ended 31 August	2006	2007	2008	2009	2010
	£	£	£	£	£
Trading profit / (loss)	18,000	20,000	58,500	(323,000)	164,250
UK property income	12,000	13,000	14,000	15,000	16,000
Net chargeable gains / (loss)	0	0	(5,000)	45,000	0
Gift Aid donation	(1,000)	(1,000)	(1,000)	(1,000)	(1,000)

Required

(a) Calculate the PCTCT for each year assuming losses are relieved using the extended carry back rules.

(b) Calculate the loss available to carry forward, if any, at 31 August 2010.

Answer

(a)

T Ltd: Corporation tax computations

Year ended 31 August	2006	2007	2008	2009	2010
	£	£	£	£	£
Trading income	18,000	20,000	58,500	0	164,250
Minus: s393 (1)	0	0	0	0	(145,500)
	18,000	20,000	58,500	0	18,750
UK property income	12,000	13,000	14,000	15,000	16,000
Net chargeable gains	0	0	0	40,000	0
Total profits	30,000	33,000	72,500	55,000	34,750
Minus s393A claim					
- current loss making CAP				(55,000)	
- carry back to previous 12 months			(72,500)		
- extended carry back claim	(17,000)	(33,000)			
	13,000	0	0	0	34,750
Minus	(1,000)	lost	lost	lost	(1,000)
PCTCT	12,000	0	0	0	33,750

Working

(b) **Record of trading losses**

	£	£
Trading loss b/f		145,500
Set off under s393(1)		(145,500)
Set off under s393A	323,000	
- in loss-making CAP	(55,000)	
- in carry-back CAP	(72,500)	
- extended carry back to 2007	(33,000)	
- extended carry back to 2006 (note)	(17,000)	
Trading loss c/f under s393(1)	145,500	Nil

Notes

(1) The extended loss relief is available because the loss making accounting period ends on 31 August 2009, which is in the period 24 November 2008 to 23 November 2010.

(2) A normal claim under s393A must be made against total profits of the year of the loss and the 12 months prior to the start of the loss making accounting period.

(3) The extended loss relief is then available for the years ended 2007 and 2006. However, the loss available for relief in these two years is restricted to a maximum of £50,000 in total.

3.3 The effect of a short CAP in the 12-month carry back period

Under the rules of s393A, trading losses can be carried back against total profits generated in the 12 months before the start of the loss-making CAP.

This usually means carrying back the loss into the immediately-preceding CAP. However, if the company changed its accounting date in the 12-month carry back period, two CAPs will fall in the 12-month carry back period.

If this is the case, the following rules apply:

Rule:	Explanation
Set off the losses on a LIFO basis	The trading loss is carried back on a last-in-first-out basis.
Can only carry back against the profits of the previous 12 months	Trading losses can be carried back exactly 12 months from the **start** of the loss-making CAP. Therefore, the total profits of the earliest CAP might need to be time-apportioned to calculate the total profits eligible for relief.
Must carry back loss for the whole 12 month carry back period	The losses must be set off as much as possible in both CAPs that fall into the 12 month carry back period (on a LIFO basis). A company cannot decide to claim relief in only one of the carry back CAPs.
The length of the loss making period is not important	Regardless of the length of the loss-making CAP itself, trading losses can be carried back exactly 12 months from the start of the loss-making CAP. For example, trading losses incurred in the 7 months CAP to 31 March 2010 can be carried back to 1 September 2008 (i.e. 12 months before the start of the 7-month CAP).

Example

U Ltd prepared its accounts to 30 September until 2007. Then it changed its accounting date to 31 December by preparing a three month set of accounts. U Ltd has supplied the following information:

	y/e 30 September 2007	3 months ended 31 December 2007	y/e 31 December 2008	y/e 31 December 2009
	£	£	£	£
Trading profit / (loss)	321,000	60,000	(457,000)	123,000
Interest income	6,000	6,000	6,000	6,000
Net chargeable gains / (loss)	Nil	(14,000)	26,000	48,500
Gift Aid donation	(1,500)	Nil	(1,500)	(1,500)

Required

(a) Calculate the PCTCT for each CAP assuming losses are relieved as soon as possible.

(b) Calculate the loss available to carry forward, if any, at 31 December 2009.

Answer

U Ltd: Corporation tax	**y/e 30 September 2007**	**3 months ended 31 December 2007**	**y/e 31 December 2008**	**y/e 31 December 2009**
	£	£	£	£
Trading income	321,000	60,000	Nil	123,000
Minus: s393 (1) trading losses b/f – see working	Nil	Nil	Nil	(123,000)
	321,000	60,000	Nil	Nil
Interest income	6,000	6,000	6,000	6,000
Net chargeable gains (see note 1)	Nil	Nil	12,000	48,500
'Total profits'	327,000	66,000	18,000	54,500
Minus s393A claim				
Current period claim - y/e 31.12.08			(18,000)	
Carry back 12 months:				
- 3 months to 31.12.07		(66,000)		
- 9 months of y/e 30.9.07 (£327,000 × 9/12)	(245,250)			
	81,750	Nil	Nil	54,500
Minus Gift Aid	(1,500)	Nil	lost	(1,500)
PCTCT	80,250	Nil	Nil	53,000

Working

Record of trading losses	**y/e 31 December 2008**	**y/e 31 December 2009**
	£	£
Trading loss b/f		127,750
Set off under s393(1)		(123,000)
Trading loss in CAP	457,000	
Set off under s393A		
- in loss making CAP	(18,000)	
Carry back 12 months:		
- 3 m/e 31.12.07	(66,000)	
- 9 months of y/e 30.9.07 (£327,000 × 9/12)	(245,250)	
Trading loss c/f	127,750	4,750

Note

(1) **Capital losses** must be carried forward and set against the first available future chargeable gains. They cannot be set against other profits in the CAP. Net chargeable gains in the year to 31 December 2008 are therefore £26,000 - £14,000 loss brought forward = £12,000.

(2) The loss available to carry forward at 31 December 2009 is £4,750. (See the working.)

3.4 Terminal loss relief

When a loss-making company ceases to trade, it must first claim s393A in the normal way in the current loss-making period before considering a carry-back claim.

The carry-back claim is then dealt with in the same way as normal ongoing losses except that **trading losses of the last 12 months of trading can be carried back three years** before the start of the CAP in which the loss was incurred.

These rules are explained in further detail in the table below.

Rule:	**Explanation**
Trading losses of the last 12 months trading may be carried back	All the trading losses incurred in the 12 months before the date of cessation of business may be carried back. The last 12 months of trading may span two CAPs. If so, trading losses eligible for the relief must be calculated in two parts: ■ the last CAP, and ■ a part of the previous CAP. The trading losses of the previous (penultimate) CAP must be time-apportioned to calculate the amount falling into the last 12 months of trading.

Rule:	Explanation
These trading losses can be carried back three years from the start of the CAP in which the loss was incurred	Trading losses can be carried back exactly 36 months from the start of the loss-making CAP, but no more than 36 months, on a LIFO basis. The carry-back could affect more than three CAPs if the company changed its accounting date in the three-year carry-back period. If so, the total profits of the earliest CAP must be time-apportioned to calculate the total profits eligible for relief (i.e the profits that fall into the 36-month carry-back period).

Example

V plc ceased to trade on 31 December 2009 and in its last 12 months of trading it incurred a trading loss of £278,500. In this last year it had no other income or gains and made no Gift Aid donations. It has supplied the following information in respect of the preceding CAPs:

	y/e 31 May 2006	7 months ended 31 December 2006	y/e 31 December 2007	y/e 31 December 2008
	£	£	£	£
Trading profit / (loss)	121,000	47,000	67,000	23,000
Interest income	12,000	7,000	12,000	12,000
Chargeable gains	Nil	Nil	12,000	48,500
Gift Aid donation	(600)	Nil	(600)	(600)

Required

Calculate the PCTCT for each CAP, assuming losses are relieved as soon as possible.

Answer

Note that, in this example, the final 12 months of trading coincide with the final 12-month CAP.

V plc Corporation tax	**y/e 31 May 2006**	**7 m/e 31 December 2006**	**y/e 31 December 2007**	**y/e 31 December 2008**
	£	£	£	£
Trading income	121,000	47,000	67,000	23,000
Minus: s393 (1) trading losses	Nil	Nil	Nil	Nil
	121,000	47,000	67,000	23,000
Interest income	12,000	7,000	12,000	12,000
Net chargeable gains	0	0	12,000	48,500
	133,000	54,000	91,000	83,500

Minus: s393A claim				
Current period claim:				
- y/e 31.12.09 = £Nil				
Carry back 36 months:				
- y/e 31.12.08				(83,500)
- y/e 31.12.07			(91,000)	
- 7 months ended 31.12.06		(54,000)		
- 5 months of y/e 31.5.06: maximum (£133,000 × 5/12) = £55,417 - (also see working)	(50,000)			
	83,000	Nil	Nil	Nil
Minus: Gift Aid	(600)	Nil	lost	lost
PCTCT	82,400	Nil	Nil	Nil

Working

Record of trading losses	**y/e 31 December 2009**
	£
Trading loss in final 12 months of trading	278,500
Set off under s393A:	
In the loss-making CAP	(0)
Carry back 36 months:	
- y/e 31.12.08	(83,500)
- y/e 31.12.07	(91,000)
- 7 months ended 31.12.06	(54,000)
- 5 months of y/e 31.5.06: Maximum relief = £133,000 × 5/12 = £55,417	(50,000)
Trading loss remaining unrelieved	0

Note that the rules for terminal loss relief are virtually identical to those for the additional relief for losses incurred in the period 24 November 2008 to 23 November 2010; however, the amount available for carry back is not restricted to £50,000.

Tax planning

- Choosing the optimum loss relief
- The rates of corporation tax savings
- Reduced capital allowances claim

4 Tax planning

4.1 Choosing the optimum loss relief

The primary aim of a company when using trading losses should be to **save the maximum amount of corporation tax**. The rates of corporation tax applicable in each CAP, including the projected future rates of tax applicable, are therefore a key factor in deciding the optimum loss relief claim.

Cash flow is another important consideration, particularly if the company has a cash flow problem. Shortage of cash may force the company to claim relief as soon as possible (i.e. claim loss relief against the current CAP and then make a carry-back claim) even though it may achieve a higher rate saving by carrying the loss forward. This is because a carry-back claim will result in a repayment of corporation tax that the company has previously paid, and may possibly also carry interest (i.e. a repayment supplement).

The wastage/loss of relief for Gift Aid donations is not desirable and is another consideration to bear in mind. However, this is unlikely to be key deciding factor.

4.2 The rates of corporation tax savings

To achieve the highest tax savings, the company will want to utilise the loss in CAPs when it is paying the highest effective marginal rate of tax. It is therefore necessary to compare the profits of the appropriate CAPs with the statutory limits to decide the rate of tax applicable.

The marginal rates of corporation tax are as follows:

Profits for a 12 month period assuming no associated companies	Effective marginal rate of tax for FY 07	Effective marginal rate of tax for FY08	Effective marginal rate of tax for FY09
£0 - £300,000	20%	21%	21%
£300,000 - £1,500,000	32½%	29¾%	29¾%
£1,500,000 +	30%	28%	28%

Although the rates have changed over the last three years, the key point to bear in mind is that the highest rate of tax saving is achieved by setting the loss against profits falling in the marginal band.

Explanation of the effective marginal rate of tax

In the marginal banding £300,000 – £1,500,000, the effective rate of tax for FY09 is 29¾%. This can be demonstrated as follows:

Profits	Tax rate	Tax	Explanation
£		£	
300,000	21%	63,000	= Tax if profits are exactly £300,000
1,500,000	28%	420,000	= Tax if profits are exactly £1,500,000
1,200,000		357,000	= Effective marginal rate of tax 29¾%

In the marginal band £300,000 to £1,500,000, £357,000 tax must be collected from £1,200,000 profits. The effective marginal rate of tax is 29¾% (£357,000 ÷ £1,200,000 expressed as a percentage).

If there is no FII, it is possible to calculate the corporation tax liability of a company by working up through the bandings and taxing the PCTCT at the effective marginal rate.

However, where there is FII, this method will not give the correct answer. Although the true effective rate in the marginal band will certainly be more than 28%, it will not be exactly 29¾%. This is because the correct corporation tax liability of a company in the £300,000 – £1,500,000 banding is:

PCTCT × Full rate of tax *minus* Marginal relief formula (which includes FII).

In an examination question on losses, the effective marginal rates of tax in the table above can be used to determine the appropriate tax savings achieved in the utilisation of losses.

Example

W Ltd prepares its accounts to 31 March each year and has supplied the following information:

Year ended 31 March	2008	2009	2010
	£	£	£
Trading profit / (loss)	558,500	(214,000)	265,000
UK Property income	14,000	9,000	16,000
Net chargeable gains	130,000	Nil	13,500
Gift Aid donation	(1,000)	(1,000)	(1,000)

Required

Calculate the PCTCT for each year assuming losses are relieved in the most tax efficient manner, and calculate the tax saving achieved.

a

Answer

W Ltd: Corporation tax computations – without loss relief

Year ended 31 March	2008	2009	2010
	£	£	£
Trading income	558,500	Nil	265,000
UK property income	14,000	9,000	16,000
Net chargeable gains	130,000	Nil	13,500
	702,500	9,000	294,500
Minus: Gift Aid	(1,000)	(1,000)	(1,000)
PCTCT before considering loss relief	701,500	8,000	293,500

Tax saving: Tax would be saved at the following rates if the losses were deducted in the periods indicated:

	FY07	FY08	FY09
Loss-making period (y/e 31.3.09)		21%	
Preceding 12 months (y/e 31.3.08)	32½%		
Following CAP (y/e 31.03.10)			21%

W Ltd would prefer to avoid making a claim in y/e 31.03.09 as it would utilise £9,000 of the loss, waste £1,000 of Gift Aid relief, and save tax at only 21%. However, it would probably be prepared to do so in order to bring back the relief to the y/e 31.03.08 where it will save tax at the highest marginal rate. It cannot carry back losses unless it has first made a current period claim.

	Amount of loss used	Rate of saving	Tax saving
	£	%	£
Current loss-making period claim	9,000	21	1,680
Carry back claim	205,000	32½	66,625
	214,000		68,305

This method also has the advantage of relieving losses as soon as possible.

If the loss were carried forward to y/e 31.3.10, the tax saving would be £44,940 (= £214,000 × 21%).

Tutorial note:

The tax saving in the current period will only be £1,680 (£8,000 × 21%) as the company only has PCTCT of £8,000. However, as the loss must be set off before the deduction of Gift Aid donations, £9,000 of the loss must be used to achieve this tax saving.

W Ltd: Corporation tax computations – with loss relief

Year ended 31 March	2008	2009	2010
	£	£	£
Trading income	558,500	Nil	265,000
Minus: s393 (1) trading losses b/f	Nil	Nil	(Nil)
	558,500	Nil	265,000
UK property income	14,000	9,000	16,000
Net chargeable gains	130,000	Nil	13,500
	702,500	9,000	294,500
Minus: s393A claim			
- current loss making CAP		(9,000)	
- carry back to previous 12 months	(205,000)		
	497,500	Nil	294,500
Minus: Gift Aid	(1,000)	lost	(1,000)
PCTCT	496,500	Nil	293,500

Working: Record of trading losses	
Trading loss b/f	
Set off under s393(1)	
Trading loss in CAP	214,000
Set off under s393A:	
- in loss making CAP	(9,000)
- in carry back CAP	(205,000)
Trading loss c/f under s393(1)	Nil

4.3 Reduced capital allowances claim

The loss relief under s393A is an all or nothing relief: maximum claims must be made if possible. Making a claim under s393A may therefore save some tax at 29¾%, but if losses are large compared with the PCTCT, they may have to be matched against profits taxed at 21%.

The rule in s393A requires the whole of the trading loss to be relieved (i.e. the adjusted loss **including** capital allowances). It is not possible to treat the adjusted loss and the capital allowances as two separate losses. Therefore, a company **cannot** set off only the adjusted loss before capital allowances under s393A to maximise the tax savings and also carry forward the unrelieved capital allowances as a separate loss.

However, a company does not have to claim **all** its capital allowances in a CAP. It can claim any amount up to the maximum capital allowances available. Therefore, it may be advantageous to reduce a trading loss by not claiming any/all of the capital allowances available.

If a reduced capital allowances claim is made, the actual allowances claimed are deducted from the appropriate columns in the capital allowances computation. The TWDVs carried forward will therefore be higher, resulting in higher capital allowances available in the future.

Restrictions on the use of trading loss reliefs

- Anti-avoidance measures
- Change in ownership
- Major change in the nature or conduct of the trade
- The operation of the rules
- Small or negligible activities

5 Restrictions on the use of trading loss reliefs

5.1 Anti-avoidance measures

S393(1) only allows trading losses to be carried forward against future profits of the same trade. If the trade changes to such an extent that a new trade is being carried on, the carry forward of losses against the profits of the new trade will be prevented.

In addition, anti-avoidance measures exist to restrict the carry forward of trading losses where there is a change in the ownership of a company.

The rules apply where there is both:

- a change in the ownership of a company and
- a major change in the nature or conduct of the trade within a period of three years. (This three year period may be before or after the change in ownership.)

5.2 Change in ownership

A change in ownership occurs where more than half of the company's ordinary share capital is acquired by a person or persons. This is most likely to occur when a company joins a group. However, the change in ownership is disregarded if the company remains a 75% subsidiary of the same company both before and after the change.

5.3 Major change in the nature or conduct of the trade

A major change in the nature or conduct of the trade includes a change in the type of property dealt in, services provided, customers or markets. However, changes made to keep up to date with technology or to rationalise existing product ranges are unlikely to be regarded as major.

5.4 The operation of the rules

The rules prevent a trading loss incurred prior to the change in ownership from being set against trading profits arising after the change in ownership. This rule applies irrespective of whether the same trade is being carried on.

The rules also operate to prevent a trading loss incurred after the change in ownership from being carried back against trading profits incurred prior to the change in ownership.

5.5 Small or negligible activities

Where the trade has become small or negligible, and a change in ownership takes place before any considerable revival of the trade, the carry forward of trading losses beyond the date of the change in ownership is prevented.

Relief for other types of losses

- Capital losses
- Property business losses
- Non-trading deficits on loan relationships
- Priority of loss claims

6 Relief for other types of losses

6.1 Capital losses

Capital losses must be set against chargeable gains arising in the current period. Any remaining losses must be carried forward and set against future chargeable gains.

6.2 Property business losses

Property business losses are set against total profits (before Gift Aid donations) of the loss making accounting period.

Any remaining losses must be carried forward and set against total profits (before Gift Aid donations) of the following period. The losses can be carried forward indefinitely as long as the letting continues.

6.3 Non-trading deficits on loan relationships

A non-trading deficit on a loan relationship arises where the interest payable on a loan for non-trading purposes (for example, a loan to purchase a property for renting out) exceeds the amount of interest receivable from interest income.

All or part of the deficit may be relieved against:

- total profits (before Gift Aid donations) of the same accounting period
- interest income of the previous 12 months
- future non-trading profits. However, unlike other forms of loss relief, a company is not required to set off a non-trading deficit in the next accounting period. Instead, it can choose to carry all or part of it forward to a later period.

6.4 Priority of loss claims

Where a company has more than one type of loss in an accounting period, it is usual to relieve the non-trading losses first. This is because, in general, non-trading losses cannot be carried backwards.

Surrender of reliefs for a repayment

- Enhanced capital allowances
- Research and development

7 Surrender of reliefs for a repayment

7.1 Enhanced capital allowances

Expenditure on energy saving or environmentally beneficial plant and machinery qualifies for a 100% first year allowance. Where a company has made a loss, it may surrender that part of the loss that relates to such allowances in exchange for a payment from HM Revenue and Customs equal to 19% of the loss surrendered. Such a claim can only be made where the company is unable to use the losses in the current accounting period against its own profits or via group relief.

The claim is made in the company's corporation tax return. The maximum payment that a company can claim is the higher of £250,000 and its total PAYE and NIC liabilities for the relevant accounting period.

Where any of the qualifying plant and machinery is sold within four years of the end of the relevant accounting period, there will be a claw-back of an appropriate part of the payment made and a reinstatement of the losses.

7.2 Research and development

As stated in the previous chapter, small or medium sized enterprises may claim 175% of their qualifying revenue expenditure on research and development as a deduction in computing their taxable trading income.

Alternatively, if an SME has made a trading loss, it may prefer an immediate repayment. It can achieve this by surrendering the R & D relief for a repayable tax credit of 14%. However, the tax credit is restricted to the amount of PAYE and NICs payable by the company for the accounting period.

If the 14% tax credit is claimed, the trading loss carried forward is reduced accordingly.

CHAPTER 22

Overseas aspects of corporation tax

Contents

Overview of the treatment of foreign income and gains

- A company with foreign investments
- The calculation of foreign income

1 Overview of the treatment of foreign income and gains

1.1 A company with foreign investments

If a company is UK resident, it is liable to UK corporation tax on its worldwide profits. Therefore, any income or gains generated from holding investments abroad (such as overseas rental income, interest from foreign bank accounts and capital gains on the disposal of foreign investments) must be brought into the PCTCT statement and taxed.

Foreign income must be brought into the PCTCT statement gross of any foreign tax suffered in the foreign country. It should be included in the PCTCT statement under the separate heading 'foreign income'.

If a UK company disposes of a foreign capital asset, a chargeable gain is calculated in the same way as for the disposal of a UK asset. The chargeable gain or allowable loss is included with UK gains and losses to calculate the overall net chargeable gains for the CAP to include in the PCTCT statement.

Foreign income and foreign gains may be subjected to local foreign income taxes or capital taxes as well as UK corporation tax. If so, double taxation relief (DTR) is available.

1.2 The calculation of foreign income

Foreign income is usually received by companies net of overseas tax.

The term 'withholding tax' (WHT) refers to any direct tax that has been deducted from the income at source before remitting it to the UK. For example, when interest is paid to a foreign investor, the interest actually received by the investor is the gross interest payable less any withholding tax deducted at source.

The amount of withholding tax is calculated as: $C \times W/(100 - W)$ where:

- C is the amount of the cash income received
- W is the percentage rate of WHT, and so
- (100 – W) is the percentage of the gross income received as cash income.

DTR is always available for WHT on any source of income or gains.

Example

X Ltd received interest of £30,000 on its French bank account. This sum was after the deduction of 15% withholding tax.

Required

Calculate the foreign income to include in X Ltd's PCTCT statement and the amount of foreign tax suffered which is eligible for DTR.

Answer

The foreign income in the PCTCT statement must be grossed up for the withholding tax suffered.

	£
Interest received	30,000
Plus: Withholding tax (£30,000 × 15/85)	5,294
Foreign income to include in the PCTCT statement	35,294
Foreign tax suffered which is eligible for DTR	5,294

Consequences of establishing trading operations abroad

- The expansion of trading operations abroad
- Operating abroad via an overseas branch
- Operating abroad via a subsidiary that is resident overseas
- Operating abroad via a subsidiary that is treated as resident in the UK
- Permanent establishment
- Overseas companies trading in the UK

2 Consequences of establishing trading operations abroad

2.1 The expansion of trading operations overseas

Exporting from the UK and importing into the UK

If a UK company wishes to expand its trading operations overseas, it will often start on a small scale by selling its products to existing overseas companies from its domestic base (exporting from the UK) and/or purchasing goods from overseas suppliers (importing to the UK).

If so, these transactions are treated as part of the trading income of the company. The income from sales is not treated as foreign income and is not adjusted for in the adjustment of profit computation. Similarly, the purchases and expenses are not adjusted for as they are allowable deductions incurred wholly and exclusively for the purposes of the trade.

Setting up trading establishments abroad

However, where a company decides to operate overseas on a larger scale by setting up a more permanent trading establishment, it has a choice of operating:

- via an overseas branch/agency, or
- via a separate overseas company.

There are important differences in the treatment for corporation tax purposes.

2.2 Operating abroad via an overseas branch

The branch is treated simply as an extension of the UK company operations. Therefore, all of the branch profits are assessed to UK corporation tax.

The trading income assessment is calculated in the normal way using UK tax rules. For example, capital allowances are available on asset purchases made by the branch. However, the branch trading income is kept separate from the UK trading income, as it has been **generated from a separate trade**.

This distinction between the different sources of trading income is only important if there are losses involved:

- Overseas branch losses can be relieved against all other income and gains in the CAP, and can then be carried back 12 months in the normal way under s393A (or 36 months if the extended carry back rules apply).
- However, trading losses of an overseas branch can only be carried forward under s393(1) and set against future profits from the same trade (i.e. trading profits of the overseas branch only, **not** the trading profits of the UK trade).

Overseas branch profits may be subjected to both local foreign tax and UK corporation tax. If so, DTR is available.

It is important to note that **an overseas branch is not a separate legal entity**. It is not associated and it has no group tax implications.

2.3 Operating abroad via a subsidiary that is resident overseas

If the foreign subsidiary is incorporated overseas and is centrally managed and controlled outside the UK, it is treated as a non-UK resident company. The implications are as follows:

- As a separate legal entity, the profits of the overseas company are assessed according to the tax rules applicable in the country in which it is resident. UK capital allowances are therefore not available on asset purchases.
- The subsidiary's profits are **not liable to UK corporation tax unless** the profits are remitted to the UK holding company.
- Profits remitted in the form of interest are grossed up and taxed as foreign income in the normal way.
- Foreign dividends received in the CAP by the UK holding company are classed as group income and are therefore ignored.
- If the overseas income is taxable both in the UK and overseas, DTR is available for any overseas tax suffered.
- The overseas subsidiary company is an associated company for corporation tax purposes, therefore it will share the statutory limits even though it is not liable to UK corporation tax.
- Losses incurred by a non-UK resident company cannot usually be utilised in the UK (and set off against profits of the UK company).
- Chargeable gains will arise on the transfer of capital assets from the UK company to the overseas company.

2.4 Operating abroad via a subsidiary that is treated as resident in the UK

If the subsidiary is incorporated overseas, but is centrally managed and controlled from the UK, it is treated as a UK resident company and is liable to UK corporation tax in the normal way, via a separate corporation tax computation.

2.5 Permanent establishment

Many double taxation treaties are based on the Model Convention of the Organisation for Economic Co-operation and Development (OECD). The OECD convention uses the term permanent establishment rather than referring to a branch.

The term permanent establishment means a fixed place of business through which the business of an enterprise is wholly or partly carried on. The following are specifically **included** within the definition of permanent establishment:

- a place of management
- a branch
- an office
- a factory
- a workshop
- a mine, an oil well or a quarry
- a building site or construction site, but only if it lasts more than 12 months.

Specifically **excluded** from the definition of permanent establishment are:

- facilities used only for the purpose of storage, display or delivery of goods
- a fixed place of business used only for the purpose of carrying on 'activity of a preparatory or auxiliary character'.

The OECD model convention provides that a company's trading profits are taxed in the country in which its permanent establishment is located.

2.6 Overseas companies trading in the UK

A company that is not resident in the UK can nevertheless be chargeable to UK corporation tax if it carries on a trade in the UK through a permanent establishment in the UK.

Such a company will be charged UK corporation tax at the full rate of 28% on:

- any trading income arising from the permanent establishment in the UK
- any income arising from property held by the permanent establishment in the UK
- any chargeable gains arising from the disposal of assets situated in the UK.

Double taxation relief (DTR)

- Overview of double taxation relief
- Treaty relief
- Unilateral relief
- The effect of deductions from total profits
- Unrelieved foreign tax

3 Double taxation relief (DTR)

3.1 Overview of double taxation relief

A UK resident company may suffer both UK corporation tax and overseas tax if it has income from foreign investments or income from trading overseas. Double taxation relief (DTR) is available to mitigate this double charge to tax.

3.2 Treaty relief

Treaty relief applies where the UK has a specific agreement with the country concerned. The detail of any **particular** treaty is not examinable, but **awareness** is required of how treaty relief is given.

Typically, a DTR treaty will contain the following:

- exemption clauses whereby some income and gains are taxable in one country but exempt in the other
- an agreement on the level of taxation to be applied to some types of income in both countries, and
- a credit relief clause: this usually specifies that relief should be given in accordance with the unilateral relief provisions.

3.3 Unilateral relief

In practice, unilateral relief applies where no treaty agreement exists or a treaty specifies that unilateral relief should apply. Examination questions will only require DTR to be given by unilateral relief.

To calculate unilateral relief, foreign income is included in the PCTCT statement gross of any overseas tax suffered.

The amount of unilateral DTR is then calculated as the lower of:

(1) overseas tax suffered on the foreign income, and

(2) UK corporation tax payable on that source of foreign income (calculated at the effective rate of UK corporation tax for the company receiving the foreign income).

In other words, DTR is the lower of the overseas tax suffered and the UK tax on the income.

Unilateral relief is given as a tax credit relief, i.e. by deduction from the UK corporation tax liability.

If there are several sources of foreign income, a separate DTR calculation is required for each source.

Example

Y Ltd prepares its accounts to 31 March each year. It has no associated companies and has not received any UK dividends. It has supplied the following information for the year ended 31 March 2010:

	£
Trading profit from UK operations	125,000
Trading profit from overseas branch (after WHT of 15%)	21,250
Rental income from an overseas property (after WHT of 25%)	56,250

Required

Calculate the corporation tax payable for the year ended 31 March 2010.

Answer

Y Ltd: Corporation tax computation

			Overseas income	
Year ended 31 March 2010	**Total profits**	**UK profits**	**Branch profits (WHT 15%)**	**Rental income (WHT 25%)**
	£	£	£	
Trading income (W1)	150,000	125,000	25,000	
Foreign rental income (W1)	75,000			75,000
PCTCT	225,000	125,000	25,000	75,000

Corporation tax liability = (£225,000 × 21%) = £47,250
This is then allocated to each source of income at 21%

Corporation tax liability	47,250	26,250	5,250	15,750
DTR (W2)	(19,500)	n/a	(3,750)	(15,750)
Corporation tax payable	27,750	26,250	1,500	Nil

Workings

(W1) Overseas income

Gross income is calculated as the cash income multiplied by a factor 100/(100 – W) where W is the rate of withholding tax as a percentage.

Branch profits	(£21,250 × 100/85) = £25,000
Rental income	(£56,250 × 100/75) = £75,000

(W2) DTR

		Branch profits	Rental income
Lower of		£	£
(a)	Overseas tax suffered		
	Branch: (£25,000 - £21,250)	3,750	
	Rental income: (£75,000 - £56,250)		18,750
(b)	UK tax on that source of foreign income	5,250	15,750

Note: DTR must be calculated separately for each source of foreign income.

3.4 The effect of deductions from total profits

If applicable, a company may deduct from total profits:

- loss relief claims under s393A
- group loss relief
- Gift Aid donations.

However, loss relief brought forward under s393(1) can only be set off against profits of the same trade.

If the company has both UK and foreign income, it is necessary to decide the particular source of income against which any deductions from total profits are to be made, as DTR requires a separate calculation of the UK tax relating to each source of foreign income.

The tax legislation does not specify a strict order of set-off, so the company can choose to set off deductions in the way that will maximise the benefit of DTR.

To maximise the DTR available, it is advantageous to set off any deductions in the following order:

- UK income first, then, if necessary
- foreign income, starting with the source suffering the **lowest** effective overseas rate of tax.

Example

Z Ltd prepares its accounts to 31 March each year. It has no associated companies and has not received any UK dividends. It has supplied the following information for the year ended 31 March 2010:

	£
Trading loss from UK operations	(37,500)
Trading profit from overseas branch (after WHT of 15%)	21,250
Rental income from an overseas property (after WHT of 25%)	56,250
Interest income	22,500

Required

Calculate the corporation tax payable for the year ended 31 March 2010 assuming loss relief is claimed as soon as possible.

Answer

Z Ltd: Corporation tax computation, year ended 31 March 2010

	Total profits	UK profits	Overseas income Branch profits (WHT 15%)	Overseas income Rental income (WHT 25%)
	£	£	£	
Trading income	25,000	Nil	25,000	
Interest income	22,500	22,500		
Foreign rental income	75,000			75,000
	122,500	22,500	25,000	75,000
s393A loss relief	(37,500)	(22,500)	(15,000)	
PCTCT	85,000	Nil	10,000	75,000
Corporation tax liability:				
(× 21%)	17,850	Nil	2,100	15,750
DTR (W)	(17,850)	n/a	(2,100)	(15,750)
Corporation tax payable	Nil	Nil	Nil	Nil

Workings

	Branch profits	Rental income
Lower of	£	£
(1) Overseas tax suffered		
Branch: (£25,000 - £21,250)	3,750	
Rental income: (£75,000 - £56,250)		18,750
(2) UK tax on that source of foreign income	2,100	15,750

Note: If the remaining loss of £15,000 had been set off against the rental income rather than the branch profits, there would have been £1,500 of corporation tax payable relating to the branch profits (i.e. £25,000 x (21% - 15%)).

3.5 Unrelieved foreign tax

If the rate of overseas tax exceeds the UK rate, the company will be left with unrelieved foreign tax. If this unrelieved foreign tax relates to the profits of a permanent establishment it can be:

- carried back up to three years on a LIFO basis,
- carried forward indefinitely, or
- surrendered to another group company.

Note, however, that as the set off in each year is always restricted to the UK tax on that source of income, the ability to carry forward or back will only result in relief where the UK rate of tax rises above that suffered overseas.

Treatment of intra-group transactions with overseas subsidiaries

- An explanation of the problem
- The transfer pricing provisions
- Thin capitalisation
- Worldwide debt cap

4 Treatment of intra-group transactions with overseas subsidiaries

4.1 An explanation of the problem

As a consequence of the close relationship between group companies, intra-group transactions can be arranged at any price the companies choose, or even free of charge. As a result, the pricing of intra-group transactions can result in group profits being transferred from one company in the group to another.

The ability to manipulate the pricing of transactions provides groups with the possibility of valuable tax planning opportunities (e.g. maximising the use of losses within a group and/or ensuring that profits are taxed at the lowest rate of tax available within the group).

Such tactics could be particularly useful in international groups, for example between a UK group company and an overseas group company. By selling to an overseas subsidiary at a price below market price, or buying goods from an overseas subsidiary at a price above the market price, profits can be shifted out of the UK corporation tax charge and advantage taken of tax rates abroad which may be lower.

However, anti-avoidance legislation (the transfer pricing provisions) prevents the manipulation of profits in this way.

4.2 The transfer pricing provisions

The transfer pricing rules apply to transactions between 50% group companies. The rules originally only applied to transactions between a UK company and an overseas company. However, they now apply to transactions where both companies are UK resident.

A 50% group exists where one company controls another company or they are both under common control. (Essentially control exists when there is an interest in the equity shares of the company in excess of 50%. A more detailed definition of control is explained in the next chapter.)

For the purposes of the examination, the rules only apply to large groups of companies. A large group is defined as a group with:

- at least 250 employees, and
- either revenue of at least €50 million or total assets of at least €43 million.

For corporation tax purposes, groups are responsible for applying an **arm's length price** to their intra-group transactions.

An arm's length price is the price that would be charged in a normal commercial transaction between two independent parties.

The rules apply not just to trading transactions, but also to payments of interest where the interest rate charged is less than the arm's length rate.

Note that as companies are required to self-assess their corporation tax liability, it is up to the companies themselves to make the appropriate adjustments. However, a system of advance pricing arrangements exists whereby a company can agree with HMRC in advance that its transfer pricing policy is acceptable.

4.3 Thin capitalisation

The term 'thin capitalisation' refers to the situation where a company is financed by having a high level of debt from another group member, as opposed to being financed by equity capital.

As interest payments are normally deductible in computing taxable profits, a company could reduce its corporation liability by having a high level of debt. The thin capitalisation rules therefore require non-arm's length interest payments between connected companies to be treated as distributions (which are not deductible in computing taxable profits).

4.3 Worldwide debt cap

Finance Act 2009 has introduced provisions to restrict the amount of interest (and other finance expenses) that can be deducted in computing the UK corporation tax payable by the UK members of a large group of companies.

For accounting periods beginning on or after 1 January 2010, the amount of finance cost deductible in computing profits chargeable to UK corporation tax is limited to 75% of the gross financial expenditure of the worldwide group.

Controlled foreign companies

- An explanation of the problem
- Definition of a controlled foreign company
- Consequences
- Exceptions

5 Controlled foreign companies

5.1 An explanation of the problem

It was explained earlier that if an overseas branch (permanent establishment) is established, the whole profit is taxable in the UK. However, if the investment is made through an overseas subsidiary, then only remittances are assessable. This gives the parent company control over the amount and the timing of the tax liability.

The controlled foreign company rules are an anti-avoidance measure that exists to prevent companies from abusing the above rules.

5.2 Definition of a controlled foreign company

A controlled foreign company (CFC) is a company which is:

- resident in a country with a lower level of tax, and
- controlled by UK resident persons.

A lower level of tax means less than 75% of the amount which would have been payable if the company had been UK resident. (HMRC has a list of excluded countries which it does not regard as being low tax countries.)

5.3 Consequences

If the CFC cannot satisfy any of the tests detailed below, its profits may be apportioned to its UK resident shareholders. This means that where a UK resident company (and its associates) is entitled to 25% or more of the profits of a CFC, the UK company is charged on its share of taxable profits less gains, not just on amounts remitted to the UK.

Thus the profits of a wholly owned subsidiary which is classed as a CFC will be fully chargeable to UK CT, irrespective of the amount actually remitted to the parent company.

The UK company must decide whether apportionment is appropriate and, if so, include the apportioned profits of the CFC in its corporation tax return. There is a clearance procedure which enables companies to check in advance whether an overseas investment falls within the CFC rules.

5.4 Exceptions

Even if a company satisfies the above definition of a CFC, it will not be treated as such if it satisfies one of the following exclusion tests:

- It is engaged in exempt activities. This involves having a real presence in the territory of residence and conducting at least 50% of its business with unconnected persons.
- Its profits are less than £50,000 per annum.
- Avoidance of UK tax was not the main purpose of setting up the CFC. This is known as the motive test.

Example

Central Ltd holds 60% of the shares in Alberto SA, an overseas company resident in Ruritania.

The tax rate in Ruritania is 20%. Central Ltd pays UK corporation tax at the standard rate of 28%.

Alberto SA has profits equivalent to £2,000,000 which are not derived from exempt activities, and it is currently not distributing profits.

Required

Is Alberto Ltd a controlled foreign company? If so what is the likely impact for Central Ltd?

Answer

Is Alberto SA controlled by UK residents? Yes.

Is Alberto SA resident in a country with a lower level of taxation? Yes, because Alberto SA's 20% tax rate is less than 75% of the UK equivalent (75% × 28% = 21%). Therefore, the CFC rules may apply.

Does Central Ltd own 25% or more of Alberto SA? Yes.

Does Alberto SA satisfy any of the exclusion tests?

■ Exempt activities?	No
■ PCTCT under £50,000?	No = £2,000,000
■ Motive?	Unknown and probably difficult to prove

In conclusion, Alberto SA is a CFC and therefore Central Ltd will be assessed on 60% × £2,000,000 = £1,200,000 of its profits. (Note, however, that the UK CT liability will be reduced by any creditable overseas tax).

CHAPTER 23

Group corporation tax

Contents

The treatment of associated companies

- Overview of group corporation tax
- Definition of an associated company
- Consequences of being associated
- Capital allowances within a group

1 The treatment of associated companies

1.1 Overview of group corporation tax

A group of companies is **not** treated as a single entity for the purpose of corporation tax. The consolidated accounts for the group are irrelevant for tax purposes.

Instead, for corporation tax purposes, each company within a group is taxed separately in its own right.

However, in calculating the corporation tax of each company, the tax legislation allows the group to deal with certain items on a group wide basis **as if** it were a single entity.

For example, two key areas where the group is looked at as a whole are:

- the treatment of profits on the disposal of capital assets by group members, and
- the utilisation of trading losses.

1.2 Definition of an associated company

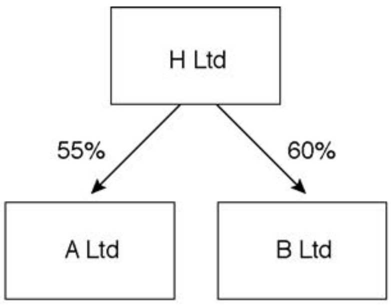
Companies are associated if:

- one company is under the control of another, or
- two or more companies are under the common control of another person, which could be another company, an individual or a partnership.

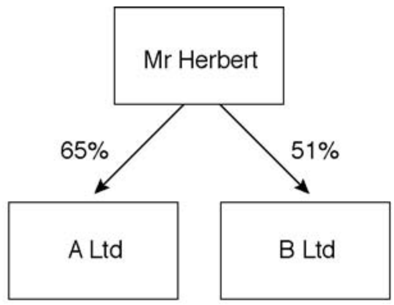
Control in this context means an interest of more than 50% in:

- the share capital, or
- the voting rights, or
- the rights to the distributable profits, or
- the net assets on a winding up of the company.

For example:



Number of associated companies = 3



Number of associated companies = 2

The definition of associated company includes companies which have been acquired, or disposed of, part way through the CAP. These joiners and leavers are deemed to be associated **for the entire CAP**.

The definition of associated company also includes overseas companies, but it excludes dormant companies (i.e. non-trading companies).

A holding company may be excluded provided:

- it does not carry on a trade
- it has no assets, other than shares in the companies it controls
- it has no income or gains other than dividends which it has distributed in full to its shareholders, and
- it is not entitled to a deduction in respect of Gift Aid donations or management expenses.

1.3 Consequences of being associated

The consequences of being associated companies are as follows:

- When calculating profits for each company in the group, any intra-group dividends are ignored entirely. They are not treated as franked investment income (FII).
- For the purpose of establishing the rate of corporation tax applicable to each company in the group, the statutory limits must be divided by the number of associated companies.

Example

For the year ended 31 March 2010, I Ltd had PCTCT of £400,000 and did not receive any dividends. It is a member of a group which has **four** associated companies (including I Ltd).

Required

Calculate the corporation tax liability of I Ltd for the year ended 31 March 2010.

a

Answer

I Ltd – corporation tax liability computation – y/e 31 March 2010

			£
PCTCT			400,000
FII			Nil
'Profits'			400,000
Small companies rate	Lower limit	300,000 ÷ 4	75,000
	Upper limit	1,500,000 ÷ 4	375,000
Decision: Full rate applies (since profits are above £375,000)			
Corporation tax liability			£
£400,000 × 28%			112,000

1.4 Capital allowances within a group

A group of companies is entitled to a single annual investment allowance (AIA). The group can choose how to allocate the AIA between its members; **it does not have to be shared equally**.

The company law definition of a group (essentially a **majority shareholding**) is used for these purposes. Accordingly, companies in a group relief group or a capital gains group are also in a group for AIA purposes.

If a number of companies in a group have incurred capital expenditure, the decision of how to share the AIA may be quite complex. The key points to bear in mind are as follows:

- The AIA effectively provides 100% relief for the expenditure to which it is allocated. It is therefore beneficial to allocate it initially to expenditure in the **special rate pool** as this converts a 10% allowance into a 100% allowance (whereas allocating it to the general pool will convert a 20% allowance into a 100% allowance). Allocating the AIA in this way will accelerate relief for the group's capital expenditure.
- Where more than one company within a group has incurred expenditure qualifying for the special rate pool and the AIA is insufficient to cover all the expenditure, it is more beneficial to allocate it to those companies paying tax at the **full or marginal rates** as this will provide a greater tax saving than allocating the relief to companies paying at the small rate. (This point is explained below in the context of group relief.)

Group loss relief

- Definition of a 75% group for group loss relief purposes
- An outline of how group loss relief works
- The rules for group relief from the surrendering company's point of view
- The rules for group relief from the claimant company's point of view
- Tax planning and group loss relief
- The Marks and Spencer case
- Anti-avoidance rules

2 Group loss relief

2.1 Definition of a 75% group for loss relief purposes

Where one company owns, directly or indirectly, at least a 75% interest in the ordinary share capital of another company, **group loss relief** (often referred to simply as **group relief**) may be available.

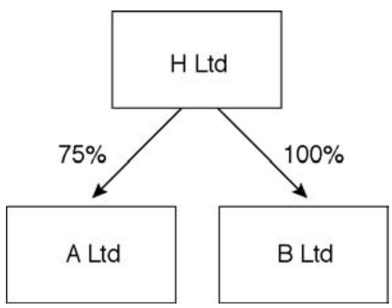
For group relief to be available, the company must **also** own at least 75% of the rights to the distributable profits **and** the net assets on a winding up of the company. However, for the examination, the ownership of the shares is the key deciding factor.

Preference shares

The definition of a group for loss relief purposes involves looking at the ownership of the equity shares. Fixed rate preference shares are excluded from the definition of equity shares. Preference shares where the terms of issue allow the company to reduce or withhold dividend payments in times of financial difficulty are also excluded from the definition of equity shares.

Direct subsidiaries

Directly-owned 75% subsidiaries will be part of a loss relief group. For example:

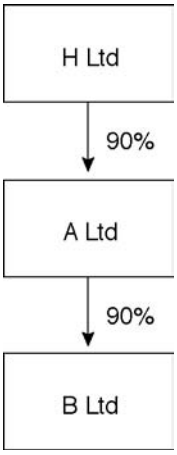


Both A Ltd and B Ltd are directly owned 75% subsidiaries of H Ltd for group loss purposes.

Indirect subsidiaries (sub-subsidiaries)

An **indirect subsidiary** is the term used to refer to the situation where the holding company of a group owns shares in a subsidiary via another company (often referred to as a **sub-subsidiary**).

Example



In this situation, the sub-subsidiary (B Ltd) can only be part of the holding company's loss relief group if the holding company (H Ltd) has an 'effective interest' of at least 75% in the sub-subsidiary (B Ltd).

The **size of the effective interest** is calculated by multiplying together:

- the percentage of the subsidiary owned by the holding company, and
- the percentage of the sub-subsidiary owned by the subsidiary.

In the above example, the effective interest of H Ltd in the sub-subsidiary B Ltd is 81% (= 90% × 90%). Both A Ltd and B Ltd are therefore 75% subsidiaries of H Ltd for group loss relief purposes.

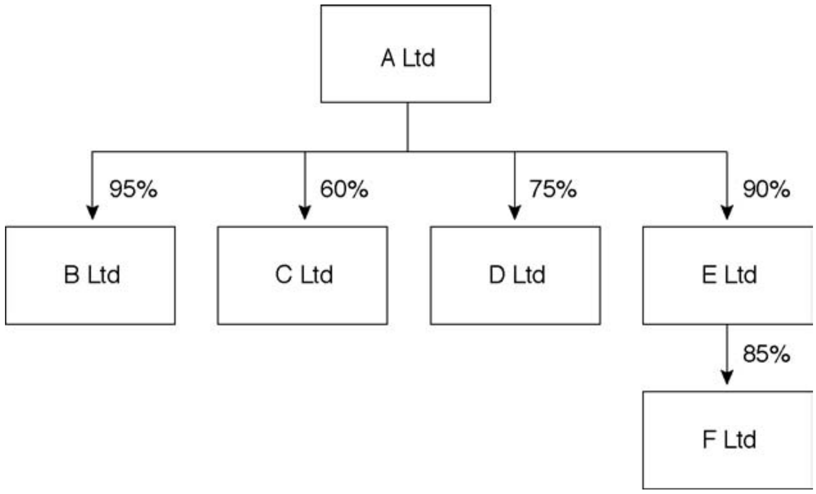
The composition of a loss relief group

To determine the **composition** of a loss relief group, both UK and overseas companies in the group are considered. For example, an overseas holding company with two UK 75% subsidiaries would form a loss relief group.

Under the group loss relief provisions, it is usually only possible to move losses between the UK companies in the group. (However, see later for an exception to this general rule following the judgement in the Marks and Spencer case.)

A company can be a member of more than one loss relief group.

Example



Required

Calculate the number of associated companies and state which companies form a loss relief group making each of the following alternative assumptions:

(a) All companies are UK companies

(b) A Ltd is an overseas company.

Answer

(a) Assuming all companies are UK companies

Number of associated companies = 6

All the companies are associated as A Ltd has an interest of more than 50% in each.

Loss relief group = A Ltd, B Ltd, D Ltd, E Ltd and F Ltd

Notes

(1) C Ltd is not included as A Ltd owns less than 75%.

(2) F Ltd is included as A Ltd has an effective interest of at least 75% (90% × 85% = 76.5%).

(b) Assuming A Ltd is an overseas company:

The answer is the same as above in (a):

Overseas companies are associates; therefore there are still 6 associated companies.

The composition of a **loss relief group** includes overseas companies; the group is therefore defined as above.

However, group losses may only move between the UK-resident companies (i.e. between B Ltd, D Ltd, E Ltd and F Ltd).

2.2 An outline of how group loss relief works

The group relief provisions allow losses to be transferred in any direction between UK companies within a loss relief group.

The loss relief is deducted from the PCTCT of the claimant (recipient) company and therefore reduces its corporation tax liability.

Group relief is not automatic. It must be claimed within two years of the end of the CAP of the company receiving the group relief.

2.3 The rules for group relief from the surrendering company's point of view

The following losses can be surrendered:

- trading losses
- unrelieved UK property business losses (i.e. losses left unrelieved after making a claim against total profits for the current period)
- unrelieved Gift Aid donations.

It is important to note that **capital losses cannot be surrendered** using these rules (but see below).

Only current period losses can be surrendered. It is not possible to surrender losses brought forward from a previous CAP or carried back from a later CAP.

The surrendering company can give away any amount of its current period losses to one or several other group companies.

The surrendering company can utilise its own losses against its own profits (for example, with a s393A claim) before surrender, if it wishes to do so. However, it is **not obliged** to utilise its own losses first. It can transfer all its losses, and pay tax itself, if it wishes to do so for tax planning reasons or other commercial reasons.

However, it cannot surrender all its losses if the claimant company can not utilise them all against its own available profits.

2.4 The rules for group relief from the claimant company's point of view

The claimant company can only accept losses up to the amount of its available profits.

'**Available profits**' are defined as **PCTCT after deducting** the following amounts relating to the claimant company:

- any trading losses brought forward
- a current period loss relief claim under s393A (see below), and
- current period Gift Aid donations.

In calculating the available profits, current period losses are deemed to be relieved under s393A, even if a claim is not actually made. However, there is no requirement to take account of a carry back claim under s393A.

Losses can only be matched against profits of a corresponding accounting period. (i.e. the period when both the surrendering and claimant companies were part of the same group).

If both companies have the same CAPs and are part of the group for the whole CAP, the maximum group relief claim = Lower of:

- the loss of the surrendering company, or
- the available profits of the claimant company.

Year ends that are not coterminous

Where the two companies have non-coterminous year ends (i.e. they do not have the same year end dates) or where a company joins or leaves a group during the CAP, the maximum group relief available is calculated by **time-apportionment** of:

- the surrendering company's losses, and
- the claimant company's available profits.

In effect, this means that the available profits are matched with the available losses in the common CAPs.

Example

G Ltd owns a 100% subsidiary, K Ltd. In the year ended 30 September 2009 the two companies had the following results:

	G Ltd	K Ltd
	£	£
Trading profit / (loss)	(125,000)	28,000
Interest income	20,000	20,000
Net chargeable gain	Nil	135,000
Gift Aid payment	(2,000)	(5,000)
Trading loss brought forward	(10,000)	(50,000)

Required

Calculate the maximum group relief surrender for the year ended 30 September 2009.

Answer

K Ltd - Available profit

	£
Trading income	28,000
Minus: Loss brought forward under s393(1)	(28,000)
	Nil
Interest income	20,000
Net chargeable gains	135,000
	155,000
Gift Aid payment	(5,000)
Available profits of K Ltd	150,000
G Ltd - Available loss = All the current period trading loss of G Ltd (see notes below)	125,000
Maximum group relief = Lower of available profits (£150,000) and available loss (£125,000)	125,000

Notes

(1) G Ltd can not surrender the £10,000 trading losses brought forward.

(2) G Ltd does not need to use its own loss first. It can surrender all the loss for its current period.

(3) G Ltd cannot group relieve its Gift Aid payment because the payment can be set off against the interest income in the CAP and is not therefore unrelieved.

2.5 Tax planning and group loss relief

In utilising the group loss provisions, the primary aim of the group should be to save the maximum amount of corporation tax for the **group as a whole**.

Therefore, the rates of corporation tax applicable to each company in the current CAP need to be considered.

In addition, the rate applicable to the loss-making company:

- in the previous 12 months is important, for deciding whether or not a s393A claim to carry back losses is beneficial (or the previous 36 months if an extended carry back claim is to be made), and
- in the future is important, for deciding whether or not losses should be carried forward under s393(1).

To achieve the highest tax savings, the group will want to utilise the loss against the profits suffering the highest effective marginal rate of tax. The optimum order of set-off is therefore as follows:

Profit limits subject to adjustments as referred to above	Effective marginal rate of tax			Order for loss allocation
	FY07	FY08	FY09	
£0 - £300,000	20%	21%	21%	3
£300,000 - £1,500,000	32½%	29¾%	29¾%	1
£1,500,000 +	30%	28%	28%	2

When allocating losses, the following points should be remembered:

- s393A is an all or nothing relief. If the relief is claimed, the maximum possible amount of loss must be used.
- However, group relief is flexible. It can be surrendered in any amount and in any direction to any other group company (or several group companies).

If cash flow is important to the group, note that:

- carrying losses back under s393A could result in a repayment of tax
- group relief reduces the group's current tax liabilities
- carrying losses forward delays the benefit of using losses.

Utilising losses with group relief: summary

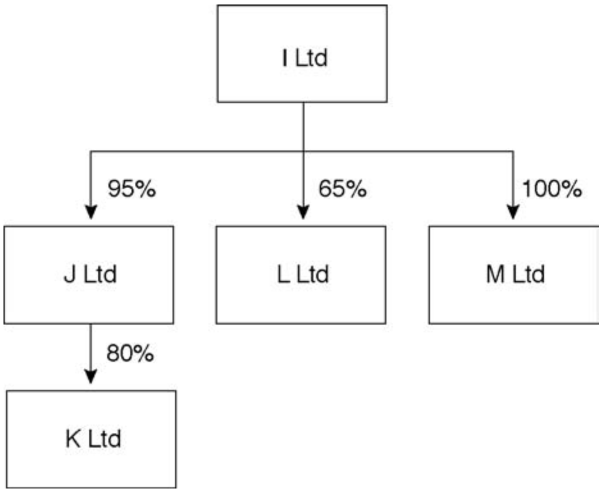
As the primary aim is to minimise the overall group tax liability, the optimum use of losses is to surrender them to the group companies in the following order:

- First. To group companies paying 29¾%, but only the amount needed to bring profits down to the relevant limit of £300,000 (as adjusted).
- Second. To group companies paying 28% tax - these companies should be given enough to bring profits down to the same relevant limit of £300,000 (as adjusted), thereby saving tax at 28% initially and then 29¾%.
- Finally, to group companies paying 21% tax.

Where several losses arise in a group, relief should first be given in respect of those losses having the most restricted usage. For example:

- Trading losses brought forward can only be set against the future trading profits of the same loss-making company.
- Capital losses can only be set against capital gains.

Example



The results of these companies for the year ended 31 March 2010 are as follows:

	I Ltd	J Ltd	K Ltd	L Ltd	M Ltd
	£	£	£	£	£
Trading profit / (loss)	340,000	(120,000)	34,000	134,000	75,000
Interest income	50,000	5,000	Nil	9,000	4,500

All companies are UK resident and none of the companies received any UK dividends.

Required

Calculate the PCTCT for each company assuming group relief is claimed in the most tax-efficient manner, and calculate the tax saving achieved.

Answer

Start by identifying the number of associated companies, as this influences the tax rates and therefore the decision on the optimum use of losses.

Number of associated companies = 5

Next, identify the group or groups which exist for group loss surrender purposes:

Group loss relief group = I Ltd, J Ltd, K Ltd, M Ltd

Notes

(1) L Ltd is not included as I Ltd owns less than 75%.

(2) K Ltd is included as I Ltd has an effective interest of at least 75% (95% × 80% = 76%).

Next: Establish the relevant limits for tax rate purposes:

Relevant limits

			£
Small companies rate	Lower limit	300,000 ÷ 5	60,000
	Upper limit	1,500,000 ÷ 5	300,000

Next: Loss relief is then allocated to group companies in such a way as to maximise the overall tax saving to the group.

	I Ltd	**J Ltd**	**K Ltd**	**L Ltd**	**M Ltd**
	£	£	£	£	£
Trading income	340,000	Nil	34,000	134,000	75,000
Interest income	50,000	5,000	Nil	9,000	4,500
PCTCT before loss relief	390,000	5,000	34,000	143,000	79,500
PCTCT = profits (no FII)	390,000	5,000	34,000	143,000	79,500
Marginal rate of relief	28%	21%	21%	29¾%	29¾%

Best tax planning option

There is no advantage in J Ltd using its own loss as it would only save tax of £1,050 (£5,000 × 21%) and use £5,000 of the loss. There is also no advantage in surrendering any loss to K Ltd as it will only save tax at 21%.

J Ltd cannot surrender losses to L Ltd as this company is not part of the loss group.

To save the most tax, J Ltd should surrender to M Ltd first to bring down its profits to the small companies rate lower limit; then surrender to I Ltd and give the maximum amount possible, which will save tax initially at 28% and then at 29¾%.

	Amount of loss used	**Rate of tax saving**	**Tax saving**
	£		£
To M Ltd to bring down to £60,000 profits	19,500	29¾%	5,801
To I Ltd to bring down to £300,000 profits	90,000	28%	25,200
To I Ltd (the balance of the loss)	10,500	29¾%	3,124
	120,000		34,125

2.6 The Marks and Spencer case

Group relief was originally only available if both the claimant and surrendering companies were resident in the UK or carried on a trade in the UK through a permanent establishment. These rules were successfully challenged by Marks and Spencer in a case taken before the European Court. As a result of the M&S decision, the legislation was changed.

A UK **parent** company can now claim group relief for losses incurred by subsidiaries resident in the **European Economic Area** provided **these losses cannot be relieved elsewhere.** The extension of the relief is therefore extremely limited and, if in doubt, you should stick to the general principle that overseas companies cannot participate in group relief claims.

2.7 Anti-avoidance rules

Group relief is not available once arrangements are in force for a company to leave a group. Therefore relief for losses may be denied as soon as agreement has been reached for the sale of a subsidiary, even though the sale may not take effect until some months later. (However, where the sale requires the approval of the shareholders, arrangements will not come into existence until that approval is given.)

If arrangements come into existence part way through an accounting period, profits and losses will need to be time-apportioned accordingly.

Group chargeable gain provisions

- Definition of a 75% group for the group chargeable gain provisions
- An outline of the advantages of having a gains group
- The treatment of intra-group transfers of capital assets
- Claiming group rollover relief
- Intangible fixed assets
- Electing to make maximum usage of capital losses
- Tax planning using capital losses
- Anti-avoidance rules

3 Group chargeable gain provisions

3.1 Definition of a 75% group for the group chargeable gain provisions

A chargeable gains group exists where one company owns, directly or indirectly, at least 75% of the ordinary share capital of another company. An indirect sub-subsidiary can be part of the gains group provided that:

- the direct subsidiary has at least a 75% holding in the sub-subsidiary and
- the holding company has an effective interest of over 50%.

Unlike group loss relief, a company can not be a member of two gains groups.

Example

	≥ 75% direct holding test	≥ 75% effective interest test	> 50% effective interest test
H Ltd			
↓ 75%	√	√	√
A Ltd			
↓ 75%	√	75% × 75% = 56.25% X	√
B Ltd			
↓ 75%	√	56.25% × 75% = 42.1875% X	X
C Ltd			

Required

Calculate the number of associated companies, state which companies form a loss relief group and state which companies form a gains group.

Would there be a difference to the answer if A Ltd were an overseas company?

Answer

There are **four associated companies**, because at each link there is a more than a 50% interest.

Loss relief groups	Gains group
Group 1: H Ltd and A Ltd Group 2: A Ltd and B Ltd Group 3: B Ltd and C Ltd	Group 1 H Ltd, A Ltd and B Ltd
Notes:	Notes:
(1) Neither B Ltd nor C Ltd can be grouped with H Ltd for group loss relief purposes as the 75% effective interest test is not satisfied.	(1) C Ltd cannot be grouped with H Ltd for group gains purposes.
(2) A company can be a member of more than one loss group.	(2) B Ltd and C Ltd cannot form another gains group as a company can not be a member of more than one gains grou.

To determine the composition of a gains group, overseas companies in the group are included. However, the advantages of having a gains group only apply to the UK companies in the group. (This is the same as for group loss relief.)

Therefore, in the example above, if A Ltd was an overseas company there would be no difference in the definitions of the groups. However:

- H Ltd and B Ltd can take advantage of the capital gains provisions, but not with A Ltd (overseas).
- Only B Ltd and C Ltd can transfer losses to each other.

3.2 An outline of the advantages of having a gains group

There are three key advantages in having a gains group. These are the ability to:

- transfer capital assets between group companies at nil gain / nil loss
- claim group rollover relief, and
- transfer capital gains and losses between group members.

Each of these advantages is now considered in more detail.

3.3 The treatment of intra-group transfers of capital assets

Transfers of capital assets between members of a gains group are deemed to take place so that no chargeable gain or loss arises on the transfer.

The asset is deemed to be transferred for a price equal to its cost to the transferor plus indexation up to the date of the transfer. Any sale proceeds actually received for the asset are ignored for tax purposes.

This treatment is automatic (i.e. a claim is not required).

When the recipient company sells the asset outside the group at a later date, the normal chargeable gain computation applies, using the deemed acquisition cost as allowable expenditure.

Example

N Ltd own 80% of O Ltd. Both companies prepare accounts to 30 June each year.

On 14 September 2003 N Ltd sold a warehouse to O Ltd for £200,000. Its market value at that date was £250,000. N Ltd had purchased the warehouse on 30 August 1999 for £120,000.

On 25 May 2009 O Ltd sold the warehouse for £300,000 to an unconnected company, P Ltd.

Required

Calculate the gains arising in the year ended 30 June 2004 and year ended 30 June 2009.

Answer

Year ended 30 June 2004: Transfer from N Ltd to O Ltd

	£
Deemed sale proceeds (ignore actual proceeds received. Use cost + IA)	132,360
Cost (August 1999)	(120,000)
IA on cost - from August 1999 to September 2003	
$\frac{182.5 - 165.5}{165.5} = 0.103 \times £120{,}000$	(12,360)
Chargeable gain	Nil

Year ended 30 June 2009: Disposal by O Ltd outside the group to P Ltd

	£
Sale proceeds	300,000
Deemed cost	(132,360)
Unindexed gain	167,640
IA on cost - from September 2003 to May 2009	
$\frac{212.8 - 182.5}{182.5} = 0.166 \times £132{,}360$	(21,972)
Chargeable gain arising in O Ltd	145,668

If the recipient company leaves the group within six years of receiving the asset, it will be treated as if it had sold and re-purchased the asset at market value on the date it **received it** from the other group member. (Note it is the company **leaving** the group that is taxed on the gain; not the company that originally owned the asset.)

The gain is treated as if it arose in the accounting period in which the company left the group. It is often referred to as a degrouping charge.

Example

The facts are the same as in the previous example. However, instead of selling the asset to a third party, on 25 May 2009 O Ltd left the group still holding the warehouse which had a market value of £300,000.

Required

Calculate the gains arising in the year ended 30 June 2004 and year ended 30 June 2009.

Answer

Year ended 30 June 2004: Transfer from N Ltd to O Ltd

	£
Deemed sale proceeds (as before)	132,360
Chargeable gain (as before)	Nil

Year ended 30 June 2009: O Ltd leaves the group

	£
Sale proceeds (Market value at September 2003)	250,000
Deemed cost	(132,360)
Chargeable gain arising in O Ltd	117,640

When O Ltd eventually does sell the warehouse, it will be treated as acquiring it for £250,000 at September 2003.

3.4 Claiming group rollover relief

For the purposes of rollover relief, a gains group is treated as a single entity.

Therefore, a gain arising on the disposal of a qualifying business asset (QBA) by one company in the group can be deferred against the base cost of a replacement QBA acquired by another group company from outside the group.

The computation of rollover relief and the mechanics of deferral are the same as for a single company.

Rollover relief may also be claimed in respect of a degrouping charge, assuming that it relates to a QBA and a replacement QBA is purchased by another group company.

3.5 Intangible fixed assets

The transfer of intangible fixed assets within a chargeable gains group is subject to similar rules to those for tangible fixed assets:

- Transfers between group members are on a no gain /no loss basis.
- A degrouping charge arises if the recipient company leaves the group within six years of receiving the asset.
- Rollover relief applies if another group member acquires in an intangible fixed asset.

3.6 Electing to make maximum usage of capital losses

Companies in a chargeable gains group can make an election to transfer the whole or part of any chargeable gain or allowable loss to another group member.

The election enables chargeable gains to be matched against capital losses. In addition, it ensures that any net chargeable gains are taxed in the hands of the group member paying the lowest marginal rate of tax.

The election must be made within two years of the end of the CAP in which the chargeable gain or loss arises. To be effective, both group companies must sign the election.

The election can also be used to transfer a degrouping charge from one group member to another.

3.7 Tax planning using capital losses

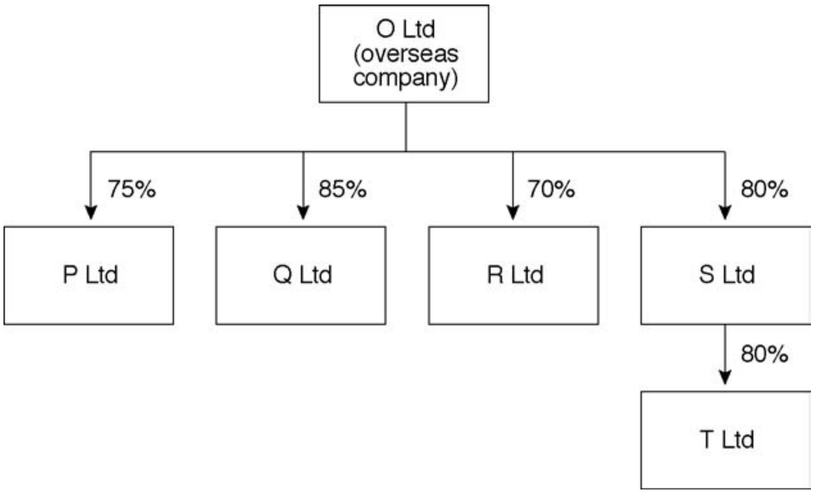
The capital gains provisions provide the opportunity to save corporation tax by making effective use of losses and crystallising gains in the group member paying the lowest marginal rate of tax. In addition, gains may be deferred using rollover relief claims.

The primary aim of the group is usually to minimise the overall group tax liability.

Therefore, as for group loss relief, the rates of corporation tax applicable to each company in the current CAP need to be considered.

The election to match gains and losses is flexible. Any amount of a gain or loss can be transferred in any direction to any other group company (or several companies).

Example



The companies pay tax at the following marginal rates:

O Inc	P Ltd	Q Ltd	R Ltd	S Ltd	T Ltd
40%	29¾%	28%	21%	28%	21%

Q Ltd disposed of a capital asset crystallising a gain.

Required

Explain what the group should do to minimise its corporation tax liability. Assume that the gain is not sufficiently large to affect the above rates of tax.

Answer

Gains group = O Inc, P Ltd, Q Ltd, S Ltd and T Ltd

The definition of the group includes O Inc. However, the benefits of being in a chargeable gains group are only available to UK resident companies (i.e. P Ltd, Q Ltd, S Ltd and T Ltd). Therefore, electing to transfer the gain to O Inc is not an option.

R Ltd is not included in the group as O Inc owns less than 75%. Therefore electing to transfer to R Ltd to take advantage of its 21% rate of tax is not an option.

T Ltd is included in the gains group as O Inc has a direct interest of at least 75% in S Ltd, S Ltd has a direct interest of at least 75% in T Ltd, and O Inc has an effective interest of over 50% (i.e. 80% × 80% = 64%).

Q Ltd may therefore pay tax on the gain itself at 28% or elect to transfer the gain to P Ltd, S Ltd or T Ltd. Of these companies, T Ltd pays tax at the lowest effective marginal rate of tax of 21%.

Q Ltd should therefore elect to transfer the chargeable gain to T Ltd where it will be taxed at 21%.

3.8 Anti-avoidance rules

Pre-entry capital losses

To prevent companies acquiring subsidiaries in order to make use of any losses they may have, there are anti-avoidance rules restricting the use of pre-entry capital losses.

When a company joins a capital gains group, it must identify its capital losses (both realised and unrealised) at the date it joined the group. Such capital losses can only be relieved against:

- the company's own assets held at the date it joined the group
- new assets acquired from outside the group, provided these are only used for the purpose of the same trade the company carried on before it joined the group.

The pre-entry loss on an asset brought into the group can be calculated by either:

- time-apportioning the actual loss arising when the asset is eventually sold
- calculating the loss that would have arisen if the asset had been sold for its market value on the date the company joined the group.

This second method requires an election that must be made within two years of the end of the accounting period in which the disposal occurs. The election also allows the company to substitute the actual loss arising on the sale, if lower.

Capital losses

Further anti-avoidance legislation ensures that a company's capital losses can only be offset against its own gains, or those of companies that are within its capital gains group **both at the time when the losses arose and when they are used**. This legislation is intended to counter tax avoidance schemes that try to circumvent the legislation on pre-entry losses.

The rules apply where there is a change in the ownership or control of a company (broadly where the company ceases to be, or becomes a member of a group), as part of arrangements which have a reduction in corporation tax liability as their sole or main purpose.

Under these rules:

- a loss on the disposal of a pre-change asset (an asset owned by a company before a change of ownership) can only be deducted from a gain arising on another pre-change asset
- a gain arising on the disposal of a pre-change asset can only be relieved by capital losses arising on the disposal of a pre-change asset.

Consortia

- Definition
- Consequences of being in a consortium

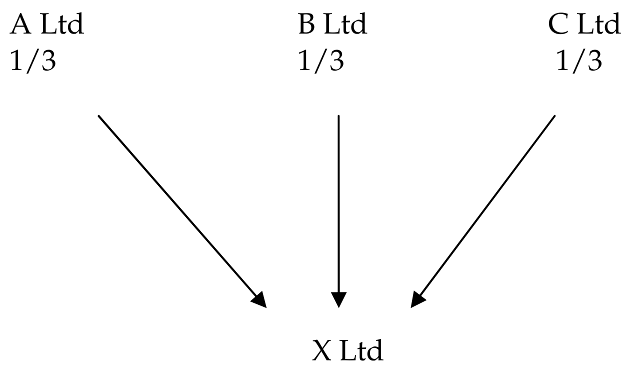
4 Consortia

4.1 Definition

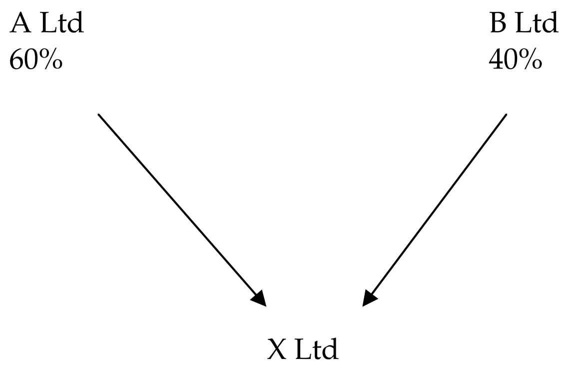
A consortium exists where two or more companies (UK or overseas) own at least 75% of another company, and each company's holding is at least 5%. Ownership includes ordinary shares and assets and profits as for a 75% group.

The investing companies are known as the consortium members. The target company is known as the consortium owned company.

In the following example, A Ltd, B Ltd and C Ltd each hold 1/3 of the shares in X Ltd. A Ltd, B Ltd and C Ltd are therefore the consortium members. X Ltd is the consortium owned company.



In this next example, A Ltd holds 60% of the shares in X Ltd; while B Ltd holds the other 40%. A Ltd and B Ltd are the consortium members. X Ltd is the consortium owned company. However, A Ltd and X Ltd are also associated companies.



In this next example, A Ltd holds 80% of the shares in X Ltd; while B Ltd holds the other 20%. No consortium can exist in this situation as A Ltd is in a 75% group with X Ltd.

A Ltd
60%

B Ltd
40%

X Ltd

4.2 Consequences of being in a consortium

Consortium relief can be claimed. This is a special type of group relief under which losses can be transferred between the consortium owned company and the members of the consortium. (Note, however, that losses cannot be transferred between one consortium member and another.)

There are two differences between consortium relief and group relief:

- Relief is limited to the relevant percentage of the **consortium owned company's** profit or loss.
- The amount of loss a consortium owned company can surrender is reduced by its own current year profits. (Note, however, that the consortium owned company does not actually have to claim relief against its own current year profits; the loss available for relief is simply reduced **as if** it had claimed relief.)

Example

A Ltd owns 40% of X Ltd. The other shares are held equally by B Ltd and C Ltd.

Required

(a) State how much loss could be surrendered by X Ltd to A Ltd, assuming X Ltd has a loss of £60,000 and A Ltd has profits of £50,000.

(b) State how much loss could be surrendered by A Ltd to X Ltd, assuming A Ltd has a loss of £60,000 and X Ltd has profits of £50,000.

Answer

(a) X Ltd can surrender a maximum of 40% of its loss to A Ltd: £60,000 × 40% = £24,000. The surrender is limited to the amount of A Ltd's profits for the current period. However, as A Ltd's profits are £50,000, it is able to absorb the full £24,000.

(b) A Ltd can surrender a loss of up to 40% of **X Ltd's profits**: £50,000 × 40% = £20,000.

Example

F Ltd has a trading loss of £80,000 and other income of £20,000.

Required

Explain how much loss F Ltd could surrender assuming it is:

(a) a member of a 75% group

(b) a member of a consortium

(c) a consortium owned company.

Answer

(a) If F Ltd was in a 75% group it could surrender the full £80,000.

(b) If F Ltd was a consortium member it could surrender the full £80,000, provided that its share of the consortium owned company's profits was sufficient to absorb it.

(c) If F Ltd was a consortium owned company it could only surrender £60,000. This is because a consortium owned company is deemed to set its loss against its own current year profits before surrendering any to the consortium members.

Finally, note that consortium relief can also be claimed in the following situation:

Consortium members

↕ (75%)

Holding company (COC)

↕ (90%)

Trading company

This enables relief to flow through the holding company from the consortium members to the trading company and vice versa.

CHAPTER 24

Corporation tax – additional aspects

Contents

Close companies

- Definition
- The provision of benefits
- The provision of loans
- Reliefs for investors

1 Close companies

1.1 Definition

A close company is a company controlled by either:

- five or fewer participators (i.e. shareholders) or
- any number of directors.

Control exists where the participators/directors:

- hold more than 50% of the issued share capital or the voting rights, or
- are entitled to more than 50% of the distributable profits or the net assets in a winding up.

In determining whether control exists, the holdings of associates are taken into account. An associate of a participator is his or her spouse, sibling, (grand) child, (grand) parent or business partner.

The term 'director' includes:

- any person holding the position of director
- any person in accordance with whose instructions the other directors are accustomed to act
- any manager who owns 20% or more of the company's ordinary share capital.

1.2 The provision of benefits

If a participator is provided with a benefit, such as a company car or medical insurance, the taxation treatment of the benefit depends on whether the individual is:

- both a participator and an employee/director
- a participator but not an employee/director.

The provision of a benefit to a participator who is also a director or employee has the following implications:

- The individual is taxed under the employment income rules.

- The expenditure incurred by the company on the provision of the benefit is a deductible trading expense (if revenue expenditure) or qualifies for capital allowances (if qualifying capital expenditure).
- Class 1A national insurance is payable by the company on the amount of benefit as quantified for employment income purposes.
- The fact that the employee/director is also a participator is irrelevant.

The provision of a benefit to a participator who is not a director or employee has the following implications:

- It cannot be assessed on the individual under the employment income rules as there is no office or employment. The benefit is instead treated as a distribution.
- The distribution is valued using the employment income rules; it is then grossed up by 100/90.
- The individual pays income tax at either 10% (if a basic rate taxpayer) or 32.5% if a higher rate taxpayer.
- A notional tax credit of 10% of the gross value of the distribution is available to set against the income tax liability, however, this tax credit is not repayable.
- The company cannot deduct the cost of the benefit in calculating its trading profits (or claim capital allowances) as the cost of providing the benefit is not 'wholly and exclusively' for business purposes.
- No class 1A national insurance is due on distributions.

e

Example

Jennifer and Hugh are shareholders of Adams Ltd, a close trading company. Jennifer is also a director. Both Jennifer and Hugh are higher rate taxpayers.

On 6 April 2009, Adams Ltd provided each of them with a new petrol engined company car. The car cost £15,000 and has a CO_2 emission rate of 171 gms/km. The company does not pay for private petrol. Adams Ltd pays corporation tax at the rate of 28%.

Required

Explain the taxation implications for both the company and the individuals.

a

Answer

The provision of the company car to Jennifer, who is both a director and a shareholder, has the following consequences:

- For Jennifer, there is an employment benefit, calculated as £15,000 × 22% = £3,300. (15% + (170 – 135)/5 = 22%).
- As Jennifer is a 40% taxpayer, this benefit will result in additional income tax of £1,320 (£3,300 × 40%), which will be collected through the PAYE system by adjusting her tax code.

- The class 1A NIC payable by Adams Ltd is £422 (£3,300 × 12.8%). There is no NIC payable by Jennifer.
- As the car has CO_2 emissions of more than 160 g/km, it will be added to the special rate pool. A writing down allowance of 10% (calculated using the reducing balance method) will be due. In the first year of ownership, this will be £1,500 (£15,000 x 10%).
- Both the capital allowance and class 1A NIC are deductible in calculating Adams Ltd's trading profits. This will reduce the corporation tax by £538 (£1,922 × 28%).
- Adams Ltd's trading profits will be further reduced by the running costs of the car.

The provision of the company car to Hugh, who is a shareholder but not a director, has the following consequences:

- There is no employment income charge as Hugh is not an employee or director.
- The distribution is valued at £3,300 as above. It is then grossed up to £3,667 (£3,300 × 100/90).
- As Hugh is a higher rate taxpayer, income tax of £1,192 is due (£3,667 × 32.5%). A tax credit of £367 (£3,667 × 10%) is available, so the additional income tax is only £825.
- No capital allowances are available to the company. The costs incurred in connection with the car are not deductible.
- No national insurance is due.

1.3 The provision of loans

The provision of a loan to a participator, irrespective of his employment status, has the following implications:

- There is a tax charge on the company of 25% per cent of the loan advance. This charge is payable nine months after the end of the accounting period, unless the loan has been repaid or written off before the due date.
- This tax is in addition to the company's CT liability.
- The tax is repaid when the loan is repaid (wholly or partly) or when the loan is written off.
- If the loan is written off, it is grossed up by 100/90 and taxed on the individual in the same way as dividend income.

The above implications do not apply where the loan meets all of the following conditions:

- The amount loaned does not exceed £15,000.
- The individual is a full-time working employee.
- The individual (together with any associates) owns less than 5% of the shares.

(Note that the Companies Act prohibits companies making loans to directors.)

Example

Peter and Gillian are both shareholders and full time employees in Lordy Ltd, a close company. Peter owns 20% of the company's ordinary share capital, whilst Gillian owns 2%. They are not connected with each other. The company loaned each of them £8,000 on 6 April 2009. Interest of 3% is charged on the loans. The official rate of interest is 4.75%. The company makes up its accounts to 31 March annually.

Required

Explain the taxation implications for both Lordy Ltd and the individuals.

Answer

The tax implications are as follows:

- Both Peter and Gillian are full-time employees and the amount loaned to both of them is less than £15,000. As Gillian owns less than 5% of the ordinary share capital, her loan has no tax implications for Lordy Ltd. However, the loan to Peter is caught by the provisions as he has more than 5% of the company's ordinary share capital.
- Lordy Ltd must pay a tax charge of £8,000 × 25% = £2,000 on 1 January 2011 in respect of the loan to Peter. If any part of the loan is repaid by 1 January 2011 then this tax charge is reduced accordingly. The £2,000 is in addition to the company's corporation tax liability. It is not recoverable until the loan is repaid or written off.
- Peter and Gillian have both received the benefit of a low interest loan. They will be taxed under the employment income rules on £8,000 × (4.75% - 3%) = £140.

1.4 Reliefs for investors

Individuals who borrow money to buy shares in or make a loan to a close company are entitled to deduct any interest payments in calculating their taxable income. In order to qualify for this deduction the investor must:

- own more than 5% of the issued share capital, or
- own any part of the share capital and work for the greater part of their time in the management of the company.

The deduction is not permitted if the individual or his spouse claimed income tax relief or capital gains tax reinvestment relief under the Enterprise Investment Scheme on the acquisition of the shares.

Investment companies

- Definition
- Management expenses
- Unrelieved management expenses
- Close investment companies (CIC)

2 Investment companies

2.1 Definition

Investment companies (which should strictly be referred to as 'companies with investment business') are companies 'whose business consists wholly or partly in the making of investments'.

Most companies derive some income from investments. However, a company will only be classed as an investment company if it derives the principal part of its income from investments.

The profits of a company with investment business are calculated in exactly the same way as those of a trading company.

2.2 Management expenses

Management expenses are the expenses incurred by investment companies in managing their investments. For example:

- Directors' fees
- Salaries of employees and managers
- Audit fees
- Rent, rates, gas and electricity.

The treatment of management expenses is as follows:

- If the expenses can be directly related to a particular source of income (for example, a property expense that can be directly set against property income), they are allowable against that source of income.
- If the expenses are general management expenses which cannot be directly related to a particular source of income, they are allowable on an accruals basis against the 'total profits' of the company (before Gift Aid donations are deducted).

To be allowable, the expenses must not be excessive and, if the expense is allowable, the amount of the deduction is calculated on an accruals basis.

2.3 Unrelieved management expenses

It is quite common for an investment company to have management expenses in excess of its taxable income. (This is because dividend income is not usually chargeable to corporation tax.)

Management expenses that cannot be relieved in the current period may be:

- Carried forward and set against future profits.
- Group relieved in the current period.

Unrelieved management expenses can never be carried backwards.

2.4 Close investment companies (CIC)

Where a company is close, but is not a trading company or a member of a trading group, then it will be classed as a close investment company (CIC). CICs are required to pay corporation tax at the full rate (i.e. 28%), irrespective of the level of their profits.

Personal service companies

- Introduction
- When do the rules apply?
- Consequences
- Calculation of the deemed payment
- Effect of deemed payment on dividends paid
- Effect on the PSC's corporation tax

3 Personal service companies

3.1 Introduction

The rules on personal service companies (PSCs) were introduced in order to avoid the loss of income tax and national insurance arising where an individual (who is in reality an employee) performs their services through the medium of a limited company.

The rules are often referred to as the IR35 provisions.

3.2 When do the rules apply?

A PSC is within the IR35 provisions if the worker controls more than 5% of any dividends from the company or receives, or could receive, payments which are not salary but which represent payments for services provided to clients.

The rules are aimed at the situation where the individual would be treated as an employee, were it not for the fact that a PSC was inserted between them and the client. In determining whether the individual is in reality an employee, the normal tests are applied (see chapter 4).

Under the situation in figure 1, there is a direct employer/employee relationship between the parties. The employer must pay the wages net of PAYE tax and class 1 National Insurance.

Figure 1	**Figure 2**
Employee provides services	Employee provides services to the client
↕	↕
Employer pays for services	PSC pays the employee
	↕
	Client receives the services but pays the PSC for them, not the employee

Under the situation in figure 2, the contractual relationship is between the client and the personal service company:

- The client pays gross fees to the PSC, but is not responsible for operating PAYE or paying National Insurance.
- The PSC is usually owned by the employee. It pays a salary to the employee. The salary may be low in order to avoid operating a PAYE scheme and paying National Insurance. The employee is likely to extract funds from the company by means of a dividend as this avoids National Insurance.

3.3 Consequences

Where the IR35 provisions apply, the PSC is deemed to make a salary payment to the employee in respect of any payments and benefits it has received from relevant engagements. Relevant engagements are those where the individual would have been treated as an employee of the client, were it not for the fact that the contract was between the PSC and the client.

The deemed salary payment is treated as if made on 5th April, therefore any PAYE tax and National Insurance is due by 19th April.

3.4 Calculation of the deemed payment

STEP ONE - Add all payments and benefits received by the PSC from relevant engagements and deduct an allowance of 5%.

STEP TWO - Add all payments and benefits received by the worker (otherwise than from the PSC) which are not chargeable as earnings, but which would be chargeable as earnings if the worker were employed by the client.

STEP THREE - Deduct expenses paid by the PSC which would have been allowable if paid by the worker as an employee of the client.

STEP FOUR - Deduct capital allowances on expenditure incurred by the PSC which would have been allowable if incurred by the worker as an employee of the client.

STEP FIVE - Deduct pension contributions paid to an approved scheme by the PSC for the worker.

STEP SIX - Deduct employer's NIC paid by the PSC.

STEP SEVEN - Deduct payments and benefits received by the worker from the PSC that are chargeable as earnings and that have not already been deducted at step 3.

STEP EIGHT - Total after step 7 $\times \frac{100}{112.8}$ = DEEMED PAYMENT.

Example

Brenda is the sole employee of Brenda Ltd. She also holds 99% of Brenda Ltd's shares. Brenda Ltd hires out Brenda on short term engagements. Brenda works from home and the assignments are classed as relevant engagements for the purpose of the IR35 provisions.

In 2009/10 the total received by Brenda Ltd is £40,000. Brenda draws a salary of £6,000 pa. Tax and NIC are paid as required. Brenda Ltd pays £4,000 into Brenda's personal pension plan. It also pays £1,500 for Brenda to travel from home to work.

Brenda received a dividend of £15,000 from Brenda Ltd during the year.

Required

Calculate the deemed payment for 2009/10.

Answer

	£
Step one – Amount received from clients £40,000 × 95%	38,000
Step two – Payments/benefit received by employee	–
Step three – Allowable expenses	–
Step four – Capital Allowances	–
Step five – Pension Contributions	(4,000)
Step six – Employer's NIC (£6,000 - £5,715) at 12.8%	(36)
Step seven – Brenda's salary	(6,000)
Gross Payment	27,964
Deemed Payment (£27,964 × 100/112.8)	24,791
Employer's NIC due (£24,791 × 12.8%)	3,173
	27,964

Note

Home to work travel is not an allowable expense for employment income purposes.

3.5 Effect of deemed payment on dividends paid

Where the profits are treated as salary under these rules, any dividend paid (up to the amount of the deemed salary) will not be taxable.

3.6 Effect on the PSC's corporation tax

The deemed salary, together with any employer's NIC, is an allowable deduction for the purpose of computing the PSC's taxable trading profits.

Purchase of own shares

4 Purchase of own shares

4.1 Introduction

A company may buy back its own shares and cancel them (or hold them for reissue).

In the hands of the shareholder the payment can be treated as either an income or a capital distribution, depending on the conditions of the payment.

4.2 Income distribution

The general rule is that the payment received for the shares is treated as a dividend. The net amount of the dividend is the amount received less the issue price of the shares.

4.3 Capital distribution

The payment will be treated as a capital distribution where the purchase is for:

- the benefit of the company's trade, or
- the purpose of paying inheritance tax.

A purchase is regarded as being for the benefit of the company's trade where:

- the owner of the company is retiring to make way for new management
- an outside shareholder wishes to withdraw his investment
- a shareholder dies and the personal representatives or beneficiaries do not want to keep the shares
- there is disagreement over the management of the company and the dissident shareholder is bought out because he is having an adverse effect on the running of the company.

The following conditions must also be met in order for the capital treatment to apply:

- The company is an unquoted trading company.
- The shareholder is UK resident and ordinarily resident (i.e. within the scope of UK CGT).
- The shares have been owned for at least 5 years (or 3 years if inherited).

- The shareholder must not be connected with the company after the buy back. An individual is connected with a company if (together with his associates) he holds more than 30% of the share capital.
- The percentage shareholding held by the vendor after the buy back is less than 75% of their percentage shareholding prior to the buy back.
- The transaction is not part of a scheme to avoid tax.

The shareholder and/or the company can seek advance clearance from the Revenue as to whether the proposed transaction will qualify for the capital treatment. Where the above conditions are satisfied the capital treatment is mandatory.

e

Example

Herbert owns 3,000 shares in Harvey Ltd. Harvey Ltd has 10,000 shares in issue. Harvey Ltd purchases 800 of Herbert's shares and cancels them.

Required

Has the 75% test been satisfied?

a

Answer

Shareholding before the buy back: 3,000/10,000 = 30%

Shareholding after the buy back: 2,200/9,200 = 24%

In order for the 75% test to be satisfied, Herbert's percentage shareholding must fall below 22.5% (30% × 75%). As this has not occurred, the purchase must be treated as an income distribution.

e

Example

Rosalind, a higher rate taxpayer, bought 5,000 shares in Brooklyn Ltd at £1 per share in May 2003. In August 2009, Brooklyn Ltd buys back Rosalind's shares at £10 per share.

Required

What are the tax implications if the buy back:

(a) qualifies as a capital distribution?

(b) does not qualify as a capital distribution?

Answer

(a) CGT implications

	£
Proceeds	50,000
Cost	(5,000)
	45,000
Annual exemption	(10,100)
Taxable gain	34,900
CGT at 18%	6,282

Note that if Rosalind is an employee of Brooklyn Ltd, the disposal may also qualify for entrepreneurs' relief.

(b) Income tax implications

Deemed distribution: 5,000 × £(10-1) = £45,000

The distribution is grossed up to £50,000 (£45,000 × 100/90) and taxed at 32.5% as Rosalind is a higher rate taxpayer. A tax credit of 10% reduces the income tax payable to: £50,000 × (32.5% - 10%) = £11,250.

As can be seen, the annual exemption and the flat rate of 18% mean that the capital treatment will usually be the most beneficial.

CHAPTER 25

Value added tax

Contents

Overview of value added tax

- The scope of VAT
- Taxable person
- Taxable supplies
- Rates of VAT
- The mechanics of VAT

1 Overview of value added tax

1.1 The scope of VAT

Value Added Tax (VAT) is an indirect tax levied on the final consumers (or end consumers) of goods and services in the UK.

VAT is charged on 'the **taxable supply** of goods and services in the UK by a **taxable person** in the course or furtherance of a business carried on by him'.

1.2 Taxable person

A taxable person is a person who is registered for VAT (or who is required to be registered for VAT). A person may be a sole trader, a partnership, a company, a club, association or charity.

1.3 Taxable supplies

A taxable supply is 'any supply of goods or services made in the UK other than **exempt supplies** or those **outside the scope of VAT'**.

A detailed knowledge of **exempt supplies** is not required for the examination. However, the following supplies are the main examples of supplies that are **exempt from VAT**:

- Land and buildings, except for the sale of new buildings, residential buildings and those used for charitable purposes
- Insurance premiums
- Postal services
- Finance services such as hire purchase arrangements, banking services and charges for making loans
- Education services provided by state schools, colleges and universities
- Health and welfare services provided by NHS-registered doctors, dentists, hospitals and pharmacies
- Subscriptions to professional bodies.

The main supplies that are **outside the scope of VAT** are as follows:

- Wages and salaries
- Dividends
- Other taxes such as stamp duty and car tax.

It is important to appreciate that no VAT is charged on exempt supplies or on supplies outside the scope of VAT. These supplies are ignored in determining whether a person should register for VAT.

By definition, taxable supplies are any other supply of goods and services that are not exempt or not outside the scope of VAT. However, there are three types of taxable supply, each taxable at a different rate of VAT.

1.4 Rates of VAT

Taxable supplies may be:

- standard rated
- charged at a reduced rate, or
- zero-rated.

A detailed knowledge of reduced rate and zero-rated goods and services is not required in the examination. However the main supplies to be aware of are listed below.

Reduced-rate taxable supplies

The reduced rate of VAT is 5%. The main reduced rated supplies are as follows:

- Domestic fuel and power
- Installation of energy-saving materials
- Children's car seats.

Zero-rated taxable supplies

The zero-rate generally applies to supplies of goods and services that are considered to be essential requirements. The main zero-rated supplies are:

- Food for human and animal consumption, except food supplied in the course of catering (e.g. in restaurants, hotels etc), luxury food (e.g. sweets and cakes), pet foods and hot take-away food
- Books, pamphlets, newspapers, journals, maps, music etc but not general stationery
- Construction of new residential buildings or those used for charitable purposes
- Transport services provided the vehicle carries more than 11 passengers (e.g. trips in buses, coaches, ships, trains, airplanes but not taxis)
- Prescription drugs and medicines and aids for the disabled
- Gifts to charities
- Children's clothing and footwear.

Zero-rated supplies are taxable supplies, but the VAT rate charged is 0%. Therefore no VAT is charged. However (unlike exempt supplies or supplies outside the scope of VAT) zero-rated supplies are considered in determining whether a person should be registered for VAT.

Standard rate of VAT

The standard rate applies to any other supply of goods and services not listed above.

For supplies up to 31 December 2009, the standard rate of VAT is calculated as:

- 15% of the VAT exclusive (or net) price, or
- 3/23 (i.e. 15/115) of the VAT inclusive (or gross) price.

For supplies from 1 January 2010, the standard rate of VAT is calculated as:

- 17½% of the VAT exclusive (or net) price, or
- 7/47 (i.e. 17½/117½) of the VAT inclusive (or gross) price.

A question will not be set involving a VAT period that spans 31 December 2009.

1.5 The mechanics of VAT

VAT is a tax on the final consumer of goods and services. It is levied at the point of sale.

HMRC could collect all the tax from the final retailer at the end of the production and distribution process. However, rather than waiting until the final sale of the end product or service, HMRC requires all businesses that are required to be registered for VAT to account for VAT **at each stage** in the production and distribution process.

Every business liable to charge VAT must therefore charge VAT on its supplies, such as its sales. This is known as **output VAT**. It must pay the output VAT to HMRC, usually on a quarterly basis.

However, as the business is not the final consumer of the goods and services, it can recover any VAT that it has paid to its suppliers on its raw material purchases and other expenses. These VAT payments are known as **input VAT**.

A VAT-registered business therefore only pays HMRC the difference between its output and input VAT.

VAT-registered businesses are therefore acting as collectors of tax on behalf of HMRC and only account for the tax on the value that they have added to the product in that stage of the production and distribution process. (This is how the name of the tax was derived.)

VAT registration

- Compulsory registration
- Exemption from registration
- Voluntary registration
- Deregistration
- Transfer as a going concern
- Group registration
- Divisional registration

2 VAT registration

2.1 Compulsory registration

A person is required to register for VAT if they make taxable supplies in excess of the VAT threshold of £68,000. This VAT registration threshold is given in the tax rates and allowances in the examination.

Failure to register for VAT is an offence. Penalties may be payable and any outstanding VAT that **should have been accounted for** from the compulsory effective registration date will be payable to HMRC.

There are two circumstances where compulsory registration is required. These are where the business exceeds the VAT threshold, based on:

- **historical** taxable supplies (known as the historic test)
- taxable supplies in the **following 30 days** (known as the future test).

Historical test rules

The historical test rules are as follows:

(1) A **person must register for VAT** if, at the end of any month, the annual turnover of taxable supplies (excluding VAT) has exceeded the threshold of £68,000.

(2) **Exception to this rule**. A person is not required to register for VAT in these circumstances if the taxable turnover in the next 12 months is not expected to exceed the deregistration threshold of £66,000 (excluding VAT). Deregistration is explained later.

(3) '**Taxable supplies**' are the total of all standard-rated, zero-rated and reduced-rate supplies, **but excluding** supplies of capital items (for example, sales of non-current assets of the business).

(4) HMRC must be notified within 30 days of the end of the month in which the threshold is exceeded.

(5) The newly-registered business/person must charge VAT from the first day after the end of the month in which notification to HMRC is required, or an earlier agreed date.

Example

Kim commenced trading on 1 January 2009. In the first four months of trading her sales totalled £3,800 per month. All her sales are standard-rated supplies. Thereafter her sales have been as follows:

2009	**£**	**2010**	**£**
May	4,000	January	6,300
June	4,200	February	7,100
July	4,400	March	8,900
August	4,500	April	10,200
September	4,600	May	12,800
October	4,700	June	13,500
November	4,100		
December	5,800		

Required

State:

(a) when it is compulsory for Kim to register for VAT

(b) when she must notify HMRC and

(c) the first date she should start to charge VAT on her invoices.

Answer

12 months ended	**Workings**	**Taxable supplies**
		£
31 December 2009	(4 × £3,800) + £4,000 + £4,200 + £4,400 + £4,500 + £4,600 + £4,700 + £4,100 + £5,800	51,500
31 January 2010	£51,500 - £3,800 + £6,300	54,000
28 February 2010	£54,000 - £3,800 + £7,100	57,300
31 March 2010	£57,300 - £3,800 + £8,900	62,400
30 April 2010	£62,400 - £3,800 + £10,200	68,800

Kim exceeded the £68,000 threshold on 30 April 2010. She is therefore required to register for VAT.

She must notify HMRC by 30 May 2010 (i.e. 30 days after the end of the month in which the threshold is exceeded).

She must start to charge VAT from 1 June 2010 (i.e. the first day of the following month after notification).

Future test rules

The future test rules are as follows:

(1) A **person must register for VAT** if at any time there are reasonable grounds to assume that the taxable turnover in the next 30 days (and only in those 30 days) will exceed £68,000 (excluding VAT).

(2) HMRC must be notified within the 30-day period in which it is thought that the threshold will be exceeded.

(3) The newly-registered person must charge VAT from the first day of the 30 day period in which it is thought that the threshold will be exceeded, or an earlier agreed date.

This test is less likely to be satisfied than the historical test. It only applies if the business has on average a taxable turnover of less than £5,600 per month but then receives a large order or signs a large contract in excess of £68,000 to be completed in the next month.

Example

Suppose that in the previous example, Kim signed a contract for £70,000 on 8 September 2009 for work to be completed by the end of the month.

Required

State:

(a) when it is compulsory for Kim to register for VAT

(b) when she must notify HMRC and

(c) the first date she should start to charge VAT on her invoices.

Answer

On 8 September 2009, Kim believes that she will exceed the threshold in the next 30 days, therefore she must register for VAT.

Kim must notify HMRC by 8 October 2009 (i.e. by the end of the 30 day period in which it is thought that the threshold will be exceeded).

She must start to charge VAT from 8 September 2009 (i.e. the first day of the 30 day period).

Note: The historical test is checked **at the end of every month**. The future test should be considered **every day**.

Disaggregation

It is the taxable person who must register for VAT, not the business. Therefore if a person has several business interests, the total taxable supplies from all his business interests must be aggregated and the registration will cover all the businesses that the person carries on.

Therefore in the previous example, if Kim had two sole trader businesses, the total taxable turnover would be considered and only one registration would be required.

It is not possible to avoid compulsory registration by artificially splitting a business into two or more smaller businesses.

In the examination, a taxable person is a sole trader, a partnership or a company. Partnerships and companies are separate persons. Therefore, if in the previous example Kim had a sole trader business and was also a partner in a partnership, two separate registrations would be required: one for Kim and another for the partnership.

Registration certificate and VAT registration number

When a person registers for VAT, HMRC will issue a registration certificate and a VAT registration number. This number must appear on the business invoices and other documentation from the effective date of registration.

2.2 Exemption from registration

When a person makes taxable supplies in excess of the VAT threshold, VAT registration is compulsory. However, where the taxable supplies are **all zero-rated**, HMRC will allow the person exemption from registration.

A zero-rated business will not charge any output VAT on its sales. However, it can recover its input VAT suffered. Therefore, if it does not register for VAT and claims the exemption, the disadvantage will be that it cannot recover its input VAT.

The advantage of the exemption from registration is that the business does not have to incur the administrative burden and costs of accounting for VAT.

A taxable person is therefore only likely to claim the exemption if it does not have significant amounts of input VAT to recover, so that the benefits of recovering the input VAT paid are less than the administrative costs of accounting for VAT.

2.3 Voluntary registration

Where a taxable person does not have taxable supplies above the VAT threshold, it is not required to register for VAT. However, a person can voluntarily register for VAT and account for VAT from an agreed date with HMRC, even though its turnover in taxable supplies is below the threshold.

Advantages of voluntary registration

The main advantage of voluntary registration is that input VAT can be recovered from HMRC on purchases and expenses. This will save money for the business by reducing the cost of its purchases by the amount of the input VAT.

It is particularly advantageous to register **if the business is zero-rated**, as it can recover input VAT but does not have to pay output VAT as it is charged at 0%.

In this situation the business will receive regular repayments of VAT from HMRC. These will help the cash flow of the business.

A possible further advantage of voluntary registration is that being VAT-registered may suggest to third parties that the business has a taxable turnover of at least £68,000, giving them a perception of an enduring, sizeable and successful business.

Disadvantages of voluntary registration

Registering for VAT will mean that the business is required to maintain up-to-date accurate accounting records. The administrative burden of accounting for VAT to HMRC will increase the costs of running the business.

The person must charge VAT on sales, adding to the amounts payable by customers. However, this is not a disadvantage if:

- the business is zero-rated (and so does not charge any VAT), or
- all customers are VAT-registered and so can recover the VAT charged (as their input VAT).

However, if customers are not VAT-registered (e.g. members of the general public) they cannot recover the VAT charged and so have to suffer the VAT payable in the prices they pay. In this situation, the business has a choice between two unwelcome options:

- It may keep its total selling prices, by reducing the net-of-VAT sales prices. This means in effect that it absorbs the cost of the VAT itself and reduces its profit margins.
- Alternatively, it may add VAT to its normal selling prices. This will risk losing customers to competitors that are not VAT-registered and so can sell at a lower price.

2.4 Deregistration

Compulsory deregistration

A person is required to deregister for VAT when they **cease to make taxable supplies.** In these circumstances, deregistration is **compulsory**.

Notification must be given to HMRC within 30 days of ceasing to make taxable supplies. Deregistration is effective from the date when taxable supplies ceased or an agreed later date.

Voluntary deregistration

Voluntary deregistration is allowed if at any time:

- there are reasonable grounds for a registered person to believe that their taxable supplies in the **next 12 months** will not exceed the deregistration threshold of £66,000, and
- the fall in value of taxable supplies is not due to a **temporary** reduction.

The deregistration threshold is given in the tax rates and allowances in the examination.

In this situation, deregistration will be effective from the date on which the request for deregistration is made or an agreed later date.

Consequences of deregistration

Whether deregistration is compulsory or voluntary, there is a **deemed supply** of all the assets held by the business on the last day of registration. VAT is therefore charged on the non-current assets (except cars) and trading stock owned by the business on which input VAT has been recovered in previous VAT returns.

Output VAT is charged on this deemed supply at the standard rate unless the amount payable is less than £1,000, in which case it is ignored.

2.5 Transfer as a going concern

If a trader ceases to make taxable supplies because he transfers his business as a going concern to another trader, the deregistration and deemed supply rules are ignored provided certain conditions are satisfied.

Where a business is transferred/sold as a going concern, no VAT is charged as long as the following conditions are satisfied:

- The whole business (or a significant part of a business which is capable of independent operation) is transferred as a going concern.
- There is no significant break in the normal trading pattern.
- The assets continue to be used in the same type of trade.
- The transferee business is already VAT-registered or will become registered immediately after the transfer.

Example

HT Ltd has been registered for VAT since 1996, but intends to cease trading on 31 March 2010. On the cessation of trade, HT Ltd can either sell its non-current assets on a piecemeal basis to individual purchasers, or it can sell its entire business as a going concern to a single purchaser.

Required

Outline the VAT consequences of each course of action.

Answer

Sale of assets on a piecemeal basis

- HT Ltd will cease to make taxable supplies so its VAT registration will be cancelled on 31 March 2010 or an agreed later date.
- The company will have to notify HMRC by 30 April 2010 (i.e. 30 days after the date of cessation).

- Output VAT must be charged in respect of the non-current assets sold, unless the VAT amounts to less than £1,000.

Sale of business as a going concern

- If the purchaser is already registered for VAT then HT Ltd's VAT registration will be cancelled, as above.
- If the purchaser is not registered for VAT then it can take over the VAT registration of HT Ltd, if it wishes.
- A sale of a business as a going concern is not treated as a taxable supply for VAT, and therefore output VAT is not due on the sale of the business assets.

2.6 Group registration

Two or more companies can elect for group registration provided that:

- one of them controls the others, or
- one person controls them all.

Each company must either be established in the UK or have a fixed place of business in the UK.

An application for group registration takes immediate effect, although HMRC have 90 days in which they can refuse the application. They will normally only refuse or cancel group registration where:

- the companies concerned are ineligible for group registration, or
- where membership would pose a threat to VAT revenue.

It is not necessary for all eligible companies to be members of a VAT group. It may, for example, be advisable to leave out companies making zero-rated supplies as their refund of VAT would be used to offset any VAT payable by the group.

Care should be taken in deciding whether to include any exempt or partially exempt companies as their inclusion may affect the amount of input tax recoverable by the group (see partial exemption rules covered later).

The effect of group registration

The group appoints a representative member to be responsible for submitting VAT returns and paying VAT on behalf of the group. However, all group members are jointly and severally liable for any VAT due.

Supplies between group members are ignored.

Only one VAT return is submitted for the whole group. This should, in theory, cut down on the amount of administration involved. However, collating the information from the various group members may prove problematic.

2.7 Divisional registration

If a single company has a number of different divisions which are largely autonomous, it may be difficult to produce one VAT return for the whole company. In such a situation, the company can elect for its various divisions to be registered separately.

The effect of divisional registration

The company as a whole will still be liable for all of the VAT.

Tax invoices must not be issued for supplies between the divisions.

Accounting for VAT

- VAT returns
- VAT records
- VAT invoices
- Output VAT
- Input VAT
- Relief for impairment losses on trade debts
- Proforma computation
- Impact of VAT on the trading income assessment

3 Accounting for VAT

3.1 VAT returns

Most businesses account for VAT on a quarterly basis, unless the business is a member of the annual accounting scheme.

However, monthly accounting is allowed by HMRC on request. Businesses making wholly zero-rated supplies usually prefer monthly accounting as they are in a regular repayment situation and prefer monthly repayments to quarterly repayments.

Electronic filing of VAT returns is to be made compulsory from 1 April 2010 for:

- VAT–registered businesses with an annual VAT-exclusive turnover of £100,000 or more, and
- All newly VAT-registered businesses, irrespective of their turnover.

3.2 VAT records

A taxable person is required to keep accurate records and accounts of all transactions to support output and input VAT on the VAT returns (unless it is a member of the flat rate scheme).

Records must be retained for at least six years.

The records that must be kept include:

- Sales and purchase invoices
- Sales and purchase day books
- Cash books, bank statements, paying in slips
- VAT accounts and returns
- Annual profit and loss accounts and balance sheets.

3.3 VAT invoices

A VAT invoice must be issued when a taxable person makes a taxable supply to another taxable person, within 30 days of the supply of goods or services.

A VAT invoice is not required, but may be issued, when the supply is made to a person who is not registered for VAT or the supply is zero-rated.

Retailers to the general public are only required to issue a VAT invoice if requested to do so by the customer.

Retailers are allowed to issue less detailed VAT invoices if the taxable supply is no more than £250 (including VAT).

3.4 Output VAT

Output VAT is charged on taxable supplies of goods and services.

The main types of taxable supply of **goods** are as follows:

- Sales of goods (for a consideration, usually a money payment)
- Gifts of business assets (excluding gifts to the same person that total no more than £50 excluding VAT in any 12 month period and gifts of trade samples)
- Goods withdrawn from the business by the owner or an employee.

The main types of taxable supply of **services** are as follows:

- Sales of services (for consideration)
- Hiring goods to a customer
- Temporary private use of business assets by the owner or an employee
- Private use of services supplied by the business to the owner or employee
- Provision of private fuel for the owner or an employee.

Note that the **gift of services** and the **private use of cars** are **not** taxable supplies.

Output VAT is charged at the appropriate rate on the 'value of the taxable supply'.

The value of taxable supplies is straightforward where there is a sale at arm's length for full consideration. VAT is charged at the appropriate rate on the sale price (excluding VAT).

Special rules apply to the following supplies:

- **Gifts of business assets**: The value of the taxable supply is the replacement price (i.e. the price payable by the person making the supply, at the time of the supply, to replace the goods with identical items, taking account of the age and condition of the goods gifted).
- **Private use of business assets**: The value of the taxable supply is the cost to the taxable person providing the service.
- **Private fuel**: Scale rates are set by HMRC and will be given in the examination question, if required.

Discounts

If a supply is offered at a discount, output VAT is calculated on the maximum discounted amount, regardless of whether the discount is taken up.

For example, a company may sell an item to a customer for £1,000, but with a 5% discount for payment within 14 days. VAT is charged on the discounted amount of £950, regardless of whether or not the customer decides to take the discount.

3.5 Input VAT

Input VAT can usually be recovered if:

- the goods or services purchased are used for business purposes, and
- the expenditure is supported by a valid VAT invoice.

Where expenditure is partly for business and partly for private purposes, the input VAT is apportioned and only the business proportion is recoverable.

The amount of input VAT that can be recovered depends on the type of taxable supplies made by the business, as follows:

If the business makes	Input VAT recovery
Wholly taxable supplies	All input VAT is recoverable, except for blocked items.
Wholly exempt supplies	Recoverable input VAT = £Nil. A person making wholly exempt supplies is not a taxable person, cannot register for VAT, does not charge VAT on their output and cannot recover any input VAT.
Partly taxable/partly exempt supplies	The person may reclaim part of their input VAT, but perhaps not all of it. This person is a partially exempt trader and special rules apply for the recovery of input VAT. These rules are covered below.

Partial exemption

The input tax of a partially exempt trader must be apportioned between taxable supplies and exempt supplies as follows:

- Input tax wholly attributable to making taxable supplies (standard or zero-rated) is fully recoverable.
- Input tax wholly attributable to making exempt supplies is not recoverable.
- Non-attributable input tax (e.g. input tax that relates to overheads) must be apportioned using a percentage to arrive at the amount recoverable.

The percentage is calculated using the formula:

$$\frac{\text{Taxable supplies}}{\text{Total supplies}} \times 100$$

The percentage is always rounded up to the next whole number.

The total amount of irrecoverable input tax should then be tested against the de minimis limits. If it does not exceed both:

- £625 per month on average, and
- 50% of the total input tax

it may nevertheless be recovered.

The supplies used in the above formula can be either:
- the supplies for the return period in question, or
- the supplies for the previous year.

However, the trader must use the same method for the full year.

The method chosen will not affect the total amount of VAT payable for the year because, at the end of the year, the trader must make an annual adjustment. This involves repeating the calculation using the supplies for the year as a whole. Any under or overpayment of VAT must be accounted for either:
- in the return for the final period of the year, or
- the first return for the following year.

Example

WRT Ltd is a partially exempt business. During the VAT quarter ending 31 March 2010 it made the following sales;

Taxable supplies	£100,000
Exempt supplies	£20,000
Input VAT directly attributable to taxable supplies	£3,000
Input VAT directly attributable to exempt supplies	£350
Input VAT attributable to overheads	£750

Required

Calculate the amount of VAT that the company may recover on the March 2010 VAT return.

Answer

The company can recover the input tax of £3,000 that is directly attributable to making taxable supplies.

Initially it cannot recover the tax of £350 that is directly attributable to making exempt supplies.

The company's partial exemption percentage is 100/120 = 83.3%. This must be rounded up to 84%. The recoverable amount of non-attributable input tax is therefore £750 × 84% = £630.

The total amount of potentially irrecoverable input tax is = (750 – 630) + £350 = £470.

As the potentially irrecoverable input tax is less than both:

- £625 per month on average; and
- one half of all the input tax for the period concerned

all the input tax in the period (i.e. £4,100) is recoverable.

Blocked items

Blocked items are items of expenditure where the VAT is irrecoverable. The main types of blocked items are as follows:

- the private use apportionment of input VAT on expenditure incurred for both business and private purposes
- cars, whether used for private purposes or not, but excluding cars purchased exclusively for business purposes (e.g. pool cars, taxis, self-drive hire cars, and driving school cars)
- entertaining costs (excluding staff entertaining).

Input VAT suffered on any other purchases (including capital asset purchases) and expenses is recoverable. This includes input VAT on **pre-registration expenditure** if the following conditions are satisfied:

- If goods, they must have been acquired in the four years prior to registration and still be owned by the business on the date of registration. (This four year time limit replaces the previous limit of three years. However, it does not permit claims to be brought for periods prior to 1 April 2006 as these were already out of date at the time the new rules were introduced.)
- If services, they must have been supplied to the person no more than 6 months before the date of registration.

3.6 Relief for impairment losses on trade debts

Output VAT is accounted for on the date of the supply. If goods are sold on credit, this is usually the invoice date not the date on which cash is received.

If a customer does not pay for a supply, the business can claim relief for the resulting impairment loss (bad debt relief) if the following conditions are satisfied:

- The debt is more than six months overdue (measured from the date that the payment was due under the supplier's terms of sale)
- The output VAT has been accounted for and paid to HMRC
- The impairment loss has been written off
- A claim is made for relief.

Relief is given in the VAT return by claiming input VAT equal to the amount of output VAT charged on the original irrecoverable bad debt.

3.7 Proforma computation

The following proforma should be used to calculate the amount of VAT payable or recoverable for a return period.

VAT return for the quarter ended:	**£**
Output VAT	
Cash and credit sales (including capital assets but excluding cars)	X
Withdrawals of stock by owner or an employee	X
Gifts of business assets if in excess of £50 per recipient	X
Private use of business assets by owner or an employee	X
Private fuel supplied to owner or an employee (scale charge) (see below)	X
	X
Input VAT	
Cash and credit purchases of goods	(X)
Cash and credit purchases of capital assets (excluding cars)	(X)
Expenses (including repairs and maintenance, car expenses, full cost of fuel) (excluding blocked items such as entertaining and items outside of the scope of VAT such as wages, salaries, dividends and other taxes)	(X)
Relief for impairment losses on trade debts	(X)
Amount payable to / (repayable by) HMRC	X/(X)
Due date: End of the month following the end of the return period	

If **private fuel** is provided to the owner or an employee, the input VAT is not apportioned. All the input VAT on the cost of the fuel paid by the business is recoverable, but output VAT must be charged at the scale rates for the provision of private fuel to the owner or employee.

If required, the appropriate fuel scale rate will be given in an examination question.

Alternatively, the output VAT charge can be avoided if no claim is made for the input VAT on the fuel provided.

Example

Lena is registered for VAT, and is in the process of completing her VAT return for the quarter ended 31 December 2009.

The following information is available:

- Sales invoices totalling £128,000 were issued in respect of standard-rated sales. Lena offers her customers a 2.5% discount for prompt payment.
- Standard-rated materials costing £32,400 were purchased, of which £600 were taken by Lena for her personal use.
- Standard-rated expenses amounting to £24,800 were incurred. This includes £1,200 for entertaining customers.
- On 15 December 2009, Lena purchased a motor car at a cost of £16,450 for the use of a sales manager, and machinery at a cost of £21,150. Both of these figures are inclusive of VAT. The motor car is used for both business and private mileage.
- On 31 December 2009, Lena wrote off £12,000 due from a customer as the customer had gone into liquidation. The loss was in respect of three invoices, each of £4,000, that were due for payment on 15 May, 15 June and 15 July 2009 respectively.
- During the quarter ended 31 December 2009, £600 was spent on mobile telephone calls, of which 40% related to private calls.

Unless stated otherwise, all of the above figures are exclusive of VAT.

Required

Calculate the amount of VAT payable for the quarter ended 31 December 2009 and state the due date of payment.

Answer

VAT return for the quarter ended: 31 December 2009

	Note	£
Output VAT		
Sales (£128,000 × 97.5% × 15%)	1	18,720
Withdrawals of stock by Lena (£600 × 15%)	2	90
		18,810
Input VAT		
Purchases of goods (£32,400 × 15%)		(4,860)
Purchase of machinery (£21,150 × 3/23)	3	(2,759)
Expenses (£24,800 - £1,200) × 15%	4	(3,540)
Mobile phone calls (£600 × 60% × 15%)	5	(54)

Relief for impairment loss on trade debt (£8,000 × 15%)	6	(1,200)
Amount payable to HMRC		6,397
Due date: 31 January 2010		

Notes

(1) Output VAT is calculated on the maximum discounted amount, regardless of whether the discount is taken up.

(2) The withdrawal of stock by the owner is a deemed supply based on the replacement value, which is assumed in this case to be the cost of £600.

(3) Input VAT on the purchase of the motor car is irrecoverable.

(4) Input VAT on entertaining expenditure is irrecoverable.

(5) An apportionment is made where a service is partly for business and partly for private use, such as mobile phone calls.

(6) Relief for impairment losses on trade debts is not given until six months have elapsed from the time that payment is due. Therefore relief can only be claimed in respect of the invoices due for payment on 15 May and 15 June 2009.

3.8 Impact of VAT on the trading income assessment

Adjustment of profit computation

Any adjustments to profit are made at whatever amount is **charged against profit** in the profit and loss account.

If the **business is VAT-registered**:

- Expenses are usually VAT-exclusive as the associated input VAT is recovered on most business expenses. An exception is entertaining expenses where the VAT inclusive amount will be charged against profit as the input VAT is irrecoverable.
- Therefore in the adjustment of profit computation the VAT-inclusive amount of entertaining expenses is added to profit, but other adjustments are made at the VAT-exclusive amounts.

If the **business is not VAT-registered**, no input VAT is recoverable. Therefore all adjustments are made for the amount charged in the accounts, i.e. the VAT-inclusive price.

Capital allowances computation

In the capital allowances computation, allowances are available for whatever amount is included in the balance sheet for that asset.

- If the **business is VAT-registered**, this is usually the VAT-exclusive price for all non-current assets except cars. For cars, the input VAT is irrecoverable. Capital allowances are therefore available on the VAT inclusive price of cars, but the VAT-exclusive price of other non-current assets.

- If the **business is not VAT-registered**, no input VAT is recoverable. Therefore the capital allowances will be available on the amounts in the balance sheet, i.e. the VAT-inclusive price.

Special schemes

- Overview of the schemes available for small businesses
- The cash accounting scheme
- The annual accounting scheme
- The flat rate scheme

4 Special schemes

4.1 Overview of the schemes available for small businesses

There are three schemes available to help small businesses in accounting for VAT: the cash accounting, annual accounting and flat-rate schemes.

They all aim to simplify VAT accounting, reduce administration and help the cash flow of small businesses.

All these schemes are optional. A small business is not obliged to join any scheme, but may find it advantageous to do so.

4.2 The cash accounting scheme

The cash accounting scheme allows small businesses to account for VAT when cash is paid and received. It therefore provides automatic relief for impairment losses; if a customer does not pay, the business does not have to account for the VAT on that sale.

A business can only join the cash accounting scheme if:

- its taxable supplies in the next 12 months are not expected to exceed £1,350,000
- it is up to date with its VAT returns and has paid all outstanding VAT liabilities
- it has not been convicted of any VAT offences, assessed for penalties for VAT evasion nor denied entry into the scheme in the last 12 months.

Once it is a member of the scheme, a business may continue to use the scheme until the value of its taxable supplies in the previous 12 months exceeds £1,600,000.

'Taxable supplies' in this context means the value of taxable supplies excluding VAT and capital items.

4.3 The annual accounting scheme

The annual accounting scheme allows small businesses to submit only one annual VAT return each year and spread the payments of VAT more evenly throughout the year. This may help cash flow.

The mechanics of the annual accounting scheme are as follows:

- HMRC estimate the total VAT liability for the year, based on the previous year's.
- Nine equal monthly payments on account are made by direct debit.
- Each of these payments on account (POAs) is equal to $1/10^{th}$ of the total estimated liability. They are paid on the last day of every month starting in the 4^{th} month and finishing on the last day of the 12^{th} month.
- A balancing payment and the annual VAT return are submitted to HMRC within two months of the end of the year.

A business can apply to make quarterly POAs of 25% of the total estimated liability at the end of the 4^{th}, 7^{th} and 10^{th} months, rather than making monthly POAs. The balancing payment must be made within two months of the end of the year.

A business can only join the annual accounting scheme if its taxable supplies in the next 12 months are not expected to exceed £1,350,000.

A business may remain a member of the scheme until the value of its taxable supplies in the previous 12 months exceeds £1,600,000.

'Taxable supplies' in this context means the value of taxable supplies excluding VAT and capital items.

Example

GF plc has taxable supplies of £392,500 each year and joined the annual accounting scheme in 2004. On 1 September 2009 HMRC estimated its total VAT liability for the year ended 31 August 2010 as £15,950.

Required

Calculate the payments GF plc has to make in respect of the year ended 31 August 2010, stating the due dates for payment and assuming the final VAT liability is agreed at £20,250.

Answer

POAs: $1/10^{th} \times$ £15,950 = £1,595 per month

Balancing payment = £20,250 – (9 × £1,595) = £5,895

Payments to be made in respect of the year end 31 August 2010:

			£
POA 1	31 December 2009	Last day of 4^{th} month	1,595
POA 2	31 January 2010	Last day of 5^{th} month	1,595
POA 3	28 February 2010	Last day of 6^{th} month	1,595
POA 4	31 March 2010	Last day of 7^{th} month	1,595
POA 5	30 April 2010	Last day of 8^{th} month	1,595
POA 6	31 May 2010	Last day of 9^{th} month	1,595
POA 7	30 June 2010	Last day of 10^{th} month	1,595
POA 8	31 July 2010	Last day of 11^{th} month	1,595

POA 9	31 August 2010	Last day of 12th month	1,595
Total POAs			14,355
Balancing payment	31 October 2010	Last day of 2nd month after year end	5,895
Total agreed VAT liability for the year ended 31 August 2010			20,250

4.4 The flat rate scheme

The flat rate scheme simplifies the preparation of the VAT return by allowing small businesses to account for VAT at a flat rate percentage of VAT-inclusive turnover, instead of accounting for VAT on every individual sale and purchase.

The flat rate percentage to apply depends on the trade sector in which the business operates. The flat rates range from 2% to 13.5% and have been calculated based on HMRC's past experience of the average level of recovery of VAT for different types of business sectors.

If required, the appropriate flat rate percentage will be given in the body of a question in the examination.

The mechanics of the flat rate scheme are as follows:

- The business issues VAT invoices and charges customers for VAT at the normal rates (e.g. standard, reduced or zero-rated)
- At the end of the return period, the taxable person pays to HMRC the following amount:

  (Appropriate flat rate) × (VAT inclusive taxable turnover)

  The appropriate flat rate is reduced by 1% for the first 12 months of VAT registration.

The business does not need to keep records of the individual purchases and input VAT suffered. The scheme therefore **reduces the administrative burden** of keeping detailed records of purchase and expense invoices and recoverable input VAT.

A business can only join the flat rate scheme if its expected taxable supplies (excluding VAT and capital items) in the next 12 months are not expected to exceed £150,000.

It must leave the scheme if its total income (including VAT) in the previous year exceeded £225,000, unless HMRC are satisfied that expected total income for the next 12 months will not exceed £187,500.

Total income includes the value of exempt supplies and supplies outside of the scope of VAT.

e

Example

Marcus set up a sole trader business on 1 October 2008. He voluntarily registered for VAT from the first day of trading.

In the quarter to 31 March 2010, Marcus had the following sales and expenditure:

	£
Credit sales	31,400
Purchases	8,850
Expenses	3,115
Purchase of a car (private use 40%)	17,750

All figures exclude VAT.

Required

Calculate the VAT due to HMRC for the quarter ended 31 March 2010 assuming:

(a) Marcus is registered under the flat rate scheme and the appropriate flat rate percentage for his trade sector is 9%.

(b) Marcus is not registered under the flat rate scheme.

a

Answer

(a) If registered under the flat rate scheme

	£
VAT inclusive turnover (£31,400 × 47/40)	36,895
VAT due to HMRC (£36,895 × 9%)	3,321

Note that no input tax is recoverable under the flat rate scheme.

(b) If not registered under the flat rate scheme

VAT return for the quarter ended: 31 March 2010

	£
Output VAT	
Sales (£31,400 × 17.5%)	5,495
Input VAT	
Purchases of goods (£8,850 × 17.5%)	(1,549)
Expenses (£3,115 × 17.5%)	(545)
Purchase of car = blocked	(Nil)
Amount payable to HMRC	3,401

VAT penalties

- Default surcharge
- Default interest
- Errors in a VAT return

5 VAT penalties

5.1 Default surcharge

A default surcharge is levied where a VAT return is submitted late or the payment of VAT is late. The mechanics of the default surcharge system are as follows:

- A surcharge liability notice is issued when the return or payment is made late. The notice specifies a default notice period which is normally 12 months.
- If within the default notice period a further default occurs (i.e. another return is submitted late or another payment is made late):

  (a) A default surcharge is levied at the following rates:

Number of defaults	Surcharge = appropriate % of tax paid late
1	2%
2	5%
3	10%
4	15%

  (b) The default notice period is extended by another 12 months.

HMRC do not collect the surcharge at the 2% or 5% rate where it is less than £400. However, at the 10% and 15% rates, there is a minimum charge of £30.

Note that the rates of surcharge are not provided in the examination.

Example

SQ Ltd has submitted its VAT returns as follows:

Quarter ended	VAT paid	Date return submitted and VAT paid
	£	
30 September 2008	3,100	5 December 2008
31 December 2008	11,300	2 March 2009
31 March 2009	4,300	25 April 2009
30 June 2009	7,600	24 July 2009
30 September 2009	1,900	25 October 2009
31 December 2009	3,200	27 January 2010
31 March 2010	6,900	16 May 2010

Required

Explain whether a default surcharge will be levied on SQ Ltd.

Answer

The 30 September 2008 return is submitted late. A surcharge liability notice will be issued, specifying a default notice period of 12 months to 30 September 2009.

The 31 December 2008 return is also submitted late and therefore:

- a default surcharge of £226 (2% × £11,300) will be levied, but not collected by HMRC as it is below £400, and
- the default notice period will be extended to 31 December 2009.

The next four returns are all submitted on time. Therefore no default surcharges are levied and the default notice period expires.

The 31 March 2010 return is submitted late. As there is no current default notice in existence, no default surcharge is levied. However, HMRC will issue a new default surcharge notice, specifying a notice period to 31 March 2011.

5.2 Default interest

Default interest may be charged on any unpaid amount from the date the VAT should have been paid to the date of payment.

5.3 Errors in a VAT return

If a taxpayer notices a misdeclaration or error before an investigation by HMRC, and its net effect does not exceed the higher of £10,000 or 1% of turnover for the VAT period, the trader is allowed to correct the mistake in the next VAT return. No interest is charged and no separate disclosure is required; however, it is sensible practice to notify HMRC of any errors as an unprompted disclosure qualifies for a reduced rate of penalty.

If the net effect exceeds the higher of £10,000 or 1% of turnover for the VAT period, separate disclosure to HMRC is required.

A penalty may be imposed in both of the above cases. It is determined according to the same penalty regime that applies to incorrect self assessment income tax and corporation tax returns. (See chapter 28.)

Land and buildings

- The rate of VAT
- The option to tax

6 Land and buildings

6.1 The rate of VAT

The supply of land and buildings is a difficult area as the rate of VAT chargeable depends on the precise details of the supply:

- freehold sales of new non-residential property are standard rated. ('New' in this context means less than three years old)
- freehold sales of residential property are zero-rated
- the conversion of residential property into a number of dwellings, or vice versa, is chargeable at the reduced rate
- most other supplies (such as the sale of a plot of land, rent or the premium payable on the grant of a lease) are exempt, but with an option to tax.

6.2 The option to tax

A trader who makes exempt supplies cannot recover their input tax. However, a trader who makes an exempt supply of land and buildings may choose to exercise an option to tax. Exercising this option enables the trader to recover their input tax.

The option to tax does, however, have some disadvantages:

- It increases the cost of the supply to the purchaser. This is probably acceptable if the purchaser is a trader and thus able to recover their input tax. It would be disadvantageous to a purchaser who is unregistered or who makes exempt supplies as it would increase their costs.
- The election applies to the whole building and remains in force for 20 years (although there is a 30 day cooling off period). Thus if the building is sold, VAT must be charged on the selling price.

Imports and exports

- Importing and exporting outside the EU
- Acquisitions and dispatches within the EU
- Place of supply of services

7 Imports and exports

7.1 Importing and exporting outside the EU

Imports

UK VAT is charged on goods imported from outside the EU. It is normally collected at the point of entry into the UK.

Any UK VAT paid by the importer is treated as input tax and is recoverable on the **next** VAT return in the usual way.

Exports

Exports to non-EU countries are zero-rated. The supplier must hold evidence that the goods have been exported, such as a bill of lading.

7.2 Acquisitions and dispatches within the EU

Acquisitions

Goods acquired from another EU member state are referred to as acquisitions rather than imports.

The purchaser must account for UK VAT at the date of acquisition. This is the earlier of:

- the date that the invoice is issued
- the 15th of the month following that in which the goods are acquired.

The UK VAT paid can then be recovered as input tax on the **same** return in the usual way.

Dispatches

Goods supplied to another EU member state are referred to as dispatches rather than exports.

The treatment of supplies depends on the status of the customer:

- if the customer is registered for VAT in their own country, the supply is zero-rated provided the customer's VAT number is quoted on the invoice.

- if the customer is not registered for VAT in their own country, the supplier must charge VAT at the same rate as applicable to a UK customer.

If supplies to non-VAT registered customers in a particular country exceed that country's registration limit, the supplier must register for VAT in that country and charge VAT at that country's rate.

Example

Expo Ltd is registered for VAT. It has the following transactions:

(a) The sale of women's clothing to a customer in Italy who is VAT registered.

(b) The purchase of men's clothing from a supplier in Hong Kong.

(c) The sale of women's shoes to the USA.

(d) The purchase of men's shoes from Spain.

(e) The sale of CDs to a non-VAT registered customer in France.

Required

Explain the VAT treatment of the above transactions.

Answer

(a) This is a zero-rated transaction as it is to a VAT registered customer within the EU. (b) Expo Ltd must account for UK VAT at the point the goods enter the UK. This can then be recovered as input tax on the next VAT return.

(c) This is a zero-rated transaction as it is an export.

(d) Expo Ltd must account for UK VAT at the point the goods enter the UK. This can then be recovered as input tax on the same return.

(e) As this is a sale to a non-VAT registered customer within the EU, Expo Ltd must charge standard rate VAT in the same way as if the supply was made to a UK customer.

7.3 Place of supply of services

The place of supply of services depends on the status of the customer:

- A VAT-registered customer within the UK who purchases services from overseas must account for output tax on those services and reclaim it as input tax in the normal way. This is known as the reverse charge procedure.
- The place of supply to a non-registered customer is the place where the supplier has established his business.

The time of supply is the earlier of the time the service is completed or the time it is paid for.

Where supplies are continuous the time of supply will be the end of each billing or payment period. Where there are no billing or payment periods, the time of supply will be the earlier of 31 December and the date on which any payment is received.

Capital goods scheme

- When does the scheme apply?
- How does the scheme work?

8 Capital goods scheme

8.1 When does the scheme apply?

The capital goods scheme applies to partially exempt traders who purchase:

- computers with a VAT-exclusive price of £50,000 or more
- land and buildings with a VAT-exclusive price of £250,000 or more.

8.2 How does the scheme work?

The scheme recognises that capital assets will remain within the business for a number of years and that the split between taxable and exempt supplies may vary during that time. The scheme therefore adjusts the percentage of input VAT recoverable on an annual basis over a recovery period of:

- five years in the case of computers
- ten years in the case of land and buildings.

If the asset is sold before the end of the recovery period, the adjustments for any years after the year of sale are calculated assuming the asset is wholly used for making taxable supplies. These additional adjustments cannot exceed the output VAT charged on the sale of the asset.

Example

MDF Ltd is a partially exempt trader.

On 1 August 2006 the company bought a new computer for £100,000 plus VAT. The taxable use of the computer was as follows:

VAT year ending 31/3/07 = 50%
VAT year ending 31/3/08 = 45%
VAT year ending 31/3/09 = 60%

MDF Ltd sold the computer for £8,000 plus VAT on 10 October 2009. Taxable use from 1 April 2009 until the date of sale was 40%.

Required

Calculate the input tax adjustments needed in each of the relevant VAT years (assume that the standard rate of VAT is 17.5%).

Answer

The computer cost **more than £50,000** and is therefore subject to input tax adjustments over a **period of 5 years.**

VAT year ending 31/3/07

The company can recover half of the total input tax as 50% of its use of the computer is for taxable purposes: £100,000 × 17.5% = £17,500 × 50% = £8,750 input tax recoverable from HMRC.

VAT year ending 31/3/08

The total input tax paid in respect of the computer was £17,500. Spread over the five years required by the capital goods scheme, this works out at £3,500 a year. As the taxable use of the computer has fallen from 50% to 45%, the company must repay 5% of the annual amount to HMRC: (£17,500/5) × (50% - 45%) = £175.

VAT year ending 31/3/09

This year the taxable use of the computer has increased from the original 50% to 60%. The company can therefore recover an additional 10% of the annual charge from HMRC: £3,500 × (50% - 60%) = £350.

VAT year ending 31/3/10

In the year of sale, the asset is treated as if it was used for the whole of the year. As the taxable use has fallen from the original 50% to 40%, the company must repay 10% of the annual amount to HMRC: £3,500 × (50% - 40%) = £350.

VAT year ending 31/3/11

Even though the computer has been sold, one year of the recovery period remains. The company can, in theory, recover the whole of the annual amount for that year as it is deemed to have used the computer wholly for the purpose of making taxable supplies: £3,500 × (50% - 100%) = £1,750.

However, the sum reclaimable from HMRC is limited to the amount of output tax charged on the sale of the asset: £8,000 × 17.5% = £1,400**.**

CHAPTER

26

Stamp duty

Contents

Stamp duty

- Stamp duty
- Stamp duty reserve tax

1 Stamp duty

1.1 Stamp duty

Stamp duty is charged on the transfer of shares and securities. It only applies to transfers made using a stock transfer form (i.e. paper transactions).

No stamp duty is charged on the transfer of government stock, units in a unit trust or most company loan stock (unless it is convertible loan stock).

Stamp duty is paid by the purchaser at the rate of 0.5% of the consideration. The duty is rounded up to the nearest £5.

1.2 Stamp duty reserve tax

As seen above, stamp duty only applies to the paper transfer of shares and securities. Where transfers are made electronically, stamp duty reserve tax applies. SDRT is charged at the same rate as stamp duty.

Example

(a) Gilbert purchased 2,000 units in the Pluto unit trust for £3,000.

(b) Graham purchased £6,000 of 5% convertible loan stock for £9,000.

Required

Explain the stamp duty/SDRT consequences of the above transactions.

Answer

(a) No stamp duty/SDRT is payable on the purchase of units in a unit trust.

(b) Loan stock is usually exempt from stamp duty/SDRT. However, as this is convertible loan stock, stamp duty/SDRT of £9,000 × 0.5% = £45 is payable.

Stamp duty land tax

2 Stamp duty land tax

2.1 Introduction

SDLT applies to transactions in UK property. It is payable by the purchaser on completion.

The value on which SDLT is charged includes any VAT payable on the transaction.

2.2 Rates of duty

There are different rates for residential and non-residential property. In addition, the threshold at which the tax becomes payable depends on whether it is in a disadvantaged area.

The following table will be provided in the exam:

£175,000* or less	Nil
£175,001 – £250,000	1%
£250,001 – £500,000	3%
£500,001 or more	4%

*For non-residential property, the nil rate band is restricted to £150,000.

Note that the relevant rate applies to the whole of the consideration, not just the amount within the relevant band.

Example

Boris is about to purchase a house. The vendor is asking for £251,000.

Required

(a) Calculate the SDLT payable if Boris pays the asking price.

(b) How would your answer differ if Boris purchased the house for £250,000?

Answer

(a) Boris would be required to pay SDLT of £251,000 x 3% = £7,530.

(b) The SDLT payable would fall to £250,000 x 1% = £2,500.

Exemptions

- Introduction
- Gifts
- Transfers within groups
- Miscellaneous

3 Exemptions

3.1 Introduction

The following exemptions apply to all three forms of stamp duty: stamp duty, SDRT and SDLT. However, for simplicity, the text simply refers to stamp duty.

3.2 Gifts

If the transfer is a gift, there is no consideration and hence no stamp duty is payable. This is in contrast to the treatment of gifts for CGT purposes, where market value is used if there are no sale proceeds.

3.3 Transfers within groups

Transfers of assets between 75% group companies are exempt from stamp duty provided that, at the time of the transfer, no arrangements exist for the transferee company to leave the group. However, stamp duty becomes payable if the **transferee** company does leave the group within **three years** of the transfer whilst still holding the asset.

Stamp duty is also not chargeable on company reconstructions where there is no change in ownership.

3.4 Miscellaneous

The following transfers are also exempt from stamp duty:

- Assets transferred as part of divorce arrangements
- Property passing to a beneficiary under a will or intestacy
- Variation of a will within two years of the date of death
- Changes in trustees.

To qualify for an exemption, the transfer document must state which exemption is being claimed.

Administration of stamp duties

- Stamp duty
- Stamp duty land tax

4 Administration of stamp duty

4.1 Stamp duty

Documents should, in theory, be stamped before they take effect. However, in practice, no penalty is charged if the document is stamped within 30 days of the date of execution.

Adjudication is the process whereby a Stamp Office assesses how much duty is payable on a document. If the full amount of stamp duty is not paid within 30 days, a penalty of up to £300 can be charged. This penalty cannot exceed the amount of stamp duty payable. (However, if the stamp duty is more than one year late, the penalty will be the higher of £300 and the amount of duty payable.)

Interest is also chargeable on any stamp duty not paid within 30 days, unless the amount due is £25 or less.

An adjudication can be appealed against. The appeal must be made within 30 days and the stamp duty, together with any penalty and interest, must be paid before the appeal can be heard.

4.2 Stamp duty land tax

The Stamp Office must be notified of a transaction within 30 days of the completion date. The return must include a self-assessment. Any tax due must also be paid within the same 30 day period. However, the tax does not have to accompany the return.

The penalties for failure to file a return on time, and the time limits for amending returns, opening enquiries, etc are the same as for income tax.

CHAPTER 27

Tax planning for businesses

Contents

Choice of trading medium

- Choosing the most suitable trading medium
- Comparison of trading as a sole trader or as a company

1 Choice of trading medium

1.1 Choosing the most suitable trading medium

If an individual is considering setting up a business, he will need to consider whether to set up a limited company or an unincorporated business (i.e. operate as a sole trader or partnership).

There are many factors to consider. If the individual sets up an unincorporated business, he will be taxed as a self-employed individual. If he sets up a company, he will be taxed on his income as an employee (director) and as a shareholder.

1.2 Comparison of trading as a sole trader or as a company

A summary of the key factors to consider is given in the table below.

	Unincorporated business	**Company**
Taxation of the individual	The individual is assessed to income tax on all trading profits, regardless of drawings from the business.	The individual is assessed on employment income and dividends received from the company.
Taxation of the profits of the trade	The profits of the business are liable to income tax. Highest marginal rate of 40% applies if profits exceed £37,400.	The profits of the company are liable to corporation tax. Corporation tax rate will be 21% if profits do not exceed £300,000.
Extraction of funds	There are no further tax consequences if a sole trader draws cash out of the business (because income tax is paid on all trading profits each year, regardless of drawings).	Extraction of funds is usually in the form of extra remuneration or dividends. Any form of extraction of funds has further tax consequences as explained below.
Relief for trading losses	Losses can be set off against the individual's personal: (1) non-trading income under s64 and s72 (2) chargeable gains under s261B.	Losses can be set against the other income and chargeable gains of the company, but cannot be set against the personal income of the individual.

	Unincorporated business	Company
NICs	Class 2 and Class 4 payable.	Class 1 primary payable for directors. These are higher than the total of Class 2 and Class 4 NICs.
Payment dates	Self assessment for income tax and Class 4 NICs. For 2009/10: ■ POA 1: 31 January 2010 ■ POA 2: 31 July 2010 ■ Balancing payment: 31 January 2011 Monthly direct debit for Class 2 NICs.	Income tax on earnings and Class 1 NICs paid monthly under PAYE. Class 1A NICs payable by the employer on 19 July following the end of the tax year. Income tax on dividend income at source and via self assessment if a higher rate taxpayer. Corporation tax is payable 9 months and one day after the end of the CAP (except for large companies).
Chargeable gains on the disposal of business assets	Gains are liable to capital gains tax at 18%. Rollover relief, gift relief and entrepreneurs' relief may be available. Annual exemption available.	Gains are liable to corporation tax at the marginal rate of tax for the company. Indexation allowance to date of disposal. Rollover relief may be available. No annual exemption

Comparison of remuneration packages

- The importance of the cost of employment
- Tax implications of providing additional cash remuneration
- Tax implications of providing benefits of employment

2 Comparison of remuneration packages

2.1 The importance of the cost of employment

When an employer decides on a remuneration package, he must consider not only the tax implications for the employee but the total cost implications for the business, including the tax consequences for the employer.

A form of remuneration which is tax-efficient for the employee may not be tax-efficient for the employer.

2.2 Tax implications of providing additional cash remuneration

An employer may provide additional cash remuneration to an employee, for example in the form of a 'cash' bonus.

The tax implications of such payments are set out in the table below.

Implications for the employee	Implications for the employer
The employee is liable to income tax and Class 1 primary NICs on a cash receipts basis.	The employer is liable to Class 1 secondary contributions at 12.8%.
Income tax and Class 1 primary NICs are collected via the PAYE system.	Class 1 secondary NICs are paid via the PAYE system.
The employee therefore pays tax and NICs on a bonus in the month that the bonus is paid.	Additional remuneration and Class 1 secondary contributions are allowable deductions against the trading income of the business, provided that the remuneration is paid within 9 months of the end of the accounting period. Tax relief is therefore available at the corporation tax rates if the employer is a company, or at the employer's income tax rates if the employer is a sole trader or a partnership.

2.3 Tax implications of providing benefits of employment

An employer may provide an employee with additional benefits, other than cash payments, that are assessable for income tax. The implications of providing benefits are set out in the following table.

Implications for the employee	Implications for the employer
The employee is liable to income tax on the value of the benefit in the tax year in which the benefit is received. Exempt benefits are tax advantageous. However, other benefits can have high values (such as cars with high CO_2 emissions). No NICs are payable on benefits. Income tax is collected via the PAYE system, usually by adjusting the employee's PAYE code number.	The employer is liable to Class 1A NICs on the value of the benefit at 12.8%. Class 1A NICs are payable in one lump sum on the 19 July following the end of the tax year. Class 1A NICs and the costs of providing the benefits are allowable deductions against the trading income of the business. Tax relief is therefore available at the corporation tax rates if the employer is a company, or at income tax rates if the employer is a sole trader or a partnership.

Example

Sasha is employed and receives a salary of £50,000.

Her employer has offered her a company car on the following terms:

- A diesel car with a list price of £13,200 and CO_2 emissions of 171 g/km
- All running cost including fuel to be provided
- Contributions of £50 per month for the car and £30 per month for the fuel is expected.

Sasha currently uses her own car for business mileage on the following terms:

- Additional salary of £2,000 received as a cash alternative to a car
- Business mileage allowance of 32p per mile
- Average business mileage per year is 7,600 miles.

Sasha has calculated that her car costs her on average £4,800 per annum to run.

Required

Calculate whether Sasha should take up the offer of the company car. (The authorised mileage allowance rate is 40p per mile for the first 10,000 miles.)

a **Answer**

Company car	**g/km**		**Diesel %**
CO_2 emissions (rounded down to nearest 5 g/km)	170		
Base level of CO_2 emissions	(135)		
	35	÷ 5	7
Minimum percentage			18
Appropriate percentage			25

	£		£
Manufacturer's list price	13,200	× 25%	3,300
Minus: Contribution for the use of the car (£50 × 12)			(600)
Car benefit			2,700
Private fuel benefit: (£16,900 × 25%)			4,225
Total benefits			6,925
Cost to Sasha:			
Income tax (£6,925 × 40%)			2,770
Contributions towards car and fuel (£80 × 12)			960
Annual cost to Sasha			3,730

Using own car

	£
Running costs	4,800
Additional salary	(2,000)
Mileage allowance (7,600 miles × 32p)	(2,432)
Income tax on additional salary (£2,000 × 40%)	800
Income tax saving on shortfall on mileage allowance (40p – 32p) × 7,600 miles × 40%	(243)
Class 1 primary NICs on additional salary (£2,000 × 1%)	20
Annual cost to Sasha	945

Sasha is better off keeping her cash alternative arrangement and not taking up the offer of a company car.

Tax efficient extraction of funds

- Extracting funds from a company: choosing a tax-efficient method
- Tax implications of paying a dividend
- Tax implications of retaining profits in the business

3 Tax efficient extraction of funds

3.1 Extracting funds from a company: choosing a tax-efficient method

If an individual is a director and shareholder of a company, he has the ability to decide how he will take profits out of the business or whether to retain the profits in the business.

He can determine his remuneration package and/or decide to pay himself a dividend. In doing so, he can influence his income tax and National Insurance liabilities.

3.2 Tax implications of paying a dividend

When a company pays a dividend, there are tax implications for both its shareholding employees and the company itself. These are set out in the following table.

Implications for the individual	Implications for the company
A shareholder is liable to income tax on the dividend received, grossed up by 100/90. A deemed tax credit of 10% can be deducted from the income tax liability. If the shareholder is a higher rate taxpayer, he or she is liable to 22.5% (32.5% - 10%) tax on the gross dividend income. This is the equivalent of 25% of the net dividend received. No NICs are payable on dividends.	No NICs are payable on dividends. Dividends paid are not an allowable deduction for the company. No tax relief is therefore available to a company for paying dividends.

3.3 Tax implications of retaining profits in the business

A company may decide to retains its profits and not pay them as dividends to shareholders.

Implications for the employee	Implications for the company
There are no immediate tax implications for a shareholding employee when profits are retained. Retained profits can be paid out to the employee in subsequent years. However any extraction of funds from the company at any time will have tax consequences as described above.	All profits, whether paid out as dividends or retained, are subject to the appropriate corporation tax rate depending on the level of 'profits' compared with the statutory limits.

Example

Tina is a director and shareholder of CV Ltd. It is the end of March 2010 and Tina is reviewing her income from the business.

During 2009/10 her employment income will be £40,000. The company has surplus funds of £20,000 which are available for Tina to extract on 31 March 2010.

Required

Explain whether Tina should take out £20,000 as a bonus (after allowing for employers' Class 1 NICs), or as a dividend (after allowing for corporation tax) assuming the company pays corporation tax at the following alternative rates:

(a) 21%

(b) 29.75%

Answer

Note that in each case the total gross cost to the company must be £20,000.

- The bonus plus the employers' Class 1 NICs must total £20,000.
- The dividend is paid out of the surplus funds of the company after corporation tax has been deducted.

The optimum decision is therefore based on the amount of cash received by Tina.

Tina is a higher rate taxpayer, paying income tax at 40% and Class 1 NICs on any additional employment income at 1%.

(a) Company pays tax at 21%

Bonus	**£**	**Dividend**	**£**
Total cost to company	20,000	Total cost to the company	20,000
Employers' Class 1 NICs		Corporation tax at 21%	(4,200)
(£20,000 × 12.8/112.8)	(2,269)	Dividend paid	15,800
Gross income received	17,731	Tax credit (£15,800 × 10/90)	1,756
Income tax at 40%	(7,092)	Gross dividend income	17,556
Employees Class 1 NICs at 1%	(177)		
Cash received by Tina	10,462	Dividend received by Tina	15,800
		Income tax payable	
		£17,556 × (32.5% - 10%)	(3,950)
		Cash received by Tina	11,850

If the company pays corporation tax at 21%, it is beneficial for Tina to take the additional funds as a dividend.

(b) Company pays tax at 29.75%

Bonus	**£**	**Dividend**	**£**
As before:		Total cost to the company	20,000
Cash received by Tina	10,462	Corporation tax at 29.75%	(5,950)
		Dividend paid	14,050
		Tax credit (£14,050 × 10/90)	1,561
		Gross dividend income	15,611
		Dividend received by Tina	14,050
		Income tax payable	
		£15,611 × (32.5% - 10%)	(3,512)
		Cash received by Tina	10,538

If the company pays corporation tax at 29.75%, it is beneficial for Tina to take the additional funds as a dividend.

Tax implications of disposing of an interest in a business

4 Tax implications of disposing of an interest in a business

4.1 Introduction

Choosing the correct trading medium for a business not only affects the taxation levied on the business and the owner during the life of the business. It also significantly affects the tax levied on the disposal of the interest in the business.

- If a company is established, the interest in the business can be disposed of more easily on a piecemeal basis, by gifting or selling shares.
- If the business is set up as an unincorporated business (e.g. sole trader or partnership), a piecemeal disposal of the business is more difficult. The business interest is usually sold or gifted in its entirety as a going concern, or the assets are sold and the business ceases.

Each of these options has tax consequences. These are considered below.

4.2 Disposal of shares in a company

The tax consequences of selling shares in a company, or gifting shares to another person, are set out below.

	Sale of shares	**Gift of shares**
Capital gains tax	A chargeable gain arises. The rules for CGT for individuals apply. Entrepreneurs' relief may be available if the shares are in a trading company, the individual is an employee of the company and has at least a 5% interest in the company.	Same consequences as for the sale of shares. In addition, **gift relief** is available if the shares are in an unquoted trading company or are shares in a quoted company where the individual has at least a 5% interest. Gift relief is restricted if the company holds chargeable assets that are not business assets.
Corporation tax	The company owns the business and the disposal of shares in the company simply represents a change in the ownership of the shares. There are no taxation consequences for the company on the sale or gift of shares by one shareholder to another.	

VAT	There are no VAT consequences on the sale of shares. Sales of shares are outside of the scope of VAT.

4.3 Disposal of an unincorporated business

For taxation purposes, the disposal of an unincorporated business is not treated as the disposal of one asset. It is treated as the disposal of each individual asset in the business.

The taxation consequences are as follows:

	Sale of an unincorporated business	**Gift of an unincorporated business**
Capital gains tax	Chargeable gains arise on each chargeable asset disposed of, using the rules applicable to individuals. Entrepreneurs' relief may be available where the disposal is of the whole or part of the business.	Same consequences as for the sale of an unicorporated business. In addition, gift relief is available.
Income tax	The trade ceases and the closing year basis of assessment rules are applied for the final period's profits. The final capital allowances computation has no WDA. Balancing charges and/or allowances arise. Terminal loss relief is available, if applicable.	
VAT	No VAT consequences arise if the business is transferred as a going concern. If not transferred as a going concern, VAT is charged on the sale of assets in the normal way. As the business is ceasing, it must de-register and, if applicable, VAT is payable on the final deemed supply unless the VAT liability is less than £1,000.	

Alternative methods of acquiring other companies

5 Alternative methods of acquiring other companies

5.1 Introduction

The business of a company can be obtained in two ways:

- By the acquisition of its shares
- By the acquisition of its assets and trade.

These methods have different taxation consequences for the vendor, the purchaser and the target company.

5.2 Acquisition of shares

Assume that A Ltd holds all of the shares in B Ltd and those shares are then purchased by C Ltd.

Vendor's position (A Ltd)

- Prior to the disposal, A Ltd and B Ltd are associated companies and also members of a 75% group (for both loss relief and chargeable gains).
- Group relief will be available between A Ltd and B Ltd up to the date of sale, provided 'arrangements' for the sale did not exist before that date.
- A Ltd will have one less associate from the beginning of the **next** accounting period.
- B Ltd must be removed from any VAT group with A Ltd.
- As A Ltd holds more than 10% of B Ltd's share capital, the substantial shareholding exemption applies and so no chargeable gain arises on the disposal. (Note, however, that if the shares in B Ltd had been held by Mr A, an individual, a chargeable gain would have arisen.)

Purchaser's position (C Ltd)

- After the purchase, B Ltd and C Ltd will be associated companies and also members of a 75% group (for both loss relief and chargeable gains).
- Group relief will be available from the date of purchase. Losses of the accounting period of acquisition will therefore need to be time-apportioned into the period before and after the change in ownership.

- There is an immediate increase in the number of associated companies.
- C Ltd could make a VAT group election with B Ltd.
- B Ltd's tax history is inherited by C Ltd on the acquisition of its shares, therefore it is advisable to obtain indemnities from A Ltd to cover any outstanding tax.

The company's position (B Ltd)

- Only the company's ownership changes. This means that its trade continues and its assets continue to attract capital allowances on their tax written down values.
- As B Ltd is leaving A Ltd's 75% chargeable gains group, there may be a degrouping charge in respect of previous no gain/no loss intra-group transfers made in the previous six years.
- The carry forward of unused trading losses may be prevented if there is a major change in the nature or conduct of the trade in the next three years.

5.3 Acquisition of assets and trade

An alternative to a share acquisition is for the purchasing company to acquire the assets and trade of the target company.

Under this method of acquisition, the purchase price must be allocated between the various assets acquired.

Vendor's position (B Ltd)

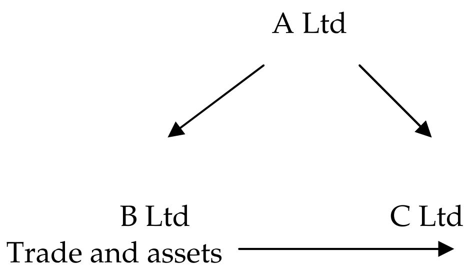
- In this case, the vendor is B Ltd itself not its shareholders.
- There will be balancing adjustments on the sale of its assets.
- There will be capital gains and/or losses in respect of the disposal of any chargeable assets. Gains in respect of qualifying business assets may be deferred using rollover relief if the relevant reinvestment in qualifying business assets is made by the company itself or by another group member.
- B Ltd retains its own trading losses and/or capital losses. However, if the whole trade is sold, then it is deemed to cease and the losses may be unrelieved.
- The transfer of trade will usually qualify as a going concern transfer and be outside the scope of VAT.

Purchaser's position (C Ltd)

- The purchaser will be entitled to capital allowances based on the purchase price of the assets acquired.
- The purchaser will not acquire losses or any liabilities. These remain with B Ltd.
- There would be no additional associated company.

5.4 Transfer of a trade and assets within a group

Where the transferor and transferee companies are members of a group, or have the same shareholders, the provisions of s343 apply. This would occur for example in the following situation:



The diagram shows that both B Ltd and C Ltd are subsidiaries of A Ltd. The trade and assets of B Ltd are transferred to C Ltd. Although the ownership of the trade and assets has passed from one subsidiary to another, it remains under the ultimate control of A Ltd.

This type of transfer has the following implications:

- The trading losses of the transferor company (B Ltd) are transferred with the trade and can be offset against the future profits of the transferred trade (which is now held by C Ltd).
- The change is ignored for capital allowance purposes. This means that assets are transferred at their tax written down values. There are no balancing adjustments for B Ltd, the transferor.
- Chargeable assets are deemed to be transferred on a no gain/no loss basis, thus avoiding any chargeable gains. Note, however, that this treatment is dependent on the transferor and transferee companies forming a chargeable gains group.
- Capital losses and deficits on non-trading loan relationships must remain with the transferor company.

In order to benefit from this treatment, the same persons must hold an interest of at least 75% in the trade:

- at some time in the year prior to the transfer, and
- at some time in the two years following the transfer.

The above rules also apply where the assets and trade are transferred into a newly created subsidiary company. This is known as a hive down.

Sources of finance available to companies

6 Sources of finance available to companies

6.1 Introduction

Companies have a number of ways of financing their operations:

- debt finance, such as loans and overdrafts
- equity finance, such as a new issue of ordinary shares
- leasing or hire purchase
- miscellaneous sources such as trade credit, invoice discounting and debt factoring.

Most of these options, with the exception of equity finance, are also available to unincorporated businesses.

6.2 Debt

Debt finance can be subdivided into:

- long term, such as mortgages, debentures and loan stock
- short term, such as overdrafts and short term loans.

Debt finance is serviced by the payment of interest. Payments of interest for trading purposes are deductible in computing trading profits. This means that interest payments reduce the company's chargeable profits and hence its corporation tax liability.

6.3 Equity finance

Equity finance is serviced by the payment of dividends. Dividends are not deductible in computing taxable profits. They therefore have no impact on a company's CT liability.

Unquoted trading companies may encourage outside investors to obtain their equity shares through the Enterprise Investment Scheme, Venture Capital Trusts and the Corporate Venturing Scheme.

6.4 Leasing and hire purchase

Both leasing and hire purchase allow a business to obtain the use of an asset without having to pay its full cost up-front.

Leasing

Under a short-term lease (less than five years) the business is effectively renting the asset. The lease payments are a deductible cost in computing trading profits.

A long-term lease is treated in a similar way to a hire purchase transaction.

Hire purchase

Assets acquired by way of hire purchase are treated as if purchased outright for the cash price. Capital allowances are available.

The finance charges are a deductible cost in computing trading profits.

Purchasing outright

The treatment of a hire purchase transaction is the same as taking out a loan to purchase an asset outright. The decision as to whether to buy using hire purchase or to take out a loan largely rests on the company's ability to obtain loan finance and the rate of interest it will have to pay.

If the business has surplus funds, it may decide to use them to purchase the asset rather than borrowing the money. If so, there will obviously be no interest cost. However, the business needs to be certain that there are no alternative uses of the funds that will be more cost efficient.

6.5 Miscellaneous sources

Trade credit

Suppliers are a source of finance if they provide goods or services on credit. This is generally seen as a free source of short-term finance. However, it is unwise to stray outside the limits of the credit agreement as it may result in the suspension of further credit or a re-assessment of the company's credit status.

Factoring

A factor can take over responsibility for the collection of the company's debts. The factor generally advances money up to an agreed proportion of the debts owed to the company. With non-recourse factoring, the factor also bears the cost of any bad debts.

Invoice discounting

Invoice discounting is similar to factoring in that it is a method of obtaining short-term finance using the company's debts as security. However, the company retains responsibility for the collection of its own debts.

CHAPTER 28

The obligations of taxpayers and their agents

Contents

Notification of chargeability

- Notification by companies
- Notification by individuals
- Penalties for failure to notify chargeability

1 Notification of chargeability

1.1 Notification by companies

When a company first comes within the scope of corporation tax (i.e. when it first has profits that are chargeable to corporation tax), it must notify HMRC of its chargeability to tax within three months after the start of its first accounting period.

Companies that have been trading for a while usually receive a notice (reminder), a few weeks before the end of their regular accounting end date, of their self assessment obligation to file a corporation tax return. If a company with taxable profits does not receive a return, it must notify HMRC within 12 months of the end of its accounting period.

1.2 Notification by individuals

Where an individual first acquires a new source of chargeable income, he must notify HMRC of his chargeability to tax by 5 October following the end of the tax year in which the new source arose.

For example, for the tax year 2009/10, HMRC must be notified by 5 October 2010. Penalties will be payable for failure to notify on time.

A self-employed individual must notify HMRC of his trading activities within three months of the end of the month in which he started to trade.

1.3 Penalties for failure to notify chargeability

Failure to notify chargeability can result in a penalty. This is determined according to the new single penalty regime that applies to income tax, capital gains tax, corporation tax and VAT.

The amount of penalty is based on the 'potential lost revenue'. This is the amount of tax due but unpaid by 31 January following the tax year (or 12 months following the end of the accounting period for companies) as a result of the late notification. The taxpayer's behaviour also affects the amount of penalty payable:

Type of behaviour	**Maximum penalty**	**Minimum penalty**
Deliberate and concealed	100%	30%
Deliberate but not concealed	70%	20%
Any other case	30%	Nil

The minimum penalties apply only where the taxpayer makes an unprompted disclosure to HMRC. To avoid a penalty entirely the unprompted disclosure must be made within 12 months of the date notification was due.

Filing returns

- Filing a corporation tax return
- Penalties for late filing of a corporation tax return
- Filing an income tax return
- Penalties for late filing of an income tax return
- Penalties for incorrect returns

2 Filing returns

2.1 Filing a corporation tax return

A company must complete a corporation tax return (Form CT600) and submit it to HMRC within 12 months of the end of its period of account, or three months from the date on which the notice to complete a return was issued, if later.

The return contains all the information required to calculate the company's PCTCT for the accounting period. It also enables the company to claim reliefs and allowances (e.g. loss reliefs and capital allowances).

The company must also calculate its own corporation tax liability and submit a copy of its financial accounts with its self assessment form.

2.2 Penalties for late filing of a corporation tax return

Penalties are levied if the corporation tax return is filed late, as follows:

Filed within	**Maximum penalty**
3 months of filing date	£100 fixed penalty. Increased to £500 if the company becomes liable to the fixed penalty for three consecutive years.
3 to 6 months of the filing date	£200 fixed penalty. Increased to £1,000 if the company becomes liable to the fixed penalty for three consecutive years.
18 to 24 months after the end of the accounting period	£200 fixed penalty plus 10% of the tax outstanding 18 months after the end of the accounting period
More than 24 months after the end of the accounting period	£200 fixed penalty plus 20% of the tax outstanding 18 months after the end of the accounting period

2.3 Filing an income tax return

The self assessment system for individuals covers:

- income tax
- Class 4 NICs, and
- capital gains tax.

Individuals whose liability to income tax is not settled in full by deduction of tax at source (for example, through the PAYE system) are required to submit a self assessment return to HMRC.

Individuals who are likely to need to submit a tax return usually receive a blank return automatically from HMRC around the end of the tax year (i.e. March/April).

An individual must complete the relevant sections of the tax return and submit it to HMRC.

The full income tax return consists of a summary form, supplementary pages and a tax calculation section.

If the taxpayer wishes to submit his return on-line, the due date for filing the return (often referred to as the **annual filing date**) is the later of:

- 31 January following the end of the tax year (i.e. for 2009/10; by 31 January 2011), or
- 3 months after the issue of the return.

If the taxpayer wishes to submit a traditional paper return, he must do so by the later of:

- 31 October following the end of the tax year (i.e. for 2009/10; by 30 October 2010), or
- 3 months after the issue of the return.

A calculation of the tax liabilities is performed automatically as part of the on-line filing process. If a traditional paper return is submitted, the taxpayer has the option of requiring HMRC to calculate their liability provided the return is submitted on time.

2.4 Penalties for late filing of an income tax return

Penalties are levied on individuals for late submission of a tax return, as follows:

Filed	Maximum penalty
Within 6 months of filing date	£100 fixed penalty
Within 6 to 12 months of the filing date	£200 fixed penalty
More than 12 months after the filing date	£200 fixed penalty plus up to 100% of the tax liability for the year

If the fixed penalty of £100 is seen to be insignificant to the individual, HMRC may apply to the tribunal for a penalty of up to £60 per day to apply instead.

The penalties (excluding the daily penalty) cannot exceed the amount of tax outstanding at the date the return was due.

2.5 Penalties for incorrect returns

A single penalty regime for incorrect returns applies:

- to incorrect income tax returns
- to incorrect corporation tax returns and
- where a misdeclaration has been made on a VAT return.

The penalty will be based on the amount of tax understated and the taxpayer's behaviour. The penalty will be:

Type of behaviour	Maximum penalty	Minimum penalty
Deliberate and concealed	100%	30%
Deliberate but not concealed	70%	20%
Careless	30%	Nil

Any penalty will be substantially reduced where a taxpayer makes disclosure, especially when this is unprompted by HMRC. For example, if a taxpayer makes an unprompted disclosure of an incorrect return following a failure to take reasonable care, the penalty could be reduced to nil.

Amendments, enquiries and appeals

- Deadlines for amendments
- Enquiries
- HMRC's information and inspection powers
- Appeals
- Determination assessments
- Discovery assessments
- Record keeping

3 Amendments, enquiries and appeals

3.1 Deadlines for amendments

HMRC's right to repair

HMRC have the right to repair (i.e. correct) self assessment returns, within 9 months of the date of receipt, if there are obvious errors or omissions (such as arithmetical errors and missing supplementary pages).

The taxpayer's right to amend

The taxpayer has the right to amend his return within 12 months of the annual filing date.

For example, for 2009/10, an individual has the right to amend until 31 January 2012, regardless of whether the return is paper-based or filed on-line.

Claims for recovery of overpaid tax

If the taxpayer notices an error in his return, he may make a claim for repayment after the amendment deadline but within four years of the end of the tax year (accounting period for companies). However, a mistake is ineligible for relief if the return was made in accordance with the generally prevailing practice at the time.

3.2 Enquiries

HMRC have the ability to enquire into a tax return to check for completeness and accuracy.

A return may be investigated:

- because information received by HMRC does not tie up with the return, or
- as a result of HMRC's random selection process, whereby it selects a small percentage of returns to check.

HMRC are not obliged to disclose the reason for the enquiry. However, they must give written notice before commencing an enquiry, within 12 months of the date the return is received.

Normally, if HMRC does not issue an enquiry notice within the time limit, the self assessment may be regarded as agreed and finalised.

On the completion of an enquiry HMRC must issue a written notice stating:

- that the enquiry has been completed, and
- the outcome of the enquiry.

Within 30 days of the completion of the enquiry, the taxpayer must amend his self assessment as required by HMRC.

If the taxpayer refuses to amend the self assessment or does not amend the return according to HMRC's request, HMRC have the right to impose their assessment within 30 days of the refusal or inadequate amendment.

The taxpayer can appeal against HMRC's amendment, in writing, within 30 days of the amendment.

3.3 HMRC's information and inspection powers

HMRC can request information and documents from taxpayers by issuing a written information notice. This power is for the purpose of checking the taxpayer's tax position and applies irrespective of whether HMRC has opened an enquiry.

HMRC can also request information from third parties provided the request is either agreed by the taxpayer or approved by a First-tier Tribunal (see later).

The taxpayer must comply with the information notice within such time as is reasonably requested by HMRC. If the taxpayer does not wish to comply, they must appeal to the First-tier Tribunal against the information notice within 30 days.

A standard penalty of £300 can be imposed for failure to comply with an information notice, unless the taxpayer can satisfy the tribunal that he has a reasonable excuse for the failure.

A penalty of £3,000 can be charged if inaccurate information is supplied either carelessly or deliberately. The penalty of £3,000 is in respect of each inaccuracy.

HMRC also has powers to enter a taxpayer's business premises and inspect their business assets and records if the inspection is reasonably required for the purpose of checking the taxpayer's tax liability. Note, however, that the power does not extend to entering and inspecting premises used solely as a dwelling.

3.4 Appeals

The taxpayer has the right to appeal against:

- an amendment to a return
- an information notice
- the imposition of a penalty or surcharge
- a discovery assessment (see below).

An appeal should be in writing, and must be made within 30 days of the relevant event. It must state the grounds for the appeal.

Appeals may initially be made to HMRC. An officer unconnected with the case will undertake a review. This review must normally be carried out within 45 days. The taxpayer then has 30 days in which to appeal to the Tribunal.

The tribunal system

The tribunal system consists of a First-tier Tribunal and an Upper Tribunal. The First-tier Tribunal deals with all but the most complex cases. The Upper Tribunal deals with the more complex cases and appeals against decisions of the First-tier Tribunal.

Cases are allocated to one of four tracks:

- The paper track hears simple appeals, e.g. appeals against the imposition of a fixed penalty. This is the default track and cases are normally decided without a hearing.
- The basic track involves a hearing but the exchange of documents beforehand is kept to a minimum.
- The standard track involves cases that are subject to more detailed case management and formality.
- The complex track is for long or complex cases, or those involving an important principle or a large financial sum.

If the decision of the First-tier Tribunal is based on:

- a matter of fact, the decision is binding and final
- a point of law, the case can be referred to the Upper Tribunal, but only with the permission of either the First-tier or Upper Tribunal.

A decision of the Upper Tribunal can be referred to the Court of Appeal.

3.5 Determination assessment

Where a taxpayer does not file his return by the filing date, HMRC may estimate the individual's self assessment and determine the amount of tax due. A determination assessment may be made at any time within four years of the end of the taxable period concerned. (The taxable period will be a tax year for income tax/capital gains tax, and an accounting period for corporation tax.)

There is no right of appeal against a determination, however the determination notice will be set aside and replaced with the taxpayer's own self assessment when it is submitted.

3.6 Discovery assessment

Where a taxpayer did file their return on time but HMRC did not enquire into the return within the permitted time period, HMRC can raise a discovery assessment where they suspect fraud, negligence or that full disclosure has not been made.

The time limits for making a discovery assessment depend on the circumstances of the case:

Situation	Time limit
Ordinary time limit	4 years from the end of the taxable period
Careless omission	6 years from the end of the taxable period
Deliberate omission	20 years from the end of the taxable period

3.7 Record keeping

Companies

A company must keep its records for at least six years from the end of the relevant accounting period.

The records to be retained by companies include records of:

- All receipts and expenses
- All sales and purchases
- Supporting documents including accounts, books, deeds, contracts, vouchers and receipts.

Individuals

An individual must retain:

- personal records for at least 1 year after the annual filing date (i.e. for a 2009/10 return, personal records must be kept until 31 January 2012), and
- business records for at least 5 years after the annual filing date (i.e. for a 2009/10 return, business records must be kept until 31 January 2016).

The above dates for both individuals and companies are replaced by:

- the date on which HMRC have completed any enquiry, or
- the date on which HMRC no longer have the power to enquire into a return, if later.

A penalty of up to £3,000 per accounting period/tax year can be levied for failure to keep records.

The obligation to preserve records may be satisfied by preserving the information contained in the records, rather than the actual records themselves. It is therefore permissible to preserve the information in electronic form.

Payment of tax

- Payment dates for corporation tax
- Payment dates for income tax, Class 4 NICs and capital gains tax
- Surcharges
- Interest on underpaid and overpaid tax

4 Payment of tax

4.1 Payment dates for corporation tax

A company that does not pay corporation tax at the full rate of 28% is liable to pay its corporation tax liability 9 months and one day after the end of the chargeable accounting period (CAP).

A large company must pay its corporation tax liability in four quarterly instalments. The definition of a large company in this context is a company that pays tax at the full rate of 28% (for example, because it has profits for a 12-month period in excess of the statutory upper limit of £1,500,000).

However, a large company does not have to pay by instalments if it:

- was not large in the preceding 12 months and does not have PCTCT in excess of £10 million in the current accounting period, or
- has a corporation tax liability of less than £10,000 and pays corporation tax at the full rate because it has substantial FII and/or a large number of associated companies.

The procedure for payments by large companies

If a company has a 12 month accounting period, the following procedure is adopted:

- First instalment - 14 days after the end of the 6th month from the **start** of the accounting period.
- Second instalment - 14 days after the end of the 9th month.
- Third instalment - 14 days after the end of the 12th month.
- Fourth (i.e. final) instalment - 14 days after the end of the 15th month.

The instalments are based on the **estimated** corporation tax liability for the **current** accounting period. The company should revise its estimates, if necessary, throughout the year and pay any shortfall in respect of the previous quarterly payments.

Accounting period less than 12 months

When a company has an accounting period of less than 12 months, the amount of the instalments is calculated as follows:

$$\text{Estimated corporation tax liability} \times \frac{3\text{ months}}{\text{Number of months in the accounting period}}$$

- The first instalment is payable six-and-a-half months after the start of the accounting period.
- The last payment can never be later than three-and-a-half months after the end of the accounting period.
- The company will pay as many three-monthly instalments as possible in between the earliest and latest payment dates, and will pay on the 14th day of the appropriate month.

Therefore if a company prepares nine-month accounts to 30 September 2009 (i.e. 1 January 2009 to 30 September 2009). Tax payments are due as follows:

- First instalment: 14 July 2009. This is six-and-a-half months after the start of the accounting period.
- Second instalment: 14 October 2009. This is three months later.
- Third instalment: 14 January 2010. This is three months later, and it is the last instalment.

4.2 Payment dates for capital gains tax, income tax and Class 4 NICs

Capital gains tax

Capital gains tax is collected under self assessment and is due in one payment by 31 January following the end of the tax year (i.e. for 2009/10; by 31 January 2011).

Income tax and Class 4 NICs

Income tax which is not collected under PAYE or at source **and** Class 4 NICs (if applicable) are usually paid in instalments as follows:

	Due date	**For 2009/10**
Two equal payments on account (POAs):		
1st payment on account	31 January in the tax year	31 January 2010
2nd payment on account	31 July following the end of the tax year	31 July 2010
Balancing payment	31 January following the end of the tax year	31 January 2011

Calculation of POAs

Each payment on account (POA) is calculated as follows:

POA = ½ × tax paid by self assessment in the preceding year

The tax paid by self assessment for the preceding year is calculated as follows:

	£
Income tax liability	X
Plus Class 4 NICs	X
Total tax liability	X
Less Tax deducted at source	(X)
PAYE	(X)
Tax paid by self assessment	X

Situations where POAs are not required

POAs are not required if the tax paid by self-assessment in the preceding tax year is either:

- Less than £1,000, or
- Less than 20% of the total tax liability.

Example

Sonia has provided the following information:

	2008/09	2009/10
	£	£
Income tax liability	31,400	41,200
Class 4 NICs	2,560	2,780
Capital gains tax liability	7,400	4,500
PAYE	13,580	16,900
Deducted at source	3,670	4,920

Required

Calculate the tax payable under self assessment for 2009/10 and state the due dates of payment.

Answer

2008/09	£
Income tax liability	31,400
Plus Class 4 NICs	2,560
Total tax liability	33,960
Less Tax deducted at source	(3,670)
PAYE	(13,580)
	16,710

This amount of £16,710 is more than £1,000 and more than 20% of the total tax liability (20% × £33,960 = £6,792). Therefore, payments on account are required in 2009/10.

2009/10	£
Income tax liability	41,200
Plus Class 4 NICs	2,780
Total tax liability	43,980
Less Tax deducted at source	(4,920)
PAYE	(16,900)
	22,160

Due dates of payment

	Due date		**Amount**
			£
POAs	31 January 2010	½ × £16,710	8,355
	31 July 2010	½ × £16,710	8,355
			16,710
Balancing payment	31 January 2011	£22,160 – £16,710	5,450
Income tax and Class 4 NICs			22,160
Capital gains tax	31 January 2011		4,500

Note

On 31 January 2011, in addition to the balancing payment, the first POA of £11,080 (½ × £22,160) for 2010/11 is also due.

Reduction of POAs

If an individual believes that his total tax liability will be less than the previous year, he can claim to reduce his payments on account at any time before 31 January following the tax year.

The individual must state the grounds for the reduction and HMRC cannot dispute a claim to reduce POAs.

If at the end of the year it is found that the POAs were incorrectly reduced but it was as a result of an innocent error, interest will be payable on the instalments but no further consequences arise.

Collection of tax via PAYE

An employee who owes less than £2,000 can choose to have it collected through his tax code, provided he files his return by 30 December following the end of the tax year.

4.3 Surcharges

A surcharge may be levied when income tax, Class 4 NICs and capital gains tax are paid late. A surcharge is an additional charge to tax designed to encourage prompt payment.

- If all or any part of the balancing payment is unpaid more than 28 days after the due date, an individual is liable to a surcharge of 5% of the overdue tax.
- A further 5% surcharge is levied if the tax is still unpaid more than 6 months after the due date.

Surcharges are not levied on POAs that are paid late.

Example

Mark made the following self assessment payments in relation to 2008/09:

	Amount paid	Paid on
1st POA	£21,650	31.5.2009
2nd POA	£21,650	31.7.2009

The balancing payment was £11,200.

Required

Calculate the surcharges arising if Mark paid the balancing payment on the following alternative dates:

(a) 19 February 2010

(b) 3 April 2010

(c) 12 September 2010.

Answer

The first POA is paid late (31.5.2009 instead of 31.1.2009), however surcharges are not levied on POAs.

The due date for the balancing payment is 31 January 2010.

Surcharges due:

Date paid	Number of days late	Surcharge
(a) 19 February 2010	Less than 28 days	Nil
(b) 3 April 2010	More than 28 days, but less than 6 months	5% × £11,200 = £560
(c) 12 September 2010	More than 6 months	10% × £11,200 = £1,120

4.4 Interest payments

Interest on underpaid tax

Interest on underpaid tax runs:

- **from** the date the tax should have been paid
- **to** the day before the date the tax is actually paid to HMRC.

In the examination, the annual rate of interest on underpaid tax is given in the tax rates and allowances sheet (as 2.5%).

Example

Ellen made the following self assessment payments in relation to 2008/09:

	Amount paid	Paid on
1st POA	£10,500	30.3.2009
2nd POA	£10,500	5.10.2009
Balancing payment	£15,000	26.2.2010

Required

State how interest will be calculated on any tax paid late.

Answer

Interest will be calculated as follows:

		Due date	Day before date paid
1st POA	£10,500 × 2.5%	from 31.1.2009	to 29.3.2009
2nd POA	£10,500 × 2.5%	from 31.7.2009	to 4.10.2009
Balancing payment	£15,000 × 2.5%	from 31.1.2010	to 25.2.2010

Interest on overpaid income tax

Interest on overpaid tax (i.e. a repayment supplement) runs:

- **from** 31 January following the end of the tax year, for tax deducted at source, and
- **from** the date of payment, for POAs and other tax payments
- **to** the date the tax is repaid by HMRC.

Interest on overpaid corporation tax

Interest on overpaid corporation tax runs:

- **from** the later of the date the tax was due to be paid and the date the tax was actually paid
- **to** the date the tax is repaid by HMRC.

In the examination, the annual rate of interest on overpaid tax is given in the tax rates and allowances sheet. However, at present no interest is paid in respect of overpaid tax.

Interest on other payments

Interest may also be payable on surcharges, penalties and where a self assessment is amended or a discovery assessment is raised.

Miscellaneous issues

- Group payment arrangements
- Deliberate tax defaulters
- Duties of senior accounting officers

5 Miscellaneous issues

5.1 Group payment arrangements

In view of the fact that it is difficult for large companies to estimate their corporation tax liability, a system exists whereby a group of companies can nominate one group member to pay instalments on behalf of the group and allocate them between the group members once the liabilities are known.

This enables groups to avoid underpayments and overpayments arising in separate companies and thereby mitigates the effect of the difference between the interest charged and paid by HMRC.

5.2 Deliberate tax defaulters

The details of tax defaulters whose deliberate actions result in potential lost revenue to HMRC of more than £25,000 will be made public. This applies to both individuals and companies. The details will not be published if the taxpayer makes a full disclosure (prompted or unprompted) of the actions resulting in the potential lost revenue.

Defaulters who have incurred a penalty for the deliberate understatement of tax of at least £5,000 will be required to submit more detailed information of their tax affairs for the following five years.

5.3 Duties of senior accounting officers

The senior accounting officer of a large company or group of companies is now required to:

- ensure that the company establishes and maintains tax accounting arrangements that enable its tax liabilities to be calculated accurately
- provide an annual certificate to HMRC to the effect that appropriate accounting arrangements were in existence together with an explanation, where necessary, of any inadequacies. This certificate must be provided by the latest permitted date for filing the company's accounts for the year in question.

A senior accounting officer is defined as the director or officer of the company who has overall responsibility for the company's financial accounting arrangements. This will usually be the finance director.

A large company is defined as one with a turnover of more than £200m or a balance sheet total of more than £2bn. The turnover and assets of other group members are aggregate in determining whether these limits are met. However, non-UK group members and LLPs are ignored.

The term 'tax accounting arrangements' applies to all those taxes which are collected by HMRC; i.e. including corporation tax, VAT, NIC, PAYE, etc.

The penalty for a late or careless certificate is £5,000. This is levied personally on the senior accounting officer.

Ethical issues for advisers

- Exam focus
- Prospective clients
- Conflicts of interest
- Tax irregularites and disclosure of information to HMRC
- Money laundering

6 Ethical issues for advisers

6.1 Exam focus

The examiner has stated that every P6 exam will include an ethical component worth approximately five marks. Questions on ethics will be confined to the following areas:

- Prospective clients
- Conflicts of interest
- Tax irregularities and disclosure of information to HMRC
- Money laundering
- Tax avoidance and tax evasion.

Tax avoidance and evasion have already been covered in chapter 1.

6.2 Prospective clients

Before accepting instructions to act for a new client, an accountant should consider whether:

- he has the necessary skills and competence to meet the client's requirements
- there is any conflict of interest in accepting the client.

A conflict of interest may arise if there is a close link between the new client and an existing client; for example, if the new client is a spouse or an employee of an existing client.

Where the new client is a spouse of an existing client, it is important to remember that the two individuals are separate clients. The tax affairs of one spouse must not be discussed with the other without first obtaining permission.

Contacting the client's previous accountant

Before a new client is accepted, the client's current accountant should be contacted so that the new accountant is fully aware of all the factors that may be relevant in deciding whether or not to accept the engagement.

If the client refuses to give the existing accountant permission to disclose information about his affairs, the engagement should be refused.

Confirming the new client's identity

In order to comply with money laundering regulations, the identity of the prospective client should be verified:

- If the prospective client is an individual, copies of his passport or driving licence should be taken. Alternatively, a document from HMRC may be used to verify his address.
- If the prospective client is a company, a copy of the certificate of incorporation should be obtained. The identities of the main shareholders/directors should also be verified.

6.3 Conflicts of interest

When an accountant is faced with a conflict of interest, there are a number of steps which should be followed as part of the resolution process:

- The relevant facts should be gathered
- The ethical issues involved should be identified
- The fundamental principles relating to the matter in question should be determined
- Any established internal procedures should be followed
- All alternative courses of action should be considered and the possible consequences of each should be weighed.

If an ethical conflict cannot be resolved satisfactorily by following the above procedure, the accountant should:

- notify the client and obtain his consent to act
- obtain professional advice from his professional body or legal advisors. However, he should be careful to avoid breaching the client's confidentiality.
- refuse to remain associated with the matter creating the conflict and, if necessary, resign.

6.4 Tax irregularities and disclosure of information to HMRC

An accountant:

- must do nothing to assist a client to commit any criminal offence
- must not shield a client from the consequences of having defrauded HMRC.

An accountant who concludes that a prospective client may have been guilty of tax irregularities should only accept the appointment on the basis that full disclosure will be made to the appropriate authorities.

If an existing client refuses to make full disclosure of his tax affairs to HMRC, the accountant should:

- explain to the client the consequences of his non-disclosure
- refuse to continue to act for the client if the client still refuses to make full disclosure.

An accountant may disclose confidential information when:

- Disclosure is permitted by law. However, disclosure must be authorised by the client.
- Disclosure is required by law, e.g. the production of documents in the course of legal proceedings.
- There is a professional duty to disclose, and the disclosure is not prohibited by law, e.g. to respond to an inquiry or investigation by a member body or regulatory body.

Before confidential information is disclosed, the accountant should consider:

- Whether the interests of all parties could be harmed if the client consents to the disclosure of the information.
- Whether all the relevant information is known and substantiated.
- The type of communication that is expected and to whom it is addressed.

6.5 Money laundering

Money laundering is the process by which the proceeds of crime are converted into assets which appear to have a legal rather than an illegal source. The aim of disguising the source of the property is to allow the holder to enjoy it free from suspicion as to its source.

Money laundering is primarily regulated by the Proceeds of Crime Act 2002 and the Money Laundering Regulations 2007.

The legislation imposes some important obligations upon professionals, such as accountants, auditors and legal advisers. These obligations require such professionals to report money laundering to the authorities and to have systems in place to train staff and keep records.

Individuals (such as accountants) may be guilty of the offence of failing to disclose knowledge or suspicion of money laundering where they know or suspect, or have reasonable grounds for knowing or suspecting, that another person is engaged in laundering the proceeds of crime.

In such a situation, the accountant is required to make disclosure to the Serious Organised Crime Agency (SOCA), as soon as is practicable.

It is also an offence to make a disclosure likely to prejudice a money laundering investigation. This is known as tipping off and it covers the situation where an accountant informs a client that a report has been submitted to SOCA.

Failure to report and tipping off are punishable on conviction by a maximum of five years' imprisonment and/or a fine.

Q&A

Practice questions

Contents

Introduction

Questions on the P6 paper are scenario-based. They typically cover a number of different topics and different taxes. This makes it difficult to attempt examination-style questions until you are well into your studies.

The questions included in this section of the study text are designed to help you apply the rules you have learned in the corresponding chapter of the study text. They are therefore **not** representative of examination questions as they tend to focus on a particular topic or tax in isolation.

The questions below are largely computational. Computational questions are a good way to test your ability to apply the rules you have learned. In addition, they make it easy for you to judge your own performance. However, **the P6 examination does not include questions that are purely computational**. The examiner has stated that calculations will normally only be required in support of explanations and advice, and not in isolation. It is therefore important that you pay particular attention to the written aspects of the questions below.

There will be four to six marks available in Section A in respect of professional skills. These marks will be awarded to candidates who demonstrate that they have planned their answers in order to provide logical, coherent advice and who have **prepared the documents requested in the correct format with the appropriate introductory and concluding paragraphs**.

It is important that you think before you start to write an answer in order to identify the relevant issues, and the calculations necessary, to support your advice. You should consider whether the necessary calculations could be carried out in a particularly time efficient way. For example, if the taxpayer will be liable at the higher rate regardless of the particular option chosen, the income tax implications can be ascertained using the marginal rate of tax without the need to prepare full income tax computations. You should try to **avoid producing detailed pro forma calculations** (for example, of capital allowances), when a simpler working will provide the figure required. While writing an answer, you must always **remember who the document is for** – for example a client or a firm's files – and try to make the answer concise, practical, relevant, and helpful.

It is also important that you supplement your studies with examination-style questions. However, it is advisable to wait until you are at least half way through this study text before doing so. Trying to attempt past examination questions at an early stage of your studies is not an efficient use of your time as the questions are likely to contain topics that you have not yet covered.

Using past examination questions from the ACCA's website is not advisable for this subject. The tax rules change annually. It is not only the rates and allowances that change, but sometimes it is the format of the computation as well. Actual past examination questions often focus on areas that are topical at the time and may therefore not be representative of the current tax system. Instead, you should purchase an examination kit as the past examination questions the kit contains will have been updated to reflect the current legislation and style of the paper.

1 Angela

Angela has the following income and payments in 2009/10:

	£
Income	
Self employment profits	3,200
Employment income	29,750
Bank deposit interest received	4,720
Treasury stock interest received	2,000
Interest on National Savings Certificates received	480
Discretionary trust income received	3,600
Dividends received from UK companies	2,205
Premium bond winnings	500
Payments	
Gift Aid donation	624
Allowable interest	300

Angela lives with her son, Jacob, who is aged 14. Jacob receives £1,500 each year from a trust set up by his grandparents and in 2009/10 he received £320 interest on a building society account set up for him by Angela two years ago.

Income tax of £5,180 was deducted from Angela's employment income under the PAYE system.

Required

Calculate the income tax payable by Angela for 2009/10.

2 Eric and Margaret

Eric and Margaret are a married couple. They provide you with the following information relating to 2009/10:

	Eric £	**Margaret** £
Age at the end of the tax year	73	77
Personal pension scheme income (gross amounts)	11,850	9,700
Property income (jointly owned property)	5,100	5,100
Debenture interest in an unquoted company	2,400	-
Building society interest	2,560	-
NSB interest – EASA	-	3,500
Interest on a cash ISA	-	620
Dividends from a stock ISA	1,800	-
Dividends from a UK company	2,700	4,500
Dividends from a REIT	3,600	-

Basic rate income tax has been deducted from the pension income. The couple have not made any elections regarding joint income or allowances.

Eric made a donation of £780 to Oxfam under the Gift Aid scheme on 16th August 2009.

Required

Calculate the income tax payable/(repayable) by Eric and Margaret for 2009/10.

3 David White

David White acquired a 25-year lease on a property on 1 May 2007 and paid a premium of £85,000. On 1 August 2009 David sub-let the property on a four-year lease for a premium of £18,000.

David is a cautious investor and wants to invest in a low risk investment which does not risk his capital, gives a reasonable return and has tax advantages. He has heard about Individual Savings Accounts, but does not know the details of such accounts.

Required

(a) Calculate David's property income assessment for 2009/10.

(b) Explain the tax advantages of Individual Savings Accounts and the conditions which must be satisfied to obtain the reliefs available.

4 Mr and Mrs Vundum

Mr & Mrs Vundum are both aged 63 and have been married for several years. They live in a farmhouse in the country which is owned by Mrs Vundum.

Mr Vundum has owned and operated his electronics business since 1978. His assessable profits for 2009/10 are £35,650.

On 6 August 2009 Mr Vundum purchased a flat in London with the aid of a loan from his bank. He immediately let the flat, unfurnished, to a tenant at an annual rent of £26,640.

He incurred the following expenses in relation to the property in 2009/10:

	£
Water rates	1,600
Electricity	1,560
Repairs (including £800 to redecorate a bedroom in October 2009)	2,550
Interest on the loan taken out to purchase the property	12,300

Mr Vundum subscribed for some new ordinary shares in an approved venture capital trust on 10 October 2009 for £20,000.

Mrs Vundum does not work but has significant investment income (see below). In addition, throughout 2009/10, she let a furnished room in the farmhouse to a trainee accountant employed in a nearby town. The gross rent received from the tenant in 2009/10 was £7,800 and allowable expenses incurred which directly relate to the letting of the room totalled £3,650. She has rented the room for a few years and elected for rent-a-room relief to apply to 2007/08.

The following investment income was received by Mr & Mrs Vundum in 2009/10:

	Mr Vundum £	**Mrs Vundum** £
Interest received from:		
Bank and building societies	7,900	6,200
Cash ISAs	400	600
National Saving Bank EASA	-	300
Dividends received from:		
EIS investments	-	4,590
VCT investments	234	-
ISA investments	2,205	1,755
Unquoted companies	1,125	9,441

Required

Calculate the income tax payable by Mr Vundum and Mrs Vundum for 2009/10.

5 Bertie

Bertie is the sales director of Basset Ltd. In 2009/10 he received a salary of £72,000 and a bonus based on the audited results. Basset Ltd prepares accounts to 31 December each year and pays a bonus based on results six months after the year end.

	£
Recent bonuses have been:	
y/e 31 December 2008	7,200
y/e 31 December 2009	7,750

Basset Ltd contributes 7% of each employee's salary into its registered occupational pension scheme. Bertie contributed 5% of his salary into the same scheme.

Bertie also received the following benefits:

(1) Bertie lives in a company flat which cost £260,000 in 2005 and has a gross annual value of £3,600.

The company furnished the house at a cost of £16,700 and paid the following bills relating to the flat:

	£
Electricity	1,800
Gas	1,200
Cleaning costs	2,600

Bertie pays Basset Ltd £200 a week as a contribution towards the cost of the accommodation. The flat is not job related accommodation.

(2) Bertie uses his own car for business travel. During 2009/10 his business mileage was 21,000, for which his employer paid him 30p per mile.

The AMAP for a car is 40p for the first 10,000 miles and 25p thereafter.

(3) Basset Ltd. provided Bertie with a train season ticket to travel to work each day which cost £1,300, and free meals in the staff canteen which cost £850 per employee.

(4) Basset Ltd. provided a mobile phone to Bertie and another to his wife. The cost of providing each phone in 2009/10 was £320.

(5) The annual staff Christmas party cost the company £80 per head.

(6) Basset Ltd. lent Bertie £90,000 on 6 October 2008. Bertie repaid £25,000 on 6th November 2009. The company charged interest of 2% of the outstanding balance at the end of each month.

Bertie paid £340 subscriptions to the Sales and Marketing Institute.

Required

Calculate Bertie's employment income for 2009/10.

6 Shetti Ltd

Shetti Ltd is an unquoted trading company which manufactures fashionable clothing accessories in the West Midlands.

On 6 April 2010 the company recruited a new finance director, Simran Bhandari, aged 37. The managing director has suggested that Simran may be offered a chance to own shares in the company after a six month probationary period. Assume today's date is 8 April 2010.

On 30 September 2010, Simran is expecting to be offered one of the following incentives:

(a) The option to purchase 5,000 ordinary shares in Shetti Ltd. The option will be provided free and will be exercisable in six years' time at £3 each. The current value of the shares is £5 and is anticipated to be £11.25 on the exercise date.

The share options will not be granted under an HMRC approved scheme.

(b) The gift of fully paid up shares in the company free of charge under an HMRC approved share incentive plan. If this incentive is taken up, Simran will receive the maximum possible entitlement to shares allowed under the scheme. However, the company does not offer any partnership shares under the scheme.

Simran is unsure of the tax implications of these incentives and has come to you for some tax advice.

Simran is also concerned about his income tax liability for 2009/10. He was made redundant from his previous employment on 31 December 2009 and he thinks that his former employer has not deducted enough tax under PAYE.

He received a lump sum redundancy payment of £58,000 after leaving employment on 31 March 2010. The £58,000 included statutory redundancy pay of £3,600 and holiday pay of £1,200. The balance of the payment was compensation for loss of office.

For 2009/10 his employment income assessment (excluding the redundancy payment) was £37,000. He also received bank interest of £6,300 (gross) and gross dividend income of £3,700. He has no other income.

Required

(a) Explain the tax implications for Simran arising from the incentives he may be offered in September 2010.

(b) Calculate Simran's income tax liability for 2009/10.

7 James Trace

James Trace is a self-employed photographer. He has been trading for many years with a 31 December year end.

His accounts for the year ended 31 December 2009 show the following results:

	£
Sales	274,400
Cost of sales	(109,200)
Gross profit	165,200
Sundry income	8,960
	174,160
Expenses	(68,320)
Net profit	105,840

The following amounts are included in his expenses:

(1) Depreciation of plant and machinery of £11,200.

(2) Hire charges of £5,600 relating to the hire of a car with CO_2 emissions of 183 g/km. The car is used by James' personal assistant.

(3) Motor expenses of £4,200 relating to James' car. On 31 August 2009 James traded in his old car for £10,900 against a new car. James paid the balancing amount due of £9,300. The new car has CO_2 emissions of 172 g/km. Both cars were used 60% for the purposes of the trade.

(4) Payment of a premium of £16,000 on 1 October 2009 for a lease on a unit in a business park. The 15 year lease was granted to James by Abdou Ltd, an unconnected trading company. James uses the unit to develop his photographs.

(5) Royalties payable of £2,250.

The sundry income in the accounts represents building society interest of £3,240 and rental income of £5,720.

James incurred the following amounts on capital expenditure:

		£
13 March 2009	Computer system	
	(including £2,350 relating to software).	15,320
26 August 2009	Plant and equipment	31,360

The computer system has an expected useful life of three years.

On 1 January 2009, the tax written down values of his assets were as follows:

		£
	General pool	87,360
	James' car	7,180

Required

Calculate James' adjusted profit after capital allowances for the period ended 31 December 2009.

8 Robyn

Robyn commenced to trade on 1 January 2008 and immediately registered for VAT. She prepared her first set of accounts to 30 June 2008 and thereafter to 30 June annually.

Robyn's adjusted profits before capital allowances are as follows:

		£
	6 m/e 30 June 2008	12,200
	y/e 30 June 2009	41,192
	y/e 30 June 2010 (estimated)	17,487

Robyn made the following purchases and sales of fixed assets acquired for use in the business:

	Net £	**VAT** £	**Total** £
Purchases			
1 January 2008			
New car	16,000	2,800	18,800
Office furniture	3,000	525	3,525
30 September 2008			
Equipment	10,425	1,825	12,250
1 December 2008			
Van (second hand)	6,460	1,130	7,590
1 July 2009			
Plant and machinery	7,680	1,344	9,024
Sales			
1 October 2008			
Plant and Machinery	800	140	940

The car is used by Robyn and 25% of the use is for private purposes.

Required

(a) Compute the trading income assessments for Robyn for the first four tax years. (You should assume that the capital allowance rules introduced with effect from 6 April 2008 have applied throughout.)

(b) State the amount of overlap profits carried forward for relief in the future.

9 William Buckle

William Buckle started to trade many years ago and initially prepared his accounts to 30 April each year. For commercial reasons he decided to change his accounting date to 31 August and prepared accounts for the 16 month period to 31 August 2009 and annually thereafter.

William's recent adjusted trading results after capital allowances are as follows:

	£
y/e 30 April 2008	29,250
p/e 31 August 2009	41,600
y/e 31 August 2010 (estimated)	39,000

There are 11 months' worth of overlap profits totalling £16,500.

Required

(a) Explain the conditions that must be fulfilled for a change of accounting date to be valid for taxation purposes.

(b) Calculate the trading income assessments arising from these accounting profits and state how much overlap profits are carried forward for relief in the future.

10 Matthew, Mark and Luke

Matthew, Mark and Luke have been in partnership for many years preparing accounts to 31 August each year.

The accounts for the year ended 31 August 2009 show a net profit of £67,350 after deducting the following amounts:

(1) Salaries to partners of £48,750 and £16,900 to Mark's wife who works part-time for the partnership as a secretary.

(2) Personal expenses of the partners of £5,000.

(3) Entertaining expenses of £13,000, which relate to business lunches and evening dinners with clients. In addition, the partners spent £6,500 on entertaining their staff at Christmas.

Capital allowances available for the year ended 31 August 2009 total £21,200.

Matthew, Mark and Luke share profits in the ratio 3:2:1, after charging partnership salaries of £13,000, £19,500 and £32,500 respectively.

On 31 May 2009, Luke left the partnership for personal reasons. On the next day John joined as a new partner. From that date the partners decided to change the agreement so that no salaries are payable to the partners and all profits must be shared equally.

Your tax files show that the original partners have the following overlap profits:

	£
Matthew	58,500
Mark	39,000
Luke	19,500

The partners expect the total assessable profits after capital allowances for the year ended 31 August 2010 to be £130,000.

Required

(a) Calculate each partner's share of the partnership profits for the year ended 31 August 2009.

(b) Calculate Luke's trading income assessment for 2009/10.

(c) Calculate John's trading income assessments for 2009/10 and 2010/11 and state the amount of overlap relief available to carry forward.

11 Martina

Martina has been a self-employed physiotherapist for many years. Her adjusted trading profits/(losses) after capital allowances for recent years have been as follows:

		£
y/e 30 April 2008	Profit	24,600
y/e 30 April 2009	Loss	(12,200)
y/e 30 April 2010	Profit	10,900

Martina's other income is as follows:

	2008/09 £	**2009/10** £	**2010/11** £
Part-time employment	12,000	3,000	NIL
Rental income	8,000	3,000	15,000

She has no other income and has not realised any capital gains. However, on 31 January 2010, Martina disposed of some EIS shares and made a capital loss of £1,600. Assume that the 2009/10 tax rates and allowances apply throughout.

Required

Explain the options Martina has available for the use of her losses and recommend the most tax efficient use of the losses.

12 Natalie

Natalie started to trade on 1 August 2008.

Anticipated results for the first two years are as follows:

		£
Year ended 31 July 2009	Loss	(22,500)
Year ended 31 July 2010	Profit	25,600

Before commencing trade Natalie was employed and had the following earnings:

	£
2005/06	27,600
2006/07	30,300
2007/08	39,500
2008/09	13,500

Natalie had no other income apart from an annuity of £5,000 (gross) each year from a trust set up by her uncle in 2001.

Natalie has no capital gains in any of the years. Assume that the tax rates and allowances for 2009/10 apply throughout.

Required

Explain the options Natalie has available for the use of her trading loss and recommend the most tax efficient use of the loss.

13 Ashley Ballantine

Ashley ceased trading as a self-employed plumber on 30 June 2009. He commenced employment on 1 July 2009, earning a salary of £30,000 p.a.

His trading results after capital allowances are as follows:

	£
Year ended 30 September 2006	42,900
Year ended 30 September 2007	26,000
Year ended 30 September 2008	5,000
9 months ended 30 June 2009	(10,400)

Ashley has no other income other than rental income of £2,000 received each year. He has no capital gains arising in any of the years.

Ashley has overlap profits not yet relieved of £8,000.

Assume that the 2009/10 tax rates and allowances apply throughout.

Required

Explain how Ashley may obtain relief for his trading loss.

14 Marion

Marion has been employed for many years.

In 2009/10 she earned a salary of £275,000 and made a contribution of £150,000 (gross amount) into a registered pension scheme.

Her employer contributed a further £100,000 into the same pension scheme. Her only other income is dividends received of £9,000 in August 2009.

Required

Show how Marion will obtain relief for her pension contribution in her income tax computation for 2009/10 assuming both the employer and Marion's contribution are made:

(1) into a registered personal pension scheme set up by Marion, or alternatively

(2) into a registered occupational pension scheme set up by Marion's employer.

15 Emma Carey

Emma Carey has been a self employed dentist for many years. Her accounting profits for the year ended 31 March 2010 are £85,800 and her taxable trading profits for 2009/10 are £65,000.

Emma has a personal pension scheme into which she contributes 20% of her taxable trading profits.

Emma employs a dental nurse, Susan, at a salary of £18,200. Emma also provides Susan with a mileage allowance of 50p per mile for business journeys, an interest free loan of £6,000 and a mobile phone which cost £120.

Susan travelled 4,000 business miles in 2009/10.

The AMAP for the first 10,000 business miles is 40p per mile. The official rate of interest for beneficial loans is 4.75%.

Susan has her own personal pension scheme into which she paid £1,200 (gross amount). Emma also contributed £2,400 into Susan's scheme.

Required

Calculate the total NICs payable by Emma Carey to HMRC in respect of 2009/10 and state the due date for payment.

16 Katie Rivers

Katie Rivers disposed of the following assets in 2009/10:

(1) An investment property. Katie purchased the property on 26 April 1991 for £48,200 (including acquisition costs of £3,600) and added an extension in June 2001 for £18,500. She sold the property on 31 May 2009 for £106,000, incurring auctioneer's expenses of 1%.

(2) A vintage Daimler car. Katie purchased the car on 22 December 2003 for £70,000 and sold it on 16 August 2009 for £85,000.

(3) A plot of land. Katie purchased the land on 12 July 1995 for £71,400. She sold the land for £51,000 on 22 October 2009.

(4) A 40% interest in Popski Ltd, an unquoted trading company. Katie purchased the shares in June 2000 for £18,000 and sold them in February 2010 for £69,000.

Katie has taxable income of £27,950 in 2009/10. She also has capital losses brought forward of £4,000.

Required

Calculate Katie's capital gains tax liability for 2009/10 and state the due date for payment.

17 Emily Freeman

Emily disposed of the following shares and securities in 2009/10:

(1) A 1% shareholding in Wild plc, a quoted trading company. The shares were acquired in July 1990 for £7,500 and sold in July 2009 for £25,000. Emily has never been employed by Wild plc.

(2) 6,200 shares in AB Ltd, an unquoted trading company. Emily bought 10,000 shares in AB Ltd on 27 September 2002 for £38,000 and on 6 October 2005 the company made a 1 for 5 bonus issue. The shares were sold on 14 August 2009 for £35,650.

(3) £20,000 13 ¾% Treasury stock for £26,200 on 13 October 2009. Emily bought the stock in August 1989 at par.

(4) 12,000 quoted ordinary shares in Hughes Ltd out of her holding of 30,000 shares. Emily originally purchased 60,000 shares in Peters Ltd in July 2000 for £33,300. In January 2003 Peters Ltd was taken over by Hughes Ltd and Emily received 1 ordinary share in Hughes plc and £3 in cash for every two shares that she held in Peters Ltd. The shares in Hughes Ltd are valued at £6 each in January 2003 and £3.50 on their sale in March 2010. The shareholdings never exceeded 3% of either company's share capital and Emily never worked for either company.

Required

Calculate Emily's capital gains tax liability for 2009/10.

18 Jack Wilson

In 2009/10 Jack Wilson made the following disposals of capital assets:

(1) Jack sold his prize winning racehorse, Suzie, for £6,800 on 30 April 2009. Jack purchased Suzie from a breeder in Ireland for £3,000 in November 2003.

(2) On 5 October 2009 Jack assigned the lease on one of his investment properties for £68,000. The 40 year lease was acquired on 1 May 1992 for £43,230.

(3) Jack's wife gave him her entire holding of 3,500 shares in Gamlin Ltd, an unquoted trading company, in June 2009. The market value of the shares at that time was £17,200. The shares were purchased for £5,965 in June 1987. Subsequently, in December 2009, Jack sold 1,500 of the shares for £19,000.

(4) Jack sold a painting to his brother-in-law for £21,000 on 10 October 2009. At that time the painting had a market value of £26,000. He had acquired the painting on the death of his grandmother in July 1996. His grandmother had bought the painting at an auction for proceeds (net of auctioneers' fees) of £2,600 in 1986. The probate value of the painting in July 1996 was £7,850.

(5) 10 acres of land for £27,550 on 23 May 2009. Jack purchased a 30 acre plot of land in June 1987 for £12,800. The value of the remaining 20 acre plot of land on 23 May 2009 was £60,200.

Jack is a higher rate taxpayer. He has no capital losses brought forward at 6 April 2009.

Required

Calculate Jack Wilson's capital gains tax liability for 2009/10 and state the due date for payment.

19 Melanie Fellows

Melanie had the following capital transactions in 2009/10:

(1) On 20 May 2009 Melanie gave an antique vase to her sister. The vase was worth £6,800 in May 1984 when she inherited it from her father. In May 2009 it was professionally valued at £15,200.

(2) On 12 July 2009 Melanie gave her daughter 8,500 shares in Match Ltd, an unquoted trading company. She originally purchased 15,000 shares (a 6% interest) in December 2001 at a cost of £16,500. At the date of the gift the shares were worth 180p each. Match Ltd had chargeable assets worth £260,000 which include £40,000 worth of investments.

(3) On 30 November 2009 Melanie sold a workshop for £100,000. The workshop was used in Melanie's business but was too big for her requirements. The workshop was purchased in October 1996 for £35,000. On 31 December 2009 she purchased a smaller workshop which cost £68,000.

(4) On 28 February 2010 Melanie sold an asset used in her business to her uncle for £18,000. This asset was worth £35,000. Melanie bought the asset in April 2008 for £5,000.

Required

Calculate Melanie's total taxable gains in 2009/10.

20 Lawrence Troth

Lawrence, who is a higher rate tax payer, has owned a three-storey house in Scotland since 1 August 1998. He purchased the house for £176,500 and incurred legal fees of £3,500.

Lawrence occupied the property as his main residence until 31 January 1999 when he left to take up permanent employment in Liverpool. At this time he sold the top floor of the house for £70,000. The market value of the remainder of the house was £140,000. He let the other two floors of the house for a rent of £12,000 p.a. from 1 April 1999 to 31 March 2003. He rented a luxury flat in Liverpool.

On 1 November 2003 Lawrence was made redundant and returned to his house in Scotland. In December 2003, with his redundancy payment, he extended the ground floor at a cost of £21,000. In January 2004 he decided to work locally for a while on a part-time basis while he redecorated the house and carried out general maintenance work. The total redecoration and maintenance work cost £14,000.

On 1 March 2006 Lawrence returned to permanent full-time employment in London. He lived in rented accommodation. He let his house in Scotland to tenants from 1 April 2006.

In 2009 he decided to settle in London and put his house in Scotland on the market. He sold the property on 30 November 2009 for £600,000 and incurred legal fees of £6,000. The tenants moved out of the house a month before the date of sale.

On 20 August 2009 Lawrence received £25,460 from his insurance company in settlement of a claim following a fire in an investment property which he let to students. On 20 August 2009 the value of the property after the fire, but before restoration, was £120,600. The property cost £50,250 in February 1994. Lawrence will use all of the insurance proceeds to restore the property.

Required

(a) Calculate Lawrence's capital gains tax liability for 2009/10 assuming Lawrence has not made an election in respect of the restoration of the investment property.

(b) Explain the consequences of making an election in respect of the restoration of the investment property.

21 Pat Brown

During his lifetime Pat made the following lifetime gifts of cash:

Date	Gift to:	£	Occasion:
19 June 2001	Thomas, his son	100,000	On his 18th birthday
14 May 2004	Linda, his wife	60,000	On their silver wedding anniversary
6 July 2006	Sarah, his daughter	200,000	On her wedding day

In addition to the above gifts, Pat put the following assets into a discretionary trust on 20 February 2006:

(1) 12,000 ordinary shares in a quoted company which represents a 3% holding. The shares were valued at 359–371p per share.

(2) £100,000 of cash.

(3) a 20% holding in Brown Ltd, an unquoted investment company owned by Pat and his family as follows:

	%
Pat Brown	30
Linda Brown	30
Other family members	40

The values of Brown Ltd shares on 20 February 2006 were as follows:

Interest in company	£
60%	600,000
40%	380,000
30%	240,000
10%	60,000

Pat agreed to pay any lifetime IHT due in respect of these lifetime gifts, if any.

Pat died on 17 April 2010. At that time the quoted shares and Brown Ltd shares had both increased in value significantly.

Required

(a) Calculate the lifetime IHT payable by Pat Brown in respect of the gits made by him and state the due date(s) of payment.

(b) Calculate the IHT due in respect of the lifetime gifts as a result of Pat Brown's death. State who is liable to pay the tax and the due dates of payment.

22 Debbie Price

Assume today's date is 5 April 2010.

Debbie Price is aged 77 and does not expect to live past her next birthday on 14 March 2011. She is concerned about any inheritance tax liabilities which may fall due as a result of her death. She has given you the following information about her lifetime gifts to date:

(1) 20,000 ordinary shares in Briggs plc were gifted to her son on 16 April 2003. The shares were valued at £10.20–£10.24 per share. There were three marked bargains for the day quoted at £10.12, £10.21 and £10.26.

(2) A holiday cottage worth £450,000 was gifted to her daughter on 27 January 2007. As the cottage is situated on the coast which is prone to tidal damage, the cottage is currently worth only £290,000.

(3) £600,000 cash was put into a discretionary trust for the benefit of her children and grandchildren on 31 December 2009. The trustees agreed to pay any IHT due.

Required:

(a) Calculate the amount of inheritance tax payable on these lifetime gifts if she were to die today. She is also interested to know who would be liable to pay the tax.

(b) Explain the inheritance tax consequences if she were to die on her next birthday.

(c) Outline any tax planning measures Debbie could take to limit the exposure of her estate to inheritance tax.

Assume that the tax rates and allowances for 2009/10 apply throughout.

23 Graham Kelsall

Graham Kelsall is a UK domiciled individual who died on 4 July 2009, aged 79. Graham owned the following assets at the date of his death:

(1) A private residence valued at £420,000. The house was purchased in 1992, partly funded by a repayment mortgage of £140,000.

(2) Bank accounts with a total value of £180,000.

(3) An ISA with the Nationwide Building Society with a balance of £48,000.

(4) A Renault car worth £20,500 and personal chattels in the UK worth £14,000.

(5) 16,000 £1 ordinary shares in Bluechip plc, a UK quoted company. The shares were quoted at 812p–828p ex dividend on 4 July 2009. A dividend of 80p per share was paid on 13 July 2009.

(6) A flat in Portugal which is valued at £255,000. The flat will be sold and estimated additional expenses of £6,250 will be incurred in realising the property. Portuguese death duties of £43,200 have been paid.

(7) Life assurance policy on his own life with a surrender value on 4 July 2009 of £160,000. The executors received £169,000 on 31 August 2009.

(8) 120,000 50p ordinary shares in Rednose Ltd, a UK unquoted trading company. The shares represent a 26% interest in the company and are worth £750,000. Rednose Ltd has assets worth £3 million, of which £500,000 comprises of investments on the UK stock exchange. Graham acquired the shares in August 2006.

In his will Graham left a cash donation to Cancer Research of £60,000, the flat in Portugal to Brian, his brother and the Rednose Ltd shares to Janis, his sister.

The rest of his estate is left to his daughter and son in equal proportions. Graham made no gifts during his lifetime.

Graham had an outstanding income tax liability of £6,300 and credit card bills of £1,280. His executors paid £5,400 for his funeral.

Required:

Calculate the inheritance tax due as a result of Graham's death, stating the due date for payment and who is liable to pay the tax.

24 Craig Dagnall

Craig Dagnall, a UK domiciled individual, owned the following assets when he died on 14 December 2009:

(1) A house in the UK which is valued at £326,000. The purchase of the house was partly funded by an endowment mortgage of £120,000.

(2) A share in a partnership worth £400,000. The partnership agreement states that on the death of a partner the remaining partners are legally obliged to purchase the deceased's share.

(3) Personal chattels and two motor cars worth £61,000. Bank and building society accounts with balances totalling £310,000.

(4) 4,000 £1 ordinary shares in Yellow River Ltd, an unquoted UK trading company worth £48,000. Craig purchased the shares on 6 November 2008.

Craig owed HMRC £7,260 income tax and his funeral cost £7,650.

In his will Craig left his son £300,000, his daughter the Yellow River Ltd shares and the rest of his estate to his wife.

During his lifetime, on 16 June 2005 Craig gifted his 20% holding in an unquoted trading company to his daughter which was worth £185,000. Craig had owned the shares for five years. His daughter sold a quarter of the shares (a 5% interest) two years later, but still owned the remaining 15% holding on 14 December 2009.

Craig inherited an antique vase worth £70,000 on 7 July 2007 on the death of his uncle. His uncle's estate was worth £760,000 and £204,000 IHT was payable on the estate. Craig had sold the vase at an auction before he died.

Required:

Calculate the IHT payable as a result of Craig Dagnall's death and the value of the legacy to Craig's wife.

25 Michelle George

Michelle George made the following lifetime gifts of cash:

	£	
9 November 2005	339,000	to her son
24 June 2007	342,000	to a discretionary trust, the trustees paid the lifetime IHT on the due date

On 14 August 2008 Michelle gifted her home to her son but continued to live in it. The house was worth £575,000 on 14 August 2008 and £750,000 on 1 July 2009. There is no mortgage on the property.

On 1 July 2009 Michelle died owning the following assets:

(1) UK quoted shares valued at £50,000 which represents a 4% interest in the company.

(2) An investment property worth £210,000.

(3) Other net assets worth £600,000.

In her will, Michelle gifted £45,000 to the Labour Party and the rest of her estate to the discretionary trust.

Required

(a) Explain the inheritance tax implications of the gift on 14 August 2008 and briefly outline how these implications could have been avoided.

(b) Calculate the lifetime IHT payable and the IHT payable as a result of Michelle's death, stating who is liable to pay and the due date of payment.

26 Amanda Irvine

Amanda Irvine's father died on 13 December 2009. He left all of his assets to Amanda and the IHT liability on his estate totalled £403,000.

Amanda is a divorcee, aged 56, and is in poor health. She is not expected to live more than a few years. In addition to the assets inherited from her father, she owns a house currently worth £600,000 and other assets worth £430,000. Consequently, she has no need of the inheritance from her father and intends to gift her father's assets to her two children, Amelia and Molly in equal shares. She has made no other lifetime gifts.

However, Amelia and Molly are aged 18 and 15 respectively and Amanda is concerned that they will not spend the inheritance wisely. She therefore wishes to use some form of trust to control the capital amounts gifted to the children.

Required

(a) Explain how Amanda could use a discretionary trust to maintain control of her father's capital and explain the capital tax implications of setting up a discretionary trust.

(b) Advise Amanda of the tax planning opportunity available in setting up the discretionary trust to avoid a potential charge to inheritance tax and capital gains tax.

27 Gerald Court

Gerald has been resident and ordinarily resident in the UK since January 2001. However, he remains domiciled in New Zealand. In 2009/10 he had the following income:

	£
UK employment income	288,000
Overseas rental income (received net of 15% withholding tax)	59,500
UK bank interest	56,000
UK dividend income	22,500

Only £4,720 of the overseas rental income was remitted to the UK.

Gerald has read in the national newspapers that a tax charge has been introduced for 'remittance basis users'. He wonders if this is applicable to him.

Required

Write a letter to Gerald:

(a) explaining whether he will be affected by the tax charge for 'remittance basis users', and

(b) advising him whether he should make a claim for the remittance basis to apply for 2009/10.

28 Ellen Smith

Ellen Smith is employed by a UK subsidiary of a multi-national group of companies. On 1 November 2009 she was seconded to work for the group's Swedish subsidiary on a 20-month assignment. Until 31 October 2009 she had always been resident and ordinarily resident in the UK. Ellen has no intention of changing her domicile.

Whilst abroad, Ellen disposed of shares in PQ plc. These represented a 1% holding and were sold for £60,000 on 20 February 2010. Ellen acquired the shares on 4 August 2008 for £43,000. Ellen has never worked for the company.

Required

(a) Explain why Ellen Smith will be treated as not resident and not ordinarily resident in the UK during the 20-month period working overseas, starting on 1 November 2009.

(b) Explain how Ellen Smith will be assessed to capital gains tax in 2009/10 to 2011/12.

(c) Calculate Ellen's UK CGT liability for 2009/10 and explain how she should have timed her disposal so as to minimise or defer her UK CGT liability.

29 Martin and Ginny Hill

Martin and Ginny Hill have been married for many years. They have come to you for some tax advice concerning their income and ownership of capital assets. You have ascertained the following information:

	Martin	**Ginny**
	£	£
Income in 2009/10		
Employment income (gross amount)	25,800	28,500
Bank interest	320	240
Rental income	8,250	–
Dividends from UK companies	18,675	–

PAYE of £4,310 has been deducted from Martin and £4,405 from Ginny

Capital assets owned		
House	480,000	–
Antiques	–	30,000
Chattels	6,300	2,500
Shares inherited from his father	185,000	–
Bank accounts	16,000	12,000
Car	18,500	–
Cottage which is let furnished	216,000	–

Martin has heard that it may be beneficial to gift some of his income bearing assets to Ginny. He is also under the impression that gifts between spouses are free of any capital taxes.

Required

(a) Calculate the income tax payable by Martin and Ginny for 2009/10.

(b) Explain whether Martin is correct in believing that gifts between spouses are free of any capital taxes.

(c) Assuming the couple maintain the same level of income and own the same assets in 2010/11, explain the appropriate tax planning measures available for them to minimise their exposure to UK taxes.

You should assume that the tax rates and allowances for 2009/10 apply throughout. You are not required to prepare detailed revised computations nor consider alternative tax efficient investments on the market.

30 Francis Slater

Francis Slater is a wealthy individual aged 64. He is married, has two children and six grandchildren. He is a higher rate taxpayer and owns £4 million worth of capital assets including a substantial portfolio of quoted and government securities, a large home and two investment properties.

Although Francis and his wife are in good health, he is considering his retirement plans and how he should pass on his wealth to the next generation in the most tax efficient manner.

Required

Explain the main advantages of lifetime giving for IHT purposes and the main factors that need to be considered in deciding which assets to gift.

31 Incorporation

Gavin has been trading successfully since May 1994. He has been approached by BAC Ltd which wants to buy his business and retain his services in the company by taking him on as a director/shareholder.

On 30 September 2009 he sold his unincorporated business to BAC Ltd for an agreed value of £695,000. Gavin transferred all of the assets of his business to BAC Ltd, with the exception of the cash and bank balances. The assets transferred were as follows:

	Date of acquisition	**Market value**	**Cost**
		£	£
Factory	July 1989	560,000	230,000
Goodwill	May 1994	100,000	Nil
Trading stock	August 2009	35,000	35,000
		695,000	

Gavin received £50,000 cash and 15,000 £1 ordinary shares in BAC Ltd in return for his business. He has made no other disposals during 2009/10.

Required

(a) Explain the conditions that must be fulfilled for Gavin to obtain incorporation relief.

(b) Calculate the capital gains tax arising in 2009/10 on the incorporation of Gavin's business and the base cost of his shares in BAC Ltd assuming incorporation relief applies.

(c) Advise Gavin how much consideration he should have taken in the form of cash in order to avoid paying any capital gains tax in 2009/10.

32 Richard and Fiona

Richard and his wife Fiona are both 35 years old. Richard has recently inherited a substantial sum of money. He is already wealthy and has a very well paid job.

Richard would like to use his inheritance to purchase shares in new companies which require funds for their development and for which tax reliefs might be available. Fiona is much more cautious. She would prefer to invest some of the money in investments with less risk to their capital, but which offer a reasonable return.

Required

(a) Identify two tax incentives that Richard might utilise when buying shares in new and/or developing companies, stating clearly the tax implications of each.

(b) Identify three types of low risk investment that would meet Fiona's investment objectives. State the factors that qualify the investments as low risk and explain their tax treatment.

(c) State the implications arising from the carrying on of investment business by a person who is not authorised to do so.

33 Change of accounting date

IJ plc decided to change its accounting date and prepared a 15-month set of accounts to 30 June 2009. The following information relates to the 15-month period:

	£
Income	
Adjusted profits before capital allowances	400,000
Bank deposit interest received (see below)	10,000
Rents accrued (see below)	45,000
Dividends received from a UK company on 30 June 2009	4,950
Expenditure	
Gift Aid donation paid on 18 March 2009	4,500
Interest payable on £180,000 10% debentures issued to finance the trade	22,500
Property expenses (see below)	

IJ plc disposed of the following capital assets:

		£
15 April 2008	chargeable gain	15,100
16 May 2009	allowable loss	22,600
20 June 2009	chargeable gain	62,500

There are no capital losses brought forward.

The bank deposit account had a capital balance of £150,000 throughout the period and earned interest at a fixed rate of 6% per annum.

IJ plc accrued rental income of £45,000 from renting a furnished property in London at £3,000 per month.

During the 15-month period IJ plc incurred the following expenses in relation to the property:

	£	
Estate agent fees	300	per month
Insurance	100	per month
Repairs to property on 16 January 2009	12,000	
Accountants' fees paid on 30 June 2009	4,200	
A conservatory extension	15,000	

Capital allowances are calculated as £67,640 for the first CAP and £14,910 for the second CAP.

Required

(a) Calculate IJ plc's corporation tax liabilities for the 15 months ended 30 June 2009, and state the due dates of payment.

(b) Assuming that £120,000 of the £400,000 adjusted profit shown above relates to the period between 1 April 2009 and 30 June 2009. Briefly explain whether it would be preferable to produce two sets of accounts (i.e. one covering the first 12 months and another for the remaining three months) rather than one set of accounts covering a 15 month period.

34 HI Ltd: loss relief

HI Ltd prepares its accounts to 31 March each year and has supplied the following information:

	Year ended 31 Mar 2007	**Year ended 31 Mar 2008**	**Year ended 31 Mar 2009**	**Year ended 31 Mar 2010**
	£	£	£	£
Trading profit/(loss)	850,380	146,800	(356,460)	85,940
Interest income	10,680	3,560	10,680	10,680
Net chargeable gains/(loss)	48,500	26,000	(14,000)	Nil
Gift Aid donation	(1,170)	(1,170)	(1,170)	(1,170)

Required

(a) Explain the options available to HI Ltd to relieve its trading loss.

(b) Calculate the PCTCT for each CAP assuming losses are relieved in the most tax-efficient manner.

35 DTR

JK plc is a UK resident company with no associated companies. The accounts of JK plc for the year to 31 March 2010 are expected to show the following:

	£
UK trading profits	10,000
Rental income from Rolandia, net of 5% withholding tax	19,000
Interest from Moravia, net of 30% withholding tax	25,410
Gift Aid donation	9,000

Required

Compute the UK corporation tax payable for the year, after maximising the benefit of double taxation relief.

36 Overseas branch or non-UK resident company

LM Ltd is a UK resident company considering expansion abroad. It is unsure whether it should set up an overseas branch or a separate non-UK resident subsidiary.

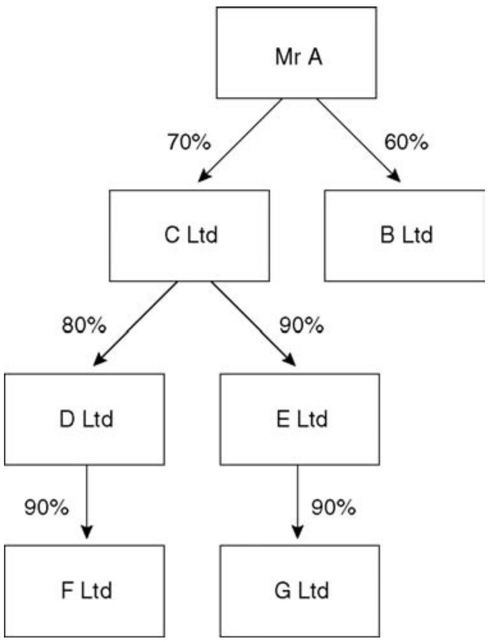
LM Ltd expects the overseas operation to be very profitable, and anticipates regular remittances back to the UK. LM Ltd does not currently have any associated companies.

Required

Contrast the key consequences of operating overseas via a branch or a non-UK resident subsidiary.

37 UK group

The following diagram indicates the percentage holding of ordinary voting shares in the companies shown:



The income received and Gift Aid donations paid by each company for the year ended 31 March 2010 were as follows:

	B Ltd	C Ltd	D Ltd	E Ltd	F Ltd	G Ltd
	£	£	£	£	£	£
Trading profit	260,000	80,000	120,000	24,000		
Trading loss					40,000	60,000
Rental income	20,000		8,000	4,000	5,000	6,000
Gift Aid donation	10,000	6,000	10,000	2,000	4,000	5,000

Required

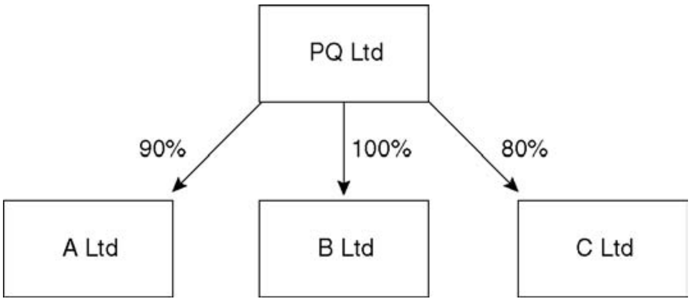
(a) Calculate the statutory thresholds for corporation tax purposes which will apply for each of the above companies for the year to 31 March 2010 to determine the appropriate rates of corporation tax.

(b) Identify, with explanations, the groups which are present in the above structure for the purposes of surrendering and receiving trading losses.

(c) Advise the group as to the most beneficial way of relieving its losses and calculate the corporation tax saving made on the assumption that the group follows your advice.

(d) Calculate the PCTCT for each company based on your advice in part (c).

38 PQ group



On 24 July 2005 C Ltd sold an office building to A Ltd for £440,000. C Ltd had purchased the building on 26 July 1996 for £260,000.

On 14 May 2009 A Ltd sold the office building for £500,000 to an unconnected company.

PQ Ltd purchased a warehouse on 1 January 2009 for £480,000.

PQ Ltd and A Ltd pay corporation tax at 28%, B Ltd at 21% and C Ltd at 29¾%. All companies have a 31 March year end.

Required

Calculate the chargeable gains arising in the years ended 31 March 2006 and 31 March 2010. State which company will be charged on the gains and the rate of tax applied, assuming all beneficial claims are made.

39 Blackbird Ltd

Blackbird Ltd is an unquoted trading company that manufactures bird tables. It has share capital of 200,000 £1 ordinary shares, which is owned equally by its four shareholders.

Noreen has been a director and shareholder of Blackbird Ltd since its incorporation on 1 October 2003. She owns 50,000 shares that are currently valued at £11 each. For the past year she has disagreed with the other directors of Blackbird Ltd over the company's business policies. It has therefore been agreed that she will resign as a director on 31 March 2010 and Blackbird Ltd will purchase her shareholding for £550,000.

Noreen acquired the shares at par, and is a 40% taxpayer.

Morgan is one of Blackbird Ltd's other shareholders, but is neither a director nor an employee of the company. On 6 April 2009 Blackbird Ltd provided Morgan with a new motor car with a list price of £21,875 and CO_2 emissions of 181 gm/km. No private petrol was provided and Morgan did not drive any business mileage. On 1 July 2009 Blackbird Ltd made an interest-free loan of £50,000 to Morgan. £30,000 of the loan was written off on 31 March 2010. Morgan is a higher rate taxpayer.

Blackbird Ltd makes up its accounts to 31 March annually.

Required:

(a) Advise Noreen:

(i) whether it will be beneficial to have the purchase of her shareholding treated as a capital gain, rather than as a distribution, and

(ii) what conditions must be satisfied in order for the capital treatment to apply.

(b) Advise both Morgan and Blackbird Ltd of the tax consequences of the provision of the company car and the loan. Assume that the official rate of interest is 4.75%.

40 Registration

Deborah started to trade as a coach operator on 1 September 2008.

In her first year of trading she made sales of £3,500 per month. Her more recent sales are as follows:

2009	**£**
September	7,300
October	9,600
November	10,900
December	12,500
2010	
January	12,600
February	12,700

Required

(a) State when it is compulsory for Deborah to register for VAT, when she must notify HMRC and the first date she should start to charge VAT on her invoices.

(b) Advise Deborah whether she can claim relief for input VAT incurred prior to the date of registration.

41 WX Ltd

WX Ltd has prepared the following draft accounts for the quarter to 31 March 2010.

	£	£
Standard rated sales		201,230
Zero rated sales		20,295
Exempt sales		13,750
		235,275
Purchases (standard rated)	41,525	
Distribution expenses (standard rated)	10,000	
Employment costs	47,150	
Bad debt written off	1,650	
Entertaining	715	
Other expenses (standard rated)	16,825	
		(117,865)
Profit		117,410

The bad debt was written off in February 2010 and relates to a debt which was due for payment on 31 December 2009.

WX Ltd purchased a car for £18,000 on 3 January 2010 and some plant and machinery for £35,000 on 13 March 2010.

All figures include VAT.

Required

(a) Calculate the VAT payable for the quarter ended 31 March 2010 and state the due date for payment.

(b) Advise WX Ltd as to whether it would be permitted to join the annual accounting scheme and outline the advantages that membership of the scheme may bring.

42 Stamp duty

(a) Henrietta purchased 1,000 £1 ordinary shares in HKM plc from William for £1,500. Their market value was £2,000.

(b) Heidi purchased £2,000 6% Treasury Stock for £2,500.

(c) Hamish purchased a new house for £300,000. He intends to use the house as his principal private residence.

(d) HKM plc purchased an office building costing £2,000,000 from MLK plc. Both companies are wholly owned subsidiaries of KMM plc.

Required

Explain the stamp duty/SDRT/SDLT consequences of the above transactions.

43 Dividend or bonus

Emily is a director of YZ Ltd and owns 100% of the shares. YZ Ltd is a large company which prepares accounts to the 31 March each year and pays corporation tax at the full rate of 28%.

For the year ended 31 March 2010 Emily received a gross salary of £55,000 and benefits of £14,000.

At the end of the year Emily wishes to withdraw additional income from the business and wants to receive £20,000 cash after tax and national insurance.

She is not concerned whether she receives the cash in the form of a dividend or a bonus as she expects to receive £20,000 under either method. However, she wants the extraction of funds to be the most tax efficient from the company's point of view.

Required

Prepare calculations showing the cost to YZ Ltd of paying a dividend or a bonus to Emily of £20,000 after tax and national insurance. Advise which payment method is the most tax efficient from the company's point of view.

44 Sole trader or company

Fiona is to set up a new business on 6 April 2009. She is unsure whether she should run the new business as a sole trader or as a company.

If she runs the business as a sole trader, she estimates that her adjusted profits after capital allowances for the year ended 5 April 2010 will be £28,500. She intends to take out £22,000 as drawings.

If she runs the business as a company, she estimates that the company's adjusted profit after capital allowances for the year ended 5 April 2010 will also be £28,500. However, this is before taking account of her director's gross salary of £22,000 and employer's national insurance.

Assume that Fiona has no other source of income in 2009/10.

Required

Calculate the total tax liabilities arising for 2009/10 assuming Fiona sets up the business as:

(a) a sole trader, or

(b) a company.

Based on the calculations in parts (a) and (b), state whether it is beneficial for Fiona to run her business as a sole trader or as a company.

45 Edward Read

Edward Read has provided the following information:

	2008/09	2009/10
	£	£
Income tax liability	19,720	23,200
Class 4 NICs	820	1,020
Capital gains tax liability	1,600	3,210
Tax deducted at source	4,060	4,640

Edward made the following payments in respect of 2009/10:

	£	Date
First payment on account	8,120	20 February 2010
Second payment on account	8,120	30 September 2010
Balancing payment	3,340	10 February 2011

Required:

(1) Calculate the tax payable under self-assessment for 2009/10, stating the due dates for payment.

(2) State how interest would be calculated on Edward's payments made in respect of 2009/10.

Q&A

Answers

Contents

1 Angela

Angela – Income Tax Computation – 2009/10

	Total Income	Other Income	Savings Income	Dividend Income
	£	£	£	£
Earned income				
Trading income	3,200	3,200		
Employment income	29,750	29,750		
Savings Income				
Bank interest				
(£4,720 × 100/80)	5,900		5,900	
Treasury stock interest				
(received gross)	2,000		2,000	
NSC interest	exempt		-	
Jacob's interest (Note)				
(£320 × 100/80)	400		400	
Dividend income				
(£2,205 × 100/90	2,450			2,450
Other investment income				
Discretionary trust income				
(£3,600 × 100/60)	6,000	6,000		
Premium bond winnings				
(exempt)	-	-		
	49,700	38,950	8,300	2,450
Allowable interest payments	(300)	(300)		
Net income	49,400	38,650	8,300	2,450
P.A	(6,475)	(6,475)		
Taxable income	42,925	32,175	8,300	2,450

Income tax	£		£
Basic rate band = other income	32,175	at 20%	6,435
savings income	6,005	at 20%	1,201
Extended basic rate band (Note)	38,180		
Higher rate band: savings income	2,295	at 40%	918
dividend income	2,450	at 32½%	796
Total taxable income	42,925		
Income tax liability			9,350
Less tax credits/deducted at source:			
Dividends (£2,450 × 10%)			(245)
Bank interest (£8,300 - £2,000) × 20%			(1,260)
Discretionary trust income (£6,000 × 40%)			(2,400)
PAYE			(5,180)
Income tax payable under self assessment			265

Notes:

1. Angela is a higher rate taxpayer and made a Gift Aid payment. The basic rate band is extended by the gross Gift Aid payment of £780 (£624 × 100/80) to £38,180 (£37,400 + £780).

2. Jacob's building society account was set up by Angela, his mother. The interest is therefore assessed on Angela as:
   - Angela set up the account.
   - Jacob is unmarried and aged under 18, and
   - the income is in excess of £100.

3. Jacob's discretionary trust was set up by his grandparents and therefore the income is assessed on Jacob.

2 Eric and Margaret

Eric – Income tax computation – 2009/10

	Total Income £	Other Income £	Savings Income £	Dividend Income £
Earned income				
Pension income	11,850	11,850		
Savings income				
Debenture interest				
(£2,400 × 100/80)	3,000		3,000	
Building society interest				
(£2,560 × 100/80)	3,200		3,200	
Dividend income				
from ISA (exempt)	-			-
from UK company				
(£2,700 × 100/90)	3,000			3,000
Other investment income				
Dividend from REIT				
(£3,600 × 100/80)	4,500	4,500		
Property income	5,100	5,100		
Total income	30,650	21,450	6,200	3,000
PAA (W1)	(6,475)	(6,475)		
Taxable Income	24,175	14,975	6,200	3,000

Income tax		£		£
Basic rate band:	other income	14,975	at 20%	2,995
	savings income	6,200	at 20%	1,240
	dividend income	3,000	at 10%	300
Total taxable income		24,175		
Income tax liability				4,535
Less tax credits/deducted at source:				
Dividends from UK companies (£3,000 × 10%)				(300)
Interest (£6,200 × 20%)				(1,240)
Dividends from REIT (£4,500 × 20%)				(900)
Pension income (£11,850 × 20%)				(2,370)
Income tax repayable				(275)

Margaret – Income tax computation – 2009/10

	Total Income £	**Other Income** £	**Savings Income** £	**Dividend Income** £
Earned income				
Pension income	9,700	9,700		
Savings income				
NSB interest (gross)	3,500		3,500	
Cash ISA (exempt)	-		-	
Dividend income				
(£4,500 × 100/90)	5,000			5,000
Other investment income				
Property income	5,100	5,100		
Total income	23,300	14,800	3,500	5,000
PAA (W1)	(9,440)	(9,440)		
Taxable Income	13,860	5,360	3,500	5,000

Income tax		£		£
Basic rate band:				
	other income	5,360	at 20%	1,072
	savings income	3,500	at 20%	700
	dividend income	5,000	at 10%	500
Total taxable income		13,860		
Income tax liability				2,272

Less tax credits/deducted at source:	
Dividends (£5,000 × 10%)	(500)
Pension income (£9,700 × 20%)	(1,940)
Income tax payable	(168)

Workings

(W1) Personal age allowance – Eric

	£
Total income per income tax computation	30,650
Less gross Gift Aid donation (£780 × 100/80)	(975)
Net income for age allowance reduction purposes	29,675

	£
PAA based on age (73)	9,490
Reduction in allowance	
(£29,675 - £22,900) × 50% = £3,388 (restricted)	(3,015)
PAA available	6,475

(W2) Personal age allowance – Margaret

	£
PAA based on age (77)	9,640
Reduction in allowance	
(£23,300 - £22,900) × 50%	(200)
PAA available	9,440

3 David White

(a) David's property income assessment – 2009/10

	£
Premium received from granting 4 year sub-lease	18,000
Less 2% × £18,000 × 3 years	(1,080)
	16,920
Less Allowable deduction	
£44,200 (W) × $\frac{4 \text{ years}}{25 \text{ years}}$	(7,072)
David's property income assessment re-premium	9,848

Working: Property income on head lease

	£
Premium received from 25-year lease	85,000
Less 2% × £85,000 × 24 years	(40,800)
Property income assessment on head lease	44,200

(b) **Individual Savings Accounts**

Individual Savings Accounts (ISAs) have the following tax advantages:

- All income generated by the account (e.g. interest, dividends) is exempt from income tax
- All capital gains on the disposal of capital assets (e.g. shares) are exempt from CGT
- Any increase in value of assets while in an ISA up to the date of transfer to the individual is exempt from capital gains tax.

Conditions which must be satisfied:

- The individual investor must be resident and ordinary resident in the UK and must be aged 16 or over to invest in the cash component of an ISA and 18 or over for the shares component.
- An individual can invest in the following components:
  - (i) cash and cash like equity products (e.g. bank and building society accounts), and
  - (ii) qualifying quoted stocks, shares and insurance products.
- The maximum investment is £7,200 per annum which can all be in the stocks and shares component (increased to £10,200 if the investor is aged 50 or over).
- However, the maximum investment in the cash element is £3,600 (increased to £5,100 if the investor is aged 50 or over).

4 Mr & Mrs Vundum

Mr. Vundum – Income tax computation – 2009/10

	Total Income £	Other Income £	Savings Income £	Dividend Income £
Earned income				
Trading profits	35,650	35,650		
Savings income				
Bank and BS interest				
(£7,900 × 100/80)	9,875		9,875	
Cash ISA	exempt			
Dividend income				
VCT dividends (note)	exempt			
ISA dividends	exempt			

UK companies				
(£1,125 × 100/90)	1,250			1,250
Other investment income				
Property income (W1)	Nil	Nil		
Total income	46,775	35,650	9,875	1,250
PA	(6,475)	(6,475)		
Taxable income	40,300	29,175	9,875	1,250

Income tax	£		£
Basic rate band:			
other income	29,175	at 20%	5,835
savings income	8,225	at 20%	1,645
	37,400		
Higher rate band:			
savings income	1,650	at 40%	660
dividend income	1,250	at 32½%	406
Total taxable income	40,300		
			8,546
Less VCT relief (30% × £20,000) (Note)			(6,000)
Income tax liability			2,546
Less tax credits/deducted at source:			
Dividends (£1,250 × 10%)			(125)
Bank and BS interest (£9,875 × 20%)			(1,975)
Income tax payable			446

Note: Income tax relief is given on the original subscription of shares. Subsequent dividends received from VCT investments are exempt from income tax provided the investment is below the maximum amount of £200,000.

Mrs. Vundum – Income tax computation – 2009/10

	Total Income	**Other Income**	**Savings Income**	**Dividend Income**
	£	£	£	£
Savings income				
Bank and BS interest				
(£6,200 × 100/80)	7,750		7,750	
Cash ISA	exempt			
NSB EASA	300		300	
Dividend income				
EIS dividends (Note (i))				
(£4,590 × 100/90)	5,100			5,100
ISA dividends	exempt			

UK companies				
(£9,441 × 100/90)	10,490			10,490
Other investment income				
Property income (W2)	3,370	3,370		
Total income	27,010	3,370	8,050	15,590
Personal allowance	(6,475)	(3,370)	(3,105)	
Taxable Income	20,535	NIL	4,945	15,590

Income tax	£		£
Starting rate band:			
savings income (Note (ii))	2,440	at 10%	244
Basic rate band:			
savings income	2,505	at 20%	501
dividend income	15,590	at 10%	1,559
Total taxable income	20,535		
Income tax liability			2,304
Less tax credits/deducted at source:			
Dividends (£15,590 × 10%) (Note (iii))			(1,559)
Bank and BS interest (£7,750 × 20%)			(1,550)
Income tax repayable			(805)

Notes:

(i) Dividends from EIS shares are treated as any other UK dividends received, no special rules apply.

(ii) The starting rate band applies as savings income falls into the first £2,440 of taxable income.

(iii) Tax credits relating to dividends are not repayable but may be set off first in order to obtain repayment of other tax credits.

Workings

(W1) Property income – Mr. Vundum

	£
Accrued rental income (£26,640 × 8/12)	17,760
Less expenses accrued	
Water rates	(1,600)
Electricity	(1,560)
Repairs/redecoration	(2,550)
Interest on loan	(12,300)
Property loss – carried forward	(250)
Property income assessment – 2009/10	Nil

(W2) Property income – Mrs. Vundum

(i) Normal property income assessment

	£
Rents accrued	7,800
Less expenses	(3,650)
Wear and tear allowance	
(10% × 7,800)	(780)
	3,370

(ii) Rent-a-room election

	£
Rents accrued	7,800
Less relief	(4,250)
	3,550

The rent-a-room relief election has already been made and therefore continues to apply in 2009/10 unless Mrs. Vundum revokes the election within one year of 31 January following the end of the tax year, i.e. by 31 January 2012.

Assuming Mrs. Vundum does revoke the election for 2009/10 she will be assessed on £3,370.

5 Bertie

Employment income – 2009/10

	£
Salary	72,000
Bonus (paid on 30 June 2009)	7,200
Benefits:	
Employer pension contributions (exempt)	-
Accommodation (W1)	10,928
Travel season ticket	1,300
Canteen meals (exempt)	-
Mobile phone - Bertie (exempt)	-
- Wife	320
Staff Christmas party (exempt)	-
Beneficial loan (W3)	2,089
	93,837
Less employee pension contributions	
(£72,000 × 5%)	(3,600)
AMAP deduction (W2)	(450)
Professional subscription	(340)
Employment income	89,447

Workings

(W1) Accommodation

	£
Capital benefit = annual value	3,600
Expensive accommodation benefit	
(£260,000 - £75,000) × 4.75%	8,788
Revenue benefit	
Electricity	1,800
Gas	1,200
Cleaning	2,600
Provision of furniture (£16,700 × 20%)	3,340
	21,328
Less employee contributions	
(£200 × 52)	(10,400)
Accommodation benefits	10,928

(W2) Business mileage

	£
10,000 × 40p	4,000
11,000 × 25p	2,750
AMAPs	6,750
Less amount paid by company	
(21,000 × 30p)	(6,300)
Allowable deduction	450

(W3) Beneficial loan

Balance at 6 April 2009	90,000
Balance at 5 April 2010	65,000
	155,000

Average loan = 155,000/ 2 = £77,500

Interest at the official rate = £77,500 × 4.75% = 3,681

Strict basis

	£
Balance from 6 April 2009 – 6 November 2009	90,000
Balance from 6 November 2009 – 5 April 2010	65,000

Interest at the official rate	£
90,000 × 4.75% × 7/12	2,494
65,000 × 4.75% × 5/12	1,286
	3,780

Bertie will not elect for the strict basis to apply. HMRC are unlikely to insist on the strict basis applying as the benefit is not materially different and there is no suggestion that repayments have been manipulated to deliberately reduce the benefit.

		£
Actual interest paid		
6 April to 6 November 2009	90,000 × 2% × 7/12	1,050
6 November to 6 April 2010	65,000 × 2% × 5/12	542
		1,592

The assessable benefit is therefore:

	£
Interest at the official rate (average basis)	3,681
Less actual interest paid	(1,592)
Assessable benefit	2,089

6 Shetti Ltd

(a) Share incentives

Unapproved share options

The tax implications for Simran are as follows:

- No income tax charge on the granting of the option on 30 September 2010.
- Income tax charge arises on the exercise of the option in six years' time as follows:

	£
MV in six years' time	
(£11.25 × 5,000)	56,250
Amount paid for shares	
(£3 × 5,000)	(15,000)
Assessable employment income	41,250

- Assuming Simran will be a higher rate taxpayer, an additional income tax liability of £16,500 (£41,250 × 40%) will arise.
- When Simran sells the shares at a later date, a capital gain will arise calculated using a base cost of £11.25 per share.
- Therefore, if Simran were to sell the shares immediately for their market value of £11.25 per share, no CGT liability will arise.

Approved share incentive plan

The maximum market value of shares that can be allocated to Simran in any year of assessment is £3,000. He will therefore receive 600 (£3,000/ £5) free shares during 2010/11.

The tax implications for Simran are as follows:

- No income tax or NIC charge arises provided the shares are held for a minimum period of five years.
- There is no capital gains tax charge when the shares are removed from the plan. Simran will only be liable to capital gains tax on any increase in the value of the shares after they have been removed from the plan. Capital gains tax can therefore be avoided by retaining the shares in the plan until their disposal.

(b) Simran – Income tax computation – 2009/10

	Total Income £	Other Income £	Savings Income £	Dividend Income £
Earned income				
Employment income	37,000	37,000		
Holiday pay	1,200	1,200		
Termination payment (W)	26,800	26,800		
Savings income (gross)	6,300		6,300	
Dividend income (gross)	3,700			3,700
Total income	75,000	65,000	6,300	3,700
PA	(6,475)	(6,475)		
Taxable Income	68,525	58,525	6,300	3,700

Income tax	£		£
Basic rate band			
Other income excluding termination payment (£58,525 - £26,800)	31,725	at 20%	6,345
savings income	5,675	at 20%	1,135
	37,400		
Higher rate band: savings income	625	at 40%	250
dividend income	3,700	at 32½%	1,202
termination payment	26,800	at 40%	10,720
Total taxable income	68,525		
Income tax liability			19,652

Working – Termination Payment

	Note	£
Cash payment		58,000
Less statutory redundancy payment	1	(3,600)
holiday pay	2	(1,200)
Compensation for loss of office		53,200
Less adjusted exemption limit	3	
(£30,000 - £3,600)		(26,400)
Taxable termination payment	4	26,800

Notes

1. Statutory redundancy pay is exempt.
2. Holiday pay is normal taxable employment income.
3. The £30,000 exemption available against genuine ex-gratia redundancy payments must be reduced by the statutory redundancy payment.
4. The taxable termination payment is assessed on a receipts basis in 2009/10 and is treated as the top slice of Simran's taxable income.

7 James Trace

James – Computation of adjusted profit after capital allowances

Year ended 31 December 2009

		Notes	£
Net profit			105,840
Add	Depreciation		11,200
	Hire charges (£5,600 x 15%)		840
	Motor expenses (£4,200 × 40%)		1,680
	Premium for granting of short lease	1	16,000
			135,560
Less	Building society interest		(3,240)
	Rental income		(5,720)
	Allowable deduction for short lease (W1)		(192)
Adjusted profit before capital allowances			126,408
Less capital allowances (W2)			(63,132)
Adjusted profit after capital allowances			63,276

Note

The premium paid to lease the unit in the business park is disallowable capital expenditure. However, an annual allowance is available for part of the cost of the lease as James uses the unit for the purposes of his photographic business.

Workings

(W1) Allowable deduction for short lease

	£
Premium paid	16,000
Less 2% × £16,000 × 14 years	(4,480)
Property income assessment on Abdou Ltd.	11,520
Annual allowable deduction for James (£11,520/15 years)	768

James owned the lease on the unit for three months in the year ended 31 December 2009.

Therefore the allowable deduction for the y/e 31 December 2009 is £192 (£768 × 3/12).

(W2) Capital Allowances

	£	General Pool £	P/u Car 1 £	P/u Car 2 £	Total Allowances £
TWDV b/f		87,360	7,180		
Additions					
Computer system	15,320				
Plant & equipment	31,360				
	46,680				
AIA	(46,680)				46,680
		-			
Additions (no AIA)					
(£10,900 + £9,300)				20,200	
Disposals		-	(10,900)	-	
		87,360	(3,720)	20,200	
BC			× 60%		(2,232)
WDA – (20%)		(17,472)			17,472
WDA – (10%)				(2,020)	
				× 60%	1,212
TWDV c/f		69,888		18,180	
Total allowances					63,132

Note

The computer system has an expected life of three years. James could therefore elect to treat it as a short life asset. However, as the full cost is covered by the AIA, the election is not beneficial as it would result in a balancing charge when the asset is sold.

8 Robyn

(i) Trading income assessments

	Adjusted profit before capital allowances £	Capital Allowances(W) £	Adjusted profit after capital allowances £
Accounting period			
6 m/e 30 June 2008	12,200	(4,125)	8,075
y/e 30 June 2009	41,192	(18,335)	22,857
y/e 30 June 2010	17,487	(9,825)	7,662

Trading starts = 1 January 2008 = in tax year 2007/08 = first tax year
First tax year = Assess profits from 1 January 2008 to 5 April 2008.

Second tax year Ask two questions:

Are there accounts which end in the tax year?	Yes = 6 m/e 30 June 2008.
Are these accounts 12 months in length?	No = less than 12 months.
Decision	Assess first 12 months' profits.

Tax Year	Basis of Assessment	Basis period	Workings (nearest month)	Trading income assessment £
2007/08	Actual	1.1.2008-5.4.2008	3/6 × £8,075	4,037
2008/09	First 12 months	1.1.2008-31.12.2008	£8,075 +	
			(6/12 × £22,857)	19,503
2009/10	12 months ending			
	in third year	y/e 30.6.09		22,857
2010/11	CYB	y/e 30.6.10		7,662

(ii) Overlap profits

		£
1.1.2008 – 5.4.2008	3/6 × £8,075	4,037
1.7.2008 – 31.12.2008	6/12 × £22,857	11,428
		15,465

Working – Capital Allowances

	£	Main pool £	Exp Car (p.u. 25%) £	Total Allowances £
6 m/e 30.6.2008				
Additions (with AIA)	3,000			
AIA	(3,000)			3,000
Additions (no AIA)			18,800	

WDA (max £3,000 × 6/12)			(1,500) × 75%	1,125
TWDV c/f		-	17,300	
Total allowances				4,125
y/e 30.6.2009				
Additions (with AIA)				
Equipment	10,425			
Van	6,460			
	16,885			
AIA	(16,885)	-		16,885
Disposals		(800)		
		(800)	17,300	
Balancing charge		800		(800)
WDA (max)			(3,000) × 75%	2,250
TWDV c/f		-	14,300	
Total allowances				18,335
y/e 30.6.2010				
Additions (with AIA)	7,680			
AIA	(7,680)			7,680
WDA (20%)		-	(2,860) x 75%	2,145
TWDV c/f		-	11,440	
Total allowances				9,825

9 William Buckle

(a) Conditions for change of accounting date to be valid for tax purposes

For a change of accounting date to be valid for tax purposes, the following conditions must be satisfied:

- The first accounting period to the new accounting end date must not exceed 18 months in length.
- The business must not have changed its accounting date in the previous five years or, if it has, it must have justifiable commercial reasons for making a further change in the five year period.
- HMRC must be notified of the change by 31 January following the tax year in which the first accounting period to the new date ends.

(b) **Trading income assessments**

The tax year of change = 2009/10

Trading income assessment for year before the change = 2008/09

2008/09: CYB : y/e 30.4.2008 £29,250

Trading income assessment for year after the change = 2010/11

2010/11: CYB : y/e 31.8.2010 £39,000

Trading income assessment for year of change = 2009/10

Period not assessed = 1 May 2008 to 31 August 2009

Gap period = 16 months > 12 months.

Therefore, assess profits of the gap period and deduct overlap relief.

	£
Profits of gap period (1.5.2008 – 31.8.2009)	41,600
Less overlap relief	
£16,500 × $\frac{(16 - 12)}{11}$	(6,000)
Trading income assessment for 2009/10	35,600

Overlap profits

	£
Opening years	16,500
On change of accounting date – amount relieved	(6,000)
Overlap profits to carry forward	10,500

10 Matthew, Mark and Luke

(a) **Partners' share of profits – y/e 31 August 2009**

Adjusted profits – y/e 31 August 2009

		Notes	£
Net profit			67,350
Add	Partners' salaries	(1)	48,750
	Personal expenses		5,000
	Entertaining clients		13,000
Less	Capital allowances		(21,200)
Adjusted profit after capital allowances			112,900

Notes

1) The salary paid to Mark's wife is allowable on the assumption that it is reasonable remuneration for the services provided to the business.

Allocation of profits – y/e 31 August 2009

	Total	Matthew	Mark	Luke	John
	£	£	£	£	£
9 m/e 31 May 2009					
Salaries					
(£13,000:£19,500:£32,500) × 9/12	48,750	9,750	14,625	24,375	-
Balance (3:2:1)	35,925	17,962	11,975	5,988	
(9/12 × £112,900)	84,675				
3 m/e 31 August 2009					
Balance (1:1:1)	28,225	9,408	9,408	-	9,409
(3/12 × £112,900)	28,225				
Total profits	112,900	37,120	36,008	30,363	9,409

(b) Luke's trading income assessment – 2009/10

As Luke is leaving the partnership, the closing year rules of assessment apply to his partnership share of profits.

Date of leaving = 31 May 2009 = In the tax year 2009/10.

Penultimate tax year: 2008/09 = CYB basis
(i.e. his profit share for y/e 31 August 2008)

Final tax year: 2009/10 = period from 1 September 2008 to 31 May 2009 less overlap profits from the opening years.

	£
Profit share (1.9.2008 – 31.5.2009)	30,363
Less overlap profits	(19,500)
Trading income assessment – 2009/10	10,863

(c) John's trading income assessment – 2009/10 and 2010/11

As John has joined the partnership, the opening year rules of assessment apply to his partnership share of profits as follows:

Starts in partnership: 1 June 2009 = in tax year 2009/10 = first tax year

First tax year = Assess profits from 1 June 2009 to 5 April 2010

Second tax year: Ask two questions:

Are there accounts which end in the tax year?	Yes = y/e 31.8.2010
Are these accounts 12 months in length?	Yes
Decision	Assess those 12 months

Tax Year	Basis of Assessment	Basis period	Workings (nearest month)	Trading income assessment £
2009/10	Actual	1.6.2009-5.4.2010	£9,409 + (£130,000 × 7/12 × 1/3)	34,687
2010/11	Accounts ending	y/e 31.8.2010	(£130,000 × 1/3)	43,333

Overlap profits

1.9.2009 to 5.4.2010 (7/12 × £130,000 × 1/3) = £25,278

11 Martina

Losses available for relief

Trading loss available = £12,200 = loss in the tax year 2009/10
Capital loss available = £1,600 = loss in the tax year 2009/10

Options available for the trading loss

1. **Carry loss forward under s83**

   If Martina carries the loss forward, relief can only be obtained against future trading income (not the rental income). Therefore, £10,900 can be set against her trading income in 2010/11. Tax relief of £2,180 (£10,900 × 20% (W)) will be obtained.

   The remaining £1,300 (£12,200 - £10,900) will be carried forward to 2011/12 and future years. The benefit of relief is therefore deferred.

2. **Claim s64 relief against total income in 2009/10 i.e. the year of the loss**

   Martina's total income for 2009/10 is already covered by her personal allowance. There is therefore no advantage in making a claim.

3. **Claim s64 relief against total income in 2008/09**

   If Martina claims s64 relief for 2008/09, she will utilise all of the loss available against her total income of £44,600.

   As a result she will obtain the following amount of tax relief:

£		£
725 (W)	× 40%	290
11,475 × 20%		2,295
12,200 Loss		
Tax relief		2,585

This relief is the most advantageous as it achieves a tax saving at the highest marginal rate of tax, utilises all of the loss as early as possible and does not result in the loss of Martina's personal allowance.

Options available for the capital loss

1. Offset against capital gains

As Martina has no capital gains in 2009/10 and 2010/11, the loss of £1,600 would have to be carried forward and offset in the future against the first available capital gain.

2. Claim s131 relief

Where a capital loss arises on the disposal of qualifying EIS shares, an election can be made to set off the capital loss against the individual's total income in the same way as for s64 relief.

As explained above, there is no advantage in claiming relief in 2009/10. However, a claim for s131 in 2008/09 will save tax.

If s64 relief is also claimed in 2008/09 (as recommended above), the tax saving will be £320 (£1,600 × 20% (W)).

Working

Income tax computations before loss relief

	2008/09	2009/10	2010/11
	£	£	£
Trading income	24,600	NIL	10,900
Employment income	12,000	3,000	NIL
Rental income	8,000	3,000	15,000
Total income	44,600	6,000	25,900
PA	(6,475)	(6,000)	(6,475)
Taxable income	38,125	NIL	19,425
Taxable at 20%	37,400		19,425
Taxable at 40%	725		

12 Natalie

Trading income assessments

Tax Year	Basis of assessment	Basis period	Workings (nearest month)		Trading income assessment £
2008/09	Actual	1.8.2008-5.4.2009	8/12 × £22,500		
			= £15,000 loss		NIL
				£	
2009/10	12 months	y/e 31.7.2009	Loss	(22,500)	
			Used in 2008/09	15,000	
			Loss left	(7,500)	NIL
2010/11	CYB	y/e 31.7.2010	Profit		25,600

Trading losses available

		£
2008/09	Amount of loss	15,000
2009/10	Amount of loss	7,500
		22,500

Options available for use of losses

(1) Carry forward loss under s83

If Natalie carries forward the losses, the full amount of £22,500 will be set against the trading income in 2010/11.

A tax saving of £4,500 (£22,500 × 20%) will be achieved. However, the benefit of the relief is not obtained until the tax for 2010/11 is due to be paid.

(2) Claim s64 relief

Relief is available to offset the losses against the total income of the year of the loss and/or the preceding year.

Applying this to Natalie's case, relief is available as follows:

Tax year	Amount £	Loss relief available against total income in:
2008/09	15,000	1. 2008/09 and/or
		2. 2007/08
		- in either order

2009/10	7,500	1. 2009/10 and/or 2. 2008/09 - in either order

If a claim for the £15,000 loss is made in 2008/09:

- All of the loss will be utilised and set against the £18,500(W) total income.
- The tax saving would be £2,405 (£12,025× 20%).
- £2,975 (£6,475 - £3,500) of the personal allowance is wasted.

If a claim for the £15,000 loss is made in 2007/08:

- All of the loss will be utilised and set against the £44,500(W) total income.
- The tax saving would be £3,125(W) [(£625 × 40%) + £14,375 × 20%)].
- There is no wastage of personal allowance.

If a claim for the £7,500 loss is made in 2009/10:

- No tax saving is achieved as the total income is already covered by the personal allowance.

If a claim for the £7,500 loss is made in 2008/09:

- Assuming the £15,000 loss has not been relieved in this year, the £7,500 loss would be set against the total income of £18,500.
- The tax saving would be £1,500 (£7,500 × 20%).

(3) Claim s72 relief

As the loss is incurred in the first four years of trading, relief is available to carry back the loss against the preceding three tax years on a FIFO basis. Applying this to Natalie's case, relief is available as follows:

Tax Year	**Amount £**	**Loss relief available against total income in:**
2008/09	15,000	1. 2005/06 and then 2. 2006/07 and then 3. 2007/08 - in that strict order
2009/10	7,500	1. 2006/07 and then 2. 2007/08 and then 3. 2008/09 - in that strict order

If a claim for the £15,000 loss is made under s72:

- All of the loss would be utilised in 2005/06 against the total income of £32,600(W).
- The tax saving would be £3,000 (£15,000 × 20%).

If a claim for the £7,500 loss is made under s72:

- All of the loss would be utilised in 2006/07 against the total income of £35,300(W).
- The tax saving would be £1,500 (£7,500 × 20%).

Conclusion

Natalie should:

- Make a claim for the £15,000 loss of 2008/09 to be set against the total income of 2007/08 under s64 as this achieves the highest rate of tax saving.
- Make a claim for the £7,500 loss of 2009/10 to be set against the total income of 2006/07 under s72 as this achieves the relief as early as possible.

The total tax saving would be:	£
s64 claim in 2007/08	3,125
s72 claim in 2006/07 (see note)	1,500
	4,625

Note: The same amount of tax relief is obtained if the £7,500 is set against 2008/09 under s64 or carried forward under s83. However, where the tax rate saving is the same, the taxpayer's secondary aim is usually to obtain relief as soon as possible. A s72 claim has the added cash flow benefit of obtaining a tax repayment with possible repayment interest (whereas a s64 claim reduces the current year's self assessment payments).

Working

Income tax computations before loss relief

	2005/06 £	2006/07 £	2007/08 £	2008/09 £	2009/10 £	2010/11 £
Trading income	-	-	-	NIL	NIL	25,600
Employment income	27,600	30,300	39,500	13,500	-	-
Annuity	5,000	5,000	5,000	5,000	5,000	5,000
Total income	32,600	35,300	44,500	18,500	5,000	30,600
PA	(6,475)	(6,475)	(6,475)	(6,475)	(6,475)	(6,475)
Taxable income	26,125	28,825	38,025	12,025	NIL	24,125
Taxable at						
20%	26,125	28,825	37,400	12,025	-	24,125
40%			625			

13 Ashley Ballantine

Ceased to trade: 30 June 2009 = tax year 2009/10

2009/10	Final year	1.10.2008-30.6.2009		£
		p/e 30.6.2009	Loss	(10,400)
		Overlap profits		(8,000)
		Overall loss		(18,400)
Trading income assessment				NIL

Options available for loss relief

1. Claim s64 against total income

Ashley can claim relief for £18,400 under s64 against his total income in the tax year of the loss (2009/10) and/or the preceding year (2008/09).

If a claim is made in 2009/10, all of the loss will be utilised. Tax of £3,605 (£18,025 × 20%) will be saved (W1). A small amount of personal allowance will be wasted.

It is pointless making a claim in 2008/09 as almost all of the income is covered by the personal allowance.

2. Claim s89 terminal loss relief against available profits

Alternatively, Ashley can claim terminal loss relief and set against his trading profits of the last tax year and three preceding tax years on a LIFO basis.

The amount of the terminal loss is £17,150 (W2).

If claimed, this loss is carried back against Ashley's trading income as follows:

		£	Comment (Assuming no s64 claims)
1.	2008/09	5,000	- £4,475 of personal allowance is wasted. - Tax saving is £105 (£525 × 20%)
2.	2007/08	12,150	- Tax saving is £2,430 (£12,150 × 20%)
		17,150	

The remaining loss of £1,250 (£18,400 - £17,150) can be set off against total income using s64. If claimed in 2009/10, the tax saving would be £250 (W1) (£1,250 × 20%).

Total tax saving from £18,400 loss:

	£	£	
Terminal loss relief	17,150	2,535	(105 + 2,430)
s64 in 2009/10	1,250	250	
	18,400		
Tax saving		2,785	

Conclusion

Ashley should claim s64 relief for all the loss in 2009/10 as this achieves the highest tax saving of £3, 605.

Workings

(W1) Income tax computations before loss relief

	2006/07	2007/08	2008/09	2009/10
	£	£	£	£
Trading income	42,900	26,000	5,000	NIL
Employment income				
(£30,000 × 9/12)	-	-	-	22,500
Dividends	-	-	-	-
Rental income	2,000	2,000	2,000	2,000
Total income	44,900	28,000	7,000	24,500
PA	(6,475)	(6,475)	(6,475)	(6,475)
Taxable income	38,425	21,525	525	18,025
Taxable at				
20%	37,400	21,525	525	18,025
40%	1,025			

(W2) Terminal loss

		£
Overlap profits not yet relieved.		8,000
Last tax year - Actual loss (6.4.2009-30.6.2009)		
(3/9) × (£10,400) loss		3,467
12 months before cessation to 5 April before cessation		
Actual loss (1.7.2008-5.4.2009)		
Period 1.7.2008-30.9.2008	£	
(3/12 × 5,000 profit)	1,250	
Period 1.10.2008-5.4.2009		
(6/9 × (10,400) loss	(6,933)	
Net loss		5,683
Terminal loss in last 12 month trading		17,150

14 Marion

Tax relief for pension contributions

Relief for Marion's contribution = lower of	£
(1) Gross pension contribution paid	150,000
(2) 100% × employment income = £275,000	275,000
Eligible gross contribution	150,000

The method of obtaining tax relief for pension contributions differs depending on whether the contributions are made into a personal pension scheme or an occupational pension scheme.

Contributions into a registered personal pension scheme

- Basic rate relief is given at source. The actual amount Marion would pay into the scheme is £120,000 (£150,000 × 80%).
- Higher rate relief of £30,000 (£150,000 × 20%) is given by extending the basic rate band as follows:

	£
Income tax computation – 2009/10	
Employment income (note 1)	275,000
Dividend income (£9,000 × 100/90)	10,000
Total income	285,000
PA	(6,475)
Taxable income	278,525

Income tax		£		£
Extended basic rate band (W1)		187,400	at 20%	37,480
Higher rate band:	other income	81,125	at 40%	32,450
	dividends	10,000	at 32½%	3,250
Total taxable income		278,525		
(Note 2)				73,180
Add excess pension contributions (W2)				2,000
Income tax liability				75,180

Notes:

(1) The employer's contributions are an exempt benefit of employment.

Contributions into a registered occupational pension scheme

- Relief at 40% is given by deduction from employment income through the PAYE system and is shown in Marion's income tax computation as follows:

Income tax computation – 2009/10

	£
Salary	275,000
Less occupational pension contributions	(150,000)
Employment income	125,000
Dividend income (£9,000 × 100/90)	10,000
Total income	135,000
PA	(6,475)
Taxable income	128,525

Income tax		£		£
Basic rate band:	other income	37,400	at 20%	7,480
Higher rate band:	other income	81,125	at 40%	32,450
	dividends	10,000	at 32½%	3,250
Total taxable income		128,525		
(Note)				43,180
Add excess pension contributions (W2)				2,000
Income tax liability				45,180

Workings

(W1) Extension of basic rate band

	£
Basic rate band threshold	37,400
Add gross pension contributions eligible for relief	150,000
Extended basic rate band	187,400

(W2) Excess pension contribution charge

Total contributions into the scheme for which relief is given:

	£
Marion's eligible contribution	150,000
Employer's contribution	100,000
	250,000

As this exceed the annual allowance of £245,000, Marion will have an additional income tax charge of £2,000 [(£250,000-£245,000) × 40%].

15 Emma Carey

Emma will pay the following contributions:

1. **Class 2 NICs**

As Emma's accounting profits are in excess of £5,075, Emma will pay class 2 NICS.

(£2.40 × 52 weeks)	£125

Due date = paid by monthly standing order or by quarterly billing.

2. **Class 4 NICs**

As Emma's taxable trading profits exceed £5,715, Emma will pay class 4 NICs.

	£
(£43,875 - £5,715) × 8%	3,053
(£65,000 - £43,875) × 1%	211
	3,264

Due date: Under self assessment with income tax payments.

3. **Class 1 secondary contributions**

As Emma employs Susan she is liable to pay class 1 secondary contributions based on Susan's cash earnings of £18,600 (W1)

Class 1 secondary contributions	
(£18,600 - £5,715) × 12.8%	£1,649

Due date: 1/12th paid monthly on 19th of each month.

4. **Class 1A contributions**

As Emma provides Susan with benefits of employment she is liable to pay class 1A contributions based on Susan's assessable benefit of £285 (W2).

Class 1A contributions	
(£285 × 12.8%)	£36
Due date: 19th July 2010.	
Emma's total NIC liability	£5,074

5. **Class 1 Primary Contributions**

Susan is liable to class 1 primary contributions.

However, it is Emma's responsibility to deduct the NICs from her salary and pay the contributions to HMRC along with the class 1 secondary contributions.

Class 1 primary contributions	
(£18,600 - £5,715) × 11%	£1,417
Due date: 1/12th paid monthly on 19th of each month.	
Total NICs payable by Emma to HMRC in respect of 2009/10	£6,491

Workings

(W1) Susan's cash earnings

	£
Salary	18,200
Excess mileage allowance	
4,000 miles × (50p – 40p)	400
Cash earnings	18,600

Note: The employer's pension contributions are excluded as they are an exempt benefit and the employee's contributions are ignored as expense deductions are not allowed for NIC purposes.

(W2) Assessable benefits for Class 1A NICs

	£
Excess mileage allowance	
= treated as cash earnings for NIC purposes.	NIL
Beneficial loan interest	
(£6,000 × 4.75%)	285
Mobile phone = exempt benefit	NIL
	285

16 Katie Rivers

Capital gains tax computation – 2009/10

	£
Investment property (W1)	38,240
Daimler car (exempt)	-
Popski Ltd shares (W3)	51,000
Current year capital loss (W2)	(20,400)
Capital loss b/f	(4,000)
Total chargeable gain	64,840
Less Annual exemption	(10,100)
Taxable gains	54,740
Capital gains tax at 18%	9,853

Due date: 31 January 2011

Workings

(W1) Investment property

	£
Sale proceeds	106,000
Less auctioneer's expenses (1%)	(1,060)
Net sale proceeds	104,940
Cost	(48,200)
Enhancement	(18,500)
Gain	38,240

(W2) Plot of land

	£
Sale proceeds	51,000
Less cost	(71,400)
Allowable loss	(20,400)

(W3) Popski Ltd shares

	£
Sale proceeds	69,000
Cost	(18,000)
Gain	51,000

17 Emily Freeman

Capital gains tax computation – 2009/10

	£
Wild plc shares (W1)	17,500
AB Ltd shares (W2)	16,017
Treasury stock (Exempt)	-
Hughes plc shares (W3)	33,120
Total chargeable gain	66,637
Less Annual exemption	(10,100)
Taxable gains	56,537
Capital gains tax at 18%	10,177

Workings

(W1) Wild plc shares

	£
Sale proceeds	25,000
Cost	(7,500)
Gain	17,500

(W2) AB Ltd Shares

		Number	Cost
27 September 2002	Purchase	10,000	38,000
6 October 2005	Bonus Issue (1:5)	2,000	NIL
		12,000	38,000
14 August 2009	Sale	(6,200)	(19,633)
Shares remaining		5,800	18,367

	£
Sale proceeds	35,650
Cost	(19,633)
Gain	16,017

(W3) Hughes Ltd Shares

Takeover Consideration	£
Cash (60,000 × ½ × £3)	90,000
Ordinary shares (60,000 × ½ × £6)	180,000
	270,000

Allocation of original cost of Peters Ltd shares to takeover consideration.

	£
Cash (£33,300 × 90/270)	11,100
Ordinary shares (£33,300 × 180/270)	22,200
	33,300

A gain in respect of the cash consideration received will have been assessed in 2002/03.

The 30,000 new ordinary shares in Hughes plc are deemed to have been acquired in July 2000 for £22,200.

Disposal of 12,000 ordinary shares in March 2010

	£
Sale proceeds (12,000 × £3.50)	42,000
Deemed cost (£22,200 × 12,000/30,000)	(8,880)
Gain	33,120

18 Jack Wilson

Capital gains tax computation – 2009/10

	£
Racehorse (Exempt)	-
Lease (W1)	32,963
Gamlin Ltd shares (W3)	16,444
Painting (W4)	18,150
Part disposal (W5)	23,531
Total chargeable gain	91,088
Less Annual exemption	(10,100)
Taxable gains	80,988
Capital gains tax at 18%	14,578

Due date 31 January 2011

Workings

(W1) Assignment of short lease

	£
Sale proceeds (22 years 7 months)	68,000
Deemed cost	
$£43,230 \times \dfrac{\text{\% for 22 years 7 months}}{\text{\% for 40 years}}$	
$= £43,230 \times \dfrac{77.365\ (W2)}{95.457}$	(35,037)
Gain	32,963

(W2) Lease percentage for 22 years and 7 months

	%		%
Percentage for 22 years			76.399
Percentage for 23 years	78.055		
Percentage for 22 years	(76.399)		
	1.656	× 7/12	0.966
			77.365

(W3) Gamlin Ltd shares

Inter spouse transfer of 3,500 shares – June 2009

An inter spouse transfer is a nil gain/nil loss transaction. The market value of the shares is ignored and the consideration is fixed to ensure there is no gain arising at the time of the transfer.

	£
Deemed consideration	5,965
Cost	(5,965)
Gain	NIL

Jack acquires the shares with a deemed cost of £5,965.

Subsequent disposal of 1,500 shares by Jack – December 2009

	£
Sale proceeds	19,000
Deemed base cost (£5,965 × 1,500/3,500)	(2,556)
Gain	16,444

(W4) Painting

This is a sale to a connected person, therefore the actual sale proceeds received are ignored and the market value is used as consideration.

	£
Market value	26,000
Probate value	(7,850)
Gain	18,150

(W5) Part disposal of land

	£
Sale proceeds	27,550
Cost	
$£12{,}800 \times \dfrac{27{,}550}{(27{,}550 + 60{,}200)}$	(4,019)
Gain	23,531

19 Melanie Fellows

Capital gains tax summary – 2009/10

	Chargeable gain £
Antique vase (W1)	8,400
Match Ltd (W2)	915
Workshop (W3)	32,000
Business asset (W4)	13,000
Total chargeable gains	54,315

Less annual exemption	(10,100)
Taxable gains	44,215
Capital gains tax at 18%	7,959

Due date 31 January 2011

Workings

(W1) Gift of an antique vase

	£
Market value	15,200
Probate value	(6,800)
Gain	8,400

Gift relief is not available as an antique vase is not a qualifying asset.

(W2) Gift of Match Ltd shares

	£
Market value (£1.80 × 8,500)	15,300
Cost £16,500 × $\frac{8,500}{15,000}$	(9,350)
	5,950

Gift relief is available as unquoted trading company shares are qualifying shares for gift relief purposes. However full gift relief is not available as Match Ltd holds investments.

Gift relief = £5,950 × $\frac{£220,000 \text{ (CBA)}}{£260,000 \text{ (CA)}}$

= £5,035

Gain after gift relief = £5,950-£5,035 = £915

(W3) Sale of workshop

	£
Sale proceeds	100,000
Cost	(35,000)
Gain	65,000

The workshop is a qualifying asset for rollover relief. However, full rollover relief is not available as not all of the sale proceeds are reinvested in a qualifying business asset between November 2008 and November 2012.

Gain chargeable in 2009/10 = lower of

(i) full gain £65,000

(ii) sale proceeds not reinvested
(£100,000 - £68,000) = £32,000

A rollover relief claim for £33,000 (£65,000 - £32,000) should therefore be made.
Gain in 2009/10 = £32,000

(W4) Sale for less than market value

	£
Market value	35,000
(ignore actual sale proceeds)	
Cost	(5,000)
Gain	30,000

Gift relief is available as the asset is a business asset used in Melanie's business. However, full gift relief is not available as the actual sale proceeds received exceed the original cost.

Gain chargeable in 2009/10	£
Sale proceeds received	18,000
Cost	(5,000)
	13,000

Gift relief = (£30,000 - £13,000) = £17,000

20 Lawrence Troth

(a) **Capital gains tax summary – 2009/10**

	Chargeable gain
	£
House in Scotland (W1)	3,331
Insurance proceeds (W5)	16,701
Total chargeable gain	20,032
Less Annual exemption	(10,100)
Taxable gains	9,932
Capital gains tax (£9,932 × 18%)	1,788

(b) **Consequences of restoring the investment property**

If all of the insurance proceeds are used to restore the property, and Lawrence makes an election to HMRC, the following capital gains tax consequences will arise:

- the charge to CGT on the investment property is deferred

- no part disposal occurs, no CGT charge arises
- Lawrence's total chargeable gains will therefore be £3,331 and no CGT will be payable as his gains are covered by the annual exemption.
- the base cost of the investment property is adjusted as follows:
  - reduced by the insurance proceeds received (£25,460)
  - increased by the restoration costs, which are treated as enhancement expenditure.

Workings

(W1) **House in Scotland**

	£
Sale proceeds	600,000
Less Incidental expenses	(6,000)
Net sale proceeds	594,000
Less Allowable deductions	
Original costs (W2)	(120,000)
Extension	(21,000)
Redecoration and maintenance (Note)	(Nil)
Gain	453,000
Less PPR relief (W3)	
$£453,000 \times \left(\frac{127}{136}\right)$	(423,022)
	29,978
Less Letting relief (W4)	(26,647)
Gain after reliefs	3,331

Note:

The redecoration and maintenance costs are revenue expenditure and not allowable against capital gains as enhancement expenditure.

(W2) **Allowable portion of original cost**

	£
Original cost	176,500
Incidental acquisition costs	3,500
	180,000
Allocated to part disposal (Jan 1999)	
$£180,000 \times \left(\frac{£70,000}{£70,000 \times £140,000}\right)$	(60,000)
Remaining cost relating to first two floors of house	120,000

(W3) **PPR relief**

	Notes	Total	Exempt	Chargeable	Let
		(Mths)	(Mths)	(Mths)	(Mths)
01.08.1998 – 31.01.1999	(1)	6	6		
01.02.1999 – 31.10.2003	(2)	57	57		
01.11.2003 – 28.02.2006	(3)	28	28		
01.03.2006 – 30.11.2006	(4)	9		1	8
01.12.2006 – 30.11.2009	(5)	36	36		
		136	127	1	8

Notes:

(1) Owner occupied – therefore exempt.

(2) Deemed occupied as working elsewhere in the UK. Periods totalling up to four years are exempt as the property is occupied by Lawrence at some time before and after this period of absence. Therefore, 48 of these months are exempt.

The remaining nine months of this period will also be exempt as periods totalling up to three years are exempt for any reason, provided Lawrence actually occupies the property both at some time before and after this period of absence.

Note that during this period the property is let, but no letting relief is needed as the period is exempt under the PPR rules.

(3) Owner occupied – therefore exempt.

(4) This period cannot be counted as a period of deemed occupation as the property is not reoccupied by Lawrence before the date of disposal. However, during some of this period the property is let to tenants and therefore letting relief is available for eight months.

(5) The last 36 months of ownership are always exempt if the property has been the PPR at some time.

(W4) **Letting relief**

		£
Lower of		
(i)	PPR relief	423,022
(ii)	That part of the remaining gain (after PPR relief) which relates to a period of letting (W3)	
	£453,000 × $\left(\frac{8}{136}\right)$	26,647
(iii)	Maximum	40,000

(W5) **Insuring and compensation**

As the property is damaged but not totally destroyed, the receipt of insurance is treated as a part disposal because Lawrence has not made any election in respect of the restoration of the property.

	£
Insurance proceeds	25,460
Allowance cost	
$£50{,}250 \times \left(\dfrac{£25{,}460}{£25{,}460 + £120{,}600}\right)$	(8,759)
Gain	16,701

21 Pat Brown

(a) **Lifetime IHT payable by Pat Brown**

Gift on 19 June 2001

- The gift is a PET
- No lifetime tax is due on PETs
- The PET utilises the annual exemptions for 2001/02 and 2000/01 b/f
- PETs are not cumulated when calculating lifetime IHT

Gift on 14 May 2004

- The gift is an inter-spouse gift and is therefore exempt
- No IHT is payable during lifetime or on death
- The gift does not utilise any annual exemptions
- The gift can be ignored.

Other lifetime gifts

		CLT 20 Feb 2006	**PET 6 July 2006**
	£	£	£
Transfer of value (W)		348,440	200,000
Reliefs (Note below)		(–)	(–)
Marriage exemptions			(5,000)
Annual exemptions			
2005/06		(3,000)	
2004/05 b/f		(3,000)	
2006/07			(3,000)
Chargeable amount		342,440	192,000
NRB	325,000		
Gross CLTs in 7 yrs before this gift (20.02.99 – 20.02.06) *(ignore the PET)*	(Nil)		
NRB available		(325,000)	
Taxable amount		17,440	

	CLT 20 Feb 2006		PET 6 July 2006
	£	£	£
		Net gift	
Lifetime IHT			
£17,440 × 25%		4,360	
No IHT = PET			Nil
Paid by		Pat	
Due date		31.08.07	
Gross CLT to c/f (£342,440 + £4,360)		346,800	

Note: There is no BPR available on this transfer because:

- Brown Ltd is an investment company
- Pat does not control the quoted company
- Cash is not a qualifying asset.

(b) **Death tax due in respect of lifetime gifts**

Date of death 17 April 2010

Seven years before 17 April 2003

Gift on 19 June 2001

- As the gift is more than seven years before death, the PET is exempt
- No death IHT arises
- The PET is not cumulated when calculating the IHT on subsequent gifts.

Gift on 14 May 2004

- Inter spouse gift, therefore exempt

Other lifetime gifts

	CLT 20 Feb 2006		PET 6 July 2006	
	£	£	£	£
Gross chargeable amount per lifetime		346,800		192,000
NRB	325,000		325,000	
Gross chargeable gifts in 7 years before this gift				
20.02.99 – 20.02.06 (ignore PET)	(Nil)			
06.07.99 – 06.07.06 (include CLT, ignore PET)			(346,800)	
NRB available		(325,000)		(Nil)
Taxable amount		21,800		192,000
IHT at 40%		8,720		76,800

	CLT 20 Feb 2006		PET 6 July 2006	
	£	£	£	£
Less Taper Relief				
20.02.06 – 17.04.10 (4–5 years) (40%)		(3,488)		
06.07.06 – 17.04.10 (3–4 years) (20%)				(15,360)
		5,232		61,440
Less Lifetime IHT paid		(4,360)		(Nil)
IHT payable on death		872		61,440
Paid by		Trustees		Daughter
Due date		31.10.10		31.10.10

Working: Gift into discretionary trust – transfer of value

Brown Ltd shares

	Before the gift	After the gift
	% holding	% holding
Pat	30	10
Wife	30	30
	60	40

		£
Value of Pat's estate before the gift	$£600,000 \times \frac{30}{60}$	300,000
Value of Pat's estate after the gift	$£380,000 \times \frac{10}{40}$	(95,000)
Transfer of value re – Brown Ltd shares		205,000

Quoted shares

Quarter up method = 359p + ¼ × (371 – 359) = 362p each.

12,000 shares = 12,000 × £3.62 = £43,440

Total transfer of value into discretionary trust:

	£
Brown Ltd shares	205,000
Quoted shares	43,440
Cash	100,000
	348,440

22 Debbie Price

(a) **IHT payable on lifetime gifts as a result of Debbie's death**

Date of death (assumed): 5 April 2010
Seven years before death: 5 April 2003

	PET 1 16 April 2003		PET 2 27 Jan 2007		CLT 1 31 Dec 2009	
	£	£	£	£	£	£
Gross chargeable amount per lifetime (W1)		197,800		444,000		594.000
Less Fall in Value Relief (W3)		(–)		(160,000)		(–)
Revised chargeable amount on death		197,800		284,000		594,000
NRB	325,000		325,000		325,000	
Gross chargeable gifts in 7 years before this gift						
16.04.96 – 16.04.03	(Nil)					
27.01.00 – 29.01.07			(197,800)			
31.12.02 – 31.12.09 (197,800 + 444,000) (Note)					(641,800)	
NRB available		(325,000)		(127,200)		(Nil)
Taxable amount		Nil		156,800		594,000
IHT at 40%		Nil		62,720		237,600
Less Taper Relief		(–)				
27.01.07 – 05.04.10 (3–4 years) (20%)				(12,544)		
31.12.09 – 05.04.10 (< 3 years)						(Nil)
		Nil		50,176		237,600
Less Lifetime IHT Paid (W1)		(–)		(–)		(53,800)
IHT payable on death		Nil		50,176		183,800
Paid by				Daughter		Trustees

Note:

The fall in value relief is available when calculating the tax on the gift to the daughter only. When calculating the tax on subsequent gifts, the original chargeable amount of £444,000 is carried forward, not the reduced chargeable amount of £284,000.

(b) **If Debbie were to die on 14 March 2011**

The inheritance tax consequences would be as follows:

- The gift on 16 April 2003 would be more than seven years before the date of death. Therefore the PET would not become chargeable on death.
- The PET would not be cumulated when calculating the tax on the subsequent gifts. Therefore the full £325,000 nil rate band is available to match against PET 2 on 27 January 2007.
- As the value of the cottage remains unchanged, the same fall in value relief is available. Therefore, there will be no tax payable by the daughter on Debbie's death. This is because the nil rate band of £325,000 will cover the revised chargeable amount of £284,000. Surviving another year will save Debbie's daughter £50,176 of IHT.
- The IHT due by the trustees will remain unchanged. There is no nil rate band available as the band is firstly matched against the original

chargeable amount of PET 2 (£444,000). Although another year has elapsed, the gift is still within three years of the date of death. Therefore no taper relief is available.

(c) **Tax planning measures**

As Debbie is only expected to live for a matter of months, there is little that she can do to limit the exposure of her estate to inheritance tax. However, the following measures will achieve a small reduction in liability:

- Make a transfer during 2010/11 to utilise her annual exemption. (The exemption for 2009/10 has already been used.) This will save IHT of £1,200 (£3,000 x 40%.)
- Make small gifts of up to £250 per recipient. Each gift will save IHT of £100 (£250 x 40%).
- Transfer any assets that are expected to increase in value over the next few months. This will freeze the value of the transfer for IHT purposes, thus any increase in value will escape IHT.

Workings

(W1) **Lifetime gifts – lifetime tax**

	PET 1	**PET 2**	**CLT 1**	
	16 Apr 2003	27 Jan 2007	31 Dec 2009	
	£	£	£	£
Transfer of value (W2)	203,800	450,000		600,000
Reliefs	(–)	(–)		(–)
Annual exemptions				
2003/04	(3,000)			
2002/03 b/f	(3,000)			
2006/07		(3,000)		
2005/06 b/f		(3,000)		
2009/10				(3,000)
2008/09 b/f				(3,000)
Chargeable amount	197,800	444,000		594,000
NRB			325,000	
Gross CLTs in 7 years before this gift 31.12.02 – 31.12.09 *(ignore PETs)*			(Nil)	
NRB available				(325,000)
Taxable amount				269,000
Lifetime IHT £269,000 × 20%				53,800

(W2) **Briggs plc shares – transfer of value**

Lower of:

(i) Quarter up method

$10.20 + \frac{1}{4} \times (10.24 - 10.20) = £10.21p$

(ii) Average of highest and lowest bargains

$\frac{10.12 + 10.26}{2} = £10.19$

Value of 20,000 shares = 20,000 × £10.19 = £203,800.

(W3) **Fall in value relief**

	£
Value of cottage at date of gift	450,000
Value of cottage at date of death	(290,000)
Fall in value	160,000

23 Graham Kelsall

Estate computation

	£	£
Private residence		420,000
Less: Repayment mortgage		(140,000)
		280,000
Bank accounts		180,000
ISA		48,000
Car and chattels (20,500 + 14,000)		34,500
Bluechip plc shares (W1)		143,360
Flat in Portugal	255,000	
Less: Expenses (Note 1)	(6,250)	
		248,750
Life assurance policy (Note 2)		169,000
Rednose Ltd shares	750,000	
Less: BPR (W2)	(625,000)	
		125,000
		1,228,610
Less: Funeral expenses		(5,400)
Income tax liability		(6,300)
Credit card bills		(1,280)
		1,215,630
Less: Exempt legacy		
Charity		(60,000)
Gross chargeable estate		1,155,630

All of the nil rate band is available as Graham has not made any lifetime gifts.

		£
IHT on estate (£1,155,630 – £325,000) × 40%		332,252
Less: DTR		
Lower of		
(i) overseas tax suffered = £43,200		(43,200)
(ii) UK IHT on flat in Portugal	£248,750 × 28.75072% = £71,517	
IHT payable		289,052

Due date of payment 31 January 2010

Allocation of IHT payable

	£	Paid by	Suffered by
Flat in Portugal			
£248,750 × 28.75072%	71,517		
Less: DTR	(43,200)		
	28,317	Brian	Brian
Rednose Ltd Shares (Note 3)			
£125,000 × 28.75072%	35,938	Executors	Son and daughter
Rest of the estate			
£781,880 × 28.75072%	224,796	Executors	Son and daughter
	289,051		

Notes:

(1) Additional expenses incurred in realising an overseas asset are an allowable deduction, subject to a maximum of £12,750 (5% × £255,000). As the expenses incurred are less than £12,750, all of them are allowable. The Portuguese death duties paid are not an allowable deduction, however DTR is available.

(2) The life assurance policy proceeds actually received are included in the estate, not the surrender value.

(3) The shares are left in the will to Janis, however she does not bear the tax on this gift. The tax is borne by the residual legatees (i.e. the son and daughter).

Workings

(W1) **Bluechip plc shares**

Ex-dividend valuation

812p + ¼ × (828 – 812) = 816p each

	£
Value of 16,000 shares	
16,000 × £8.16	130,560
Plus next dividend payment	
16,000 × 80p	12,800
Value of shares	143,360

Note: There is no BPR available as it is assumed that Graham does not have a controlling interest in the quoted company.

(W2) **Rednose Ltd shares – BPR**

Graham has held the Rednose Ltd shares for more than two years and is therefore entitled to BPR.

However, full BPR is not available as Rednose Ltd has excepted assets (i.e. investments).

$$BPR = 100\% \times £750{,}000 \times \left(\frac{3{,}000{,}000 - 500{,}000}{3{,}000{,}000}\right)$$

$$= £625{,}000$$

(W3) **Average rate of IHT on estate**

$$\frac{£332{,}252}{£1{,}155{,}630} \times 100 = 28.75072\%$$

24 Craig Dagnall

Lifetime gifts

	PET 16 June 2005
	£
Transfer of value	185,000
Less: BPR (100%)	(185,000)
Chargeable amount at time of gift	Nil

The gift is a PET, so there is no lifetime IHT payable.

As the gift is within seven years of the date of death, the PET becomes chargeable. If Craig's daughter still owned all of the shares on 14 December 2009, the chargeable amount would be Nil. However, as she disposed of ¼ of the shares before Craig died, BPR is clawed back in respect of those shares.

The chargeable amount on death is calculated as follows:

	£
Chargeable amount per lifetime	Nil
Add: BPR claw back (Note) (¼ × £185,000)	46,250
	46,250
Less: Annual exemptions not previously used	
2005/06	(3,000)
2004/05 b/f	(3,000)
Revised chargeable amount on death	40,250

There is no IHT payable as the gift is covered by the nil rate band.

However, the nil rate band available against the death estate is £284,750 (325,000 – £40,250).

Estate computation

	Notes	£
House in UK	(1)	326,000
Partnership share	(2)	400,000
Chattels and cars		61,000
Bank accounts		310,000
Yellow River Ltd shares	(3)	48,000
		1,145,000
Less: Funeral expenses		(7,650)
Income tax		(7,260)
		1,130,090
Less: Exempt legacy to wife (W1)		(739,924)
Gross chargeable estate		390,166
IHT payable on estate (W1) (£390,166 – £284,750) × 40%		42,166
Less: Quick succession relief (W2)		(11,273)
IHT payable		30,893

Notes:

(1) The endowment mortgage is not deducted in the estate as the endowment element will generate a lump sum to pay off the mortgage loan.

(2) There is no BPR available on the partnership share as there is a binding contract of sale at the date of Craig's death.

(3) There is no BPR available on the Yellow River Ltd shares as they have not been held for two years.

Workings

(W1) **Exempt legacy to wife**

As the specific gifts in the will are UK assets and all of the residue is left to an exempt person, grossing up is required as follows:

	£	£
Net chargeable estate (£300,000 + £48,000)		348,000
Nil rate band (NRB)	325,000	
Gross chargeable transfers in 7 years before death	(40,250)	
NRB available		(284,750)
Net taxable amount		63,250

	£	£
IHT payable at (2/3)		42,166
Gross chargeable estate (£348,000 + £42,166)		390,166
Legacy to wife (£1,130,090 – £390,166)		739,924

(W2) **Quick succession relief**

Appropriate percentage = 07.07.2007 to 14.12.2009 = 2 to 3 years

= 60%

Tax charged on earlier transfer:

Average rate of tax on uncle's estate

$$= \left(\frac{204{,}000}{760{,}000}\right) \times 100 = 26.8421\%$$

Tax on antique vase = £70,000 × 26.8421% = £18,789

QSR = 60% × £18,789 = £11,273

Note: The fact that Craig had sold the vase before his death is not important.

25 Michelle George

(a) **Treatment of gift on 14 August 2008**

The gift of the house on 14 August 2008 was a gift with reservation as Michelle continued to live in the house until her death. At the time, the gift was treated as a PET and no lifetime IHT was payable. On Michelle's death, the PET becomes chargeable. However, HMRC will ignore the PET and treat the house as part of Michelle's estate, as if the gift had not been made. This is because the IHT payable by including the house in the estate will be greater than the IHT payable on the PET becoming chargeable.

The gift with reservation rules could have been avoided by Michelle paying market rent for the occupation of the property. However, this would have resulted in a property income charge on her son.

(b) (i) **Lifetime IHT payable**

	PET 9 Nov 2005	**CLT** 24 June 2007	
	£	£	£
Transfer of value	339,000		342,000
Reliefs	(–)		(–)
Annual exemptions			
2005/06	(3,000)		
2004/05 b/f	(3,000)		
2007/08			(3,000)
2006/07 b/f			(3,000)
Chargeable amount	333,000		336,000
NRB		325,000	

	PET 9 Nov 2005	CLT 24 June 2007	
	£	£	£
Gross CLTs in previous 7 years 24.06.00– 24.06.07 *(ignore PET)*		(Nil)	
NRB available			(325,000)
Taxable amount			11,000
Lifetime IHT			
No IHT = PET	Nil		
£11,000 × 20%			2,200
Payable by			Trustees
Due date			30 April 2008

(ii) **IHT on lifetime gifts as a result of Michelle's death**

Date of death: 1 July 2009
7 years before death: 1 July 2002

	PET 9 Nov 2005		CLT 24 June 2007	
	£	£	£	£
Chargeable amount per lifetime		333,000		336,000
NRB	325,000		325,000	
Gross chargeable gifts in previous 7 years				
09.11.98 – 09.11.05	(Nil)			
24.06.00 – 24.06.07			(333,000)	
NRB available		(325,000)		(Nil)
Taxable amount		8,000		336,000
IHT at 40%		3,200		134,400
Less: Taper relief				
09.11.05 – 01.07.09				
(3–4 years) (20%)		(640)		
24.06.07 – 01.07.09 (< 3 yrs)				(Nil)
		2,560		134,400
Less: Lifetime IHT paid		(Nil)		(2,200)
IHT payable		2,560		132,200
Paid by		Son		Trustees
Due date		31 Jan 2010		31 Jan 2010

(iv) **Estate computation**

	£
UK quoted shares (Note 1)	50,000
Investment property	210,000
Other net assets	600,000
	860,000
Less: Exempt legacy	(45,000)
Free estate	815,000
Gift with reservation	750,000
Gross chargeable estate	1,565,000

There is no nil rate band remaining to match against the estate.

IHT on estate (£1,565,000 × 40%) 626,000

Allocation of IHT payable

	£	**Paid by**
Investment property (£210,000 × 40%)	84,000	Executors (Note 2)
Rest of free estate (£605,000 × 40%)	242,000	Executors (Note 3)
Gift with reservation (£750,000 × 40%)	300,000	Son (Note 4)
	626,000	

Notes:

(1) There is no BPR on the quoted shares as Michelle does not have a controlling interest.

(2) The IHT payable in respect of the investment property can be paid in ten equal annual instalments of £8,400 starting on 31 January 2010 if the executors make an election for the instalment option to apply. Interest will be charged on the instalment payments.

(3) The executors must pay the IHT in respect of the remaining free estate in one lump sum by 31 January 2010. The IHT in respect of the quoted shares cannot be paid by instalments as Michelle does not have a controlling interest.

(4) The IHT payable in respect of the GWR is payable by the donee (i.e. the son) by 31 January 2010.

26 Amanda Irvine

(a) **Use of a discretionary trust**

Amanda can set up a discretionary trust and nominate herself as a trustee. The trustees of a discretionary trust have the discretion over how the capital assets will be used and ultimately distributed to the beneficiaries.

Amanda can therefore protect the capital value of the assets and control how Amelia and Molly:

(i) have access to the income generated from the assets, and

(ii) receive the capital assets at a later date.

Inheritance tax consequences of setting up a discretionary trust

- Gifts of any assets into a discretionary trust would be treated as a CLT by the settlor (Amanda).
- Lifetime IHT would be payable calculated at 20% (if the trustees pay) or 25% (if Amanda pays) on the excess over £325,000.
- Further tax is payable if Amanda dies within seven years of setting up the trust.
- Once the assets are in the trust, the trust will be liable to a ten-yearly principal charge based on the value of the trust on the ten-year anniversary date. The maximum charge is 6% payable by the trustees.
- When the capital assets are distributed to Amelia and Molly, an exit charge is levied based on the value of the capital assets distributed. The maximum charge is 6%.

Capital gains tax consequences of setting up a discretionary trust

- Gifts of chargeable assets into a discretionary trust are chargeable disposals at full market value and may give rise to a CGT liability payable by the settlor (Amanda).
- As there is an immediate charge to inheritance tax, gift relief is available to defer the gains arising on setting up the trust on any asset.
- Once the assets are in the trust, a CGT liability only arises if the trustees sell assets to third parties or distribute the capital assets to the beneficiaries
- The trustees have an annual exemption of £5,050 (2009/10) and pay CGT at 18%.
- The distribution of capital assets to the beneficiaries is a chargeable disposal at full market value. However, gift relief is available on any asset as there is an immediate charge to IHT.

(b) **Tax planning opportunity**

If Amanda creates the discretionary trust, she is the settlor of the trust and the capital tax consequences that arise are given in part (a).

However, if Amanda were to use a deed of variation within two years of her father's death, she can alter her father's will so that his assets pass directly to the discretionary trust for the benefit of his grandchildren.

Provided the deed includes a statement that it is to be effective for IHT and CGT purposes, the transfer will be treated as a legacy under the will and not a lifetime gift by Amanda.

As a result:

- The IHT payable on Amanda's father's estate remains unchanged (£403,000).

- However, there is no CLT arising on Amanda when the trust is set up, no additional IHT charges and no chargeable disposal for CGT purposes.
- The trust is set up and the trustees acquire the assets at probate value.

Amanda will preserve her own nil rate band for use against any future lifetime gifts she wishes to make and/or against the value of her own estate on death.

27 Gerald Court

Tax adviser
I High Street
Anytown

Date

Gerald Court
3 Acacia Ave
Midtown

Dear Mr Court

Thank you for contacting me to discuss the tax charge applicable to remittance basis users.

The rules apply to individuals who have been UK resident for at least seven out of the nine tax years preceding the relevant tax year. As you have been UK resident since January 2001, you will be caught by the rules.

The rules only apply if you wish to claim the remittance basis in respect of your overseas income. The rules require you to pay a tax charge of £30,000 on your unremitted income/gains **in addition to** the tax due on any amounts remitted to the UK.

If you do not claim the remittance basis, your overseas income will be assessed on the arising basis, i.e. the full amount of income for the year will be chargeable to UK income tax, not just the amount of income brought into the UK.

The level of your UK income means that you are clearly a higher rate taxpayer. Your overseas income will therefore be taxable at 40%. The appendix shows the amount of UK income tax you will pay on your overseas income both with and without a claim for the remittance basis. It shows quite clearly that the level of your overseas income is such that a claim for the remittance basis is not beneficial as it will increase your UK income tax liability by £6,811.

The claim for remittance basis will need to be reconsidered every year.

Please let me know if I can be of further assistance.

Yours sincerely

Tax Adviser

Appendix

UK income tax payable under remittance basis

	£
£4,720 × 100/85 = £5,553 × 40% =	2,221
Loss of personal allowance £6,475 x 40% =	2,590
Charge for using remittance basis	30,000
	34,811

UK income tax payable under the arising basis

	£
£59,500 × 100/85 = £70,000 × 40% =	28,000

Tutorial note

The P6 examiner would not expect you to undertake a full income tax computation in order to answer this question. The remittance basis election only affects the amount of tax payable on the overseas income and, as the taxpayer will clearly be higher rate under both options, your calculations should focus only on those areas of difference between the two options.

28 Ellen Smith

(a) **Status of Ellen Smith**

An individual is normally treated as resident in the UK if they are present in the UK for 183 days or more. However, when an individual works abroad under a full-time contract which spans a complete tax year, they are treated as not resident and not ordinarily resident in the UK from the date of departure to the date of return.

As Ellen is leaving the UK to work full-time abroad under a contract of employment for 20 months and the period includes the complete tax year (2010/11), she will be treated as not resident and not ordinarily resident in the UK from the date of departure (1 November 2009) to the date of return (30 June 2011).

However, Ellen will remain resident in the UK if her return visits to the UK are 91 days or more on average per tax year.

(b) **Capital gains tax assessments**

Despite being classed as not resident and not ordinarily resident in the UK, Ellen will not be exempt from CGT on her disposals of capital assets whilst abroad.

This is because she is only temporarily absent and will return to the UK within five complete tax years.

As a result she will be assessed as follows:

- Year of departure (2009/10) – liable on any disposals in the normal way.
  – She will therefore be liable to CGT on the disposal of the PQ plc shares on 20 February 2010.
- Year abroad (2010/11) – Not liable on any disposals.
- Year of return (2011/12) – Liable on all disposals whilst abroad and any disposals in the tax year since the date of return (known as the re-entry charge).

(c) **Capital gains tax liability – 2009/10**

	£
Chargeable gain	
PQ plc shares (W)	17,000
Less: Annual exemption	(10,100)
Taxable gain	6,900
CGT at 18%	1,242

Payable 31 January 2011.

Working:

Shares in PQ plc	£
Sale proceeds	60,000
Cost	(43,000)
Gain	17,000

Ellen should have delayed the disposal until 6 April 2010. The disposal would then have fallen into the 2010/11 tax year. As Ellen was not resident and not ordinarily resident throughout that year, the gain would not have been charged until 2011/12, the year of her return. This would have deferred the resulting liability until 31 January 2013.

As the disposal relates to shares in a quoted company, it should have been possible for Ellen to phase her disposal over two tax years. A gain of £10,100 could have been generated in 2009/10 without incurring any liability. The remaining shares could then have been disposed of on 6 April 2010 allowing the balance of the gain to be covered by the 2010/11 annual exemption.

29 Martin and Ginny Hill

(a) Martin – Income tax computation – 2009/10

	Total income	Other income	Savings	Dividends
	£	£	£	£
Employment income	25,800	25,800		
Bank interest (× $^{100}/_{80}$)	400		400	
Rental income	8,250	8,250		
Dividends (× $^{100}/_{90}$)	20,750			20,750
Total income	55,200	34,050	400	20,750
Less: PA	(6,475)	(6,475)		
Taxable income	48,725	27,575	400	20,750

Income tax		£		£
Basic rate band:	Other income	27,575	at 20%	5,515
	Savings	400	at 20%	80
	Dividends	9,425	at 10%	942
		37,400		
Higher rate band:	Dividends	11,325	at 32½%	3,681
Total taxable income		48,725		
Income tax liability				10,218
Less: Tax credits				
Dividends (£20,750 × 10%)				(2,075)
Bank interest (£400 × 20%)				(80)
PAYE				(4,310)
Income tax payable				3,753

Ginny – Income tax computation – 2009/10

	Total income	Other income	Savings income
	£	£	£
Employment income	28,500	28,500	
Bank interest (× $^{100}/_{80}$)	300		300
Total income	28,800	28,500	300
PA	(6,475)	(6,475)	
Taxable income	22,325	22,025	300

Income tax		£		£
Basic rate band:	Other income	22,025	at 20%	4,405
	Savings income	300	at 20%	60
Total taxable income		22,325		
Income tax liability				4,465
Less: Tax credits				
Savings (£300 × 20%)				(60)
PAYE				(4,405)
Income tax payable				Nil

(b) Inter-spouse transfers – capital taxes

Inheritance tax

- Inter-spouse transfers are exempt from IHT.

Capital gains tax

- Inter-spouse transfers are not exempt from CGT, however they are treated as disposals which give rise to neither a capital gain nor loss.
- The consideration for the disposal is fixed such that no gain arises (i.e. at cost plus any enhancement expenditure).
- The recipient spouse acquires the asset at a base cost equal to the deemed consideration at the time of the inter-spouse transfer.
- When the recipient spouse disposes of the asset in the future, a gain arises.

(c) Tax planning advice

Income tax planning

As Martin is a higher rate tax payer and Ginny has part of her basic rate band which is not utilised, the couple should transfer the ownership of income-bearing capital assets from Martin to Ginny.

Martin could transfer some of his shares, an interest in the cottage and/or some of his bank account to Ginny.

The simplest assets to transfer would be some of the shares. Their transfer would also attract the biggest tax saving.

As Ginny is a basic rate tax payer and dividends attract a deemed tax credit of 10%, sufficient shares which give rise to £15,075 (W) dividends (gross) should be transferred.

The effects would be:

- Ginny's tax payable would remain at £Nil as her tax credits will still exactly match her tax liability.

- Martin will save tax of £3,392 [£15,075 × (32½% – 10%)]
- The transfer of shares will be exempt from IHT and will not give rise to a CGT liability.

Working: Ginny – basic rate band not utilised

	£
Basic rate band	37,400
Taxable income	(22,325)
Unutilised basic rate band	15,075

Inheritance tax planning

The couple's capital assets are currently held in the following proportion:

	£
Martin	921,800
Ginny	44,500
	966,300

Although Ginny is not currently using the whole of her nil rate band, if she were to die first the whole of her unused nil rate band could be transferred to Martin. It is therefore unnecessary for the couple to equalise their estates.

Capital gains tax planning

Ginny's capital assets currently consist of antiques and chattels. The likelihood is that any disposals will be covered by the chattels exemption.

The transfer of some of the shares, as recommended above, will allow the couple to make use of both of their annual exemptions when making future disposals.

The couple could also consider putting the house and/or the cottage in their joint names as these may give rise to a substantial capital gain on their eventual disposal. However, any gain on the house is likely to be covered by principal private residence relief. In addition, transferring the cottage into joint names would result in part of the rental income being assessable on Ginny; this would result in higher rate income tax liability if the advice concerning the shares is also followed.

30 Francis Slater

The main advantages of lifetime giving for IHT purposes

1. Lifetime gifts ensure that the individual uses his annual exemption each year and other exemptions, such as the small gifts exemption and wedding gift exemption.

2. Lifetime gifts reduce the individual's chargeable estate at death.
3. Most lifetime gifts are PETs. No IHT is payable at the time of the gift and the gift is completely exempt if the individual lives for seven years.
4. Even if the individual dies within seven years of the gift, IHT is usually saved by making lifetime gifts as:
   - the value of the asset for calculating any IHT due on death is fixed/frozen at the time the gift is made
   - if the individual lives for at least three years after the gift, taper relief is available.

The main factors to consider in deciding which assets to gift

1. Whether the asset is a chargeable asset for CGT purposes:
   - Gifts of motor cars and cash are exempt from CGT and therefore are assets recommended to be gifted during an individual's lifetime.
   - Gifts of chargeable assets may give rise to a chargeable gain and therefore are not recommended to be gifted during the individual's lifetime as gifts on death have no CGT consequences.
   - However, a gain may arise but not be taxable if it is covered by the CGT annual exemption or can be deferred with a gift relief claim.
2. Whether the asset is appreciating or declining in value:
   - If an asset is appreciating in value it is better to gift during the individual's lifetime as the taxable value is frozen at the time of the gift.
3. Whether the donor can afford to make the gift:
   - IHT savings may be achieved, however the individual will need to maintain his standard of living and make provisions for his old age.
4. The availability of BPR and APR:
   - If an asset is eligible for 100% BPR or APR there is no need to gift the asset during the individual's lifetime as it will have £Nil taxable value whether gifted during lifetime or on death.
   - If business property or agricultural property is gifted during the individual's lifetime, BPR/APR is denied on the event of the donor's death if the donee does not still own the asset (or a replacement asset). The intentions of the donee are therefore an important factor.

31 Incorporation

(a) Incorporation relief is an automatic relief which applies where the following conditions are satisfied:

- The transfer must be of a business as a going concern.
- All the assets in the business must be transferred. (The only exception is that the owner is allowed to retain the cash in the unincorporated business.)
- The consideration received from the company must be wholly or partly in the form of shares.

(b) Gains arise on the factory and the goodwill as they are chargeable assets, but not the trading stock as it is not a chargeable asset.

	Factory	Goodwill
	£	£
Disposal consideration = Market value	560,000	100,000
Cost	(230,000)	(Nil)
Gain	330,000	100,000

Total gains on incorporation: £330,000 + £100,000 = £430,000

Consideration received	**£**
Cash received	50,000
Market value of 15,000 £1 ordinary shares received	645,000
Market value of the business	695,000

Capital gains tax payable	**£**
Total gains	430,000
Less: Incorporation relief (£430,000 x £645,000/£695,000)	(399,065)
Chargeable gain	30,935
Annual exemption	(10,100)
Taxable gain	20,835
CGT at 18%	3,750

Base cost of the 15,000 £1 ordinary shares received in BAC Ltd:	**£**
Market value of the shares issued on incorporation	645,000
Minus: Gains deferred	(399,065)
Base cost of shares	245,935

(c) By realising a gain of exactly £10,100, Gavin would have avoided any capital gains tax in 2009/10. This gain could have been achieved by receiving cash consideration of only £16,324 (£10,100/£430,000 x £695,000). The value attributable to the shares would then have been £678,676 (£695,000 - £16,324).

32 Richard and Fiona

(a) The two tax incentives that would provide tax relief for investing in new and/or developing companies are the Enterprise Investment Scheme (EIS) and Venture Capital Trusts (VCT).

The EIS provides tax reliefs for direct investment in unquoted trading companies. The reliefs and the conditions that must be satisfied are as follows:

- The minimum investment is £500. There is a maximum investment of £500,000 per year, the whole or part of which can be treated as having been made in the previous year provided the limit for that year has not been exceeded. (Investment in excess of the maximum £500,000 is possible, but does not qualify for relief.)
- A credit of 20% of the amount of capital invested is available to set against the individual's income tax liability. (If the credit exceeds the individual's income tax liability, the excess is not repayable.)
- Chargeable gains on other assets can be deferred if the investment in EIS shares is made in the period one year before to three years after the disposal. The deferred gains will crystallise when the EIS shares are sold.
- Gains arising on the EIS shares themselves are exempt from CGT. Relief is available for any losses suffered, although the cost of the shares is reduced by the income tax relief obtained.
- Richard must not be an employee or director of the company at the time of the investment, nor must he hold more than 30% of the company's ordinary share capital.
- The subscription must be for new ordinary shares and must be paid in cash.
- The shares must be held for a minimum of three years, otherwise the income tax relief will be clawed back.
- The company must be unquoted and must carry on a qualifying trade in the UK. The company can become listed, provided there were no arrangements for it to do so at the time of the investment.
- The company must use the whole of the funds raised in its qualifying trade within two years following the share issue.

VCTs provide tax reliefs for indirect investment in unquoted trading companies. The reliefs and the conditions that must be satisfied are as follows:

- There is a maximum investment of up to £200,000 per year.
- A credit of 30% of the amount of capital invested is available to set against the individual's income tax liability.
- Dividends received from a VCT are exempt from income tax.
- Gains arising on the disposal of VCT shares are exempt from CGT; any losses are not allowable.
- The shares must be held for a minimum of five years, otherwise the income tax relief will be clawed back.

(b) Fiona should be advised to choose deposit based investments as these are low risk. She should consider the following:

- Fiona could invest up to £3,600 per year in a cash ISA. The interest will be tax free.

- National Savings Certificates offer a fixed return (possibly index linked) usually over a five year period. The return is tax free. The maximum investment is usually £15,000.
- Bank and building society deposit accounts are also viewed as low risk. It is rare for banks and building societies to go out of business and, if they do, an investor's compensation scheme is available. Accounts may offer fixed or variable rates of interest. They may be instant access or require a period of notice. The interest is paid net of tax at the rate of 20%; this will satisfy any basic rate income tax liability.

(c) A person who carries on investment business without being authorised to do so commits a criminal offence. The penalty is a maximum two years in prison and/or an unlimited fine.

There are also civil penalties:

- Any agreement entered into by an unauthorised person is unenforceable by that person.
- The customer may take civil action in the courts to recover any money paid and may seek compensation for any losses suffered.

33 Change of accounting date

(a)

IJ plc: Corporation tax computations	12 months ending 31 March 2009	3 months ending 30 June 2009
	£	£
Adjusted profit before capital allowances		
(£400,000 × 12/15 : £400,000 × 3/15)	320,000	80,000
Capital allowances	(67,640)	(14,910)
Trading income	252,360	65,090
Interest income		
(£150,000 × 6% : £150,000 × 6% × 3/12)	9,000	2,250
UK property income		
(£18,300 × 12/15 : £18,300 × 3/15)	14,640	3,660
Net chargeable gains		
(Second CAP: £62,500 – £22,600)	15,100	39,900
	291,100	110,900
Gift Aid donation	(4,500)	Nil
PCTCT	286,600	110,900

To determine the rate of corporation tax to apply	12 months ended 31 March 2009	3 months ended 30 June 2009
	£	£
PCTCT	286,600	110,900
FII (£4,950 × 100/90)	Nil	5,500
Profits	286,600	116,400
Small companies rate		
Upper limit (full limit : full limit × 3/12)	1,500,000	375,000
Lower limit (full limit : full limit × 3/12)	300,000	75,000

Decision : First CAP – Tax rate = 21%

Second CAP – Tax rate = 28% less marginal relief

Notes

(1) Bank deposit interest actually received is not relevant. Interest income is assessed on an accruals basis.

(2) Debenture interest payable is an allowable deduction from trading profits and will have already been deducted in the adjusted profits figure given in the question.

	12 months ended 31 March 2009	3 months ended 30 June 2009
Corporation tax liabilities	£	£
£286,600 × 21%	60,186	
£110,900 × 28%		31,052
Minus Marginal relief		
(375,000 – 116,400) ×(£110,900/£116,400) × 7/400		(4,312)
Corporation tax liability	60,186	26,740
Due dates for payment	1 Jan 2010	1 April 2010

Working: UK property income assessment for the 15-month accounting period	£
Rents accrued: (£3,000 × 15 months)	45,000
Minus: Allowable expenses	
Estate agent fees (£300 × 15 months)	(4,500)
Insurance (£100 × 15 months)	(1,500)
Repairs	(12,000)
Accountants' fees	(4,200)
	22,800
Minus: Wear and tear allowance - 10% × (£45,000 minus Nil)	(4,500)
	18,300

Notes

(1) The conservatory extension is capital expenditure and not an allowable deduction from rental income.

(2) In a long period of account, UK property income is time-apportioned.

(b) Producing two sets of accounts would result in £40,000 of the adjusted trading profit moving from the first accounting period to the second. Most of the other items, such as the interest income, chargeable gains, franked investment income and gift aid payments would remain unchanged.

The tax payable on the £40,000 of trading profits would be deferred for three months, thus easing cash flow. However, this must be weighed against the fact that the profits for the first period are currently chargeable at the small companies rate of 21%, whereas those for the second period are already in the marginal band. Producing two sets of accounts would therefore increase the corporation tax liability by £3,500 [£40,000 × (£29.75% - 21%)].

On balance, therefore, it is probably not beneficial for IJ plc to produce two sets of accounts.

Tutorial note

It is not necessary for you to produce a full corporation tax computation for the alternative course of action. Instead, you should simply focus your attention on those aspects that will be affected by the change.

34 HI Ltd: loss relief

(a) **Options for relieving the trading loss**

Carry forward of loss: s393(1)

HI Ltd can carry forward its loss against its future trading profits under s393(1).

This option would utilise only £85,940 of the loss in y/e 31 March 2010 and would save tax of £18,047 (£85,940 × 21%).

£270,520 of the loss would be carried forward against profits of the same trade in future periods.

HI Ltd would need to wait to benefit from the loss and it is uncertain as to what rate of tax saving would be achieved.

s393A claim against total profits

HI Ltd can claim relief against its total profits before gift aid payments of the current accounting period. This will utilise £10,680 of the loss and achieve a tax saving of only £1,997 [(£10,680 - £1,170) × 21%)]. In addition, the Gift Aid payment of the loss making period will not be relieved.

Once a current period claim has been made, HI Ltd can claim relief against its total profits before gift aid payments of the previous 12 months. Relief will therefore be given in the year ended 31 March 2008. Relief for this year will be given wholly or partly at the small companies rate of tax and utilise a further £176,360 of the loss.

Extended carry back

As the loss was incurred in an accounting period ending between 24 November 2008 and 23 November 2010 it can be carried back against total profits generated in the previous 36 months on a last-in-first-out (LIFO) basis. However, the maximum carry back under this provision is £50,000.

This would enable £50,000 of the loss to be set off against the profits for the year ended 31 March 2007. Relief would be obtained at the marginal rate of tax.

A claim under s393A followed by the extended carry back is therefore the most tax efficient use of the loss.

(b) PCTCT assuming most tax efficient use of losses

HI Ltd: Corporation tax computations with optimum loss relief

	Y/e 31 Mar 2007	**Y/e 31 Mar 2008**	**Y/e 31 Mar 2009**	**Y/e 31 Mar 2010**
	£	£	£	£
Trading income	850,380	146,800	Nil	85,940
Minus: s393(1) trading losses b/f	(Nil)	(Nil)	(Nil)	(85,940)
	850,380	146,800	Nil	Nil
Interest income	10,680	3,560	10,680	10,680
Net chargeable gains	48,500	26,000	Nil	Nil
	909,560	176,360	10,680	10,680
Minus: s393A claim				
– current loss-making CAP			(10,680)	
– carry back 12 months				
y/e 31 March 2008		(176,360)		
- extended carry back	(50,000)			
y/e 31 March 2007				
	859,560	Nil	Nil	10,680
Minus: Gift Aid	(1,170)	Lost	Lost	(1,170)
PCTCT	858,390	Nil	Nil	9,510

Record of trading losses	**£**
Loss in CAP	356,460
Set off under s393A	
– in loss-making CAP	(10,680)
–year ended 31 March 2008	(176,360)
Extended carry back – year ended 31 March 2007 (maximum)	(50,000)
Trading loss c/f under s393(1)	119,420
Set off under s393(1) in year ended 31 March 2010	(85,940)
Trading loss c/f under s393(1)	(33,480)

There is an allowable capital loss of £14,000 available to carry forward.

35 DTR

JK plc: Corporation tax computation
Year ended 31 March 2010

			Overseas income	
	Total profits	**UK profits**	**Rental income**	**Interest income**
	£	£	£	£
Trading income	10,000	10,000		
Foreign rental income (£19,000 x 100/95)	20,000		20,000	
Foreign interest income (£25,410 x 100/70)	36,300			36,300
	66,300	10,000	20,000	36,300
Minus: Gift Aid	(9,000)	(9,000)		
PCTCT	57,300	1,000	20,000	36,300

Corporation tax liability = (£57,300 × 21%) = £12,033
- which is then allocated to each source of income at 21%

Corporation tax liability	12,033	210	4,200	7,623
DTR (W)	(8,623)	n/a	(1,000)	(7,623)
Corporation tax payable	3,410	210	3,200	Nil

Working

DTR	Rental income	Interest income
Lower of:	£	£
(1) Overseas tax suffered:		
- Rental income (£20,000 x 5%)	1,000	
- Interest income (£36,300 x 30%)		10,890
(2) UK tax on that source of foreign income	4,200	7,623
	= 1,000	= 7,623

36 Overseas branch or non-UK resident company

	Operating as a branch	Operating as a non-UK resident company
Assessment of trading income	All branch profits are assessed on LM Ltd as trading income. DTR may be available.	Profits of the overseas company are assessed on that company according to the tax rules in that country. Not assessed to UK corporation tax.
Remittances to the UK	The amount of remittances to the UK is irrelevant. All branch profits are assessed on LM Ltd regardless of the amount remitted to the UK.	Remittances to the UK will probably be in the form of dividends. The dividends will be classed as group income and will be exempt from UK corporation tax.
Availability of capital allowances	Capital allowances are available according to UK rules on overseas branch purchases.	Capital allowances are not available on purchases by the foreign company.
Group tax implications	There are no group tax implications in setting up an overseas branch.	The overseas company will be an associate of LM Ltd, and this may affect the rate of tax payable by LM Ltd.

Note

No reference is made to loss relief because the question states that the overseas company is likely to be very profitable.

The advantages of group loss relief and capital gains groups are only available to UK group members. They do not apply to the overseas company.

37 UK group

(a) Statutory thresholds for corporation tax purposes

Number of associated companies = 6

C Ltd is associated with D Ltd, E Ltd, F Ltd and G Ltd because it has a more-than-50% interest in each company.

C Ltd group and B Ltd are associated because they are under the common control of Mr A.

Thresholds for corporation tax purposes

			£
Small companies rate	Upper limit	1,500,000/6	250,000
	Lower limit	300,000/6	50,000

(b) Identification of loss relief groups

Group 1: C Ltd, D Ltd, E Ltd, G Ltd

C Ltd has at least a 75% interest in D Ltd and E Ltd. G Ltd is included because the effective interest of C Ltd in G Ltd is also at least 75% (i.e. 90% × 90% = 81%).

F Ltd is not included in Group 1 because C Ltd does not have an effective interest of at least 75% in F Ltd. (The effective interest is 80% × 90% = 72%.)

Group 2: D Ltd and F Ltd

A separate loss relief group exists. D Ltd can be a member of more than one loss group.

(c) Calculation of tax savings

Tutorial note

Start by producing a table showing the PCTCT of each company prior to claiming relief for the losses. This will enable you to identify the rate of tax applicable to each company. Your table can then be used as the start of your answer for part (d) and can be completed by showing the use of the losses.

The loss of F Ltd should be dealt with first as there are fewer options for relief available.

Loss of F Ltd

F Ltd should not claim relief against its current year profits as this would utilise £5,000 of the loss, achieve a tax saving of only £210 (£1,000 × 21%) and waste £4,000 of the Gift Aid donation.

F Ltd should therefore surrender all its loss under the group relief provisions. F Ltd is in Group 2 and so can only surrender its loss to D Ltd. This will reduce the PCTCT of D Ltd to £78,000 (£118,000 - £40,000) and save tax of £11,900 (= £40,000 × 29¾%). D Ltd still has profits in the marginal band.

Loss of G Ltd

G Ltd should not claim relief against its current year profits as this would utilise £6,000 of the loss, achieve a tax saving of only £210 (£1,000 × 21%) and waste £5,000 of the Gift Aid donation.

G Ltd is in Group 1 and so can surrender its loss to C Ltd, D Ltd or E Ltd.

Both C Ltd and D Ltd are liable to corporation tax at 29¾% on the profits above £50,000 and 21% on the profits that fall between £0 and £50,000.

The losses of G Ltd should therefore be given to both C Ltd and D Ltd, to bring their profits down to the small companies upper limit of £50,000. The balance of the loss can then be surrendered to C Ltd, D Ltd or E Ltd, and this will save tax at 21%.

Group relief claim for loss of G Ltd

	Loss		**Tax saving**
	£		£
To C Ltd: (£74,000 - £50,000)	24,000	× 29¾%	7,140
To D Ltd: (£78,000 - £50,000) (after loss of F Ltd has been surrendered)	28,000	× 29¾%	8,330
To C Ltd, D Ltd or E Ltd	8,000	× 21%	1,680
	60,000		17,150

Total tax saving achieved

	£
F Ltd's loss	11,900
G Ltd's loss	17,150
	29,050

(d) **Corporation tax computations: with loss relief**

It is assumed that as G Ltd is indifferent as to which company should receive the balance of the loss based on the corporation tax saving, the loss will be surrendered to E Ltd.

	B Ltd	C Ltd	D Ltd	E Ltd	F Ltd	G Ltd
	£	£	£	£	£	£
Trading profit	260,000	80,000	120,000	24,000	Nil	Nil
Rental income	20,000		8,000	4,000	5,000	6,000
	280,000	80,000	128,000	28,000	5,000	6,000
Gift Aid donations	(10,000)	(6,000)	(10,000)	(2,000)	(4,000)	(5,000)
PCTCT before loss relief	270,000	74,000	118,000	26,000	1,000	1,000
Group relief:						
From F Ltd			(40,000)			
From G Ltd		(24,000)	(28,000)	(8,000)		
PCTCT	270,000	50,000	50,000	18,000	1,000	1,000

38 PQ group

All companies in PQ Ltd group are members of the same gains group as PQ Ltd has at least a 75% interest in all companies.

Year ended 31 March 2006: Inter-group transfer from C Ltd to A Ltd	
	£
Deemed sale proceeds	327,860
(Ignore actual proceeds received: Use cost plus IA)	
Cost (July 1996)	(260,000)
IA on cost from July 1996 to July 2005	(67,860)
(192.2 – 152.4)/152.4 = 0.261 × £260,000	
Chargeable gain	Nil

Year ended 31 March 2010: Disposal by A Ltd outside the group	
	£
Sale proceeds	500,000
Deemed cost	(327,860)
Unindexed gain	172,140
IA on deemed cost from July 2005 to May 2009	(35,081)
(212.8 – 192.2)/192.2 = 0.107 × £327,860	
Chargeable gain arising in A Ltd before considering rollover relief	137,059

As the office building is a QBA and PQ Ltd has purchased a QBA within a four-year time period (14 May 2008 to 14 May 2012). A group rollover relief claim can be made.

PQ Ltd has not reinvested all the sale proceeds. Therefore a chargeable gain still arises in respect of the disposal of the office building, as follows:

Chargeable gain =	**£**
Lower of:	
(1) All of the gain	£137,059
(2) Sale proceeds not reinvested in QBAs (£500,000 - £480,000)	£20,000
Rollover relief claim = £137,059 - £20,000)	£117,059

The gain will be chargeable on A Ltd at 28% unless an election is made to transfer the gain to another group company.

It would be advantageous to make an election to transfer the gain to B Ltd, because tax will be charged on the chargeable gain of £20,000 at a rate of only 21%.

The election must be made within two years of the end of the accounting period in which the disposal takes place, i.e. by 31 March 2012.

39 Blackbird Ltd

(a) (i) If treated as a capital distribution, Noreen's CGT liability for 2009/10 will be as follows:

	£
Sale proceeds	550,000
Cost	(50,000)
	500,000
Entrepreneurs' relief (£500,000 x 4/9)	(222,222)
	277,778
Annual exemption	(10,100)
Taxable gain	267,678
CGT at 18% (due 31 January 2011)	48,182

If treated as a distribution, Noreen will be assessed on a grossed up distribution of £555,556 ((£550,000 - £50,000) × 100/90). This will result in additional income tax liability of:

Dividend £555,556 × 32.5% =	£180,556
Less tax credit £555,556 × 10% =	£55,556
Additional liability	£125,000

The capital treatment is beneficial as it results in a tax saving of £76,818 (£125,000 - £48,182).

(ii) The payment will be treated as a capital distribution where the purchase is for:

- the benefit of the company's trade, or
- the purpose of paying inheritance tax.

A purchase is regarded as being for the benefit of the company's trade where:

- the owner of the company is retiring to make way for new management
- an outside shareholder wishes to withdraw his investment
- a shareholder dies and the personal representatives or beneficiaries do not want to keep the shares
- there is disagreement over the management of the company and the dissident shareholder is bought out because he is having an adverse effect on the running of the company.

The following conditions must also be met in order for the capital treatment to apply:

- The company is an unquoted trading company.
- The shareholder is UK resident and ordinarily resident (i.e. within the scope of UK CGT).
- The shares have been owned for at least five years (or three years if inherited).
- The shareholder must not be connected with the company after the buy back. An individual is connected with a company if (together with his associates) he holds more than 30% of the share capital.
- The percentage shareholding held by the vendor after the buy back is less than 75% of their percentage shareholding prior to the buy back.
- The transaction is not part of a scheme to avoid tax.

All of these conditions would appear to be met.

(b) Morgan is a shareholder in Blackbird Ltd (a close company). As such, he is a participator. As he is neither a director nor an employee of the company, the provision of a company car is treated as a distribution. The amount of the distribution for 2009/10 is £5,250 (£21,875 × 24%), based on the car benefit that would have been charged had he been an employee. The gross income is £5,833 (£5,250 × 100/90). It will be taxed at the rate at the rate of 32.5%, with a related tax credit of £583. The tax payable will therefore be £5,833 × (32.5% - 10%) = £1,312.

The loan to Morgan is treated as his income when it is written off. He will therefore be assessed on gross income of £33,333 (£30,000 × 100/90) in 2009/10. It will be taxed at the rate at the rate of 32.5%, with a related tax credit of £3,333 (10% of £33,333). The tax payable will therefore be £33,333 × (32.5% - 10%) = £7,500.

There will be a beneficial loan charge of (£50,000 + £20,000)/2 = £35,000 × 4.75% × 9/12 = £1,247 based on the average method. However, it is likely that HMRC will elect for the statutory method to apply, in which case the charge will be £50,000 × 4.75% × 9/12 = £1,781.

Blackbird Ltd will also have to pay a tax charge of 25% of the amount still outstanding. £5,000 (£20,000 × 25%) will therefore be payable on 1 January 2011 unless the loan has been repaid or written off before that date.

40 Registration

(a)

12 months ended	Workings	Taxable supplies
		£
31 August 2009	(12 × £3,500)	42,000
30 September 2009	£42,000 - £3,500 + £7,300	45,800
31 October 2009	£45,800 - £3,500 + £9,600	51,900
30 November 2009	£51,900 - £3,500 + £10,900	59,300
31 December 2009	£59,300 - £3,500 + £12,500	68,300

Deborah exceeded the £68,000 threshold on 31 December 2009.

She must notify HMRC by 30 January 2010 (i.e. 30 days after the end of the month in which the threshold is exceeded).

She must start to charge VAT from 1 February 2010 (i.e. the first day of the month following the end of the month in which the threshold is exceeded).

(b) Pre-registration input VAT is recoverable if the following conditions are satisfied:

- If goods, they must have been acquired in the 4 years prior to registration (but not prior to 1 April 2006) and still be owned by the business on the date of registration
- If services, they must have been supplied to the person no more than 6 months before the date of registration.

41 WX Ltd

(a)

VAT return for the quarter ended: 31 March 2010	
	£
Output VAT	
Standard rated sales (£201,230 × 7/47)	29,970
Input VAT	
Purchases of goods (£41,525 × 7/47)	(6,185)
Distribution expenses (£10,000 × 7/47)	(1,489)
Other expenses (£16,825 × 7/47)	(2,506)
Purchase of plant machinery (£35,000 × 7/47)	(5,213)

Bad debt relief (not six months old)	(Nil)
Amount payable to HMRC	14,577

Due date: 30 April 2010

Notes

(1) Employment costs are outside of the scope of VAT.

(2) Input VAT on entertaining and the motor car is blocked.

(b) WX Ltd will be permitted to join the annual accounting scheme if its taxable supplies in the next 12 months are not expected to exceed £1,350,000. Based on the turnover for the present quarter, this seems likely.

The annual accounting scheme allows small businesses to submit only one annual VAT return each year and spread the payments of VAT more evenly throughout the year. This may help cash flow.

Nine equal monthly payments on account are made by direct debit. Each of these payments on account (POAs) is equal to 1/10th of the total estimated liability. They are paid on the last day of every month starting in the 4th month and finishing on the last day of the 12th month.

A balancing payment and the annual VAT return are submitted to HMRC within two months of the end of the year.

42 Stamp duty

(a) If the shares are transferred using a paper stock transfer form, stamp duty will be payable; if transferred electronically, stamp duty reserve tax will be payable. In both cases the charge is based on the amount of consideration, not on the market value of the shares. Henrietta will therefore have to pay £1,500 × 0.5% = £7.50. This will be rounded up to the nearest £5, giving a charge of £10.

(b) Treasury Stock is exempt from stamp duty/SDRT.

(c) Hamish will have to pay stamp duty land tax of £300,000 × 3% = £9,000. The reason for the purchase of the property is irrelevant.

(d) A transfer between members of a 75% group is exempt from stamp duty land tax, provided there are no arrangements in force for the transferee company to leave the group. If the transferee company does leave the group within three years, SDLT of £2,000,000 × 4% = £80,000 will become payable.

43 Dividend or bonus

Emily is a higher rate taxpayer.

If she receives a bonus, she will pay income tax at 40% and Class 1 NICs of 1% on any additional employment income. She will therefore receive only 59% (100% - 41%) of any additional employment income paid.

YZ Ltd is liable to pay the gross employment income and Class 1 secondary NICs, but both are allowable deductions against profits chargeable to corporation tax at 28%.

If she receives dividends, she will be liable for 32.5% income tax with a 10% tax credit. YZ Ltd receives no tax relief for the payment of dividends.

Bonus	£	**Dividend**	£
Cash to be received by Emily			
Gross income required		Gross income required	
(£20,000 × 100/59)	33,898	(£20,000 × 100/67.5)	29,630
Income tax at 40%	(13,559)	Income tax at 32.5%	(9,630)
Employees Class 1 NICs at 1%	(339)		
Cash income required	20,000	Cash income required	20,000
Cost to YZ Ltd			
Gross employment income	33,898	Cash dividend payable	
Employer's NICs at 12.8%	4,339	(£29,630 × 90/100)	26,667
	38,237	Cost to YZ Ltd	26,667
Corporation tax saving at 28%	(10,706)		
Cost to YZ Ltd	27,531		

It costs YZ Ltd £864 less (£27,531- £26,667) to pay Emily £20,000 net cash in the form of a dividend rather than a bonus.

44 Sole trader or company

(a) **If Fiona operates as a sole trader**

Income tax computation – 2009/10		**Total tax**
	£	£
Trading income	28,500	
Minus: Personal allowance	(6,475)	
Taxable income	22,025	

Income tax computation – 2009/10		**Total tax**
	£	£
Income tax liability at 20%		4,405
Class 2 NICs (£2.40 x 52)		125
Class 4 NICs	£	
Trading income	28,500	
Minus: Personal allowance	(5,715)	
Chargeable at 8%	22,785	1,823
		6,353

(b) **If Fiona operates as a company**

Income tax computation – 2009/10		**Total tax**
	£	£
Employment income	22,000	
Minus: Personal allowance	(6,475)	
Taxable income	15,525	
Income tax liability at 20%		3,105
Class 1 primary NICs		
(£22,000 - £5,715) × 11%		1,791
Class 1 secondary NICs		
(£22,000 - £5,715) × 12.8%		2,084
Corporation tax computation		
Trading income	28,500	
Minus Director's salary	(22,000)	
Employer's NICs	(2,084)	
PCTCT	4,416	
Corporation tax × 21%		927
Total tax liabilities		7,907

Based on the above calculations, Fiona should be advised to run her business as a sole trader as the total tax liabilities are £1,554 less (£7,907 - £6,353).

The difference in tax liabilities between the two options is due to the national insurance contributions that would be payable if profits were extracted in the form of salary. If Fiona chose to withdraw some of her profits in the form of dividends instead, the conclusion would be different.

45 Edward Read

(1) **Tax payable under self assessment for 2009/10**

2008/09	£
Income tax liability	19,720
Class 4 NICs	820
Total tax liability (ignore CGT)	20,540
Less Tax deducted at source	(4,060)
Tax paid by direct assessment	16,480

Payments on account (POAs) are required in 2009/10 as £16,480 is

(1) More than £1,000, and

(2) More than (20% × £20,540) = £4,108.

2009/10	£
Income tax liability	23,200
Class 4 NICs	1,020
Total tax liability (ignore CGT)	24,220
Less Tax deducted at source	(4,640)
Tax paid by direct assessment	19,580

Due dates of payment

			£
POAs	31 January 2010	(½ × £16,480)	8,240
	31 July 2010	(½ × £16,480)	8,240
			16,480
Balancing payment	31 January 2011	(£19,580 – £16,480)	3,100
Income tax and Class 4 NICs			19,580
Capital gains tax	31 January 2011		3,210

In addition, on 31 January 2011, the first POA of £9,790 (½ × £19,580) for 2010/11 is due.

(2) **Interest on underpaid tax**

Interest is due on payments made late from the due date to the day before the date of payment as follows:

	£	**From**	**To**
1st POA	8,120	31 January 2010	19 February 2010
	120	31 January 2010	9 February 2011
2nd POA	8,120	31 July 2010	29 September 2010
	120	31 July 2010	9 February 2011
Balancing payment	3,100	31 January 2011	9 February 2011
	19,580		

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