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F6 UK Study Text
Taxation (Finance Act 2009)

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Paper F6 (UK)

Taxation FA2009

Welcome to Emile Woolf's study text for
Paper F6 (UK) *Taxation FA2009* 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

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Syllabus and study guide

Aim

To develop knowledge and skills relating to the tax system as applicable to individuals, single companies, and groups of companies.

Main capabilities

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

A Explain the operation and scope of the tax system

B Explain and compute the income tax liabilities of individuals

C Explain and compute the corporation tax liabilities of individual companies and groups of companies

D Explain and compute the chargeable gains arising on companies and individuals

E Explain and compute the effect of national insurance contributions on employees, employers and the self employed

F Explain and compute the effects of value added tax on incorporated and unincorporated businesses

G Identify and explain the obligations of tax payers and/or their agents and the implications of non-compliance

Rationale

The syllabus for Paper F6, *Taxation,* introduces candidates to the subject of taxation and provides the core knowledge of the underlying principles and major technical areas of taxation as they affect the activities of individuals and businesses.

Candidates are introduced to the rationale behind – and the functions of – the tax system. The syllabus then considers the separate taxes that an accountant would need to have a detailed knowledge of, such as income tax from self-employment, employment and investments, the corporation tax liability of individual companies and groups of companies, the national insurance contribution liabilities of both employed and self employed persons, the value added tax liability of businesses, and the chargeable gains arising on disposals of investments by both individuals and companies.

Having covered the core areas of the basic taxes, candidates should be able to compute tax liabilities, explain the basis of their calculations, apply tax planning techniques for individuals and companies and identify the compliance issues for each major tax through a variety of business and personal scenarios and situations.

Syllabus

A The UK tax system

1. The overall function and purpose of taxation in a modern economy
2. Different types of taxes
3. Principal sources of revenue law and practice
4. Tax avoidance and tax evasion

B. Income tax liabilities

1. The scope of income tax
2. Income from employment
3. Income from self-employment
4. Property and investment income
5. The comprehensive computation of taxable income and income tax liability
6. The use of exemptions and reliefs in deferring and minimising income tax liabilities

C Corporation tax liabilities

1. The scope of corporation tax
2. Profits chargeable to corporation tax
3. The comprehensive computation of corporation tax liability
4. The effect of a group corporate structure for corporation tax purposes
5. The use of exemptions and reliefs in deferring and minimising corporation tax liabilities

D Chargeable gains

1. The scope of the taxation of capital gains
2. The basic principles of computing gains and losses

3 Gains and losses on the disposal of movable and immovable property
4 Gains and losses on the disposal of shares and securities
5 The computation of the capital gains tax payable by individuals
6 The use of exemptions and reliefs in deferring and minimising tax liabilities arising on the disposal of capital assets

E National insurance contributions

1 The scope of national insurance
2 Class 1 and Class 1A contributions for employed persons
3 Class 2 and Class 4 contributions for self-employed persons

F Value added tax

1 The scope of value added tax (VAT)
2 The VAT registration requirements
3 The computation of VAT liabilities
4 The effect of special schemes

G The obligations of tax payers and/or their agents

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

Approach to examining the syllabus

The paper will be predominantly computational and will have five questions, all of which will be compulsory.

- Question one will focus on income tax and question two will focus on corporation tax. The two questions will be for a total of 55 marks with one of the questions being for 30 marks and the other for 25 of the marks.
- Question three will focus on chargeable gains (either personal or corporate) and will be for 20 marks.
- Questions four and five will be on any area of the syllabus and will be respectively for 15 marks and 10 marks.

There will always be at a minimum of 10 marks on value added tax. These marks will normally be included within question one or question two, although there might be a separate question on value added tax.

National insurance contributions will not be examined as a separate question, but may be examined in any question involving income tax or corporation tax.

Groups and overseas aspects will only be examined in question two, and will account for no more than one third of the marks available for that question.

Question one or question two might include a small element of chargeable gains.

Any of the five questions might include the consideration of issues relating to the minimisation or deferral of tax liabilities.

Study guide

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

A THE UK TAX SYSTEM

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

(a) Describe the purpose (economic, social etc) of taxation in a modern economy.

2 Different types of taxes

(a) Identify the different types of capital and revenue tax.

(b) Explain the difference between direct and indirect taxation.

3 Principal sources of revenue law and practice

(a) Describe the overall structure of the UK tax system.

(b) State the different sources of revenue law.

(c) Appreciate the interaction of the UK tax system with that of other tax jurisdictions.

4 Tax avoidance and tax evasion

(a) Explain the difference between tax avoidance and tax evasion.

(b) Explain the need for an ethical and professional approach.

Excluded topics

Anti-avoidance legislation.

B INCOME TAX LIABILITIES

1 The scope of income tax

(a) Explain how the residence of an individual is determined.

Excluded topics

The treatment of a person who comes to the UK to work or a person who leaves the UK to take up employment overseas.

Foreign income, non-residents and double taxation relief.

Income from trusts and settlements.

2 Income from employment

(a) Recognise the factors that determine whether an engagement is treated as employment or self-employment.

(b) Recognise the basis of assessment for employment income.

(c) Compute the income assessable.

(d) Recognise the allowable deductions, including travelling expenses.

(e) Discuss the use of the statutory approved mileage allowances.

(f) Explain the PAYE system.

(g) Identify P11D employees.

(h) Compute the amount of benefits assessable.

(i) Explain the purpose of a dispensation from HM Revenue & Customs.

(j) Explain how charitable giving can be made through a payroll deduction scheme.

Excluded topics

The calculation of a car benefit where emission figures are not available.

Share and share option incentive schemes for employees.

Payments on the termination of employment, and other lump sums received by employees.

3 Income from self-employment

(a) Recognise the basis of assessment for self-employment income.

(b) Describe and apply the badges of trade.

(c) Recognise the expenditure that is allowable in calculating the tax-adjusted trading profit.

(d) Recognise the relief that can be obtained for pre-trading expenditure.

(e) Compute the assessable profits on commencement and on cessation.

(f) Change of accounting date

- (i) Recognise the factors that will influence the choice of accounting date.
- (ii) State the conditions that must be met for a change of accounting date to be valid.
- (iii) Compute the assessable profits on a change of accounting date.

(g) Capital allowances

- (i) Define plant and machinery for capital allowances purposes.
- (ii) Compute writing down allowances, first year allowances and the annual investment allowance.
- (iii) Compute capital allowances for motor cars.
- (iv) Compute balancing allowances and balancing charges.

- (v) Recognise the treatment of short life assets.
- (vi) Explain the treatment of assets included in the special rate pool.
- (vii) Define an industrial building for industrial buildings allowance purposes.
- (viii) Compute industrial buildings allowance for new buildings.

(h) Relief for trading losses

- (i) Understand how trading losses can be carried forward.
- (ii) Explain how trading losses can be carried forward following the incorporation of a business.
- (iii) Understand how trading losses can be claimed against total income and chargeable gains.
- (iv) Understand how additional loss relief allows a trading loss to be set against trading profits of the previous 3 years.
- (v) Explain and compute the relief for trading losses in the early years of a trade.
- (vi) Explain and compute terminal loss relief.

(i) Partnerships and limited liability partnerships

- (i) Explain how a partnership is assessed to tax.
- (ii) Compute the assessable profits for each partner following a change in the profit sharing ratio.
- (iii) Compute the assessable profits for each partner following a change in the membership of the partnership.
- (iv) Describe the alternative loss relief claims that are available to partners.
- (v) Explain the loss relief restriction that applies to the partners of a limited liability partnership.

Excluded topics

The 100% first-year allowance for expenditure on renovating business premises in disadvantaged areas, flats above shops and water technologies.

Capital allowances for agricultural buildings, patents, scientific research and know how.

Enterprise zones.

Capital allowances involving the purchase of a new motor car prior to 6 April 2009 (1 April 2009 for companies) (although the treatment of motor cars already owned at this date is examinable).

Apportionment in order to determine the rate of writing-down allowance where a period of account spans 6 April 2008 (1 April 2008 for companies).

Apportionment in order to determine the amount of annual investment allowance where a period of account spans 6 April 2008 (1 April 2008 for companies).

Apportionment in order to determine the rate of industrial building writing down allowance where a limited company's chargeable period falls into two financial years.

The calculation of industrial buildings allowance on the purchase of a second-hand industrial building.

Additional loss relief in respect of a trading loss made in the tax year 2008-09.

Investment income of a partnership.

The allocation of notional profits and losses for a partnership.

Farmers averaging of profits.

The averaging of profits for authors and creative artists.

Loss relief for shares in unquoted trading companies.

4 Property and investment income

(a) Compute property business profits.

(b) Explain the treatment of furnished holiday lettings.

(c) Describe rent-a-room relief.

(d) Compute the amount assessable when a premium is received for the grant of a short lease.

(e) Understand how relief for a property business loss is given.

(f) Compute the tax payable on savings income.

(g) Compute the tax payable on dividend income.

(h) Explain the treatment of individual savings accounts (ISAs) and other tax exempt investments.

Excluded topics

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

5 The comprehensive computation of taxable income and income tax liability

(a) Prepare a basic income tax computation involving different types of income.

(b) Calculate the amount of personal allowance available to people aged 65 and above.

(c) Compute the amount of income tax payable.

(d) Explain the treatment of interest paid for a qualifying purpose.

(e) Explain the treatment of gift aid donations.

(f) Explain the treatment of property owned jointly by a married couple, or by a couple in a civil partnership.

Excluded topics

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

Tax credits.

Maintenance payments.

The income of minor children.

6 The use of exemptions and reliefs in deferring and minimising income tax liabilities

(a) Explain and compute the relief given for contributions to personal pension schemes, using the rules applicable from 5 April 2006.

(b) Describe the relief given for contributions to occupational pension schemes, using the rules applicable from 5 April 2006.

(c) Explain how a married couple or couple in a civil partnership can minimise their tax liabilities.

Excluded topics

The conditions that must be met in order for a pension scheme to obtain approval from HM Revenue & Customs.

The anti-forestalling provisions restricting tax relief where excessive pension contributions are made.

The enterprise investment scheme.

Venture capital trusts.

C CORPORATION TAX LIABILITIES

1 The scope of corporation tax

(a) Define the terms 'period of account', 'accounting period', and 'financial year'.

(b) Recognise when an accounting period starts and when an accounting period finishes.

(c) Explain how the residence of a company is determined.

Excluded topics

Investment companies.

Close companies.

Companies in receivership or liquidation.

Reorganisations.

The purchase by a company of its own shares.

Personal service companies.

2 Profits chargeable to corporation tax

(a) Recognise the expenditure that is allowable in calculating the tax-adjusted profit.

(b) Explain how relief can be obtained for pre-trading expenditure.

(c) Compute capital allowances (as for income tax).

(d) Compute property business profits.

(e) Explain the treatment of interest paid and received under the loan relationship rules.

(f) Explain the treatment of gift aid donations.

(g) Understand how trading losses can be carried forward.

(h) Understand how trading losses can be claimed against income of the current or previous accounting periods.

(i) Recognise the factors that will influence the choice of loss relief claim.

(j) Explain how relief for a property business loss is given.

(k) Compute profits chargeable to corporation tax.

Excluded topics

Research and development expenditure.

Non-trading deficits on loan relationships.

Relief for intangible assets.

3 The comprehensive computation of corporation tax liability

(a) Compute the corporation tax liability and apply marginal relief.

(b) Explain the implications of receiving franked investment income.

(c) Explain how exemptions and reliefs can defer or minimise corporation tax liabilities.

Excluded topics

The corporate venturing scheme.

4 The effect of a group corporate structure for corporation tax purposes

(a) Define an associated company and recognise the effect of being an associated company for corporation tax purposes.

(b) Define a 75% group, and recognise the reliefs that are available to members of such a group.

(c) Define a 75% capital gains group, and recognise the reliefs that are available to members of such a group.

(d) Compare the UK tax treatment of an overseas branch to an overseas subsidiary

(e) Calculate double taxation relief.

(f) Explain the basic principles of the transfer pricing rules.

Excluded topics

Relief for trading losses incurred by an overseas subsidiary.

Consortia.

Pre-entry gains and losses.

The anti-avoidance provisions where arrangements exist for a company to leave a group.

The tax charge that applies where a company leaves a group within six years of receiving an asset by way of a no gain/no loss transfer.

Controlled foreign companies.

Foreign companies trading in the UK.

Expense relief in respect of overseas tax.

Overseas dividends received prior to 1 July 2009.

Transfer pricing transactions not involving an overseas company.

5 The use of exemptions and reliefs in deferring and minimising corporation tax liabilities

(The use of such exemptions and reliefs is implicit within all of the above sections 1 to 4 or part C of the syllabus, concerning corporation tax)

D CHARGEABLE GAINS

1 The scope of the taxation of capital gains

(a) Describe the scope of capital gains tax.

(b) Explain how the residence and ordinary residence of an individual is determined.

(c) List those assets which are exempt.

Excluded topics

Assets situated overseas and double taxation relief.

Partnership capital gains.

2 The basic principles of computing gains and losses

(a) Compute capital gains for both individuals and companies.

(b) Calculate the indexation allowance available to companies.

(c) Explain the treatment of capital losses for both individuals and companies.

(d) Explain the treatment of transfers between a husband and wife or between a couple in a civil partnership.

(e) Compute the amount of allowable expenditure for a part disposal.

(f) Explain the treatment where an asset is damaged, lost or destroyed, and the implications of receiving insurance proceeds and reinvesting such proceeds.

Excluded topics

The capital gains tax rules that applied to 5 April 2008.

Small part disposals of land.

Losses in the year of death.

Relief for losses incurred on loans made to traders.

Negligible value claims.

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

(a) Identify when chattels and wasting assets are exempt.

(b) Compute the chargeable gain when a chattel is disposed of.

(c) Calculate the chargeable gain when a wasting asset is disposed of.

(d) Compute the exemption when a principal private residence is disposed of.

(e) Calculate the chargeable gain when a principal private residence has been used for business purposes.

(f) Identify the amount of letting relief available when a principal private residence has been let out.

Excluded topics

The disposal of leases and the creation of sub-leases.

4 Gains and losses on the disposal of shares and securities

(a) Calculate the value of quoted shares where they are disposed of by way of a gift.

(b) Explain and apply the identification rules as they apply to individuals and to companies, including the same day, nine day, and thirty day matching rules.

(c) Explain the pooling provisions.

(d) Explain the treatment of bonus issues, rights issues, takeovers and reorganisations.

(e) Explain the exemption available for gilt-edged securities and qualifying corporate bonds.

Excluded topics

A detailed question on the pooling provisions for shares as they apply to limited companies.

The small part disposal rules applicable to rights issues.

Substantial shareholdings.

Gilt-edged securities and qualifying corporate bonds other than the fact that they are exempt.

5 The computation of the capital gains tax payable by individuals

(a) Compute the amount of capital gains tax payable.

6 The use of exemptions and reliefs in deferring and minimising tax liabilities arising on the disposal of capital assets

(a) Explain and apply entrepreneurs' relief as it applies to individuals.

(b) Explain and apply rollover relief as it applies to individuals and companies.

(c) Explain and apply holdover relief for the gift of business assets.

(d) Explain and apply the incorporation relief that is available upon the transfer of a business to a company.

Excluded topics

Reinvestment relief.

Entrepreneurs' relief for associated disposals.

E NATIONAL INSURANCE CONTRIBUTIONS

1 The scope of national insurance

(a) Describe the scope of national insurance.

2 Class 1 and Class 1A contributions for employed persons

(a) Compute Class 1 NIC.

(b) Compute Class 1A NIC.

Excluded topics

The calculation of directors' national insurance on a month by month basis.

Contracted out contributions.

3 Class 2 and Class 4 contributions for self-employed persons

(a) Compute Class 2 NIC.

(b) Compute Class 4 NIC.

Excluded topics

The offset of trading losses against non-trading income.

F VALUE ADDED TAX

1 The scope of value added tax (VAT)

(a) Describe the scope of VAT.

(b) List the principal zero-rated and exempt supplies.

2 The VAT registration requirements

(a) Recognise the circumstances in which a person must register for VAT.

(b) Explain the advantages of voluntary VAT registration.

(c) Explain the circumstances in which pre-registration input VAT can be recovered.

(d) Explain how and when a person can deregister for VAT.

Excluded topics

Group registration

3 The computation of VAT liabilities

(a) Explain how VAT is accounted for and administered.

(b) Recognise the tax point when goods or services are supplied.

(c) List the information that must be given on a VAT invoice.

(d) Explain and apply the principles regarding the valuation of supplies.

(e) Recognise the circumstances in which input VAT is non-deductible.

(f) Compute the relief that is available for impairment losses on trade debts.

(g) Explain the circumstances in which the default surcharge, a serious misdeclaration penalty, and default interest will be applied.

Excluded topics

VAT periods spanning 31 December 2009

Imports, exports and trading within the European Community

Partial exemption

In respect of property and land: leases, do-it-yourself builders, and a landlord's option to tax.

Penalties apart from those listed in the study guide (repeated misdeclarations are excluded).

4 The effect of special schemes

(a) Describe the cash accounting scheme, and recognise when it will be advantageous to use the scheme.

(b) Describe the annual accounting scheme, and recognise when it will be advantageous to use the scheme.

(c) Describe the flat rate scheme, and recognise when it will be advantageous to use the scheme.

Excluded topics

The second-hand goods scheme.

The capital goods scheme.

The special schemes for retailers.

G THE OBLIGATIONS OF TAX PAYERS AND/OR THEIR AGENTS

1 The systems for self-assessment and the making of returns

(a) Explain and apply the features of the self-assessment system as it applies to individuals.

(b) Explain and apply the features of the self-assessment system as it applies to companies.

2 The time limits for the submission of information, claims and payment of tax, including payments on account

(a) Recognise the time limits that apply to the filing of returns and the making of claims.

(b) Recognise the due dates for the payment of tax under the self-assessment system.

(c) Compute payments on account and balancing payments/repayments for individuals.

(d) Explain how large companies are required to account for corporation tax on a quarterly basis.

(e) List the information and records that taxpayers need to retain for tax purposes.

Excluded topics

The payment of CGT by annual instalments.

3 The procedures relating to enquiries, appeals and disputes

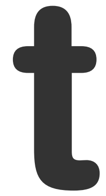
(a) Explain the circumstances in which HM Revenue & Customs can enquire into a self-assessment tax return.

(b) Explain the procedures for dealing with appeals and disputes.

4 Penalties for non-compliance

(a) Calculate interest on overdue tax.

(b) State the penalties that can be charged.



Tax rates and allowances

Contents

1 Tax rates and allowances
2 Retail price indices
3 Abbreviations

1 Tax rates and allowances

1.1 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 10% rate applies where savings income 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

The maximum contribution that can be made without any earnings is £3,600.

Authorised mileage allowances: cars

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

Capital allowances

		%
Plant and machinery		
General pool	– First year allowance	40
	– Writing-down allowance	20
Special rate pool		10
Motor cars		
CO_2 emissions up to 110 grams per kilometre		100
CO_2 emissions between 111 and 160 grams per kilometre		20
CO_2 emissions over 160 grams per kilometre		10
Annual investment allowance		
First £50,000 of expenditure		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%
Lower limit	300,000	300,000	300,000
Upper limit	1,500,000	1,500,000	1,500,000
Marginal relief fraction	1/40	7/400	7/400

Marginal relief

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

Extended loss relief

Extended loss relief is capped at a maximum of £50,000. For limited companies it applies to loss-making accounting periods ending between 24 November 2008 and 23 November 2010.

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

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 (not contracted out rates)

		%
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 1A		12.8
Class 2		£2.40 per week
Class 4	£1 – £5,715 per year	Nil
	£5,716 – £43,875 per year	8.0
	£43,876 and above per year	1.0

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)

2 Retail price indices

2.1 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	200.1	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

3 Abbreviations

AIA	Annual investment allowance
AMA	Approved mileage allowances
ATPD	Actual tax point date
AVCs	Additional voluntary contributions
BA	Balancing allowance
BC	Balancing charge
BTPD	Basic tax point date
CAP	Chargeable accounting period
CGT	Capital gains tax
CYB	Current year basis
DTR	Double taxation relief
FA	Finance Act
FIFO	First in, first out
FII	Franked investment income
FY	Financial year
FYA	First year allowance
HMRC	Her Majesty's Revenue and Customs
IA	Indexation allowance
IBA	Industrial buildings allowance
ICTA 1988	Income and Corporation Taxes Act 1988
ITA 2007	Income Tax Act 2007
LIFO	Last in, first out
LPE	Lower-paid employee
MR	Marginal relief
NIC	National Insurance contributions
NRE	Net relevant earnings
PA	Personal allowance
PAYE	Pay as you earn
PCTCT	Profits chargeable to corporation tax
POA	Payment on account
PPP	Personal pension plan
QBA	Qualifying business asset
TCGA 1992	Taxation of Chargeable Gains Act 1992
TPD	Tax point date
TWDV	Tax written down value
WDA	Writing down allowance
WHT	Withholding tax

CHAPTER 1

The UK tax system

Contents

1 The overall function and purpose of taxation in a modern economy
2 The different types of taxes
3 Principal sources of revenue law and practice
4 Tax avoidance and tax evasion

The overall function and purpose of taxation in a modern economy

- The economic function of taxation
- The social justice purpose of 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 15% VAT 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.

The different types of taxes

- Income tax
- National insurance contributions
- Corporation tax
- Capital gains tax
- Inheritance tax
- Value added tax
- Stamp duty
- Direct and indirect taxation

2 The different types of taxes

2.1 Income tax

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

It is collected from employees using the Pay As You Earn (PAYE) system, and from self-employed individuals using the self assessment system.

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

2.2 National insurance contributions (NICs)

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

2.3 Corporation tax

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

2.4 Capital gains tax

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

2.5 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.

2.6 Value added tax

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

2.7 Stamp duty

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

2.8 Direct and indirect taxation

All of the above taxes can be classified as either direct or indirect taxation.

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.

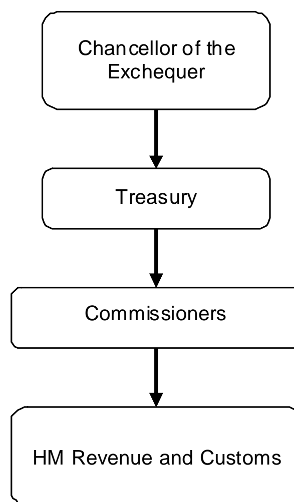
Principle sources of revenue law and practice

- 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.

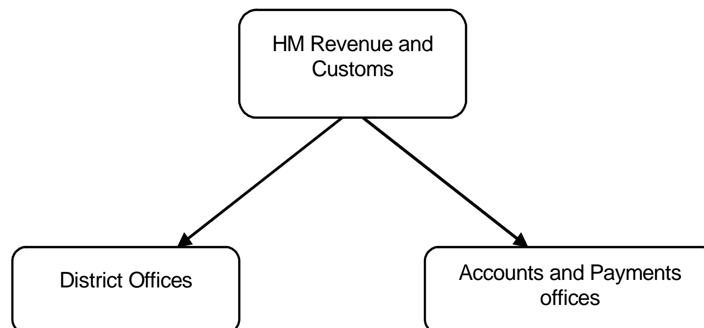
Their duties include:

- Administering the UK tax system
- Implementing tax 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 of 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 explain how the tax law is applied in a particular situation.
- **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 to the general public. For instance, the Revenue leaflet on 'residence' explains all the relevant 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, ordinary 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.

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 and will be covered in detail a in later chapter.

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.

Tax evasion

Tax evasion is illegal. It involves reducing your 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

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.

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

Introduction to income tax

Contents

1	Overview of income tax
2	The taxable income statement
3	Computation of income tax liability
4	Computation of income tax payable
5	Gift Aid donations paid by individuals
6	Personal Age Allowance
7	Tax planning for married couples

Overview of income tax

- The basic charging rules
- Taxable income
- The tax year
- Preparing an income tax computation

1 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.

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

There is no statutory definition of the term 'resident'. An individual is generally considered to be resident in the UK if:

- he is physically present in the UK for 183 days or more in the tax year, or
- he makes frequent and substantial visits to the UK. Visits are classed as frequent if they occur for four consecutive years and are substantial if they average three months a year.

1.2 Taxable income

Individuals are liable to:

- income tax on their taxable income, and
- a separate tax, capital gains tax, on their chargeable gains.

Taxable income is defined as:

- income generated from all sources which is not specifically exempt**, minus**
- tax allowable interest payments and personal allowances.

Taxable income is listed in a taxable income statement according to its nature and source.

1.3 The tax year

Income tax rates and allowances are fixed for each tax year. A tax year is the period from 6 April in one year to the following 5 April.
Tax years are quoted as the calendar years in which the tax year begins and ends. For example, the tax year 2009/10 is the period from 6 April 2009 to 5 April 2010.

Income tax is based on the income relating to a particular tax year. For the 2010 examinations, questions will be based on the 2009/10 tax year.

The tax year is sometimes referred to as the **fiscal year** or the **year of assessment**.

1.4 Preparing an income tax computation

There are three key steps in the preparation of an income tax computation.

Step 1: Prepare a statement of taxable income for the tax year

The first step is to prepare a statement listing all the income that is chargeable to income tax in the tax year, after deducting allowable interest payments and personal allowances.

Step 2: Calculate the income tax liability

The next step is to calculate the income tax liability on the taxable income. Income tax rates need to be applied carefully, as different types of income are taxed at different rates of tax.

Step 3: Calculate the income tax payable

The last step, which may be required in some examination questions, is to calculate how much of the income tax liability is still payable after taking account of any tax already deducted at source. If required, the due dates of payment of income tax still payable and the filing dates for self-assessment return forms need to be stated.

Each step involved in calculating the income tax payable is explained in more detail in the rest of this chapter. Self-assessment is explained in a later chapter.

The taxable income statement

- Overview of the taxable income statement
- Classification of income
- Employment income
- Trading income
- Property income
- Savings income
- UK dividends received
- Interest payments
- Personal allowance
- Taxable income and exempt income

2 The taxable income statement

2.1 Overview of the taxable income statement

The first step in preparing an income tax computation is to produce a list of the sources of income which are taxable. This should be presented as follows:

Name of individual **Income tax computation: 2009/10**	*See paragraph*	£
Earned income		
Employment income	*2.3*	X
Trading income	*2.4*	X
Property income	*2.5*	
Savings income (gross)	*2.6*	
Building society interest (amount received × 100/80)		X
Bank interest (amount received × 100/80)		X
Dividends received (amount received × 100/90)	*2.7*	X
Total income		X
Minus Interest payments	*2.8*	
		(X)
Net income		X
Minus Personal allowance (PA)	*2.9*	(6,475)
Taxable income	*2.10*	X

The items in this statement are explained in more detail in the following sections.

2.2 Classification of income

Each source of income must be shown separately in the statement, because the rules to determine the amount of income that is taxable are different for each source of income.

In addition, it is important to group sources of income together, into earned income, savings income and dividend income. This is because different rates of tax apply to the different groupings of taxable income.

2.3 Employment income

Employment income is the primary source of income for an employed individual. The amount of income assessed for tax under the employment income rules is the total **gross** remuneration (gross salary, plus benefits such as the use of a company car etc) **received** in the tax year.

In examination questions, salaries and other remuneration are usually quoted as a gross amount. Gross means that the amount quoted is the amount of income before pay-as-you-earn (PAYE) income tax has been deducted at source by the employer.

The rules governing the computation of employment income are explained in detail in a later chapter.

2.4 Trading income

Trading income is the primary source of income for a self-employed individual. It assesses the profits of a trade, profession or vocation of a self-employed individual. The taxable trading income is based on the accounting results of the business.

The rules applicable to the trading income of individuals are covered in later chapters.

2.5 Property income

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

See the following chapter for details.

2.6 Savings income

Savings income consists mainly of interest income. Interest falls into three categories:

- interest received net of tax
- interest received gross
- exempt interest.

Individuals are liable to income tax on the **gross** interest **received** in the tax year (i.e. a receipts basis of assessment).

Interest received net of tax

The most common type of interest income is interest from banks and building societies. Individuals usually receive this interest **net** of 20% income tax. This tax is deducted at source by the bank or building society on behalf of HMRC.

Interest received net must be grossed up (i.e. multiplied by 100/80) before entering it in the taxable income statement.

Example

Gareth received £1,200 in annual interest on a building society savings account on 4 February 2010, after deduction of interest at 20% at source.

In Gareth's income tax assessment for 2009/10, his interest income is £1,500 (= £1,200 × 100/80).

Interest received gross

Interest on all National Savings Bank (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.

Easy Access Savings Accounts (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.

Other types of interest received gross are:
- Gilt-edged security interest (i.e. Government stock interest) (e.g. Treasury stock interest, Exchequer stock interest, 3½% War Loan 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.

Exempt interest

The main types of exempt interest are:
- Interest on ISAs (individual savings accounts)
- Interest on National Savings Certificates.

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.

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.

Maximum annual investment in each component:	
– cash products	£3,600 (£5,100 if aged 50 and over)
– stocks, shares and insurance products	£7,200 (£10,200 if aged 50 and over)
Maximum annual total investment:	£7,200 (£10,200 if aged 50 and over)
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) in cash products.

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

(3) The increased limits for investors aged 50 and over apply from 6 October 2009.

2.7 UK dividends received

Individuals are deemed to receive UK dividends after the deduction of 10% tax. They are taxed on the grossed up dividends **received** in the tax year (i.e. a receipts basis of assessment). Therefore, dividends received must be multiplied by 100/90 to obtain the amount of dividend income for the taxable income statement.

Dividends from REITs

Dividends from REITs (Real Estate Investment Trusts) are received net of the basic rate of income tax. They are not treated as dividend income; instead they are taxed in the same way as property income.

2.8 Interest payments

Interest paid for trading purposes is deducted in calculating trading income.

The main types of interest payments deductible from total income are:

- Interest on a loan taken out by an individual to:
  - purchase a share in,
  - increase a capital contribution to,
  - make a loan to, or
  - purchase plant or machinery for use in

  a partnership in which the individual is a partner
- Interest on a loan taken out by an individual to purchase plant or machinery for use in his employment.

This type of interest is paid gross by an individual.

No relief is available for interest paid in respect of a mortgage to purchase the individual's residence.

2.9 Personal allowance

Every individual is entitled to a personal allowance (PA). This is an amount of income that can be received free of tax. The allowance is given in the tax rates and allowances in the examination. For 2009/10 the PA is £6,475.

The PA is deducted from **net income**. Net Income is defined as the total of income from all sources after the deduction of allowable interest payments.

Use of the abbreviation PA is acceptable in the examination.

Note that if net income is less than the PA, the excess allowance is lost. For example, if an individual has net income of just £4,000 in 2009/10, the excess allowance of £2,475 is lost.

Individuals aged 65 or over are entitled to a higher amount of PA, known as Personal Age Allowance (PAA). The rules relating to PAA are covered later in this chapter.

2.10 Taxable income and exempt income

The taxable income statement lists all taxable income that is **not specifically exempt** from income tax. There are many types of exempt income. Detailed knowledge of exempt income is not required for the examination, but a general awareness of the following main categories of exempt income might be useful.
The main types of exempt income to be aware of are:

- some social security benefits (e.g. income support, housing benefit)
- statutory redundancy pay
- the first £30,000 of compensation for loss of office
- competition prizes, national lottery and premium bond prizes, betting winnings
- income from ISAs (Individual Savings Accounts)

- income tax repayment supplement (i.e. interest on overpaid income tax that has been repaid by HMRC).

Example

Annabel received the following income in 2009/10:

	£
Employment income	60,000
Bank deposit interest	2,800
Dividends from a UK company	6,300

Required

Calculate Annabel's taxable income for 2009/10.

Answer

Annabel **Taxable income computation: 2009/10**	**£**
Earned income	
Employment income	60,000
Savings income (gross)	
Bank interest (£2,800 × 100/80)	3,500
Dividends received (£6,300 × 100/90)	7,000
Total Income	70,500
Minus Personal allowance (PA)	(6,475)
Taxable income	64,025

Computation of income tax liability

- Overview of the income tax liability computation
- The taxation of other income
- The taxation of savings income
- The taxation of dividend income

3 Computation of income tax liability

3.1 Overview of the income tax liability computation

Different rates of income tax apply to the different sources of income.
Before calculating the income tax, it is first necessary to deduct from the appropriate sources of income:

- allowable interest payments and
- the PA.

There is a **strict order of set-off** as follows:

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

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

(3) Dividend income.

An easy method to ensure the correct allocation of the deductions is to lay out the taxable income computation as follows:

Name of individual

Income tax computation: 2009/10	**Total income**	**Other income**	**Savings income**	**Dividend income**
	£	£	£	£
Earned income				
Employment income	X	X		
Trading income	X	X		
Property income	X	X		
Savings income (gross)				
Building society interest	X		X	
Bank interest	X		X	
UK dividends received	X			X
Total income	X	X	X	X
Minus Interest payments	(X)	(X) [1]	(X) [2]	(X) [3]
Net income	X	X	X	X
Minus Personal allowance (PA)	(6,475)	(X) [1]	(X) [2]	(X) [3]
Taxable income	X	X	X	X

To calculate an individual's income tax liability, the appropriate rate of tax must be applied to each category of taxable income.

The liability must be calculated in the following same strict order:

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

(2) Savings income (e.g. interest income) then lastly,

(3) Dividend income.

3.2 The taxation of other income

For 2009/10 other income is taxed at the following rates:

Name of banding:	Other income in the banding:	Tax rate
Basic rate band	£0 - £37,400	20%
Higher rate band	Excess over £37,400	40%

3.3 The taxation of savings income

For 2009/10 savings income is taxed at the following rates:

Name of banding:	Savings income in the banding:	Tax rate
Starting rate band (note)	0 - £2,440	10%
Basic rate band	£2,441 - £37,400	20%
Higher rate band	Excess over £37,400	40%

Note The 10% band for savings income only applies where savings income falls within the first £2,440 of taxable income. As other income is taxed first, if other taxable income exceeds £2,440 then this starting rate will not apply.

3.4 The taxation of dividend income

For 2009/10 dividend income is taxed at the following rates:

Name of banding:	Dividend income in the banding:	Tax rate
Starting rate band **and** basic rate band	0 - £37,400	10%
Higher rate band	Excess over £37,400	32.5%

Example

Barry, a self employed plumber, received the following income in 2009/10:

	£
Building society interest	4,600
Dividends from a UK company	4,500

He paid allowable interest of £1,000 on 13 August 2009.

Required

Calculate Barry's income tax liability for 2009/10, assuming his trading income for 2009/10 was:

(a) £60,000

(b) £35,000

(c) £5,000

Answer

Barry: Income tax computation: (a) (Trading income = £60,000)	**2009/10 Total income**	**Other income**	**Savings income**	**Dividend income**
	£	£	£	£
Earned income				
Trading income	60,000	60,000		
Savings income (gross)				
Building society interest (£4,600 × 100/80)	5,750		5,750	
UK dividends received (£4,500 ×100/90)	5,000			5,000
Total income	70,750	60,000	5,750	5,000
Minus Interest payments	(1,000)	(1,000)		
Net income	69,750	59,000	5,750	5,000
MInus Personal allowance (PA)	(6,475)	(6,475)		
Taxable income	63,275	52,525	5,750	5,000

Income tax		**Income**		**Tax**
				£
Basic rate band:	Other income	37,400	at 20%	7,480
		15,125	at 40%	6,050
		52,525		
	Savings	5,750	at 40%	2,300
	Dividends	5,000	at 32.5%	1,625
Total taxable income		63,275		
Income tax liability				17,455

Barry: Income tax computation:	**2009/10**			
(b) (Trading income = £35,000)	**Total income**	**Other income**	**Savings income**	**Dividend income**
	£	£	£	£
Earned income				
Trading income	35,000	35,000		
Savings income (gross)				
Building society interest	5,750		5,750	
UK dividends received	5,000			5,000
Total Income	45,750	35,000	5,750	5,000
Minus Interest payments	(1,000)	(1,000)		
Net income	44,750	34,000	5,750	5,000
Minus Personal allowance (PA)	(6,475)	(6,475)		
Taxable income	38,275	27,525	5,750	5,000

Income tax		**Income**		**Tax**
		£		£
Basic rate band:	Other income	27,525	at 20%	5,505
	Savings	5,750	at 20%	1,150
	Dividends	4,125	at 10%	412
		37,400		
Higher rate band:	Dividends	875	at 32.5%	284
Total taxable income		38,275		
Income tax liability				7,351

Barry: Income tax computation:	**2009/10**			
(c) (Trading income = £5,000)	**Total income**	**Other income**	**Savings income**	**Dividend income**
	£	**£**	**£**	**£**
Earned income				
Trading income	5,000	5,000		
Savings income (gross)				
Building society interest	5,750		5,750	
UK dividends received	5,000			5,000
Total income	15,750	5,000	5,750	5,000
Minus Interest payments	(1,000)	(1,000)		
Net income	14,750	4,000	5,750	5,000
Minus Personal allowance (PA)	(6,475)	(4,000)	(2,475)	
Taxable income	8,275	Nil	3,275	5,000

Income tax		Income		Tax
		£		£
Starting rate band:	Savings	2,440	at 10%	244
Basic rate band:	Savings	835	at 20%	167
	Dividends	5,000	at 10%	500
Total taxable income		8,275		
Income tax liability (note)				911

Note As non-savings income was nil, the 10% starting rate band for savings income could be used.

Computation of income tax payable

- Proforma income tax payable computation
- Excess tax credits
- Tax payable on savings and dividend income

4 Computation of income tax payable

4.1 Proforma income tax payable computation

The computations explained so far are needed to derive the **income tax liability** of an individual. This is frequently the requirement of an examination question. However, an examination question may ask for a computation of the amount of **income tax payable**.

The concepts of tax liability and tax payable can be contrasted as follows:

- The **tax liability** is the total amount of tax which the individual is liable to pay to the tax authorities for the tax year.
- The **tax payable** is the amount of the tax liability outstanding, and still to be paid to the tax authorities.

Calculating the income tax payable

	£
Income tax liability	X
Minus Tax credits/deducted at source	
Dividends at 10% (see paragraph 4.3)	(X)
Savings at 20% (see paragraph 4.3)	(X)
PAYE	(X)
Income tax payable/(repayable) under self assessment	X / (X)

In your examination, you should read carefully any question on income tax. If the question asks for the income tax **payable**, marks will be lost if the full computation is not presented. However, if the question asks for the income tax **liability**, do not waste time presenting the income tax payable computation, as no marks will be awarded for it.

4.2 Excess tax credits

Tax credits is the term used to refer to amounts of income tax that have been paid by deduction at source. This arises where the **payer** of the income is required by law to deduct tax from the income before it is paid. The examples given in the proforma computation above are the tax credits likely to appear in examination questions.

If there is insufficient income tax liability to deduct all the tax credits, it is important to ensure that the tax credit on dividends is deducted first.

- This is because any excess tax credits in relation to dividends will not be refunded by HMRC.
- However, excess tax credits in relation to other income (e.g. tax deducted at source from interest income and PAYE deducted from employment income) will be refunded.

4.3 Tax payable on savings and dividend income

If the individual is a basic rate taxpayer, savings income is taxed at 20% and dividend income at 10%. The individual will have no income tax payable in respect of this income, because 20% tax is deducted at source from savings income and dividends carry a 10% tax credit.

If the individual is a higher rate taxpayer, there will be additional income tax payable of:

- 20% (40% - 20%) in respect of savings income and
- 22½% (32½% - 10%) in respect of dividend income.

Example

The facts are the same as in the previous example – Barry.

Required

Calculate the income tax payable/repayable for Barry in scenarios (b) and (c).

Answer

Barry: Income tax payable 2009/10

	Scenario (b)	Scenario (c)
	£	
Income tax liability	7,351	911
Minus Tax credits/deducted at source		
Dividend income (£5,000 × 10%) – set off first	(500)	(500)
Savings income (£5,750 × 20%)	(1,150)	(1,150)
Income tax payable / (repayable)	5,701	(739)

Gift Aid donations paid by individuals

- How the Gift Aid scheme operates
- The tax relief for basic rate taxpayers
- The tax relief for higher rate taxpayers

5 Gift Aid donations paid by individuals

5.1 How the Gift Aid scheme operates

The Gift Aid scheme gives tax relief for cash donations made to registered charities.

Individuals are deemed to make Gift Aid donations **net of 20% tax**, which is recoverable by the charity from HMRC. Tax relief is available on the gross amount of the payment.

For individuals the scheme operates as follows:

- If an individual makes a Gift Aid payment of, say, £800, the gift is treated as a gross gift of £1,000 (= £800 × 100/80). The charity will receive £800 from the individual and a tax repayment of £200 from HMRC.
- The individual is entitled to tax relief on the gross donation of £1,000 at his highest marginal rate of tax.

5.2 The relief for basic rate taxpayers

A basic rate taxpayer is entitled to 20% tax relief. This relief is automatically obtained at source in his payment to the charity.

Gift Aid donations are therefore ignored in the individual's income tax computation as they have already obtained their tax relief at source.

5.3 The relief for higher rate taxpayers

A higher rate taxpayer is entitled to 40% tax relief. This relief is obtained in two steps as follows:

- 20% tax relief is automatically obtained at source in his payment to the charity, in the same way as for basic 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 Gift Aid payment.

As a result, that amount of income will be taxed at 20% instead of 40%, thereby achieving a 20% (40% - 20%) tax saving for the individual.

Example

Carla is a higher rate taxpayer. In 2009/10 she had no income other than her employment income of £50,000.

Required

Calculate Carla's income tax liability for 2009/10 assuming:

(a) Carla did not make a Gift Aid donation

(b) On 16 March 2010 Carla made a donation of £1,760 to a charity under the Gift Aid scheme.

Answer

Carla : Income tax computation:	**2009/10**	**(a) Total income**	**(b) Total income**
		£	£
Employment income = Net income		50,000	50,000
Minus PA		(6,475)	(6,475)
Taxable income		43,525	43,525

	Scenario (a)			**Scenario (b)**		
Income tax	**Income**		**Tax**	**Income**		**Tax**
	£		£	£		£
Basic rate band:	37,400	at 20%	7,480			
Extended basic rate band limit: (see working)				39,600	at 20%	7,920
Higher rate band	6,125	at 40%	2,450	3,925	at 40%	1,570
Total taxable income	43,525			43,525		
Income tax liability			9,930			9,490

Working

Gross Gift Aid donation = £1,760 × 100/80 = £2,200

Extended basic rate band = £37,400 + £2,200 = £39,600

Note that the tax saving as a result of extending the basic rate band
= £9,930 - £9,490 = £440

(i.e. 20% saving on the gross donation: £2,200 × 20% = £440).

Personal Age Allowance
■ The personal age allowance

6 Personal Age Allowance

6.1 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. 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.

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	£30,000	£24,250
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	30,000	24,250
Less PAA (see workings)	(9,265)	(6,475)	(9,165)
Taxable income	14,085	23,525	15,085

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)		
(£30,000 – £22,900) × 50% = £3,550 (Note)		(3,015) restricted	
(£23,850 (below) - £22,900) × 50% = £475			(475)
PAA available	9,265	6,475	9,165

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	24,250
Less Gross Gift Aid donation (£320 × 100/80)	(400)
Net income for age allowance reduction purposes	23,850

Tax planning for married couples

- The concept of independent taxation
- The taxation of married couples
- Opportunities for minimising tax liabilities

7 Tax planning for married couples

7.1 The concept of independent taxation

The concept of independent taxation means that every individual (whether married, in a civil partnership or single) is treated as a separate taxable person. Each taxable person is liable to income tax on his or her own income.

7.2 The taxation of married couples

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

Where a couple jointly own assets that generate income, the income is *shared equally* between them, regardless of the actual ownership of the asset. (This is known as the 50:50 rule).

For example, if a couple jointly own a 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%.

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).

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

7.3 Opportunities for minimising tax liabilities

A married couple (or civil partners) should ensure that each spouse (or civil partner) 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 note below)
- Put assets into joint names so that the taxable income is split using the 50:50 rule
- If the spouse paying the higher rate of tax has an unincorporated business:
  - employ the spouse (see note below), or
  - take the spouse on as a partner.
- Ensure that any allowable interest or Gift Aid donations are paid by the spouse paying the higher rate of tax.

Note:

To be effective for income tax purposes, 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.

Note also that the gift will only affect the treatment of future income generated.

Individuals employed by their spouse in an unincorporated business should be paid only at a level commensurate with their duties else a tax liability may arise on the employing spouse.

CHAPTER 3

Income from property

Contents

1	Income derived from land and buildings in the UK
2	Premiums

Income derived from land and buildings in the UK

- The scope of the syllabus
- Rental income
- Nominal rent leases
- Furnished holiday lettings
- Rent-a-room relief

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.

(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.

(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**.

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 bank loan 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 Hannah's property income assessment for 2009/10.

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

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 in the first section as earned income along with employment income or other trading income, not as other 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: –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** to 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 is 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 ▪ 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 Victorian house to a lodger for the whole of 2009/10.

Required

Calculate Ivor's property income assessment for 2009/10 assuming 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.

Premiums

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

2 Premiums

2.1 Premiums received on the granting of a short lease

A premium is a lump sum received by the landlord at the start of the lease in return for giving the tenant the **exclusive right to use** the property for the duration of the lease. When the lease terminates, the property reverts back to the owner.

A property income assessment arises on both:

- the **premium** received at the start of the lease, and
- the rent receivable on a monthly or quarterly basis for the actual use of the property.

The key points to remember are as follows:

- An assessment only arises on the **granting** of a **short** lease.
- A **short** lease is defined as a leasehold interest of **not more than 50 years** in duration.
- 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 owns a warehouse which is surplus to his requirements. Rather than selling the warehouse, Jacob granted a 35 year lease on the property 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.

a

Answer

	£
Premium received	65,000
Less 2% × £65,000 × 34	(44,200)
Property income assessment on the premium received	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 the exclusive right to use the property for the duration of the lease. If in that period the taxpayer 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 the short lease interest the taxpayer owns).

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.

The 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 × $\frac{\text{Length of sub-lease}}{\text{Length of head lease}}$	(X)
Property income assessment	X
where: n = number of years of the lease	

e

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	$2\% \times £12{,}500 \times 9$	(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

CHAPTER 4

Employment income

Contents

1 Deciding whether an individual is employed or self-employed
2 Overview of the employment income assessment
3 Benefits assessed on all employees
4 Benefits assessed on P11D employees only
5 Allowable deductions against employment income
6 The employment income computation

Deciding whether an individual is employed or self-employed

- The problem of deciding whether or not an individual is employed
- The 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 or not an individual is employed

It is important to establish whether an individual is employed or self-employed as the status of the individual determines how he will be taxed on his income. An employed person is taxed under the employment income rules and a self-employed individual is taxed under the trading income rules for an unincorporated business.

In most cases the position is clear, but this is not always the case.

For example, it can be argued that an individual who provides consultancy services to two or three major clients is self-employed. However, it can also be argued that he has two or three part-time employments with different employers.

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.

Over many years cases have gone to court to decide whether a contract **of** service exists or whether the individual has been contracted **for** his services. As a result of court decisions, there is a list of factors that HMRC will consider in deciding whether an individual is employed or self-employed.

1.2 The factors to determine the status of an individual

In cases where there is doubt regarding the status of the individual, HMRC will consider the following factors:

- Degree of control
- Provision of the tools of the trade
- Degree of financial risk
- Ability to delegate work
- The client base
- Extent of enjoyment of normal employment rights.

There is no single factor that is more important than another, and no single factor will determine the treatment on its own. HMRC will look at all 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. For example, a painter and decorator is contracted to decorate a room.

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.

In summary, the exercise of a high level of control over an individual is a factor that may support the view that the individual is an employee. The exercise of a lesser degree of control over an individual may support the view that the individual has self-employed status.

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. For example, a painter and decorator will bring his own ladders, dust sheets, paint brushes and so on.

However, an **employee** would expect the employer to provide the tools required to perform the tasks expected of him.

Intellectual assets (such as knowledge and experience) as well as physical assets may be considered in applying this test.

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 correction of 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 by an employee to another employee within the same organisation is, of course, normal business practice. However, an employee has no right personally to delegate work to others outside the organisation and cannot send a substitute if he is unable or unwilling to perform the work.

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 the individual 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.

Overview of the employment income assessment

- The scope of employment income
- The receipts basis of assessment
- Overview of assessing benefits of employment
- Exempt benefits
- Definition of P11D and lower paid employees
- The general rules for assessing benefits of employment

2 Overview of the employment income assessment

2.1 The scope of employment income

Employment income primarily assesses income received by an individual from his employer in respect of his employment. 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 received (such as salary, bonuses, commissions and termination payments) but **all** forms of remuneration **including benefits** derived from the employment.

The scope of the employment income rules is wider than just income from the employer. For income tax purposes, employment income also includes:

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

2.2 The receipts basis of assessment

Employment income is assessed on a receipts basis. This means that the individual is taxed on the income in the tax year (i.e. 5 April to 6 April) in which the cash or benefit is **received**, not necessarily when it is earned.

Date of receipt

Tax legislation provides a definition of the date of receipt. The date of receipt is the **earlier** of:

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

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

Date of receipt for directors

Directors, as the senior management in an organisation, determine when employees – including themselves – will receive their remuneration. They are therefore in a position to manipulate their income tax liability by deliberately accelerating or delaying the receipt of income between tax years, to ensure they are taxed at the lowest possible rate of tax.

The date of receipt for directors is the same as for employees, but with two further rules, as follows. The date of receipt is the **earliest** of:

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

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

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

(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**.

PAYE: deduction of income tax on employment income at source

Usually cash remuneration is received by an employee on a regular weekly or monthly basis, and income tax is deducted at source under the PAYE (pay-as-you-earn) scheme.

However, **the gross remuneration received in the tax year** must be brought into the employee's income tax computation in order to compute the income tax **liability**. Any PAYE deductions are an allowable tax credit in the income tax **payable** computation.

2.3 Overview of assessing benefits of employment

Benefits of employment are rewards to an employee that are not received in cash but in kind (i.e. in a form other than cash). For example, an employer may provide an employee with a company car or mobile phone and pay all the expenses relating to the asset. Benefits are often referred to as benefits-in-kind or BIKs.

Cash remuneration is straightforward to quantify and charge to tax. However, deciding the amount that should be charged to tax in respect of a benefit received from employment is more complex.

The tax legislation therefore provides a benefits code setting 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 benefits that are not subject to income tax. There are many examples of exempt benefits. The most common examples are listed below.

- Employer's contributions to an approved pension scheme for the employee
- 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 and death-in-service benefit
- Subsidised canteen meals, provided they are available to all employees
- Work place nurseries
- Child care payments of up to £55 per week, provided the child care 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 the limit is exceeded the **full amount** is taxable, not just the excess over the limit)
- Overseas medical insurance and treatment, if the employee is working abroad
- The provision of one mobile phone to the employee himself (but not the cost of the employee's own private mobile phone bill or top-up vouchers)
- 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)
- Car mileage allowances for the use of employee's own car within statutory limits (Approved Mileage Allowances): this is explained later
- Sporting and recreational facilities, provided they are available to all employees and not available to members of the public generally (for example membership at a public gym 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 head. (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 the costs of working at home, up to £3 per week without the need for supporting documentation. Contributions in excess of £3 require supporting 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 (e.g. 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 (including 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 to decide whether an employee is a P11D employee	X

Note that an individual's earnings in this context are **before** deducting most allowable expenses. The only two allowable deductions are shown above.

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 of employment

There are two valuation rules for the assessment of benefits from employment. One rule is for LPEs and the other is for P11D employees.

These general valuation rules apply to:

- all benefits that are not specifically exempt (listed above) and
- all benefits that are not subject to specific statutory valuation rules (described later).

Lower paid employees

In general, LPEs are only assessed on benefits that 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, a P11D employee is assessed on benefits provided to him, or to a member of his family or household, 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 a benefit, two further rules generally apply:

- **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 amount of 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 provided for only 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.

Benefits assessed on all employees

- Overview of the benefits assessed on all employees
- Living accommodation benefits
- Vouchers and company credit cards

3 Benefits assessed on all employees

3.1 Overview of the benefits assessed on all employees

There are two key benefits assessed on all employees, regardless of their earnings or status. These are:

- the provision of living accommodation
- the provision of vouchers.

3.2 Living accommodation benefits

An employee who lives in accommodation provided by the employer may be assessable for the living accommodation benefits. These are covered in the next section.

3.3 Vouchers and company credit cards

Vouchers

Vouchers exchangeable for goods or services (such as gift vouchers and travel season tickets) are assessable benefits unless they are specifically exempt. (Exempt items include meal vouchers up to 15p per day, child care vouchers costing up to £55 per week, and car parking vouchers).

All employees are assessed on the cost to the person providing the vouchers.

Company credit cards

Where an employee uses a company credit card, they 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).

However, an allowable deduction against employment income will be allowed in the normal way if the expenditure satisfies the wholly, exclusively and necessary tests. (These are explained later).

Example

George has been employed by Harris Ltd throughout 2009/10. He is a LPE. He received wages of £6,700 and the following benefits of employment:

- Free meals in the works canteen, costing the company £575
- A place at the factory nursery for his daughter, costing £4,000
- An annual season ticket to travel on the local buses and trains which would have cost George £1,050, but which Harris Ltd negotiated at a discount and paid only £960
- Attendance at an internal training course which cost the company £450 per employee.

Required

Calculate George's employment income for 2009/10.

Answer

		£
Wages		6,700
Benefits of employment:		
Free meals	Exempt	Nil
Workplace nursery	Exempt	Nil
Season ticket	Cost to employer	960
Provision of work related training courses	Exempt	Nil
Employment income		7,660

Season tickets for use on train or tram services are not exempt benefits. A bus-only season ticket would qualify as an exempt benefit.

Benefits assessed on P11D employees only

- Overview of the benefits assessed on P11D employees only
- The provision of a company car
- The provision of private fuel
- The provision of a van
- Approved mileage allowances
- Living accommodation benefits
- The private use of business assets
- The provision of beneficial loans

4 Benefits assessed on P11D employees only

4.1 Overview of the benefits assessed on P11D employees only

For P11D employees there are several benefits with special statutory rules for calculating the assessable amount of employment income, namely:

- the provision of a motor vehicle (for example, a car or van)
- the provision of private fuel
- the provision of living accommodation
- the private use of business assets
- the provision of loans at a cheap rate of interest.

4.2 The provision of a company car

A car provided to an employee by an employer is often referred to as 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 value of this benefit is based on the list price of the car and its CO_2 (carbon dioxide) emissions.

The assessable benefit for each car is calculated separately as follows:

Assessable benefit of a car		**£**		**£**
Manufacturer's list price (MLP)	(max £80,000)	X		
Minus Employee's capital contribution	(max £5,000)	(X)		
		X	at appropriate %	X
Minus Employee's contribution for the private 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
- optional accessories provided at a later date which cost in excess of £100.

However, the MLP is **restricted to a maximum of £80,000**.

Any contribution by the employee towards the capital cost of the car, including qualifying accessories, can be deducted from the MLP, subject to a maximum deduction of £5,000.

The **appropriate percentage** to apply 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 percentage of 10% is used for petrol cars with CO_2 emissions of exactly 120 g/km or less. A percentage of 13% applies to diesel cars with CO_2 emissions of 120 g/km or less.

The appropriate annual percentage for cars with CO_2 emissions of more than 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			
Minus Base level of CO_2 emissions				
(i.e. 135 g/km for 2009/10)	(135)			
(See tax rates and allowances)				
	X	÷ 5 g/km	X	X
Plus Minimum percentage			15	18
Appropriate annual percentage			X	X
			Restricted to a maximum of 35%	

The appropriate percentage is an **annual percentage**. 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.
- It also applies if the car is made unavailable to the employee for at least 30 consecutive days during the year.

Example

Harry and Janice are P11D employees. They are provided with the following company cars:

	Harry	Janice
Type of car	Citroen	Honda
Type of engine	Petrol	Diesel
Date car was made available	6 July 2007	6 September 2009
Manufacturer's list price	£20,235	£19,600
CO_2 emissions	162 g/km	198 g/km
Capital contribution	£5,900	Nil
Contribution for the private use of the car	£55 per month	£20 per month

Required

Calculate the benefits assessable on Harry and Janice in 2009/10.

Answer

	Harry g/km	Janice g/km		Harry Petrol %	Janice Diesel %
CO_2 emissions (rounded down to nearest 5 g/km)	160	195			
Base level of CO_2 emissions	(135)	(135)			
	25	60	÷ 5 g/km	5	12
Minimum percentages				15	18
Appropriate percentages				20	30
Number of months car available in 2009/10				12	7

	Harry's car benefit		
	£		
Manufacturer's list price	20,235		
Minus Harry's capital contribution (restricted)	(5,000)		
	15,235	at 20%	3,047
Minus Contribution for the private use of the car (£55 × 12)			(660)
Car benefit			2,387

	Janice's car benefit		
	£		£
Manufacturer's list price	19,600		
Minus Capital contribution	(Nil)		
	19,600	at 30% × 7/12	3,430
Minus Contribution for the private use of the car (£20 × 7)			(140)
Car benefit			3,290

Note that the assessable benefit is for the **private use** of the car. There is no assessable benefit on the provision of a car if the car is used **entirely for business** purposes.

Pool cars

There is also no benefit arising 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.

Costs covered by the car benefit

The benefit is meant to cover 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).

You should therefore ignore any information about these associated costs in an examination question, as they have already been taken into account in the calculation of the car benefit.

However, the car benefit does not take into account the provision of private fuel.

4.3 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. (Note that there is no private fuel benefit if an employee is provided with a pool car and is also provided with private fuel.)

The provision of **private fuel for a company car** is a common scenario in practice and in examination questions.

An employee with the use of a company car is **automatically taxed** for a fuel benefit, **unless**:

- the individual 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.

In both these situations, the employer does not bear the cost of any private fuel, and the employee does not receive a private fuel benefit.

However, 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 of the**

private mileage costs, the fuel benefit will be assessed on the employee **in full** with no deduction allowed for the employee's contributions.
This is the exception to the general rule that contributions paid by an employee to an employer in respect of a benefit will reduce the taxable amount of that benefit.

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 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 as car benefit appropriate percentage)

Note that the percentage is an **annual** percentage.

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.
- It also applies if the car is made unavailable to the employee for at least 30 consecutive days during the year.

The fuel benefit can also be time-apportioned where the employee opts out of private fuel provision by the employer or where the fuel itself is only provided for part of the year. Time-apportionment in these situations is only available provided that the withdrawal from the provision of fuel is a **permanent** rather than a temporary withdrawal.

Example

The facts are the same as in the previous example – Harry and Janice.

Required
Calculate the assessable fuel benefits for Harry and Janice in 2009/10.

Answer

The appropriate percentage, calculated in the previous example, is 20% for Harry and 30% for Janice.

			Benefit
	£		£
Harry's fuel benefit (full year)	16,900	at 20%	3,380
Janice's fuel benefit (7 months of the year)	16,900	at 30% × 7/12	2,958

4.4 The provision of a van

If a P11D employee is provided with a van that 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 that these scale rates are **not** provided in the tax rates and allowances in the examination.

4.5 Approved mileage allowances

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.

Approved mileage allowances are statutory tax-allowable mileage rates for the use of privately-owned cars, vans, motor cycles and bicycles. In addition, there is a tax-free allowance for payments made to an employee who carries one or more colleagues as passengers in his own car or van to make the same business trip.

The rates for a car, van, motor cycle and bicycle are different. For example, the approved mileage allowance for 2009/10 for the first 10,000 business miles in a privately owned car is 40p, and 25p thereafter. The approved mileage allowances for cars are given in the table of tax rates and allowances. If required in the examination, the statutory mileage rates for other vehicles will be given in the question.

The consequences of approved mileage allowances are as follows:

If the mileage allowance received is:	Consequence:
▪ Equal to the approved mileage allowance	▪ The allowance received is tax-free ▪ No benefit arises
▪ In excess of the approved mileage allowance	▪ An assessable benefit arises ▪ Benefit = excess allowance received
▪ Less than the approved mileage allowance	▪ An allowable deduction from employment income is available. ▪ Deduction = shortfall of allowances received

Example

Kevin uses his own car for business travel. During 2009/10 his business mileage was 14,000 miles, for which his employer paid him 45p per mile. Included in this mileage was a trip to Glasgow to a business conference, totalling 460 miles. Kevin took his colleague Len to the conference in his car as Len could not drive, and received £45 for taking Len as a passenger.

The approved mileage allowance (AMA) 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 Kevin as a result of receiving the mileage allowances.

Answer

		£	£
Mileage allowance received	14,000 × 45p		6,300
AMA for the car	10,000 × 40p	4,000	
	4,000 × 25p	1,000	
			(5,000)
			1,300
Passenger allowance received		45	
AMA for passengers	460 × 5p	(23)	
			22
Assessable benefit			1,322

4.6 Living accommodation benefits

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. a 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 employee, hotel employee, policeman).
- It is provided as **part of security arrangements** as there is a special threat to the employee's security (e.g. the Prime Minister's official residence).

Living accommodation that is not job-related

When the living accommodation is **not** job-related accommodation, there may be four separate elements to calculate in order to arrive at the total amount of living accommodation benefits. 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 accommodation, 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
4. Provision of furniture benefit	X	√	X	√*	to 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 associated benefits are potentially taxable.

In the examination, always assume that 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 depends on whether the property has been purchased by the employer or rented by the employer on behalf of the employee. It 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.

This additional benefit is calculated as follows:

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

Example

Linda was provided by her employer with unfurnished living accommodation on 5 June 2006. She pays all the running costs and a monthly contribution of £200 towards the provision of the accommodation.

Her employer purchased the property for £300,000 and built an attached garage in July 2008 for £2,800. The annual value of the property is £6,700.

Required

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

a

Answer

	£	£
Capital benefit = annual value of the property		6,700
Cost of acquiring the property	300,000	
Plus: Capital improvements incurred before the **start** of the tax year	2,800	
Minus: Capital contributions made by the employee	(Nil)	
Cost of providing accommodation	302,800	
Minus: Limit	(75,000)	
	227,800	
× Official rate of interest at the start of the tax year	4.75%	10,821
		17,521
Minus: Employee contributions towards the benefit: (£200 × 12)		(2,400)
Total assessable accommodation benefits		15,121

(3) The revenue benefit

Any running costs relating to the accommodation paid by an 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, using the general rule for P11D employees. In other words, the benefit is assessable at the cost to the employer.

(4) Provision of furniture benefit

If furniture is provided with the accommodation, the assessable benefit is calculated using the rules applicable to the use of assets, which are explained later.

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

Job-related accommodation: the revenue benefit and 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 is subject to a maximum amount. This maximum amount is calculated as follows:

	£	£
Employee's employment income assessment **excluding** the accommodation benefits	Y	
10% of this amount		X
Minus: Employee contribution		(X)
Maximum total benefit for job-related accommodation		X

4.7 The private use of business assets

If a P11D employee is provided with the private use of a business asset (other than a car or van), 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.

If the asset used by the P11D 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
	Minus: Price paid by employee, if any	(X)
		X
(2)	Market value when first provided to any employee	X
	Minus: Benefits already assessed	(X)
	Minus: Price paid by employee, if any	(X)
		X

However, **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 August 2007, a company provided one of its directors, Michael, with a home entertainment system for his own use. The system cost £5,500 in December 2006 and was used by the company until 5 August 2007 when its market value was estimated to be £5,000.

On 6 April 2009 Michael purchased the system from the company for £1,200. Its market value was estimated to be £2,800 at the date of sale.

Required

Calculate the assessable benefits arising on Michael each year.

Answer

		£	£
2007/08	20% × £5,000 × 8/12 (private use for only 8 months)		667
2008/09	20% × £5,000		1,000
2009/10			
Higher of:			
(1)	MV at the date of sale	2,800	
	Minus: Price paid by employee	(1,200)	
		1,600	

		£	£
(2)	Market value when first provided to any employee	5,000	
	Minus: Benefits already assessed	(1,667)	
	Minus: Price paid by employee, if any	(1,200)	
		2,133	2,133
Total assessments			3,800

These rules do not apply to the sale or gift of a company car, van, bicycle or computer. In these cases, the assessable benefit is calculated as follows:

	£
Market value at the date of sale/gift	X
Minus Price paid by employee, if any	(X)
Assessable benefit	X

4.8 The provision of beneficial loans

When an employer provides a P11D employee or any of his relatives with a loan and does not charge a commercial rate of interest (i.e. when the employer provides a cheap loan to a P11D employee), a taxable benefit arises as follows:

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

However, an assessable benefit arises on a cheap loan only if the total loans made to that employee (and/or relatives) are in excess of £5,000.

The official rate of interest on beneficial loans is set by HMRC each tax year. The rate to be used in the examination for 2009/10 is 4.75%. This rate is given in the tax rates and allowances sheet in the examination.

Calculating the interest on the loan at the official rate of interest

The interest on the loan at the official rate of interest can be calculated in one of two ways, using:

- the average method or
- the strict basis of calculation.

(1) The average method

The interest is calculated on the average amount of the loan outstanding. The average is calculated as follows:

(Balance at start of tax year + balance at end of tax year) divided by 2

If the loan was taken out part way through the year, the opening balance of the loan is used instead of the balance at the start of the tax year. Similarly, if the loan was

repaid part way through the year, the closing balance of the loan is used instead of the balance at the end of the tax year.

(2) The strict basis calculation

The interest is calculated on the actual loan outstanding during each month of the year.

Example

Nigel is a P11D employee. His company lent him £50,000 on 6 June 2009. Nigel repaid £10,000 on 6 December 2009. The company charged him £1,500 interest in 2009/10.

Required

Calculate the assessable benefit on Nigel for 2009/10.

Answer

Average method - Interest at the official rate

Loan taken out part-way through the year = £50,000

Balance outstanding at the end of the tax year = £40,000

Length of time loan outstanding = 10 months

Interest at the official rate:

$$\frac{50{,}000 + 40{,}000}{2} = £45{,}000 \times 4.75\% \times 10/12 = £1{,}781$$

Strict basis – Interest at the official rate

Balance outstanding from 6 June 2009 to 6 December 2009 (6 months) = £50,000

Balance outstanding from 6 December 2009 to 6 April 2010 (4 months) = £40,000

Interest at the official rate:

	£
Interest from 6 June 2009 to 6 December 2009 (6 months) = £50,000 × 4.75% × 6/12	1,188
Interest from 6 December 2009 to 6 April 2010 (4 months) £40,000 × 4.75% × 4/12	633
	1,821

	Average method	Strict basis
	£	£
Interest on the loan at the official rate of interest	1,781	1,821
Minus Interest paid	(1,500)	(1,500)
Assessable benefit	281	321

Note that the two methods give slightly different benefit values.

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. He will do so if the strict basis calculation gives a lower benefit.

However, HMRC also have the right to insist on the strict basis if they so wish. They 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, **or**
- the difference between the two methods is material (i.e. significant in amount).

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 against employment income

- Overview of allowable expenses
- The treatment of travel expenses
- The treatment of entertainment expenses
- Dispensations

5 Allowable deductions against employment income

5.1 Overview of allowable expenses

The legislation specifically allows the following deductions from employment income:

- Employee contributions into an occupational pension scheme up to a maximum of 100% of earnings. (Pension contributions are dealt with in more detail in a later chapter.)
- Donations to charity under an approved payroll giving scheme (known as Give As You Earn). The employer deducts the donations from the employee's salary before calculating PAYE (thus giving tax relief for the donation) and pays them to an approved agent. The agent distributes the funds to charities selected by the employee.
- Subscriptions to approved professional bodies, if the subscription is relevant to the employment.

In addition, where an employee uses his own car and claims a mileage allowance, any shortfall in allowance received compared with the approved mileage allowances is an allowable deduction from employment income. (This was illustrated earlier.)

Expenses other than those referred to above are only allowable deductions if they satisfy the general rule and are incurred wholly, exclusively and necessarily in the performance of the employee's duties. This general rule for an employee is more rigorous than the wholly and exclusively rule for a self-employed individual.

- The expense must be wholly and exclusively incurred such that only the business benefits from the expenditure. Any personal benefit that the employee gains as a result of the expenditure must be incidental to the primary purpose of the expense.
- The expense must also be necessarily (i.e. unavoidably) incurred by the employee in order for him to carry out his duties. To satisfy the necessary 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.

- The expense must also be 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. ordinary commuting costs) are not allowable.

5.2 The treatment of travel expenses

Travelling and subsistence expenses are allowable provided that:

- they are not expenses of ordinary commuting
- they are not expenses of private travel, and
- they are necessary in the performance of duties (i.e. the job can not 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 third party entertaining expenses

The treatment of third party entertaining expenses depends on how the expense is paid for.

If the entertaining is paid for by the employee and reimbursed by the employer (or if it is paid for with a specific entertainment allowance):

- 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 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.
- In this instance, the expenses **are 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.

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.

The employment income computation

- A proforma for the employment income computation
- Example of an employment income calculation

6 The employment income computation

6.1 A proforma for the employment income computation

The following proforma can be used to compute employment income.

	£
Wages / salary	X
Bonuses / commissions	X
Assessable benefits	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
Subscriptions to professional bodies	(X)
Expenses incurred wholly, exclusively and necessarily	
e.g. Travel and subsistence expenses	(X)
Entertaining expenses	(X)
AMA deduction	(X)
	X

6.2 Example of an employment income calculation

Olga is employed by Pacific Enterprises plc. In 2009/10 she received a salary of £60,000 and a bonus of £15,000 paid on 15 January 2010.

She also received the following benefits:

(a) A diesel engined company car costing £23,000, with a list price of £26,500 and CO_2 emissions of 229 g/km. She contributed £4,600 towards the purchase of the car and £60 per month towards the use of the car. The company paid the car tax of £160, insurance of £550, and repairs in the year which cost £1,350.

(b) Private fuel which cost the company £2,400.

(c) Vouchers for a car park next to the Pacific Enterprise plc offices which cost £900.

(d) Private medical insurance which cost £1,300, permanent health insurance which cost £400, and death in service insurance cover which cost £340.

(e) Employer contributions into the occupational pension scheme of 5% of salary.

(f) Use of a new laptop computer and software for private use which cost the company £500.

Olga paid the following amounts during 2009/10:

(a) 3% of her salary into the company's occupational pension scheme.

(b) £2,250 on entertaining clients and suppliers, which Pacific Enterprises plc reimbursed as they were genuine business expenses.

(c) £400 donation to charity under the approved payroll giving scheme administered by Pacific Enterprises plc.

Required

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

Answer

	£
Salary	60,000
Bonus	15,000
Assessable benefits	
Car benefit (W1)	6,945
Fuel benefit (£16,900 × 35%)	5,915
Car parking vouchers = exempt	Nil
Private medical insurance	1,300
Permanent health insurance = exempt	Nil
Death in service insurance = exempt	Nil
Employer contributions to pension scheme = exempt	Nil
Use of laptop (£500 × 20%)	100
Entertaining clients and suppliers	2,250
	91,510
Allowable deductions:	
Employee pension contributions (£60,000 × 3%)	(1,800)
Donations to charity under an approved payroll giving scheme	(400)
Earnings for deciding whether an employee is a P11D employee	89,310
Expenses incurred wholly, exclusively and necessarily = entertaining expenses	(2,250)
Employment income	87,060

Workings

(W1) Car benefit	**g/km**		**Diesel**
			%
CO_2 emissions (rounded down to nearest 5 g/km)	225		
Base level of CO_2 emissions	(135)		
	90	÷ 5	18
Minimum percentage			18
Appropriate percentage = restricted to maximum 35%			35

	£		£
Manufacturer's list price	26,500		
Minus: Capital contribution towards the car	(4,600)		
	21,900	at 35%	7,665
Minus: Contribution for the use of the car (£60 × 12)			(720)
Car benefit			6,945

CHAPTER

5

Trading income

Contents

1 Does a trade exist?
2 Overview of the trading income assessment for an unincorporated business
3 The adjustment of profit computation
4 Disallowable expenditure
5 Specifically allowable expenditure
6 Amounts credited in the accounts that are not taxable as trading income
7 Proforma adjustment of profit computation

Does a trade exist?

- Deciding whether or not a trading activity exists
- The badges of trade

1 Does a trade exist?

1.1 Deciding whether or not a trading activity exists

Before starting to compute the trading income assessment of an individual, it is important to establish that the income should be taxed as trading income. Income should only be taxed as trading income if a trading activity exists.

What constitutes a trade is widely defined by UK tax law as '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 or not a trade exists is not clear-cut.

If a profit is made on the disposal of an asset, it can be argued that:

- it is a one-off capital disposal and so should be liable to capital gains tax and
- it does not constitute a trading activity.

Alternatively, depending on the type of asset, the disposal may be exempt from tax.

However, the conclusion might not be the same if another similar disposal were to take place six months later, or one week later, or every four months. It could be argued that the profits from these disposals should be liable to income tax as trading income, and that they are not capital gains from a non-trading activity.

Over many years cases have gone to court to decide whether or not a trading activity exists. As a result of court decisions, there is a list of factors (known as the badges of trade) which HMRC will consider in deciding:

- whether a trading activity exists, and therefore
- whether the profits derived from the activities should be taxed as trading income.

1.2 The badges of trade

In cases where there is doubt as to whether or not a trading activity exists, HMRC will consider six factors to decide the appropriate tax treatment.

No single factor is more important than another and no single factor will determine the treatment on its own. HMRC will look at all the facts of the given situation in making a decision.

The badges of trade (i.e. factors to consider) are as follows:

(1) The subject matter of the transaction and the motive at the time of purchase

(2) The reason for the disposal

(3) The length of ownership

(4) The frequency of transactions

(5) Altering the asset before resale

(6) Other general circumstances.

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. It is considered 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 of these three reasons 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.

Acquiring an asset as a gift or by inheritance from a relative suggests that any profit made on the sale does not constitute a trading transaction.

The reason for the disposal

The motive behind the disposal is also considered.

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 transaction. 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 the period 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 the transactions will constitute a trading activity.

Altering the asset before resale

If an individual purchases an asset and then alters the asset in some way, HMRC is likely to treat the profit on disposal as a trading profit.

Therefore any manufacturing process or repairs that enhance the value of the asset, or simply repackaging an asset to increase its attractiveness in the market place, will signify a trading activity.

Other general circumstances

Other circumstances suggesting that a trading activity exists include evidence of the setting up of a business vehicle, advertising expenditure to promote the business, registering for VAT, and printing business stationery.

If an individual raises finance to purchase and/or process the asset before resale, the raising of finance also suggests that a trading activity exists.

The extent to which the individual relies on the profit as a source of income is also a factor to consider.

Overview of the trading income assessment for an unincorporated business

- The principles of assessing trading income
- Preparation of the trading income assessment for income tax
- Proforma trading income assessment computation for income tax

2 Overview of the trading income assessment for an unincorporated business

2.1 The principles of assessing trading income

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.

The net profit in the financial accounts must be adjusted for taxation purposes because the treatment of some items for tax purposes differs from accepted accounting practice:

- Some items of expenditure in the financial accounts cannot be deducted as an expense in calculating the taxable profit.
- Some items of expenditure are allowable for taxation purposes, but the amount of expenditure that is allowable must be calculated under special tax rules rather than by following the accounting convention rules. An important example is the calculation of how much capital expenditure is allowable for tax purposes. Under the tax rules, capital allowances are calculated. The amount of these capital allowances is different from the depreciation charges in the financial accounts.

2.2 Preparation of the trading income assessment for income tax

There are three key steps in the calculation of a trading income assessment for a sole trader:

Step 1: Prepare an adjustment of profit statement

The first step is to prepare a statement adjusting the net profit of the business (in the financial accounts) to calculate the adjusted profit before capital allowances.

Step 2: Calculate the capital allowances available

The next step is to calculate the capital allowances available for plant and machinery and, if applicable, industrial buildings.

Step 3: Calculate the trading income assessment for the correct tax year

The last step is to apply special basis of assessment rules to the figure of adjusted profit after capital allowances, in order to decide in which tax year the profits will be taxed. These rules are explained in a later chapter.

2.3 Proforma trading income assessment computation for income tax

A proforma for the computation of trading income is shown below.

		£
Net profit		X
Add/Deduct:	Required adjustments of profit (**Step 1**)	X/(X)
Adjusted profits before capital allowances		X
Minus	Capital allowances (**Step 2**)	
	Plant and machinery	(X)
	Industrial buildings	(X)
Adjusted profit after capital allowances		X

The adjustment of profit computation

- Preparing an adjustment of profit computation
- Basic adjustment of profit computation
- The principles of allowable expenditure
- The wholly and exclusively test
- Private use by the owner
- Appropriations of profit by the owner of the business

3 The adjustment of profit computation

3.1 Preparing an adjustment of profit computation

There are two key steps for calculating the adjusted profit figure.

Step 1: Review the expenditure charged in the financial accounts

The first step is to review the items of expenditure charged in the financial accounts, in order to identify the items that are not allowable for tax purposes under the trading income rules. These items of expenditure are often referred to as disallowable expenditure and must be added back to the net profit as shown in the financial accounts.

Step 2: Review the amounts credited to the financial accounts

The second step is to review the amounts credited to the financial accounts to identify any items that are not assessable as **trading** income. These amounts are deducted from the net profit to leave only the profits that relate to the trading business.

3.2 Basic adjustment of profit computation

A proforma for calculating the adjusted profits figure is shown below.

		£
Net profit in the accounts		X
Add	Items of expenditure charged in the accounts that are not allowable for tax under the trading income rules	X
Add	Trading income not recorded in the accounts	X
Minus	Amounts credited in the accounts that are not taxable as trading income	(X)
Minus	Amounts not charged in the accounts that are allowable for trading income purposes	(X)
Adjusted profits before capital allowances		X

3.3 The principles of allowable expenditure

In order to be an allowable expense for tax purposes, the expenditure:

- must be revenue expenditure (not capital expenditure), and
- must be incurred **wholly and exclusively for the purposes of the trade**, and
- must not be specifically disallowed by statute law.

Most items charged as expenses in the accounts satisfy this rule and are allowable expenditure, therefore no adjustment is required.

3.4 The wholly and exclusively test

The wholly and exclusively test requires that an item of expenditure, to be tax-allowable, must be:

- incurred for the purposes of the trade and
- incurred wholly and exclusively for trading purposes.

For example, the cost of sales, and the normal direct production and distribution costs of a business are incurred wholly and exclusively for the purposes of the trade.

3.5 Private use by the owner

The requirement for expenditure to be for the purposes of the trade means that any expenditure that is far removed (remote) from the purposes of the trade is not allowable. This principle is often referred to as the **remoteness test**.

Accordingly, when a business pays for personal expenditure of the owner that is not related to the trade, the expenditure is not allowable. For example, the personal income tax liability and national insurance contributions of the owner are not allowable. If the business pays for these items, they must be added to profit in the adjustment of profit computation.

If expenditure is not incurred **wholly and exclusively** for trade purposes it is also not allowable. Therefore, where a business incurs expenditure that is partly for business and partly for the private purposes of the owner:

- the expenditure is not incurred wholly and exclusively for the purposes of the trade and so
- is not allowable.

Examples of expenditure not incurred wholly and exclusively for the purposes of the trade include:

- motor expenses incurred in running the owner's car, when the car is used partly for business and partly for private mileage, and
- expenditure on telephones used partly for business and partly for private calls.

In theory, all this type of expenditure should be disallowed, because the expenditure has a dual purpose (business use and private use). However, HMRC

will allow an **apportionment** of the associated costs, provided that there is an identifiable part of the expense which is incurred wholly and exclusively for the trade.

The appropriate percentage of the associated costs of providing an asset with an element of private use **by the owner** must therefore be adjusted for (i.e. added to profit) in the adjustment of profit computation.

Note that adjustments are only made for private use **by the owner**. The private use of assets **by employees** is irrelevant and is ignored in the adjustment of profit computation. This is because the expenditure is incurred wholly and exclusively for the purposes of the trade from the business point of view.

All the costs associated with providing the asset for both business and private use **by employees** are allowable for income tax (trading income) purposes. The individual employee is assessed to income tax on the private use under the employment income rules.

3.6 Appropriations of profit by the owner of the business

Any amounts taken out of the business by a sole trader or by a partner in a partnership are known as appropriations of profit. They include drawings, salary or wages for the owner or partner, and interest on capital introduced to the business.

The owner of an unincorporated business is liable to income tax on **all** the tax-adjusted profits of the trade, not just on the amount he chooses to draw from the business.

Accordingly, any appropriations of profit are not allowable deductions for income tax purposes. Since they are not allowable, they must be added back to profit in the adjustment of profit computation.

This rule applies **only** to appropriations of profit **by the owner**.

Where the business employs the spouse or a child of the owner, the normal costs of employment of the spouse or child (for example, gross wages or salary, employee's and employer's national insurance contributions, and the employer's contributions into the employee's pension scheme) are allowable deductions for the business, **provided that they are reasonable** in relation to the services provided to the business.

Disallowable expenditure

- Items specifically disallowed or specifically allowed for tax purposes
- Capital expenditure versus revenue expenditure
- Provisions and allowances against asset values
- Donations and subscriptions
- Interest and royalties
- Legal and professional fees
- Hire and leasing costs
- Gifts
- Entertaining expenses
- Fines and penalties
- Employee-related costs
- Trading income not recorded in the accounts

4 Disallowable expenditure

4.1 Items specifically disallowed or specifically allowed for tax purposes

There are some items of business expenditure that are specifically disallowable for tax under the trading income rules. There are other expenses which are specifically allowable. The main examples that feature in examination questions are explained here.

If a question includes an item of expenditure that does not fall into a specific category explained here, you should apply the general principles of revenue expenditure or capital expenditure and then apply the wholly and exclusively test to make a decision about whether the expenditure should be allowable or not.

4.2 Capital expenditure versus revenue expenditure

In the financial accounts, the cost of purchasing non-current assets is usually taken to the balance sheet, and depreciation is charged against the profit for the period.

However, if the cost is not significant the purchase may be charged in full against profit. In addition, the costs of repairs and maintenance of non-current assets are usually charged against profit.

Any capital purchases, or other capital-related expenditure, that is charged in full against profit is disallowed in the adjustment of profit computation. The amount of the expense must be adjusted for by adding it back to profit. This is because the trading income rules only allow revenue expenditure to be charged against profit for tax purposes.

Capital expenditure

Capital expenditure is expenditure incurred on an asset which provides an enduring benefit to the business and, as a result of the expenditure, there is an element of improvement or enhancement in the value of the asset.

Capital expenditure therefore includes:

- the cost of purchasing non-current assets, and the cost of improvements, enhancements, extensions, etc
- incidental costs, including legal and professional fees, relating to the purchase, improvement, etc of a non-current asset
- **depreciation** and other equivalent write off of capital cost against profit (e.g. amortisation of leases)
- profit (and loss) on the disposal of non-current assets.

Since they are capital expenditure, all these items are not allowable and must be added back to profit in the adjustment of profit computation.

(**Note**: For many businesses, **depreciation** is a major expense in the financial accounts. Depreciation and amortisation are capital-related expenses and are not allowable, so they must be added back to profit. However, there are **capital allowances** on items of capital expenditure for trading purposes. Capital allowances can be thought of as tax-allowable depreciation.)

Revenue expenditure

Revenue expenditure is expenditure incurred in running the business, maintaining the value of the assets or returning an asset to its original condition. Revenue expenditure is an allowable cost for trading income purposes.

Revenue expenditure therefore includes:

- repair costs
- maintenance costs
- re-decoration, re-plastering costs, etc.

However, if a business purchases an asset in such a condition that it is not usable and the purchase price reflects the poor condition of the asset, any expenditure incurred in bringing the asset into use in the business should be treated as capital-related expenditure and the expense will be disallowed.

4.3 Provisions and allowances against asset values

In the financial accounts, in accordance with generally accepted accounting principles (UK GAAP or International Accounting Standards (IAS)), a business may reflect in the profit figure the movement in provisions or allowances made against the value of assets at the end of the period. For example, there may be provisions in the financial accounts against inventory values or allowances against amounts owed by customers.

If accounted for under UK GAAP or IAS, the movement in the provision or allowance in the financial accounts is **allowable** for trading income purposes.

Similarly, provisions for future costs are allowable against trading income provided the provision can be estimated accurately and is accounted for under UK GAAP or IAS.

Normal trade debts that are written off or recovered, and which are reflected in the accounts, do not need to be adjusted for. This is because they are items wholly and exclusively relating to the purposes of the trade.

However, the write off of **non-trade** debts such as a loan to a customer, supplier or an employee, must be adjusted for by adding back to the net profit.

4.4 Donations and subscriptions

Subscriptions to professional and trade associations (for example, subscriptions to the ACCA and the Chamber of Commerce) **are allowable** against trading income provided they are incurred wholly and exclusively for the purposes of the trade. Therefore no adjustment is required to the profit figure.

However, **donations** are **usually not allowable** against trading income. They must be added back to the profit, with the exception of small donations to local charities.

In summary:

- **small** donations to local charities are, by concession, usually allowable
- **any political** donation or subscription is not allowable
- **any** donation to a **national charity** is not allowable, and
- **any** donation made under the **Gift Aid scheme**, regardless of size, is not allowable under the trading income rules.

4.5 Interest and royalties

Interest payable in respect of loans for trading purposes (e.g. bank overdraft interest, hire purchase interest and loan interest) is allowable against trading income. Therefore no adjustment is required.

Interest payable on underpaid tax is not allowable for income tax purposes and must therefore be added back.

In the examination, all royalties payable and receivable, such as patent royalties and copyright royalties, will be treated as trading expenditure or trading receipts. Therefore no adjustment for royalties is required.

In addition, although they are of a capital nature, any costs incurred in relation to the registration of a patent or copyright for the purposes of the trade are specifically allowable.

4.6 Legal and professional fees

Legal and professional fees relating to capital expenditure are, in principle, not allowable against trading income.

However, legal and professional fees relating to revenue expenditure are allowable. These include legal and professional fees incurred in relation to:

- the collection of debts
- employment issues
- claims for breach of contract (including damages paid, if any, provided the court action relates to the trade and it is not proven that the business had broken the law)
- preparing and auditing the financial accounts and normal tax compliance work.

Costs in relation to **tax planning advice** and appealing against assessments and investigations are, however, **not tax allowable**.

Legal and professional costs **relating to leases** are capital in nature and therefore not allowable. Thus the costs associated with the setting up of a new lease, regardless of the length of the lease, would need to be added back in the adjustment of profit computation.

However, tax rules specifically allow against trading income any legal costs in relation to the **renewal** of a **short** lease (i.e. a lease with a life of ≤50 years remaining).

4.7 Hire and leasing costs

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 of more than 160 g/km is specifically disallowed 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

Queenie hired a car for a rental cost of £6,600 per annum.

Required

Calculate the amount to add back to profit in the adjustment of profit computation 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.

4.8 Gifts

The treatment of gifts in an adjustment of profit computation depends on the recipient of the gift and nature of the gift.

Special rules apply as follows:

- Gifts to customers are not allowable for trading income purposes unless they carry a conspicuous advertisement for the business and the total cost per recipient does not exceed £50.
- Gifts of food, drink, tobacco or vouchers exchangeable for goods are not allowable under any circumstances, whatever the cost, with or without an advertisement.
- Gifts to employees are allowable for trading income purposes for the business (but the employee may be taxed on the receipt of a benefit from employment).

4.9 Entertaining expenses

Expenses incurred in **entertaining existing or potential customers or suppliers** are **not allowable** against trading income and therefore need to be added back in the adjustment of profit computation.

However, expenses incurred in **entertaining staff** are **allowable**, provided the entertainment is for staff and the cost is not part of the cost of entertaining others (who are not staff).

4.10 Fines and penalties

Any costs associated with breaking the law, such as fines and penalties, are not allowable for tax purposes and therefore need to be added back to the net profit.

However, parking fines incurred by an employee (but not the proprietor) while on a business activity are, by concession, allowable against trading income.

4.11 Employee-related costs

The gross salaries of employees and other employee-related costs are allowable as wholly and exclusively incurred. Other employee-related costs include expenditure such as:

- the costs of providing benefits such as cars, accommodation, permanent health insurance, death in service benefit, removal expenses, etc
- employer's national insurance contributions

- employer's pension contributions
- compensation for loss of office and redundancy pay
- counselling services provided for redundant employees, etc.

The business can claim **all** these employee-related costs **in full** as tax-allowable expenditure, even if the employee enjoys the benefit of private use of assets (for example, using a company car for both business and private mileage or a laptop for both business and personal use).

Since these employee-related costs will have been deducted in full in arriving at the figure of net profit, no adjustment will be required. However, the individual employee will be personally assessed to income tax for the element of private use.

4.12 Trading income not recorded in the accounts

Most sources of trading income are correctly reflected in the financial statements of the unincorporated business.

However, where the owner takes goods/stock out of the business for personal use or for use by family or friends, the treatment in the accounts must be considered. The transaction may not have been processed through the accounts at all, or may have been accounted for at cost (which is the correct accounting treatment according to UK GAAP).

In both of these circumstances, an adjustment of profit is required because the tax rules state that the owner must be taxed on the profit of the transaction **as if** the goods had been sold to a third party at full market value.

- If not recorded in the accounts, the full market value of the goods must be added to profit.
- If recorded in the accounts but accounted for at cost, the gross profit that would have been made on the transaction must be added to profit.

This rule does not apply to the supply of services from the business to the owner.

Specifically allowable expenditure
■ Specific allowable items ■ Pre-trading expenditure ■ Short leases on a property ■ Expenditure paid personally by the owner and not recorded in the accounts

5 Specifically allowable expenditure

5.1 Specific allowable items

Many items of expenditure which are **specifically allowed** against trading profits have already been mentioned in the explanations of specifically disallowable items.

There are, however, two other types of specific allowances available against trading profits which have not yet been mentioned in detail. These relate to:

- pre-trading expenditure, and
- short leases.

5.2 Pre-trading expenditure

Expenditure incurred prior to the business's first day of trading is, in principle, not incurred *wholly and exclusively for the purposes of the trade,* as a trade does not exist at that time.

However, tax law specifically permits pre-trading expenditure to be allowable under the trading income rules, and treated as if incurred on the first day of trading, 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.

5.3 Short leases on a property

Where a landlord grants a short lease on a property and receives a premium, this is treated for tax purposes partly as property income of the landlord and partly as a capital receipt.

The tenant who is granted the lease pays the premium to the landlord and in addition is usually required to pay rent on a monthly or quarterly basis.

If the tenant uses the property for the purposes of a trade, in the financial accounts the lease will be treated as follows:

- The premium is shown in the balance sheet as the cost of the lease.

- The premium is written off over the life of the lease against profit in each accounting period (i.e. depreciation of the premium is charged against profit, and is referred to as amortisation of lease in the accounts).
- Any rent payable is charged against profit for the period.

In the tenant's adjustment of profit computation, 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 of the lease is capital-related and therefore is 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** is the landlord's property income assessment in respect of the premium received spread over the length of the lease. It is calculated as follows:

	£
Premium paid to landlord	X
Minus 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 against profit is sometimes called **notional rent**.

If the tenant obtained the lease part-way through their accounting period, the notional rent must be time-apportioned according to the number of months the lease was held by the tenant in the accounting period.

Example

Rupert owns a property which he decided to lease on 1 January 2010. He granted a 25-year lease to Susan for a premium of £98,000 and quarterly rent of £6,800 payable in advance starting on 1 January 2010.

Susan prepares her accounts to 30 June each year. She has capitalised the lease on her balance sheet and, in addition to the rent payable, she has charged amortisation of £1,960 against her profit for the year ended 30 June 2010.

Required

Calculate the adjustments Susan needs to make to her profit for the year ended 30 June 2010 for trading income purposes.

a

Answer

Adjustment of profit – Susan: year ended 30 June 2010

Add back	Amortisation charge	£1,960
Deduct	Allowable deduction (see working below)	£1,019

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.

Property income assessment for Rupert in 2009/10:

	£
Premium paid to Rupert	98,000
Minus 2% × £98,000 × 24	(47,040)
Property income assessment	50,960

Allowable deduction for Susan in year ended 30 June 2010:

	£
Annual allowable deduction against profit (£50,960 ÷ 25 years)	2,038
Allowable deduction for year ended 30 June 2010: £2,038 ÷ 6/12 (leased for 6 months of Susan's accounting period)	1,019

5.4 Expenditure paid personally by the owner and not recorded in the accounts

If an owner incurs a business expense and pays for it personally, the expense is still allowable for income tax purposes (provided it complies with the normal rules for allowable expenses). The expense can therefore be deducted in the adjustment of profit computation.

A common example occurs where a sole trader uses a room in his home as an office for business purposes. The business proportion of expenses incurred in heating and lighting the room and a proportion of telephone calls etc is allowable expenditure, even if paid for personally by the sole trader.

Amounts credited in the accounts that are not taxable as trading income

- Income taxed under other assessment rules
- Exempt income
- Capital profits

6 Amounts credited in the accounts that are not taxable as trading income

6.1 Income taxed under other assessment rules

In the adjustment of profit computation, the aim is to adjust the figure of net profit recorded in the financial accounts and to identify the profit arising from the trading activities of the business.

The figure of net profit in the accounts may include income receivable from non-trading sources. It is therefore necessary to deduct any income credited in the accounts that is not assessable as trading income. This includes items such as:

- interest income
- dividend income
- UK property income
- foreign income.

This income is then included separately in the individual's income tax computation, applying the assessment rules for that source of income.

6.2 Exempt income

The net profit figure may also include income receivable that is exempt from income tax. This must be deducted in the adjustment of profit computation.

The main types of exempt income which could appear in the accounts of an unincorporated business are:

- competition prizes, national lottery and premium bond prizes, betting winnings
- income from ISAs (Individual Savings Accounts)
- income tax repayment supplement.

6.3 Capital profits

Capital profits on the disposal of assets also need to be deducted in the adjustment of profit computation, as these profits are not taxed as trading income. Capital profits are either liable to capital gains tax or not taxable at all.

Proforma adjustment of profit computation

- Detailed proforma adjustment of profit computation

7 Proforma adjustment of profit computation

7.1 Detailed proforma adjustment of profit computation

The proforma below sets out some of the adjustments that may be required to calculate the figure of adjusted trading profit.

(W1) Proforma computation: Adjustment of profit	**£**
Net profit as shown in the accounts	X
Add Items of expenditure charged in the accounts that are not allowable for tax under the trading income rules	
Capital expenditure (may be eligible for capital allowances)	X
Legal or professional fees relating to capital expenditure (including leases, except fees relating to the renewal of a short lease)	X
Depreciation/amortisation charges for 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
Appropriations of profit by the owner	X
Private expenditure by the owner	X
Goods taken out of the business by the owner	X
Professional fees in relation to tax advice	X
Disallowable portion of lease rental on car with CO_2 emissions over 160 g/km	X
Gifts to customers (if > £50 and no advertisement, or if a gift of alcohol, food or tobacco)	X
Fines and penalties	X
Entertaining expenses (except entertainment of employees)	X
	X
Minus Amounts credited in the accounts that are not taxable as trading income	
Income taxed under other assessment rules (e.g. income taxed as property income, interest income)	(X)
Exempt income (e.g. ISA interest, repayment supplement)	(X)
Capital profits (may be assessed as a chargeable gain instead) (e.g. profit on the disposal of a non-current asset, profit on the sale of shares etc)	(X)
Minus Amounts not credited in the accounts that are allowable for trading income purposes	
Allowable deduction for short leases	(X)
Adjusted profits before capital allowances	X

Example

David runs a printing business. He produces accounts to 31 March each year. The net profit for the year ended 31 March 2010 is £82,200 after taking account of the following:

	Notes	£
Stationery	1	9,200
Salaries and wages	2	109,000
National insurance	3	5,400
Depreciation		14,800
Repairs and maintenance	4	7,400
Gas, electricity, water		5,800
Royalties payable (gross)	5	4,000
Motor vehicle expenses	6	17,925
Hire of car for an employee	7	4,300
Bank overdraft interest and charges		3,900
Sundry expenses	8	2,300
UK dividends received		2,700
Bank deposit interest received		4,800

Notes

(1) During the year David had some stationery specially designed and printed by the firm for his daughter's wedding. David did not reimburse the business, but the goods were taken out of stock in the accounts at their cost of £300. If sold to a customer the stationery would have been invoiced at £450.

(2) Salaries and wages comprised

	£
Staff wages (including £8,500 salary to David's wife, who is employed as a part-time administrator)	66,250
Salary to David	40,000
Staff Christmas party	450
Agency fees for hiring of temps	2,300
	109,000

(3) National insurance includes Class 2 NICs of David at £125. The remainder of this expense relates to the employer's NI contributions on staff salaries.

(4) Repairs and maintenance include £3,100 relating to the repair of the office roof following a violent storm and £2,000 relating to alterations needed for the installation of a new printing press.

(5) Royalties of £4,000 (gross) were paid on 28 February 2010 to another printing firm for the use of a logo on a customer's product.

(6) Motor expenses consist of the following:

	£
Running costs of staff cars	9,105
Running costs of David's car	8,320
Loss on the sale of a car	500
	17,925

David's annual mileage was as follows:	Miles
Home to work	3,500
Visits to customers and suppliers	4,500
Private journeys	12,000
	20,000

(7) The hire car has a retail price of £24,000 and CO_2 emissions of 180 g/km. The employee uses the car 30% for business purposes.

(8) Sundry expenses include £150 paid to a charity under the Gift Aid scheme and a £20 donation to the local church appeal.

Required

Calculate David's adjusted profit before capital allowances for the year ended 31 March 2010.

a

Answer

David – year ended 31 March 2010		**Notes**	**£**
Net profit			82,200
Add	Goods taken for own use		
	– profit on wedding stationery (£450 – £300)		150
	Depreciation		14,800
	Appropriations of profit		
	– Salary to David	1	40,000
	– Class 2 NICs of David		125
	Capital expenditure		
	– Alterations relating to the installation of the press	2	2,000
	Motor expenses (15,500/20,000 × £8,320)	3	6,448
	Loss on the sale of car		500
	Disallowable portion of hire charge on employee's car	4	645
	Gift Aid donation	5	150
			147,018
Minus	Dividends received from a UK company		(2,700)
	Bank deposit interest received		(4,800)
Adjusted profits before capital allowances			139,518

Notes

(1) The wages paid to David's wife will probably be allowed as they appear to be reasonable remuneration for the services provided to the business. However, David's salary and his personal national insurance contributions are not allowable.

(2) The installation costs relating to the new printing press are capital-related and are not allowable. However, capital allowances will be available on the cost of the new printing press, including the installation costs.

(3) Ordinary commuting from home to work is deemed to be private mileage. Therefore David's total private mileage is 15,500 out of his total annual mileage of 20,000.

(4) The disallowable portion of the hire charge of the car is £4,300 x 15% = £645.

(5) The Gift Aid donation is not allowable as a trading expense. The amount charged in the accounts must be added to profit. If a basic rate taxpayer, no further adjustment is required as basic rate tax relief will automatically be obtained in paying the donation net of 20% tax. If a higher rate taxpayer, the higher rate relief is obtained by extending the basic rate band by the gross amount of the Gift Aid donation.

(6) The gift to the local church appeal will be allowable as a small donation to a local charity.

(7) No adjustment is needed in respect of the royalties as they are regarded as a trading expense.

(8) The examiner will normally just ask you to 'calculate' the adjusted profit therefore there is no need to explain the reasons for your adjustments.

CHAPTER 6

Capital allowances – plant and machinery

Contents

1	An overview of capital allowances
2	The definition of plant and machinery
3	The system of capital allowances for plant and machinery
4	The main pool
5	The special rate pool
6	Cars
7	Short life assets
8	Capital allowances for unincorporated businesses

An overview of capital allowances

- The primary aim of capital allowances
- The types of capital allowance available

1 An overview of capital allowances

1.1 The primary aim of capital allowances

Capital purchases and other capital-related expenditure, such as depreciation charges and legal fees incurred in making purchases of capital items, are not allowable deductions in the adjustment of profit computation. However, businesses are able to claim capital allowances instead. Capital allowances can be thought of as tax depreciation allowances.

The depreciation charges in the financial accounts are calculated on a subjective basis. Depreciation charges are therefore not allowed as a deduction in calculating trading income. Instead, tax relief is given for the purchase cost of certain non-current assets and subsequent capital expenditure (such as extensions and improvements) using a standardised set of rules for capital allowances.

The primary aim of the capital allowance rules is to give tax relief for the **net cost** of non-current assets by means of deductions from the adjusted profits figure over one or more accounting periods.

The **net cost** of a non-current asset means the actual cost of using the asset in the business over its useful life, after taking account of any sale proceeds received. In other words, net cost is the original cost less any eventual sale/disposal proceeds.

Capital allowances are calculated for each accounting period separately and deducted in the calculation of the trading income assessment.

1.2 The types of capital allowance available

For the purposes of the examination, the only relevant rules for capital allowances are those that apply to:

- plant and machinery (explained in this chapter), and
- industrial buildings (explained in the next chapter).

The definition of plant and machinery

- The source of the definition of plant and machinery
- Case law

2 The definition of plant and machinery

2.1 The source of the definition of plant and machinery

Tax legislation does not provide a comprehensive definition of plant and machinery.

Case law provides some guidance on items which have been held to be plant and machinery in the courts in the past, and in recent years some of these decisions have been brought into the tax legislation.

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. However, statute law does not provide a formal all-inclusive definition of plant and machinery.

Deciding whether or not an item is plant and machinery is important because the capital allowances available on plant and machinery are more generous than the allowances available on other types of asset. In some cases, if an item is not deemed to be plant and machinery, there may be no allowances available.

2.2 Case law

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 (i.e. the asset performs an active function and is used in the trade), it 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 this functional test, it should be clear that plant and machinery includes the typical non-current assets used by a business such as motor vehicles, machines, computers, office furniture, equipment, fixtures and fittings, and so on. It also includes assets creating an atmosphere for the public appropriate to the business (such as pictures and artefacts in a hotel or restaurant).

The system of capital allowances for plant and machinery

- The different categories of plant and machinery
- Allowances available for plant and machinery
- Preparation of a capital allowances computation
- Proforma capital allowances computation – plant and machinery

3 The system of capital allowances for plant and machinery

3.1 The different categories of plant and machinery

For the purpose of capital allowances, plant and machinery must be grouped into different categories. This is because different rates of allowances are available for different types of asset.

All items of plant and machinery are included in the **general pool** (sometimes referred to as the main pool) **unless** they are:

- Expensive cars = cars costing **more than** £12,000 which were acquired before 6 April 2009
- Short life assets = plant and machinery, other than cars, with a useful life of **less than** 5 years and for which an election has been made
- Private use assets = assets with an element of private use by the proprietor
- Integral features, long life assets, thermal insulation and cars with CO_2 emissions of more than 160 g/km. These go into the special rate pool.

3.2 Allowances available for plant and machinery

The types of capital allowances available are as follows:

- **Annual investment allowance**: this is available in the accounting period in which an asset is purchased
- **Writing down allowances**: these are available every accounting period
- **First year allowances**: these depend on the date on which an asset is purchased
- **Balancing allowances and charges**: these are only applicable on the eventual disposal of an asset.

The rules for each allowance are explained in detail later in this chapter.

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. It is their written down value for tax purposes.

3.3 Preparation of a capital allowances computation

There are seven key steps in preparing a computation of capital allowances. To ensure that the rules for capital allowances are applied correctly, it is important to follow these steps in the strict order shown below, and to set out the computations for capital allowances using the proforma that is given here.

Step 1: Review additions to non-current assets in the accounting period

Decide whether the purchased asset is plant and machinery and therefore eligible for capital allowances. Then decide the appropriate category of the asset and therefore to which column the addition should be allocated.

If the asset does not qualify for an AIA or FYA, add the cost of the asset to the tax written down value brought forward from the previous period (TWDV b/f) in the appropriate column of the proforma.

The TWDV b/f, if applicable, will be given in the examination question.

Step 2: Bring in additions that qualify for the AIA and calculate the AIA available

The cost of assets qualifying for the AIA should be entered as an addition in the appropriate column, and the AIA entered as a deduction.

Step 3: Deal with disposals of plant and machinery in the accounting period

Capital allowances are given on the **net cost** of an asset. Therefore, when an asset has been disposed of, the sale proceeds are deducted from the TWDV. This deduction should be entered in the appropriate column of the proforma.

There are two exceptions to this rule:

- If the asset was sold for more than its original cost, deduct the original cost instead of the sale proceeds. (Never take out from a column more than the amount that was originally put in.)
- If the asset was given away (gifted) or sold for less than it was worth, the amount of the deduction is the lower of:
  - the full market value on the disposal date, and
  - the original cost.

When a building is sold, the vendor and purchaser make a joint election to determine how much of the sale proceeds is to be allocated to any fixtures included

within the building. However, the amount allocated to the fixtures cannot exceed their original cost.

Step 4: Calculate balancing allowances (BAs) and balancing charges (BCs)

Next, the balancing allowances and balancing charges should be calculated and entered in the appropriate column of the proforma. The calculation of BAs and BCs is explained later.

Step 5: Calculate the writing down allowances (WDAs) available

Next, the writing down allowances should be calculated, and entered (as a deduction) in the appropriate column of the proforma. The calculation of WDVs is explained later.

Step 6: Bring in additions that qualify for FYAs and calculate the FYAs available

Enter the qualifying cost as an addition to the main pool and enter the FYA as a deduction.

Step 7: Calculate the total capital allowances for the period

There is a column in the proforma for capital allowances for the period. The amount of balancing allowances and balancing charges, WDAs, FYAs and the AIA are recorded in this column. The capital allowances available for the period should be totalled. (Total = BAs + WDAs + FYAs + AIA – BCs). This total should then be deducted from the adjusted profits before capital allowances to calculate the trading income assessment.

The TWDV is then calculated for each column and carried forward to the next period.

Study the proforma carefully. It may seem complicated initially. You should keep returning to the proforma as you learn more about calculating capital allowances.

3.4 Proforma capital allowances computation

Proforma capital allowances computation

Note: This proforma is the same as for corporation tax, except for the private use assets (shown in bold) which are specific to income tax

		Main pool	Special rate pool	Expensive cars A	B	Short life assets C	D	Private use assets **E**	**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											X
(2) maximum £3,000					(X)						
		X	X		X		X		**X**		
Acquisitions qualifying for FYA											
Additions	X										
FYA (100% or 40%)	(X)										X
		X									
TWDV c/f		X	X		X		X		**X**		
Total capital allowances											XX

The main pool

- The calculation of the AIA on main pool items
- The calculation of FYAs on main pool items
- The calculation of WDAs on main pool items
- Rate of WDAs on main pool plant and machinery items
- The calculation of balancing allowances and balancing charges on main pool items
- Small pools

4 The main pool

4.1 The calculation of the AIA on main pool items

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.

4.2 The calculation of FYAs on main pool items

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.

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 for 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).

4.3 The calculation of WDAs on main pool items

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 main pool 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.

4.4 Rate of WDAs on main pool plant and machinery items

The rate of WDAs on main pool items is **20% for a 12-month accounting period**, calculated on the balance in the pool.

The length of ownership of the asset in the accounting period is irrelevant. However, for WDAs the length of the accounting period is very important. If the accounting period is less than 12 months, the WDA must be time-apportioned.

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.

a **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

4.5 The calculation of balancing allowances and balancing charges on main pool items

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**.

Where a main pool asset is disposed of, deduct the following disposal value from the pool:

Disposal value = Lower of:

- Sale proceeds (or market value if gifted)
- Original cost

(This is the application of Step 3, as explained earlier.)

Disposal value more than the balance in the pool

If the disposal value exceeds the balance on the pool, a balancing charge arises (i.e. a negative figure). A balancing charge means that allowances claimed in the past exceed the **net cost** of the asset. These excess allowances are clawed back in the year of disposal, by reducing the capital allowances in the year of disposal. A balancing charge is therefore a negative allowance.

A balancing charge can arise in any accounting period. It reduces the capital allowances claim for the 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	
Acquisitions qualifying for AIA		21,000	
Cost	45,000		
AIA	(45,000)		45,000
		Nil	
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
TWDV c/f		Nil	
Total allowances available			43,000

Disposal value less than the balance in the pool

If the disposal value is less than the balance on the pool, this means that allowances claimed in the past have been less than the **net cost** of the asset. The rest of the net cost can therefore be claimed as a capital allowance.

However, for the main pool assets, a balancing allowance does not arise at the time of the disposal. Instead, the shortfall in the allowances claimed for the asset will be claimed in the future by WDAs, in the normal way, on a reducing balance basis.

A BA **will only arise in the main pool in the period in which the business ceases to trade**, (i.e. the last accounting period) when all the assets of the business are being disposed of. In this case, all the shortfall of allowances is claimed in the final period as a BA. This increases the capital allowances claim for the accounting period.

e

Example

William ceased trading on 31 December 2009 and produced a three-month final set of accounts. On 1 October 2009 the TWDV b/f on William's main pool was £64,000. There were no additions in the final three months of trading.

On cessation William sold his plant and machinery for scrap, and realised proceeds of £20,000.

Required

Calculate the capital allowances available for the three month accounting period to 31 December 2009.

a

Answer

William - Capital allowances on cessation of trade – 3 months ending 31 December 2009	**Main pool**	**Total allowances**
	£	£
TWDV b/f	64,000	
Disposals - Lower of (i) sale proceeds, or (ii) original cost	(20,000)	
	44,000	
Balancing allowance	(44,000)	44,000
TWDV c/f	Nil	
Total allowances available		44,000

4.6 Successions

Where a trade passes from one connected person to another, balancing adjustments can be avoided by making a succession election. This election allows assets to be transferred to the purchaser at their TWDVs.

The election must be made within two years of the date the trade is transferred. If it is not made, the assets are deemed to be sold to the successor at their market values.

(The definition of a connected person is covered in chapter 13.)

4.7 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.

The special rate pool

- Introduction
- Integral features
- Long life assets
- The AIA
- FYAs
- WDAs in the special rate pool
- Balancing adjustments

5 The special rate pool

5.1 Introduction

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.

5.2 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.

5.3 Long life assets

Long life assets are defined as 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 purchase cost of more than £100,000 in a 12-month period.

The expected working life relates to the capability of the plant and machinery, not just 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.

5.4 The AIA

The AIA **is** available on assets qualifying for inclusion in the special rate pool, with the exception of motor cars. 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.)

5.5 FYAs

FYAs are not available on assets qualifying for inclusion in the special rate pool.

5.6 WDAs in the special rate pool

The WDA in the special rate pool is calculated using the reducing balance method in the same way as for the main pool, except that the rate of **WDA is 10% for a 12-month period** (not 20%).

The 10% must be time-apportioned if the accounting period is less than 12 months.

5.7 Balancing adjustments

The method of calculating balancing adjustments in the special rate pool is the same as for the main pool:

- A balancing charge can occur in any accounting period.
- A balancing allowance can only occur on the cessation of trade.

Example

ZPP Ltd prepares its accounts to the 31 March 2010.

On 1 April 2009 the TWDVs brought forward were as follows:

	£
Main pool	24,000
Special rate pool	134,400

During the year ZPP Ltd made the following acquisitions:

	£
New packing machine (May 2009)	66,800
Delivery van (June 2009)	14,500
Motor car (July 2009) (CO_2 emissions of 170 g/km)	18,000

Disposals made in the year were as follows:

	£
Fork lift truck (sold for less than cost)	3,600

The new packing 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.

a

ZPP Ltd - Capital allowances – y/e 31 March 2010		**Main pool**	**Special rate pool**	**Total allowances**
	£	£	£	£
TWDV b/f		24,000	134,400	
Acquisitions (66,800 + 14,500)	81,300		18,000	
AIA	(50,000)			50,000
	31,300			
Disposals		(3,600)	(Nil)	
		20,400	152,400	
WDA (20%)		(4,080)		4,080
WDA (10%)			(15,240)	15,240
FYA (40%)	(12,520)			12,520
Transferred to pool	(18,780)	18,780		
TWDV c/f		35,100	137,160	
Total allowances available				81,840

Notes

The packing machine has a life of ≥ 25 years. However, it cost < £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.

The car does not qualify for either the AIA or a FYA.

Cars

- The new rules for cars
- The old rules for expensive cars
- Private use

6 Cars

6.1 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 Ltd prepares its 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 Ltd 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 Ltd - 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

6.2 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.

The calculation of WDAs on expensive cars

There must be a separate column in the proforma for each expensive car.

Expensive cars qualify for a WDA of 20%; however, this is restricted to a maximum of £3,000 p.a. for each car. This maximum WDA must be time-apportioned if the accounting period is less than or more than 12 months long.

The calculation of BAs and BCs on expensive cars

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.

If the disposal value is higher than the TWDV for the expensive car, a balancing charge arises, which is a negative capital allowance.

If the disposal value is less than the TWDV for the expensive car, a balancing allowance arises, which is added to the total capital allowances available for the period.

6.3 Private use

Private use of a car by an employee is irrelevant and has no effect on the WDA available.

Private use of a car by the proprietor of the business is covered later.

Example

WXG Ltd prepares accounts for the nine months ended 31 December 2009. Its TWDVs b/f were £31,000 on the main pool, £16,000 in respect of a BMW purchased two years ago for the use of the sales manager and £25,000 in respect of a Peugeot purchased one year ago for the finance director.

On 10 December 2009 the company sold the BMW for £11,600 and replaced it with a Ford which cost £15,000. The new Ford has CO_2 emissions of 150 g/km. There are no other additions.

Required

Calculate the capital allowances available for the nine months ended 31 December 2009.

Answer

WXG Ltd - Capital allowances – 9 months ended 31 December 2009	**Main pool**	**BMW**	**Peugeot**	**Total allowances**
	£	£		£
TWDV b/f	31,000	16,000	25,000	
Acquisitions **not** qualifying for FYAs	15,000			
Disposals	(Nil)	(11,600)	(Nil)	
	46,000	4,400	25,000	
Balancing allowance		(4,400)		4,400
		Nil		
Writing down allowance (WDA)				
(1): 20% × £46,000 × 9/12	(6,900)			6,900
(2): restricted to £3,000 × 9/12			(2,250)	2,250
TWDV c/f	39,100		22,750	
Total allowances available				13,550

Short life assets

- The treatment of short life assets
- The calculation of the AIA and FYA on short life assets
- The calculation of WDAs on short life assets
- The calculation of BAs and BCs on short life assets
- The tax planning opportunities of making the de-pooling election

7 Short life assets

7.1 The treatment of short life assets

Short life assets are defined as plant and machinery, other than cars, with a useful economic life of less than five years (i.e. when they are purchased, the intention of the business is to dispose of them within the following four accounting periods).

In the examination, the most common examples of short life assets are computers and computer software.

Short life assets are treated as normal main pool items **unless a de-pooling election is made.** Companies must make the election within two years of the end of the accounting period in which the expenditure was incurred. Individuals have one year after the 31 January following the end of the period of account in which the expenditure was incurred.

If the de-pooling election is made in respect of a short life asset, instead of including the asset in the main pool, a separate record is maintained for that asset. There should be a separate column for the asset in the capital allowances computation proforma.

If elections are made to de-pool several short life assets, a separate record is maintained for each individual short life asset.

7.2 The calculation of the AIA and FYA on short life assets

Short life assets qualify for the AIA and 40% FYA in the same way as main pool items.

7.3 The calculation of WDAs on short life assets

WDAs are claimed on short life assets in the same way and at the same rate as in the main pool.

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.

7.4 The calculation of BAs and BCs on short life assets

If the short life asset is disposed of within four years of the end of the accounting period in which it is acquired, a BA or a BC will arise.

- If the disposal value is higher than the TWDV for the short life asset, a balancing charge arises, which is a negative capital allowance.
- If the disposal value is less than the TWDV for the short life asset, a balancing allowance arises, which is added to the total capital allowances available for the period.

7.5 The tax planning opportunities of making the de-pooling election

The de-pooling election is optional and should **only** be made where it is anticipated that the asset will be **sold for less than its TWDV** while it is being treated as a separate short life asset.

The aim of de-pooling is to accelerate the capital allowances available on that asset (i.e. allow the allowances to be claimed earlier), but the benefit does not crystallise until the period of disposal.

Up to the disposal of the asset, the same amount of allowances will be claimed whether or not the asset is de-pooled. However, on its disposal:

- if de-pooled and sold for less than its TWDV, a balancing allowance will arise
- if not de-pooled, the disposal value is deducted in the main pool and the allowances for the remaining net cost of the asset will be claimed as WDAs on a 20% reducing balance basis over several years; no balancing allowance arises.

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

Y Ltd prepares its accounts to 31 March each year. On 1 November 2009 it purchased a laptop computer and software for £3,200. It 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 March 2013, both with and without the short life asset (de-pooling) election, assuming that the computer is disposed of on 31 October 2011 for £950. Assume also that there is a substantial balance brought forward on the main pool and that the AIA is not available.

Answer

Y Ltd Capital allowances	Short life election made: Short life asset	Short life election made: Total allowances	Short life asset election not made: Main pool	Short life asset election not made: Allowances re the computer
y/e 31 March 2010	£	£	£	£
TWDV b/f			X	
Acquisitions	3,200		3,200	
WDA (20%)	(640)	640	(640)	640
TWDV c/f	2,560		2,560	
y/e 31 March 2011				
WDA (20%)	(512)	512	(512)	512
TWDV c/f	2,048		2,048	
y/e 31 March 2012				
Disposal	(950)		(950)	
	1,098		1,098	
Balancing allowance	(1,098)	1,098		
WDA (20%)			(220)	220
TWDV c/f	Nil		878	
y/e 31 March 2013				
WDA (20%)	Nil	Nil	(176)	176
TWDV c/f	Nil		702	
Total allowances claimed to date		2,250		1,548

The net cost of the computer is £2,250 (£3,200 - £950).

The full net cost is allowed by 31 March 2012 if the short life asset election is made.

If the election is not made, only £1,372 will have been allowed by 31 March 2012 and £1,548 by 31 March 2013. The remaining £702 of net cost will be relieved, but over several years on a 20% reducing balance method.

The 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 £950 on the disposal of the asset. In that situation, it would be better to leave the asset in the main pool.

Capital allowances for unincorporated businesses

- The treatment of private use assets
- Short periods of account
- Long periods of account

8 Capital allowances for unincorporated businesses

8.1 The treatment of private use assets

Full capital allowances are available to a company, even if there is an element of private use of an asset by a director or employee. The benefit of private use will be assessed on the individual as a benefit of employment; but it is irrelevant for calculating the capital allowances available to the company.

However, as regards an unincorporated business, 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. This is because capital allowances are only available on the business proportion of the expenditure.

The most common example of a private use asset is a car used by the owner of the business.

(You should refer to the Proforma capital allowances computation when reading the following rules.)

(1) **WDA on private use assets**. The WDA on private use assets is calculated in the normal way on a reducing balance method (or restricted to a maximum of £3,000 if an expensive car). The WDA is deducted from the tax written down value in the appropriate private use asset column in the proforma. However, **only the business proportion of this WDA** can be claimed as a tax deduction and entered in the total allowances column in the proforma.

(2) **Disposal of private use assets**. On the disposal of a private use asset, a balancing adjustment is calculated in the normal way. However, in the case of assets with a private use element, **only the business proportion of the BA or BC** is entered in the total allowances column in the proforma.

(3) **Annual investment allowance (AIA) and First year allowance (FYA) on private use assets**. If a private use asset is purchased in the accounting period and the AIA (and/or a FYA) is available, the AIA (and/or FYA) is calculated in the normal way and deducted from the cost in the appropriate private use asset column in the proforma. However, **only the business proportion of the AIA (and/or FYA)** calculated can actually be claimed and entered in the total allowances column.

These rules only apply to assets with an element of private use **by the owner**. Private use by an employee of the business is irrelevant. The assets are treated as normal additions and disposals and allowances are available in full.

Example

Francis is a self-employed electrician. He prepares his accounts to 31 March each year. On 1 November 2009 he bought a Nissan car for £11,500 and sold it for £8,000 on 30 January 2011. The Nissan has CO_2 emissions of 140 g/km. His private mileage in the car is 5,000 out of his annual total of 25,000. The TWDV b/f on the main pool on 1 April 2009 was £16,500.

Required

Calculate the capital allowances available for the years ended 31 March 2010 and 31 March 2011.

Answer

The private use of the car is 20% (= 5,000/25,000). The business use is therefore 80%.

Francis – Capital allowances, year ended 31 March 2010	Main pool	Nissan car (80% business use)		Total allowances
	£	£		£
TWDV b/f	16,500			
Acquisitions not qualifying for AIA		11,500		
WDA (20%)	(3,300)			3,300
- Business % claim only		(2,300)	(= 80%)	1,840
TWDV c/f	13,200	9,200		
Total allowances				5,140

Francis - Capital allowances, year ended 31 March 2011				
	£	£		£
TWDV c/f	13,200	9,200		
Disposals	(Nil)	(8,000)		
	13,200	1,200		
Balancing allowance		(1,200)	(80%)	960
WDA (20%)	(2,640)			2,640
TWDV c/f	10,560			
Total allowances				3,600

8.2 Short periods of account

When there is a short period of account, the tax rules for capital allowances are the same as for companies (as explained above).

If there is an expensive car with private use, the WDA is calculated in the following order:

- restrict to £3,000 if necessary first, then
- time-apportion the WDA for the length of the accounting period and deduct from the expensive car column, then
- enter the business proportion of the allowance in the total allowances column in the proforma.

8.3 Long periods of account

If an individual sole trader or a partnership changes its accounting date and produces a set of accounts in excess of 12 months, the treatment for capital allowances depends on whether or not the accounts exceed 18 months in length.

Long period of account not exceeding 18 months

If the accounts are more than 12 months in length, but not in excess of 18 months:

- One adjustment of profit computation is produced for the long period of account.
- Only one capital allowance computation is produced and the WDA is scaled up according to the length of the accounting period. For example if a 17-month set of accounts is produced, the WDA for plant and machinery is 20% × 17/12. **This is different from the rule for companies (see later chapter)**.

Note that only the AIA and WDA are scaled up. FYAs and balancing adjustments are not subject to time-apportionment.

If there is an expensive car with private use in a long period of account, the WDA is calculated in the same order as mentioned above for short periods of account, except that the WDA is scaled up, not time-apportioned downwards.

Long period of account in excess of 18 months

If the accounts are in excess of 18 months in length:

- **One** adjustment of profit computation is produced for the long period of account.
- However, **two** capital allowance computations are required, one for the first 12 months of the long period of account and one for the remaining period.
- The first capital allowances computation will show the normal AIA, FYA and WDAs. The balance period will be a short period of account and the AIA and WDA must therefore be time-apportioned. As always, FYAs and balancing adjustments are not subject to time apportionment.
- The capital allowances of both periods are deducted from the one adjusted profit before capital allowances figure and then the basis of assessment rules are applied to the adjusted profit after capital allowances.

For example, if the accounts are from 1 January 2009 to 30 September 2010 (i.e. 21 months):

- The first capital allowances computation brings in additions and disposals for the 12 months ended 31 December 2009 and full annual rates of WDAs are available.
- The second capital allowances computation brings in additions and disposals for the nine months ended 30 September 2010 and the WDAs are restricted to 9/12.

Example

Gwen started to trade as a self-employed dressmaker on 6 April 2009 and prepared her first set of accounts to 31 July 2010. In the 16 month period she made the following capital purchases:

Purchases		£
6 April 2009	Two sewing machines	6,200
15 June 2009	Office equipment	2,000
1 July 2009	Computer equipment and software	5,500
1 July 2009	Second hand car	15,800
	(60% private use and CO_2 emissions of 150 g/km)	

Gwen has no asset disposals in the period.

Required

Calculate the capital allowances for the 16 month period ended 31 July 2010.

Answer

Gwen – Capital allowances, 16 months ended 31 July 2010		**Main pool**	**Second hand car (40% business use)**		**Total allowances**
		£	£		£
Acquisitions not qualifying for AIA		Nil	15,800		
Acquisitions qualifying for AIA					
	£				
Sewing machines	6,200				
Office equipment	2,000				
Computer equipment	5,500				
	13,700				
AIA	(13,700)				13,700
		Nil			
WDA (20% × 16/12)		(Nil)	(4,213)	(40%)	1,685
TWDV c/f		Nil	11,587		
Total allowances					15,385

Note

As the car was purchased after 6 April 2009, the new rules apply and its WDA is **not** restricted to £3,000 pa.

CHAPTER

7

Capital allowances – industrial buildings

Contents

1 Definition of an industrial building

2 Allowances for industrial buildings

Definition of an industrial building

- Industrial buildings and structures
- Non-industrial buildings and structures
- Qualifying hotels

1 Definition of an industrial building

1.1 Industrial buildings and structures

The tax legislation provides a comprehensive definition of an industrial building. This definition includes buildings and structures that are 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).

Industrial buildings allowances (IBAs) are available on the cost of these buildings.

If the industrial building is built by or for the business, IBAs are available on the cost of the construction. This 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. architect's fees, solicitors' fees)
- associated car parks, roads and fencing.

However, IBAs are **never allowed on the cost of the land itself**, nor any associated incidental expenses (including legal and professional fees) relating to acquiring the land.

- If the business purchased the building second-hand, but is the first business to use the building for industrial purposes, the qualifying cost depends on whether the seller of the building is a builder.
- If the building is purchased from a builder, IBAs are available on the purchase price paid to the builder.
- If the building is purchased from anyone else, IBAs are available on the lower of the cost of construction and the purchase price.

1.2 Non-industrial buildings and structures

The following buildings and structures are non-industrial buildings:

- shops and showrooms
- residential accommodation
- general offices.

However, IBAs are available on non-industrial buildings in the following circumstances:

- if the non-industrial buildings are an integral part of a factory site, and
- the cost of the non-industrial part is **not material** in terms of the total cost of all of the buildings on the factory site.

The cost of the non-industrial part is **not material** if it is not more than 25% of the total cost of all of the buildings (= 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, IBAs are only available on the industrial buildings element. The full cost of the non-industrial element is not eligible for IBAs.

Example

A plc constructed a new factory site in the year ended 31 December 2009. The cost of construction was as follows:

	£
Land (including £2,500 legal costs relating to the purchase of land)	118,500
Preparation of the land before building commenced	58,000
Architect's fees	42,000
Main factory building	335,000
Canteen	23,200
General offices	101,800

Required

Calculate the cost which qualifies for IBAs.

Answer

			Qualifying cost for IBAs
	£		£
Land	116,000	Not allowable	0
Legal costs (re the land)	2,500	Not allowable	0
Preparation of the land	58,000	Allowable	58,000
Architect's fees	42,000	Allowable	42,000
Main factory building	335,000	Allowable	335,000
Canteen	23,200	Allowable	23,200
General offices	101,800	See working below	101,800
	678,500		560,000

Working

The general offices are non-industrial buildings that are an integral part of the factory site.

25% × Total cost of all buildings on the site (but excluding the cost of the land and associated legal costs)

= 25% × (£678,500 - £118,500)
= 25% × £560,000 = £140,000.

Cost of office space = £101,800. This is less than 25% of the total cost of all the buildings (£140,000). Therefore the cost of the general offices qualifies for IBAs.

1.3 Qualifying hotels

A qualifying hotel is a hotel that meets all of the following conditions:

- It has at least 10 letting bedrooms available for short-term stays. (A short-term stay is defined as not more than 30 days).
- It is open for at least 4 months during the holiday season. (The holiday season is defined as April to October).
- It provides normal hotel services such as bed-making and cleaning services, and offers both breakfast and evening meals.

If the definition of a qualifying hotel is satisfied, the hotel is treated as if it is an industrial building.

Allowances for industrial buildings

- Writing down allowances
- Disposal of a building

2 Allowances for industrial buildings

2.1 Writing down allowances

A WDA of 2% (3% for the year ended 31 March 2009) 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.

2.2 Disposal of a building

The disposal of an industrial building on or after 21 March 2007 has no tax consequences. No balancing adjustments arise.

Example

B plc prepares its accounts to 31 March each year. On 14 February 2008 it purchased a factory for £590,000 (including land of £90,000) and brought it into industrial use on 1 April 2008.

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 for all relevant years.

a

Answer

	Allowances claimed
y/e 31 March 2009	£
Qualifying cost (£590,000 - £90,000) = 500,000	
WDA (3% × £500,000)	15,000
y/e 31 March 2010	
WDA (2% × £500,000)	10,000

Notes

No WDA is available in the year ended 31 March 2008 as the building is not in industrial use on that date.

As the building has been disposed of after 21 March 2007, no balancing adjustment occurs.

CHAPTER

8

The basis of assessment rules for unincorporated businesses

Contents

1 Overview of the basis of assessment rules
2 The opening year rules
3 The closing year rules
4 Choice of accounting date
5 The rules on a change of accounting date

Overview of the basis of assessment rules

- The need for basis of assessment rules
- The current year basis of assessment

1 Overview of the basis of assessment rules

1.1 The need for basis of assessment rules

Sole traders and partnerships can prepare their accounts to any date they choose. They are not obliged to produce accounts to the end of the tax year (i.e. with a year ending 5 April). However, it is important to know in which tax year the tax-adjusted profits will be assessed to tax.

Tax legislation therefore needs rules for matching the adjusted profits after capital allowances of an unincorporated business with tax years. These rules are known as the basis of assessment rules.

1.2 The current year basis of assessment

The normal basis of assessment for trading income is the current year basis (CYB):

Basis period for a tax year =	the 12-month **accounting period ending in the current tax year**

The term **basis period** refers to the time period which is assessed for a particular tax year.

Example

John has been trading for many years preparing accounts to 31 March each year. He has recently received an enquiry from HMRC regarding the trading income figures he entered into his tax return for 2009/10.

Required

Which set of accounts must John find to check the facts of the enquiry from HMRC?

Answer

The accounts which **end** in the 2009/10 tax year = Year ended 31 March 2010.

The opening year rules

- The need for special opening year rules
- Calculating the opening year assessments

2 The opening year rules

2.1 The need for special opening year rules

When an individual starts to trade, he must choose a convenient ending date for the accounting period. Having chosen his accounting period closing date, his first set of accounts may be of any length:

- more than 12 months,
- less than 12 months, or
- exactly equal to 12 months.

As a result, if the CYB rule explained above is applied, it would be possible for a trader to avoid paying tax in the first tax year of trading. For example, if a trader commences trade on 1 January 2010 and prepares the first set of accounts to 31 December 2010, he was trading in the tax year 2009/10. However, as there are no accounts which end in that tax year, application of the CYB rule would mean there is no assessment to tax for 2009/10.

To ensure that some profits of the business are taxed in every tax year in which the individual is in business, the **CYB rule is not used**:

- in the opening year itself, and
- usually the next few years as well.

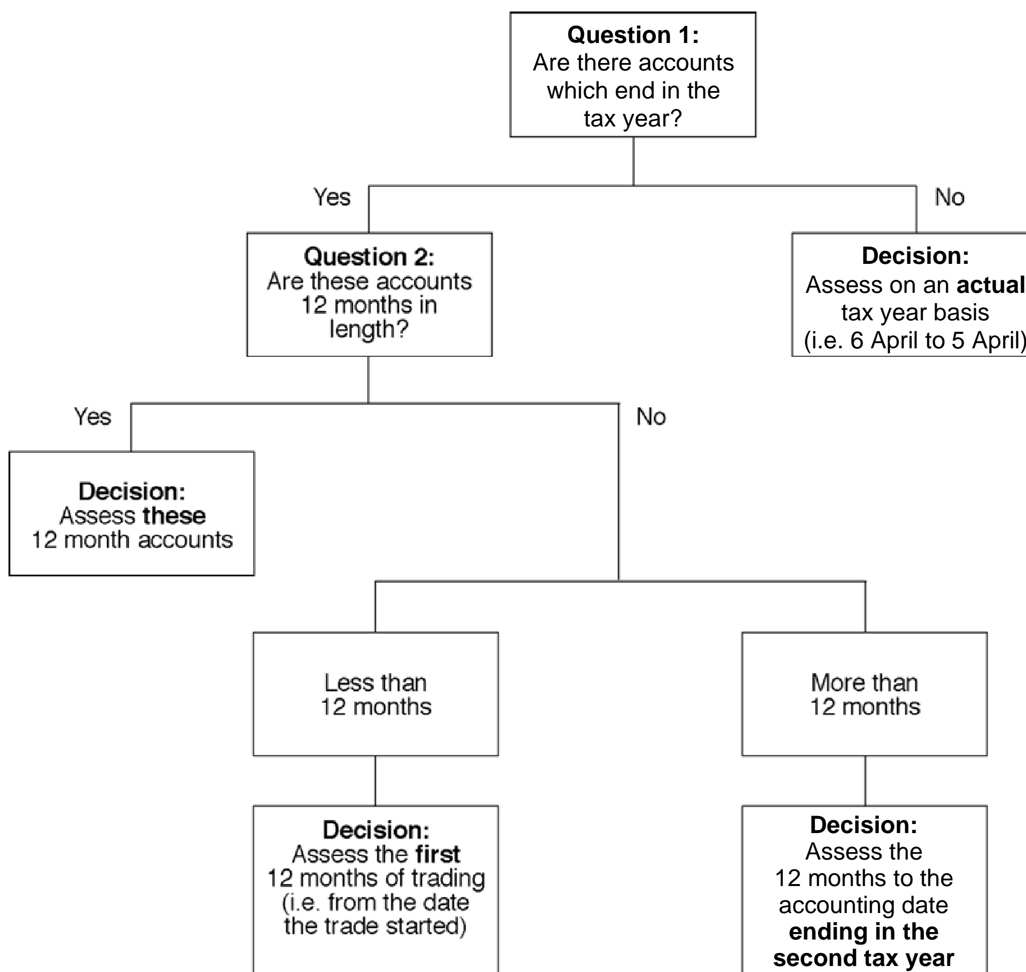
Instead, special opening year rules are applied.

2.2 Calculating the opening year assessments

The opening year assessment rules are summarised below.

Tax year	Basis period
First tax year	Assess on an actual tax year basis (i.e. from the date the trade started to the following 5 April)
Second tax year	See the 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 using CYB rules 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. Therefore, where calculations to obtain an assessment require profits to be taken from more than one set of accounts, the profits must be time-apportioned.

The tax legislation requires apportionment in days, but in the examination calculations should 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 tax year on the cessation of trade, or possibly earlier if the business changes its accounting date.

Second tax year

From the decision table above, it can be seen that there are four possible decisions for the second tax year.

Each of the four possible scenarios is illustrated on the following examples.

Example 1

Katie started to trade on 1 October 2008 and decided to prepare her accounts to 30 September each year. Her results for the first two years are as follows:

Year ended	Adjusted profit before capital allowances	Capital allowances
	£	£
30 September 2009	21,600	5,600
30 September 2010	64,800	6,500

Required

Calculate Katie's trading income assessments for the first three tax years, and the overlap profits arising from the application of the opening year rules.

Answer

Step 1. Calculate the adjusted profit after capital allowances for each accounting period

Year ended		Adjusted profit after capital allowances
		£
30 Sept 2009	(£21,600 - £5,600)	16,000
30 Sept 2010	(£64,800 - £6,500)	58,300

Step 2. Work out the basis period for the first tax year of trading

Trading starts on 1 October 2008 = In tax year 2008/09 = First tax year.
Tax year 1: Tax the profits from 1 October 2008 to 5 April 2009.

Step 3. Work out the basis period for the second tax year

Second tax year = 2009/10. Ask two questions:

Are there accounts which end in the tax year?	Yes = Year ended 30 September 2009
Are these accounts 12 months in length?	Yes
Decision	Assess the profits of those 12 months

Step 4. Summarise and calculate the trading income assessments

Tax year	Basis of assessment	Basis period	Workings	Trading income assessment
				£
2008/09	Actual	1.10.2008 – 5.4.2009	6/12 × £16,000	8,000
2009/10	12 months ending in second year	Year ended 30.9.2009		16,000
2010/11	12 months ending in third year	Year ended 30.9.2010		58,300

Step 5. If required, calculate the overlap profits

Profits are assessed more than once for the period 1.10.2008 – 5.4.2009.
Overlap profits = 6/12 × £16,000 = £8,000.

Example 2

Len started to trade on 1 November 2007 and decided to prepare his accounts 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 2008	13,400
31 May 2009	51,470

Required

Calculate the trading income assessments for Len for the first three tax years and calculate the overlap profits.

Answer

Trading starts on 1 November 2007 = In tax year 2007/08 = First tax year.
First tax year: Assess profits from 1 November 2007 to 5 April 2008.

Second tax year = 2008/09. Ask two questions:

Are there accounts which end in the tax year?	Yes = 7 months ended 31 May 2008
Are these accounts 12 months in length?	No: less than 12 months
Decision	Assess the profits of the first 12 months

Tax year	Basis of assessment	Basis period	Workings (nearest month)	Trading income assessment
				£
2007/08	Actual	1.11.2007 – 5.4.2008	5/7 × £13,400	9,571
2008/09	First 12 months	1.11.2007 – 31.10.2008	£13,400 + (5/12 × £51,470)	34,846
2009/10	12 months ending in third year	Year ended 31.5.2009		51,470

Overlap profits

		£
1.11.2007 – 5.4.2008	5/7 × £13,400	9,571
1.6.2008 – 31.10.2008	5/12 × £51,470	21,446
		31,017

Example 3

Mary started to trade on 1 June 2007 and decided to prepare her first accounts to 31 August 2008 and then to 31 August each year. Her results for the first two accounting periods are as follows:

Period ended	Adjusted profit after capital allowances
	£
31 August 2008	20,110
31 August 2009	77,200

Required

Calculate Mary's first three years' trading income assessments and the overlap profits.

Answer

Trading starts on 1 June 2007 = In tax year 2007/08 = First tax year.

First tax year: Assess the profits from 1 June 2007 to 5 April 2008.

Second tax year = 2008/09. Ask two questions:

Are there accounts which end in the tax year?	Yes = 15 months ended 31 August 2008
Are these accounts 12 months in length?	No: More than 12 months
Decision	Assess profits for the 12 months ending on 31 August 2008

Tax year	Basis of assessment	Basis period	Workings (to nearest month)	Trading income assessment
				£
2007/08	Actual	1.6.2007 – 5.4.2008	10/15 × £20,110	13,407
2008/09	12 months ending in second year	1.9.2007 – 31.8.2008	12/15 × £20,110	16,088
2009/10	12 months ending in third year	Year ended 31.8.2009		77,200

Overlap profits

1.9.2007 – 5.4.2008: 7/15 × £20,110 = £9,385.

Example 4

Nicholas started to trade on 1 January 2007 and decided to prepare his first accounts to 30 April 2008 and thereafter to 30 April each year. His results for the first two accounting periods are as follows:

Period ended	Adjusted profit after capital allowances
	£
30 April 2008	34,140
30 April 2009	51,250

Required

Calculate Nicholas' first four years' trading income assessments and the overlap profits.

Answer

Trading starts on 1 January 2007 = In tax year 2006/07 = First tax year.

First tax year: Assess the profits from 1 January 2007 to 5 April 2007.

Second tax year = 2007/08. 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 2007 to 5 April 2008

Third tax year = 2008/09. The 16-month accounts to 30 April 2008 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 30 April 2008).

Tax year	Basis of assessment	Basis period	Workings (to nearest month)	Trading income assessment
				£
2006/07	Actual	1.1.2007 – 5.4.2007	3/16 × £34,140	6,401
2007/08	Actual	6.4.2007 – 5.4.2008	12/16 × £34,140	25,605
2008/09	12 months ending in third year	1.5.2007 – 30.4.2008	12/16 × £34,140	25,605
2009/10	CYB	Year ended 30.4.2009		51,250

Overlap profits

1.5.2007 – 5.4.2008: 11/16 × £34,140 = £23,471.

The closing year rules

- The need for special closing year rules
- Calculating the closing year assessments

3 The closing year rules

3.1 The need for special closing year rules

The primary aim of the basis of assessment rules is that the business should be taxed on the exact amount of adjusted profits after capital allowances earned over the entire life of the business.

In the opening years, overlap profits are assessed to tax more than once. To ensure that no more than the exact amount of adjusted profits is assessed to tax, relief is given for the overlap profits in the final tax year.

3.2 Calculating the closing year assessments

The closing year rules and approach are summarised as follows:

- **Step 1**. Work out which tax year is the final tax year.
- **Step 2**. Work out the trading income assessment of the **penultimate** year using the normal CYB rules.
- **Step 3**. Work out the final trading income assessment as follows:

	£
All profits not yet assessed (i.e. profits from the end of the accounting period ending in the penultimate year to the date of cessation)	X
Minus: Overlap relief	(X)
Closing year trading income assessment	X

Example

Owen has been trading for many years preparing accounts to 31 May each year. His overlap profits are £3,650. Owen ceased to trade on 30 September 2009 and has provided the following results for the last three accounting periods:

Period ended	Adjusted profit before capital allowances	Capital allowances
	£	£
31 May 2008	38,610	13,160
31 May 2009	23,200	10,000
30 September 2009	15,300	12,350

Required

Calculate Owen's last two trading income assessments.

Answer

The adjusted profit after capital allowances for each accounting period

Year ended		Adjusted profit after capital allowances
		£
31 May 2008	(£38,610 - £13,160)	25,450
31 May 2009	(£23,200 - £10,000)	13,200
30 Sept 2009	(£15,300 - £12,350)	2,950

Step 1: Work out the final tax year

Cessation of trade: 30 September 2009 = In tax year 2009/10 = Last tax year.

Step 2: Work out the trading income assessment of the penultimate year

2008/09	CYB	Year ended 31.5.2008	£25,450

Step 3: Work out the final trading income assessment

	£
Profits not yet assessed (1.6.2008 – 30.9.2009)	
Year ended 31 May 2009	13,200
Period ended 30 September 2009	2,950
Minus overlap relief	(3,650)
Closing year trading income assessment	12,500

Choice of accounting date

- A date early in the tax year
- A date late in the tax year

4 Choice of accounting date

4.1 A date early in the tax year

A trader has a choice of accounting date. If he picks a date early in the tax year, for example 30 April, this will have the advantage of maximising the gap between earning profits and paying the tax on them. In 2009/10, for example, the assessment will be based on the profits of the year ended 30 April 2009. If profits are rising, this will produce a lower assessment than an accounting date of 31 March 2010.

However, a date early in the tax year may result in the assessment of more than 12 months' profits in the final year. See the previous example in which Owen was assessed on the profits of both the year ended 31 May 2009 and the period ended 30 September 2009 in 2009/10.

4.2 A date late in the tax year

A date late in the tax year, for example 31 March, will avoid the bunching of profits in the final tax year. So, in the previous example, if Owen had had an accounting date of 31 March instead of 31 May, his final tax year would have been based only on the profits of the period ended 30 September 2009 as the profits for the year ended 31 March 2009 would have been assessed in the penultimate year.

Choosing 31 March as the accounting date would also avoid overlap profits under the commencement rules. In addition, it has the advantage of being easy for the taxpayer to understand. However, its drawback is that it minimises the gap between earning profits and paying tax on them.

The rules on a change of accounting date

- The need for special change of accounting date rules
- The conditions for a valid change of accounting date
- Calculating the change of accounting date assessments

5 The rules on a change of accounting date

5.1 The need for special change of accounting date rules

Apart from in the first and last tax years, the basis of assessment rules seek to assess 12 months' worth of profits every tax year.

However, when an unincorporated business decides to change its accounting date, it will need to produce a set of accounts that is either more than or less than 12 months in length.

The normal current year basis of assessment cannot be used, as the accounts ending in the tax year will not be exactly 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 of 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.

5.2 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 the 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 will be apportioned accordingly.

5.3 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 CYB basis using the old accounting date.

Step 3

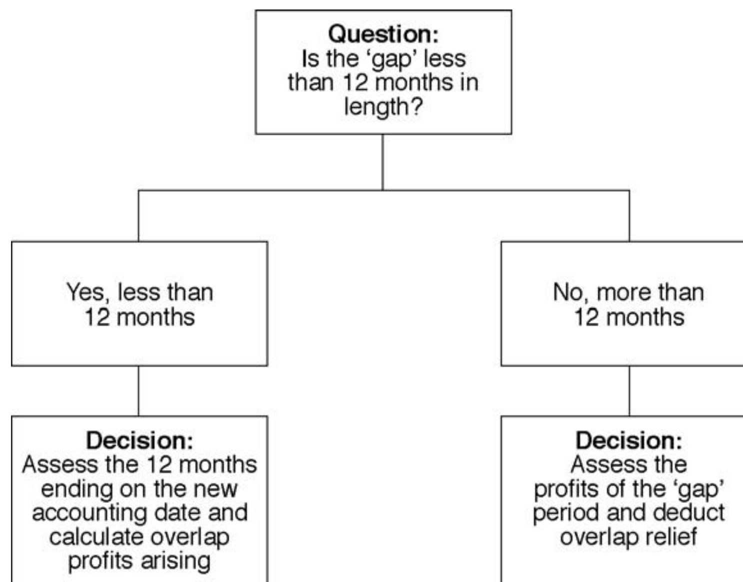
Work out the trading income assessment of the **year after the tax year of change** on a normal CYB basis using the new accounting date.

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 period is less than 12 months, some profits will be assessed more than once. Relief is given for these overlap profits in the last tax year on the cessation of trade (or possibly earlier if there is another change of accounting date).

Where the gap period is more than 12 months, overlap relief is available. This is because the basis of assessment rules only seek to assess 12 months' profits each tax year. As the gap profits exceed 12 months, the appropriate number of months of overlap profits can be deducted so that only 12 months 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

Paul prepared his accounts to 31 December each year until 2009 when he changed his accounting date by preparing a short set of accounts to 30 September 2009. His adjusted profits after capital allowances are as follows:

	Adjusted profit after capital allowances
	£
Year ended 31 December 2008	42,000
9 months ended 30 September 2009	37,800
Year ended 30 September 2010	63,000

In his opening years, Paul had three months of overlap profits of £12,000.

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

Step 1. Work out the tax year of change

The tax year of change = 2009/10 = the earlier of the first tax year where the accounts are:

(1) prepared to the new accounting date (i.e. 2009/10), or

(2) not prepared to the old accounting date (i.e. also 2009/10 in this example)

Step 2. Work out the trading income assessment for the year before the tax year of change

This is tax year 2008/09.

CYB: Trading income assessed on profits for the year ended 31.12.2008: £42,000.

Step 3. Work out the trading income assessment for the year after the tax year of change

In this example, the year after the tax year of change is 2010/11

Trading income assessed on profits for the year ended 30.09.2010: = £63,000.

Step 4: Work out the length of the gap period

The period not assessed under steps 2 and 3 = 1 January 2009 to 30 September 2009.

Gap period = 9 months.

Step 5: Work out the trading income assessment in the tax year of change

Gap period is less than 12 months. Therefore assess the 12 months ending on the new accounting date in the tax year 2009/10.

Tax year	Basis period	Workings (nearest month)	Trading income assessment
			£
2009/10	1.10.2008 – 30.9.2009	(3/12 × £42,000) + £37,800	48,300

Step 6: Calculate the overlap profits

			£
Opening years			12,000
On change of accounting date	1.10.2008 – 31.12.2008	(3/12 × £42,000)	10,500
Overlap profits to carry forward			22,500

Example 2

Rosemary prepared her accounts to 31 December each year until 2009 when she changed her accounting date by preparing a long set of accounts to 28 February 2010. Her adjusted profits after capital allowances are as follows:

	Adjusted profit after capital allowances
	£
Year ended 31 December 2008	54,600
14 months ended 28 February 2010	63,000
Year ended 28 February 2011	52,500

In her opening years, Rosemary had three months of overlap profits of £12,000.

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

(1) prepared to the new accounting date (i.e. 2009/10), or

(2) not prepared to the old accounting date (i.e. also in 2009/10 in this example).

Trading income assessment for the year before the change: 2008/09

CYB: Trading income assessed on profits for the year ended 31.12.2008: £54,600.

Trading income assessment for the year after the change: 2010/11

CYB: Trading income assessed on profits for the year ended 28.02.2011 £52,500.

Period not assessed = 1 January 2009 to 28 February 2010

Gap period = 14 months.

Gap period is more than 12 months

Therefore assess the profits of the gap period and deduct overlap relief

	£
Profits of the gap period (1.1.2009 – 28.2.2010)	63,000
Minus overlap relief $12{,}000 \times \frac{14 - 12}{3}$	(8,000)
Trading income assessment for 2009/10	55,000

Overlap profits

		£
Opening years		12,000
On change of accounting date	– amount relieved	(8,000)
Overlap profits to carry forward		4,000

Note

If Rosemary had chosen 31 March 2010 as her new accounting date, she could have relieved all of her overlap profits.

Example 3

Simon prepared his accounts to 30 September each year until 2010 when he changed his accounting date by preparing a short set of accounts to 31 March 2010. His adjusted profits after capital allowances are as follows:

Adjusted profit after capital allowances	
	£
Year ended 30 September 2008	15,000
Year ended 30 September 2009	12,000
6 months ended 31 March 2010	8,500
Year ended 31 March 2011	10,000

In his opening years, Simon had six months of overlap profits of £9,000.

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 = the earlier of the first tax year where the accounts are:

(1) prepared to the new accounting date (i.e. 2009/10), or

(2) 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

CYB: Trading income assessed on profits for the year ended 30.09.2008: £15,000.

Trading income assessment for the year after the change: 2010/11

CYB: Trading income assessed on profits for the year ended 31.03.2011: £10,000.

Period not assessed = 1 October 2008 to 31 March 2010. Gap period = 18 months.

Gap period is more than 12 months therefore assess the profits of the gap period and deduct overlap relief.

	£
Profits of the gap period (1.10.2008 – 31.3.2010)	
Year ended 30 September 2009	12,000
6 months ended 31 March 2010	8,500
Minus overlap relief $9{,}000 \times \frac{18 - 12}{6}$	(9,000)
Trading income assessment for 2009/10	11,500

Overlap profits

		£
Opening years		9,000
On change of accounting date	– amount relieved	(9,000)
Overlap profits to carry forward		Nil

CHAPTER 9

Trading losses of an unincorporated business

Contents

1 Overview of trading losses
2 The carry forward of trading losses
3 Relief against total income
4 Loss relief in the opening years
5 Loss relief in the closing years
6 Tax planning

Overview of trading losses

- The calculation of trading losses
- The loss relief available

1 Overview of trading losses

1.1 The calculation of trading losses

A trading loss occurs when a sole trader or a partnership has:

- an adjusted trading loss before capital allowances that is increased by the addition of capital allowances, or
- an adjusted trading profit before capital allowances that becomes a loss when capital allowances are deducted.

If a trading loss occurs, the trading income assessment for the appropriate tax year is £Nil.

1.2 The loss relief available

A range of loss reliefs is available to individuals who incur a trading loss.

The reliefs available depend on whether or not the business is:

- in its opening years,
- in its closing years, or
- neither starting to trade nor closing down (an ongoing business).

An individual will choose to make use of his trading loss in the best way, by applying the tax planning principles described at the end of this chapter.

Ongoing business

The following reliefs for trading losses are available to an ongoing unincorporated business.

(1) Carry forward the trading loss and set it off against the first available profits from the trade that produced the loss.

(2) Make a claim 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 to extend the relief in 2 above to set off the trading loss against the net gains of the individual:

- in the tax year of the loss, **and/or**
- in the preceding tax year.

Business in its opening years

In addition to the options for an ongoing business, an individual whose business is in its opening years can claim the following relief.

(5) Make a claim to set off the trading loss against the total income of the three tax years preceding the tax year of the loss.

Business in its closing years

The following reliefs for trading losses are available to an individual whose business is in its closing years:

(1) Make a claim 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.

(2) Make a claim to extend the relief in 2 above, to set off the trading loss against the net gains of the individual:

- in the tax year of the loss, **and/or**
- in the preceding tax year.

(3) Make a claim to set off the trading loss against the trading income of the individual:

- in the tax year of the loss **and**
- in the preceding three tax years.

(4) If the cessation of trade is due to the transfer of the business to a company (i.e. the incorporation of the business), unrelieved losses can be carried forward against future income derived by the individual from the new company.

These rules are explained in the rest of this chapter, except for relief against net gains which is explained in a later chapter.

Note: section numbers and the Income Tax Act 2007

The rules on reliefs for trading losses are now contained in the Income Tax Act 2007. Knowledge of section numbers is not required for the examination. However, using section numbers can useful in an income tax loss computation, and so they are used in this text. You will not be penalised if you quote section numbers incorrectly in an answer to an examination question.

The carry forward of trading losses

- The rules of s83 ITA 2007

2 The carry forward of trading losses

2.1 The rules of s83 ITA 2007

The rules for the carry forward of trading losses for an unincorporated business are contained in section 83 of the ITA 2007.

Income tax trading losses can be carried forward indefinitely, but the following rules apply.

The trading loss must be set off against:	Explanation:
The first available	▪ They must be set off in the next tax year if possible. ▪ An individual cannot choose to miss out a tax year, for example to obtain a higher rate of tax relief.
Trading profits	▪ Set-off is against trading income only. ▪ Trading losses carried forward cannot be set off against other income or gains.
Of the trade which produced the loss	▪ If an individual operates more than one type of trading activity, trading losses carried forward can only be set off against future profits from the activity that produced the loss. They cannot be set off against profits of a different trading activity.
Using as much as possible of the trading loss	▪ 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, and - the trading profit of the tax year.

Trading losses will be carried forward **automatically** and relieved in this way, unless the individual claims another type of loss relief.

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.

Example

Anne has traded for many years and prepares her accounts to 31 July each year. She has supplied the following information:

Year ended 31 July	2007	2008	2009
	£	£	£
Trading profit / (loss)	(12,000)	8,000	45,500
Bank interest received	2,000	3,000	1,800
Dividends received from a UK company	540	630	900

Required

Calculate the taxable income for each tax year assuming losses are carried forward, and calculate the unrelieved loss, if any, at 6 April 2010. Assume the 2009/10 personal allowance applies in each year.

Answer

Step 1

Apply the basis of assessment rules to determine the trading income assessments. A nil assessment arises in the tax year in which the loss-making accounts end. Here the loss-making accounts end on 31 July 2007, which is in 2007/08.

Year ended	Basis of assessment	Tax year	Trading income assessment
31 July 2007	CYB	2007/08	Nil
31 July 2008	CYB	2008/09	£8,000
31 July 2009	CYB	2009/10	£45,500

Step 2

Prepare the income tax computations and working of trading losses for each tax year affected.

Anne: Income tax computations	2007/08	2008/09	2009/10
	£	£	£
Trading income	Nil	8,000	45,500
Minus: s83 trading losses b/f	Nil	(8,000)	(4,000)
	Nil	Nil	41,500
Bank interest (× 100/80)	2,500	3,750	2,250
Dividend income (× 100/90)	600	700	1,000
Total income	3,100	4,450	44,750
PA (part wasted in 2007/08 and 2008/09)	(3,100)	(4,450)	(6,475)
Taxable income	Nil	Nil	38,275

Working: Record of trading losses	**2007/08**	**2008/09**	**2009/10**
	£	£	£
Unrelieved trading loss b/f	12,000	12,000	4,000
Set-off under s83	0	(8,000)	(4,000)
Trading loss c/f under s83	12,000	4,000	0

There is no loss left to carry forward at 6 April 2010.

Notes

(1) Losses brought forward can only be set against trading profits, not other income. The maximum amount possible must be deducted each year.

(2) A better rate of tax saving would be achieved if the loss could be set off in 2009/10. However, losses brought forward must be set against the first available future trading profits (i.e. 2008/09). It is not possible to skip a year.

(3) Unrelieved personal allowances are lost. Loss relief may therefore result in the wastage of personal allowances.

(4) It is not possible to make a partial claim in 2008/09 to maximise the use of personal allowances and save more loss for 2009/10. In any tax year the loss to be relieved is the lower of:

- the loss available, and
- the trading profit of the tax year.

(5) It may be possible to avoid the wastage of personal allowances by not claiming the maximum capital allowances in the accounting period. Tax planning issues are considered later.

Relief against total income

- The rules of s64 ITA 2007
- Proforma income tax loss relief computation
- Additional relief for trading losses incurred in 2009/10

3 Relief against total income

3.1 The rules of s64 ITA 2007

The objective of s64 loss relief is to allow an individual relief for a trading loss immediately the loss is incurred, rather than waiting to obtain the relief in the future years under s83.

An individual can make a claim to set off losses against his total income:

- in the tax year of the loss, **and/or**
- in the preceding tax year.

In effect, this means that the individual can make a current year and carry back claim.

The basic rule allows a s64 claim to be made:

- in both years in any order,
- in neither year, or
- in either year in isolation.

An individual therefore has four options under s64 as follows:

(1) Set off in the current year only (i.e. the year of the loss).

(2) Carry back and set off in the preceding year only.

(3) Set off in the current year first, then carry back and set off in the preceding year.

(4) Carry back and set off in the preceding year first, then set off in the current year.

Note also that **a s64 claim is optional**; therefore a fifth option is available:

(5) Make no specific loss relief claim and the trading losses will be automatically carried forward under s83, as explained earlier.

When setting off the trading loss in the current or preceding year, the following rules apply:

Rule:	Explanation:
Set off against total income	▪ Total income is all other income **after deducting** allowable interest payments, but **before the PA**.
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. ▪ Loss relief may reduce the total income to £Nil, so that the relief for personal allowances is lost. ▪ The personal allowances cannot be carried forward, or carried back: they are wasted/lost.

A claim must be made for s64 relief within one year of the 31 January following the end of the tax year of the loss (i.e. the 31 January immediately prior to the second anniversary of the end of the tax year of the loss).

If an individual claims under s64, 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 or a claim is made to extend the use of s64 to match against capital gains.

This extension claim is sometimes referred to as a s261B claim, as the relief is contained in section 261B of the Taxation of Chargeable Gains Act 1992. (The claim is considered in a later chapter.)

3.2 Proforma income tax loss relief computation

A proforma for an income tax loss relief computation is set out below. This proforma assumes that the trading loss arises in the accounting period that forms the basis of the 2009/10 tax year.

Income tax computations	**2008/09**	**2009/10**	**2010/11**
	£	£	£
Trading income	X	Nil	X
Minus: s83 trading losses b/f	-	-	(X)
	X	Nil	X
Other income	X	X	X
Minus: Allowable interest payments	(X)	(X)	(X)
Total income before loss relief	X	X	X
Minus: s64 claim			
- current year claim		(X)	
- carry back claim	(X)		
Taxable income	-	-	X

Working: Record of trading losses	**2009/10**	**2010/11**
	£	£
Trading loss b/f		X
Set off under s83		(X)
Trading loss in the tax year	X	
Set off under s64		
- in year of loss (i.e. 2009/10)	(X)	
- in preceding year (i.e. 2008/09)	(X)	
Trading loss c/f under s83	X	X

Example

Chris prepares his accounts to 31 December each year and has supplied the following information:

Year ended 31 December	**2008**	**2009**	**2010**
	£	£	£
Trading profit / (loss)	35,500	(32,000)	16,250
Building society interest	1,600	640	880
Dividends received from a UK company	270	63	810
Allowable interest paid	500	500	500

Required

Calculate the taxable income for each tax year assuming losses are relieved as soon as possible, and calculate the unrelieved loss available to carry forward, if any, at 6 April 2011. Assume the 2009/10 personal allowance applies in each year.

Answer

Trading income assessments

Year ended	**Basis of assessment**	**Tax year**	**Trading income assessment**
31 December 2008	CYB	2008/09	£35,500
31 December 2009	CYB	2009/10	Nil
31 December 2010	CYB	2010/11	£16,250

2009/10 = tax year of the loss

Chris: Income tax computations	2008/09	2009/10	2010/11
	£	£	£
Trading income	35,500	Nil	16,250
Building society interest (× 100/80)	2,000	800	1,100
Dividend income (× 100/90)	300	70	900
	37,800	870	18,250
Minus: Allowable interest payments	(500)	(500)	(500)
Total income before loss relief	37,300	370	17,750
Minus s64 loss relief	(32,000)	(Nil)	(Nil)
Total income after loss relief	5,300	370	17,750
PA	(5,300)	(370)	(6,475)
Taxable income	Nil	Nil	11,275

(W) Record of trading loss	2009/10
	£
Trading loss in tax year	32,000
s64 loss relief claimed in 2008/09	(32,000)
Trading loss c/f	Nil

There is no loss left to carry forward at 6 April 2011.

Note on this example

The requirement in this example was that relief should be set off as soon as possible. This means that a s64 claim is to be made in the preceding year and then 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 in this example. This is because:

- the total income in the current year (i.e. 2009/10) is covered by the PA
- carrying forward the loss will waste more personal allowances and save tax at a lower rate. In addition, 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, in this example, the claim saves the individual the most amount of tax. It may also be possible to avoid the wastage of personal allowances by not claiming full capital allowances.

3.3 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.

Loss relief in the opening years

- The s64 rules in the opening years
- The procedure for opening year loss relief
- Special opening year loss relief claim under s72 ITA 2007

4 Loss relief in the opening years

4.1 The s64 rules in the opening years

The rules of s64 in the opening years are exactly the same as the rules applying in the ongoing years. However, there are three issues to consider when claiming s64 relief in the opening years:

- working out the trading income assessment in the opening years where a loss is involved
- deciding the tax year of the loss, and
- calculating the amount of loss relief available under s64.

It is possible for one accounting period loss to give rise to two separate losses for s64 relief in different years.

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.

4.2 The procedure for opening year loss relief

The procedure to adopt for dealing with an opening year loss is as follows:

Step 1: Trading income assessments for each tax year

The opening year basis of assessment rules are applied to both profits and losses in the normal way. However, where an overall net loss arises (i.e. where the calculations give a negative figure), the trading income assessment for that tax year is £Nil.

Note that a loss may only be relieved once. There is no such thing as overlap losses. It is not possible to obtain relief for an amount greater than the loss that is actually incurred. Therefore, if a loss (or part of a loss) is brought into the calculation of an assessment in one tax year, it cannot also be taken into account in the next tax year's calculation. (See the example below).

Step 2: The loss relief available, the tax year(s) to which the loss(es) relate and the options available for loss relief

If an overall net loss is calculated in Step 1, this 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, read the requirements 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 is considered later.

Example

Debbie started to trade on 1 November 2008 and decided to prepare her accounts to 30 September each year. Her results for the first two years are as follows:

Period ended	Adjusted profit/(loss) after capital allowances
	£
30 September 2009	(22,000)
30 September 2010	60,000

Required

Calculate Debbie'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

Step 1: Trading income assessments for each tax year

(a) Work out the **first tax year** of trading:

Trading starts on 1 November 2008 = In tax year 2008/09 = First tax year

i.e. 1 November 2008 to 5 April 2009

(b) Make the **second tax year** decision:

Second tax year = 2009/10. Ask two questions:

Are there accounts which end in the tax year?	Yes = period ended 30 September 2009
Are these accounts 12 months in length?	No = less than 12 months
Decision	Assess the first 12 months' profit/(loss)

(c) **Third tax year** = the 12 months ending in the third tax year

i.e. 1 October 2009 to 30 September 2010

Summarise and calculate the trading income assessments

Tax year	Basis period	Workings (nearest month)		Assessable trading income
			£	£
2008/09	**Actual**:			
	1.11.2008 – 5.4.2009	5/11 × £22,000 loss		
		= Net loss	(10,000)	Nil
2009/10	**First 12 months**:			
	11 months ended 30.9.2009	Loss in the period	(22,000)	
		Loss already used in 2008/09 calculation	10,000	
			(12,000)	
	1 month 30.9.2010	Profit (1/12 × £60,000)	5,000	
		Net loss	(7,000)	Nil
2010/11	**12 months ending in third year**			
	Year ended 30.9.2010			60,000

Step 2: Work out the loss relief available if s64 relief is claimed

For the £22,000 adjusted loss after capital allowances arising in the 11 months' accounting period ended 30 September 2010, the following loss relief is available:

Tax year of loss	Amount of loss	Loss relief available
	£	
2008/09	10,000	s64 relief available against total income in: (1) 2008/09 and/or (2) 2007/08
2009/10	7,000	s64 relief available against total income in: (1) 2009/10 and/or (2) 2008/09
Remaining loss	5,000	Used in calculating the 2009/10 assessment
	22,000	

Note

The 2009/10 assessment is nil. However, as £5,000 of profit was allocated to that year, £5,000 of loss must have been used in order to reduce the £5,000 profit to nil. This is referred to as relieving losses in aggregation.

4.3 Special opening year loss relief claim under s72 ITA 2007

Relief is available under s72 if the normal opening year rules result in a net loss arising in one or more of the **first four tax years of trading**.

Calculating the amount of loss relief available under s72 is the same as for s64. However, s72 gives relief for the loss in different tax years from those used under s64.

For a trading loss incurred in one of the **first four tax years**, an individual can make a claim 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:

Rule:	Explanation:
Set off against total income	▪ Total income is all other income **after deducting** allowable interest payments, but **before the PA**.
Strict order of set off	▪ Relief is 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).
All three years must be relieved, if possible	▪ 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. ▪ 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 each tax year	▪ It is an all or nothing relief. ▪ The maximum amount must be deducted from the total income. ▪ Loss relief may reduce the total income to nil, so that the relief for personal allowances is lost.

A claim must be made for s72 relief 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. the 31 January immediately prior to the second anniversary of the end of the tax year of the loss).

Example

The facts are the same as the previous example involving Debbie.

Required

State the amount of loss relief available under s72 and the years against which a claim can be made under s72.

a

Answer

The trading income assessments are calculated in the same way as in the previous answer.

If s72 relief is claimed

For the £22,000 adjusted loss after capital allowances arising in the 11 months' accounting period ended 30 September 2009 the following loss relief is available:

Tax year of loss	Amount of loss	Loss relief available
	£	
2008/09	10,000	s72 relief available against total income in: (1) 2005/06 and then (2) 2006/07 and then (3) 2007/08 - in that strict order - as much as possible each year
2009/10	7,000	s72 relief available against total income in: (1) 2006/07and then (2) 2007/08 and then (3) 2008/09 - in that strict order - as much as possible each year
Remaining loss	5,000	Used in calculating the 2009/10 assessment
	22,000	

Loss relief in the closing years

- The rules of s89 ITA 2007: closing year loss relief
- The procedure for closing year loss relief
- The carry forward of losses following incorporation

5 Loss relief in the closing years

5.1 The rules of s89 ITA 2007: closing year loss relief

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 income in the three preceding tax years** on a last-in-first-out (LIFO) basis.

When setting off the trading loss the following rules apply:

Rule:	Explanation:
Set off against trading income	▪ The loss can only be set against trading income. Not against other types of income or gains.
Strict order of set-off	▪ Relief is on a LIFO basis. The most recent year must be relieved first and then the previous year, and so on, in reverse date order.
All three years must be relieved, if possible	▪ A s89 claim involves a single claim which 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. ▪ The individual will want to claim as much relief as possible, because the business has ceased and there is no carry forward relief available.
Must set off as much as possible in each tax year	▪ It is an all or nothing relief. ▪ The maximum amount must be deducted from trading income.

A claim must be made for s89 relief within four years of the end of the tax year in which the cessation occurs.

Calculating the available loss

The amount of loss that can be relieved in this way is the **loss of the last twelve months 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)	X
(Ignore if a profit)	
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.

5.2 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 and 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

Eva has been trading for many years preparing accounts to 31 January each year. On 30 September 2009 she ceased to trade. Her results for the last years are as follows:

	Adjusted profit / (loss) after capital allowances
	£
Year ended 31 January 2007	42,000
Year ended 31 January 2008	14,000
Year ended 31 January 2009	12,000
Eight months ended 30 September 2009	(8,000)

Eva received £800 fixed interest on a building society account on 31 December each year and paid allowable interest of £1,200 (gross) on 30 June each year. She also received a dividend of £2,700 from a UK company on 14 May 2008.

Her overlap profits not yet relieved total £32,000.

Required

Calculate Eva'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

Step 1: Identify the last tax year and work out the trading income assessments for this and the preceding three tax years

Cessation of trade: 30 September 2009 = In tax year 2009/10 = Last tax year.

Penultimate year: 2008/09 = CYB basis of assessment = Year ended 31 January 2009.

Last tax year assessment – 2009/10	£
Profits not yet assessed (1.2.2009 – 30.9.2009)	
Period ended 30 September 2009 - loss	(8,000)
Minus: Overlap relief	(32,000)
Net loss = Loss relief available under s64	(40,000)
Final tax year assessment for 2009/10	Nil

Summary of assessments:

Tax year	Basis of assessment	Basis period	£
2006/07	CYB	Year ended 31 January 2007	42,000
2007/08	CYB	Year ended 31 January 2008	14,000
2008/09	CYB	Year ended 31 January 2009	12,000
2009/10	as above		Nil

Step 2: Set up the income tax loss computations in columnar format, for all the tax years affected

Set out the income tax computations in columnar form, as follows, inserting all known figures. Note that at this stage, the terminal loss figures and therefore the final result are not known.

Income tax computations	2006/07	2007/08	2008/09	2009/10
	£	£	£	£
Trading income	42,000	14,000	12,000	Nil
Minus: s89 terminal loss relief	(?)	(?)	(?)	Nil
				Nil
Building society interest (× 100/80)	1,000	1,000	1,000	1,000
Dividend income (× 100/90)	Nil	Nil	3,000	Nil
				1,000
Minus: Allowable interest payments	(1,200)	(1,200)	(1,200)	(1,200)
Total income				Nil
Minus: Personal allowance	(6,475)	(6,475)	(6,475)	Wasted
Taxable income				Nil

The final year (2009/10) can be completed:

- there will be no s64 claim as there is no total income
- there is £200 of unrelieved interest in the last year and
- the personal allowance is wasted.

Step 3: Work out the amount of loss relief available and the tax year(s) to which the loss(es) relate

		£	£
1.	Overlap profits not yet relieved		32,000
Last tax year			
2.	Actual trading loss in last tax year		
	Period 6.4.2009 to 30.9.2009: (6/8 × £8,000 Loss) = £6,000 loss		6,000
12 months before cessation to 5 April before cessation			
1.10.2008 to 5.4.2009 = 6 months			
3.	Actual trading loss in this 6 month period		
	Period 1.10.2008 to 31.1.2009: (4/12 × £12,000) profit	4,000	
	Period 1.2.2009 to 5.4.2009: (2/8 × £8,000 loss) loss	(2,000)	
	Net profit for the period	2,000	
	– Ignore profit in loss calculation		Nil
Terminal loss of the last 12 months trading			38,000

Step 4: Complete the income tax computations

Complete the income tax computations, carrying back the terminal loss on a LIFO basis. The loss should be deducted from trading income.

Income tax computations	2006/07	2007/08	2008/09	2009/10
	£	£	£	£
Trading income	42,000	14,000	12,000	Nil
Minus: s89 terminal loss relief	(12,000)	(14,000)	(12,000)	Nil
	30,000	Nil	Nil	Nil
Building society interest (× 100/80)	1,000	1,000	1,000	1,000
Dividend income (× 100/90)	Nil	Nil	3,000	Nil
	31,000	1,000	4,000	1,000
Minus: Allowable interest payments	(1,200)	(1,200)	(1,200)	(1,200)
Total income	29,800	Nil	2,800	Nil
Minus: Personal allowance	(6,475)	wasted	(2,800)	wasted
Taxable income	23,325	Nil	Nil	Nil

Working: Record of trading losses	£
Terminal loss	38,000
Set off under s89	
- in tax year of loss 2009/10	Nil
- carry back to 2008/09	(12,000)
- carry back to 2007/08	(14,000)
- carry back to 2006/07	(12,000)
	Nil

5.3 The carry forward of losses following incorporation

When a business ceases to trade, any trading losses are relieved in the tax year of the loss and/or the preceding year under s64 if possible. Terminal loss relief is then available to carry back losses to the preceding three tax years. Normally, if there are any unrelieved trading losses after a terminal loss claim, they are lost.

However, where a business ceases to trade because it incorporates and certain conditions are satisfied, unrelieved trading losses can be carried forward indefinitely under s86 ITA 2007.

The conditions which must be satisfied are as follows:

- 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. ('Mainly' in this context is taken to mean at least 80% of the consideration is 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 period in which loss relief is being claimed.

The rules for the relief are as follows:

Set off against:	Explanation:
The first available	▪ The trading loss must be set off in the next tax year if possible. ▪ An individual can not choose to miss out a tax year, for example to obtain a higher rate of tax relief.
Income derived from the company	▪ The set-off is against any employment income, interest and dividend income **received by the previous owner from the company**. ▪ The set off can be made against the income in any order. However, it will usually produce most benefit if set off against earned income first, followed by savings income and finally dividends. ▪ The trading losses cannot be set off against other income or gains.
Using as much as possible of the trading loss	▪ 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.

Note that s86 gives loss relief to the **previous owner** of the business **against his personal income**. The losses cannot be utilised by the company against its profits chargeable to corporation tax.

Tax planning

- Choosing the optimum loss relief
- Reduced capital allowances claim

6 Tax planning

6.1 Choosing the optimum loss relief

When using trading losses, the primary aim of an individual should be to save the maximum amount of tax.

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, are therefore a key factor in deciding the optimum loss relief claim.

However, cash flow could also be an important consideration. An individual may wish, for cash flow purposes, to claim relief as soon as possible, and carry back losses to obtain a cash repayment, and possibly a repayment supplement. This may be more important to the individual than a higher rate of relief at a later date.

If possible, the individual should prefer not to 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 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 or 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 10

Partnerships

Contents

1 Overview of the trading income assessment for a partnership
2 The treatment of partnerships
3 Partnership losses

Overview of the trading income assessment for a partnership

- Preparation of the trading income assessment

1 Overview of the trading income assessment for a partnership

1.1 Preparation of the trading income assessment

There are four key steps in the calculation of a trading income assessment for a partnership:

Step 1: Prepare an adjustment of profit statement

The first step is to prepare a statement adjusting the net profit of the business (in the financial accounts) to calculate the adjusted profit before capital allowances.

Step 2: Calculate the capital allowances available

The next step is to calculate the capital allowances available for plant and machinery and, if applicable, industrial buildings.

Step 3: Allocate the adjusted profit after capital allowances between the partners

Each partner in a partnership is taxed separately, in his own income tax computation, on his share of the partnership profits. The partnership is not treated as a separate entity and the partnership itself does not pay income tax.

Each partner is responsible for paying income tax at the appropriate rate on his share of the profits of the partnership, based on his own personal circumstances. It is therefore necessary to determine the amount of profits that relate to each partner.

The adjusted profits after capital allowances of the partnership are allocated between the individual partners in accordance with the profit-sharing agreement of the partners during the accounting period. The detailed rules governing the allocation of profit between partners are explained later.

Step 4: Calculate the trading income assessment for the correct tax year

The last step is to apply the basis of assessment rules to each partner's adjusted profit after capital allowances figure, in order to decide in which tax year the profits will be taxed.

The treatment of partnerships

- The adjustment of profit computation
- The allocation of partnership profits
- Allocation where there is a change in the partnership agreement
- Calculating the trading income assessments

2 The treatment of partnerships

2.1 The adjustment of profit computation

Partners in a business partnership are treated as a group of individual sole traders. The calculation of the trading income assessments for partners is therefore the same as for a sole trader.

The adjusted profit (or loss) after capital allowances of the partnership is calculated first. In this calculation it is important to remember to add to profit any appropriations by the partners that have been charged through the accounts (such as salaries paid to partners and interest on partners' capital introduced).

2.2 The allocation of partnership profits

The adjusted profit (or loss) after capital allowances of the partnership is then allocated between the partners. This allocation is made in accordance with the terms of the **partnership agreement in the accounting period** in which the profit (or loss) arises.

A partnership agreement will specify the allocation rules that must be followed. Typically, an agreement will allocate the partnership profits in three ways:

- a fixed salary for some or all of the partners
- a fixed rate of interest on capital introduced to the partnership
- a profit-sharing ratio 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).

Example

Henry and Ivan are in partnership. The partnership agreement provides for the following:

	Henry	Ivan
	£	£
Salary per annum	50,000	30,000
Capital introduced	100,000	100,000
Interest on capital (rate per annum)	10%	10%
Profit sharing ratio	45%	55%

The adjusted profit of the partnership after capital allowances for the year ended 31 December 2009 was £246,000.

Required

Allocate the partnership profits for the year ended 31 December 2009 between Henry and Ivan.

Answer

	Total	Henry	Ivan
	£	£	£
Salary	80,000	50,000	30,000
Interest on capital introduced (10% × £100,000)	20,000	10,000	10,000
Balance of profits (45%: 55%)	146,000	65,700	80,300
Allocation of profits	246,000	125,700	120,300

2.3 Allocation where there is 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 should be applied to each period separately.

Example

Henry and Ivan are in partnership. The partnership agreement at 1 January 2009 provided for the following:

	Henry	Ivan
	£	£
Salary per annum	50,000	30,000
Capital introduced	100,000	100,000
Interest on capital (rate per annum)	10%	10%
Profit sharing ratio until 30 September 2009	45%	55%

The partnership agreement changed on 1 October 2009 and the new arrangement is as follows:

	Henry	Ivan
	£	£
Salary per annum	50,000	50,000
Interest on capital (rate per annum)	10%	10%
Profit sharing ratio from 1 October 2009	50%	50%

The adjusted profit of the partnership after capital allowances for the year ended 31 December 2009 was £246,000.

Required

Allocate the partnership profits for the year ended 31 December 2009 between Henry and Ivan.

a

Answer

	Total	Henry	Ivan
9 months to 30 September 2009	£	£	£
Salary (£50,000 × 9/12 : £30,000 × 9/12)	60,000	37,500	22,500
Interest on capital introduced			
(10% × £100,000 × 9/12)	15,000	7,500	7,500
Balance of profits (45%: 55%)	109,500	49,275	60,225
Allocation of profits (£246,000 × 9/12)	184,500	94,275	90,225
3 months to 31 December 2009			
Salary (£50,000 × 3/12)	25,000	12,500	12,500
Interest on capital introduced			
(10% × £100,000 × 3/12)	5,000	2,500	2,500
Balance of profits (50%: 50%)	31,500	15,750	15,750
Allocation of profits (£246,000 × 3/12)	61,500	30,750	30,750
12 months to 31 December 2009			
Total allocation of profits	246,000	125,025	120,975

2.4 Calculating the trading income assessments

When a partnership is originally set up:

- the opening year rules are applied in the normal way to each partner's share of the profits in the opening tax years
- the overlap profits of each individual partner are calculated separately.

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.

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.

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 tax year.

Where there is a change in the accounting date of the partnership business, the change of accounting date rules are applied to each partner's share of profits separately.

Example

Tina and Vincent are partners and have been trading as a firm of solicitors for many years preparing accounts to 31 December each year. They have agreed to share profits equally. On 1 September 2009 William joined the firm on the agreement that the three partners would share profits in the ratio 3:2:1.

The adjusted profits after capital allowances of the partnership are as follows:

	Adjusted profit after capital allowances
	£
Year ended 31 December 2009	24,000
Year ended 31 December 2010	30,000

Required

Calculate the trading income assessments of each partner for 2009/10 and 2010/11 and William's overlap profits.

a Answer

(1) Allocate the adjusted profits after capital allowances between the partners in accordance with the partnership agreement in the accounting period

Year ended 31 December 2009:	Total	Tina	Vincent	William
(1) 8 months to 31 August 2009	£	£	£	£
Profit share (50%: 50%)	16,000	8,000	8,000	Nil
(2) 4 months to 31 December 2009				
Profit share (3/6: 2/6: 1/6)	8,000	4,000	2,667	1,333
Allocation of profits	24,000	12,000	10,667	1,333
Year ended 31 December 2010				
Profit share (3/6: 2/6: 1/6)	30,000	15,000	10,000	5,000

(2) Work out the trading income assessments of the existing partners using normal CYB

			Tina	Vincent
			£	£
2009/10	CYB	Year ended 31 December 2009	12,000	10,667
2010/11	CYB	Year ended 31 December 2010	15,000	10,000

(3) Work out the trading income assessments of the new partner

William's share of profits:	£
4 months to 31 December 2009	1,333
Year ended 31 December 2010	5,000

William started to trade: 1 September 2009 = In tax year 2009/10 = His first tax year.

First tax year: Assess William's profits from 1 September 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 31 December 2010
Are these accounts 12 months in length?	Yes
Decision	Assess those 12 months' profits

Tax year	Basis of assessment	Basis period	Workings (nearest month)	Trading income assessment
				£
2009/10	Actual	1.9.2009 – 5.4.2010	£1,333 + (3/12 × £5,000)	2,583
2010/11	12 months ending in second year	Year ended 31.12.2010		5,000

(4) Work out the overlap profits of the new partner

Overlap profits: Period 1.1.2010 – 5.4.2010.

Overlap profits = 3/12 × £5,000 = £1,250.

Partnership losses

- The allocation of partnership losses
- The loss relief options available to each partner
- Limited liability partnerships

3 Partnership losses

3.1 The allocation of partnership losses

If a partnership makes a trading loss, it is allocated between the partners in accordance with the partnership agreement in the accounting period in which it arises.

The allocation of partnership losses is therefore the same as for profits. Any fixed salary or interest on partner's capital must be allocated first. These items are classed as trading income for the partners. The balance of the loss is then allocated in accordance with the profit-sharing ratio.

Example

Frank and Gwen are in partnership and have the following partnership agreement:

	Frank	Gwen
	£	£
Salary (per annum)	45,000	25,000
Capital introduced	70,000	70,000
Annual interest on capital	8%	8%
Profit sharing ratio	40%	60%

The adjusted loss of the partnership after capital allowances for the year ended 31 December 2009 was £126,000.

Required

Allocate the partnership profits for the year ended 31 December 2009 between Frank and Gwen.

Answer

	Total	Frank	Gwen
	£	£	£
Salary	70,000	45,000	25,000
Interest on capital introduced (8% × £70,000)	11,200	5,600	5,600
	81,200	50,600	30,600
Balance of loss (40%: 60%)	(207,200)	(82,880)	(124,320)
Allocation of loss	(126,000)	(32,280)	(93,720)

Note that the balance of the partnership loss is the adjusted loss of the partnership after capital allowances, **plus** the partners' salaries and income on capital. This balancing loss is shared between the partners in their profit-sharing ratio.

3.2 The loss relief options available to each partner

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 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 business incorporated
s72 claim		s89 claim

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.

3.3 Limited liability partnerships

A limited liability partnership (LLP) is a partnership whereby the partners' liability to contribute towards the partnership debts and losses is limited in the partnership agreement.

A partner in an LLP is taxed in the same way as a partner in a normal partnership. However, the amount of loss that 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.

CHAPTER 11

Taxation relief for pension contributions

Contents

1 Overview of taxation relief for pensions
2 The maximum relief available
3 Relief for contributions to occupational pension schemes
4 Relief for personal pension plan contributions

Overview of taxation relief for pensions

- The choices available for providing a pension for retirement
- Overview of the options available for pension contributions

1 Overview of taxation relief for pensions

1.1 The choices available for providing a pension for retirement

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 tax efficient provision for their retirement, therefore generous tax relief is given for pension contributions.

In addition to tax relief for the pension contributions, any income or profits earned by the pension fund itself are exempt from income tax and capital gains tax. Investments held in a pension fund will therefore grow in value more rapidly than investments held by an individual personally.

On retirement, an individual can withdraw from the pension fund a lump sum and regular pension income thereafter. Lump sum payments are tax-free. However, regular pension income is taxable.

Rules on pension contributions

The choices for providing a pension and the tax relief available for the pension contributions depend on whether the individual is:

- employed, or
- self-employed, or
- not working.

There are two types of pension scheme that may be **available to an employee**:

- an employer's occupational pension scheme, or
- if the employee opts out of the employer's scheme, he can set up his own personal pension plan (PPP).

An occupational pension scheme is a scheme established by an employer solely for the benefit of the employees of that business. Therefore an occupational pension

scheme only relates to that employment. If an individual leaves that employment he will need to set up new pension arrangements.

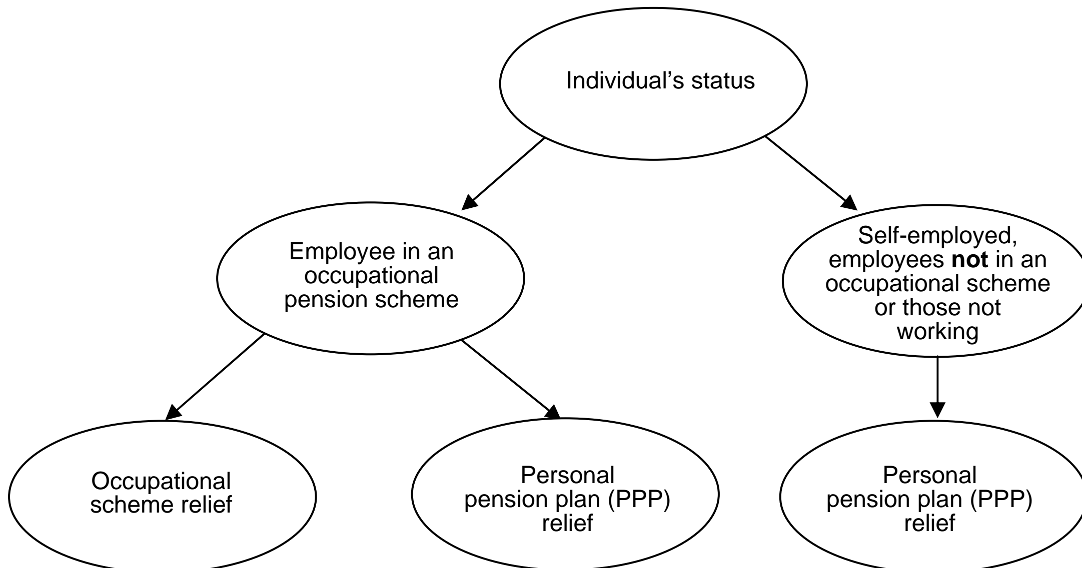
A PPP (also sometimes referred to as a stakeholder pension) is a separate fund, usually established by way of a contract between the individual and an approved pension provider (a bank or life assurance company).

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 his employment status.

Unlike an employed individual who has a choice of an occupational pension scheme and/or a PPP, a self-employed individual and those who are not working can only set up a PPP.

1.2 Overview of the options available for pension contributions

The options available for pension contributions depend on the status of the individual as follows:



The maximum relief available

- The amount of relief available
- Net relevant earnings of an individual who is not working
- Net relevant earnings of working individuals
- Contributions in excess of the annual allowance
- The lifetime allowance

2 The maximum relief available

2.1 The amount of relief available

Any amount can be contributed into a pension scheme. However, tax relief is only available on contributions up to the higher of:

(1) £3,600, and

(2) 100% of net relevant earnings.

2.2 Net relevant earnings of an individual who is not working

If an individual is not working, he will have no net relevant earnings (NRE) and therefore his maximum (gross) contribution is £3,600. This figure is given in the tax rates and allowances in the examination.

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%).

2.3 Net relevant earnings of working individuals

Where an individual is working, the NRE depends on whether the individual is employed or self-employed, and is calculated as follows:

Employed individual		**Self-employed individual**	
	£		£
Employment income	X	Trading income	X
(including benefits)		**Minus** Trading losses brought	
= NRE for employee		forward	(X)
		NRE for self-employed	X

2.4 Contributions in excess of the annual allowance

Although an individual can receive tax relief on contributions of up to 100% of his earnings, there is effectively an upper limit of £245,000 on the amount of contribution which can qualify for relief. The figure of £245,000 is known as the annual allowance. Contributions in excess of the annual allowance are taxed at the rate of 40%. This tax is paid under the self-assessment system. The purpose of this charge is to cancel out the tax relief that will have been given in respect of the contribution. Therefore there is no charge where contributions have not qualified for relief.

Note that all contributions to an individual's pension scheme(s) during a particular tax year count towards this annual allowance. This means that you need to take account of any contributions paid by the individual's employer in deciding whether the annual limit has been exceeded.

2.5 The lifetime allowance

The total funds that can be built up within a person's pension schemes is £1,750,000. This figure is known as the lifetime allowance. Where it is exceeded, there will be an additional tax charge when the funds are eventually withdrawn.

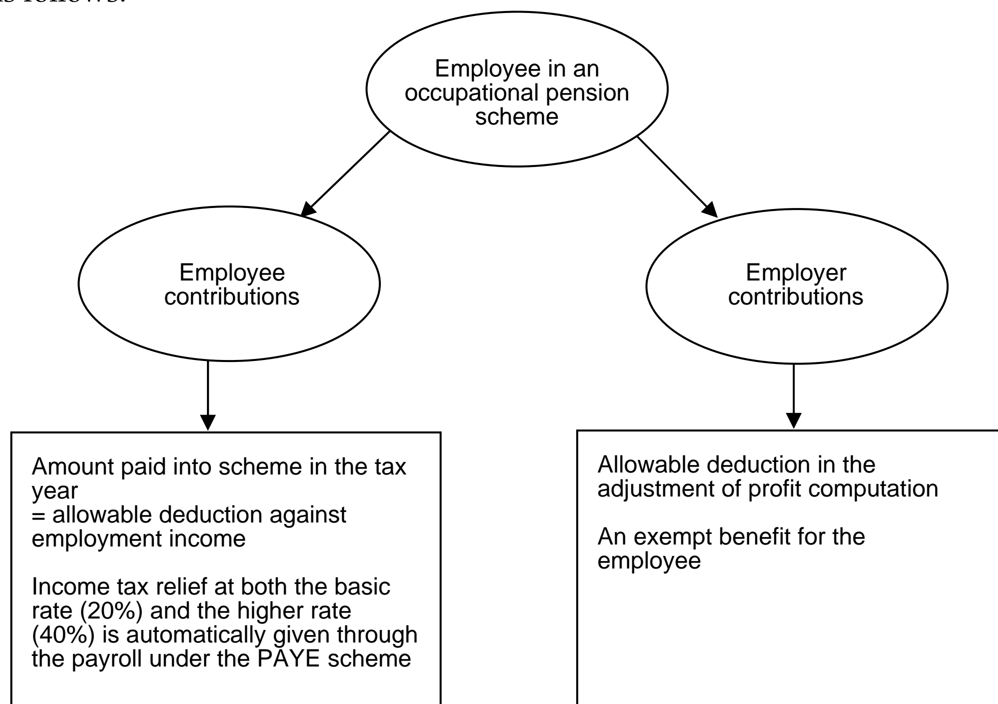
Relief for contributions to occupational pension schemes

- Relief for regular contributions into an occupational pension scheme
- The treatment of additional voluntary contributions (AVCs)

3 Relief for contibutions to occupational pension schemes

3.1 Relief for regular contributions into an occupational pension scheme

The tax relief obtained for contributions made into an occupational pension scheme is as follows:



3.2 The treatment of additional voluntary contributions (AVCs)

The rules of the occupational pension scheme itself usually require an employee to contribute a certain amount of their salary (e.g. 6% or 7%) to the scheme.

Contributions above those required under the rules of the scheme itself are referred to as additional voluntary contributions (AVCs). 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. (This is explained later.)

Relief for personal pension plan contributions

- The scope of personal pension plan relief
- The relief for contributions into a PPP

4 Relief for personal pension plan contributions

4.1 The scope of personal pension plan relief

Personal pension plan tax relief (PPP tax relief) is available to:

- the self-employed
- employees who choose not to join their employer's occupational pension scheme
- individuals who are not working.

Relief is available for contributions made by the individual, the employer and third parties, as long as the overall contribution limit is not exceeded.

4.2 The relief for contributions into a PPP

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. (For example, if an individual pays £200 each month gross into his pension scheme, he will actually pay only £160. This is the £200 less tax relief at 20%.)

Higher rate taxpayers

The additional 20% relief is obtained by extending the basic rate band in the same way as for gift aid contributions. The basic rate band is extended by adding to the £37,400 threshold, the **gross** amount of the pension contributions.

Example

Nicholas is aged 49 and is a self-employed electrician who has been trading for many years. His trading profits have been steadily increasing and his results for the last two years are as follows:

Year ended	Adjusted profit after capital allowances
	£
31 January 2009	53,400
31 January 2010	71,470

Nicholas has non-trading income of £6,000 each year. He has no trading losses brought forward.

Required

(a) Calculate the amount of pension contribution Nicholas could make to his PPP in 2009/10.

(b) Assuming Nicholas decides to make a gross contribution of £20,000, state how the relief will be obtained.

Answer

(a) Calculate NRE for 2009/10

	£
Trading income (CYB = y/e 31 January 2010)	71,470
Minus Trading losses	(Nil)
NRE	71,470

Maximum relief = Higher of:	**£**	**£**
(1) £3,600	3,600	
(2) Net relevant earnings	71,470	71,470

(b) State how the relief will be obtained

Pension contributions are paid net of 20% tax. Therefore to make a gross contribution of £20,000, Nicholas must pay £16,000 (= £20,000 × 80%) into the scheme in 2009/10.

Nicholas is clearly a higher rate taxpayer as shown below:

	£
Trading income	71,470
Non-trading income	6,000
Total income	77,470
Minus PA	(6,475)
Taxable income	70,995

Relief at 20% is given at source for his payments into the pension scheme.

Higher rate relief is obtained by extending his basic rate band to £57,400, i.e. by adding the gross pension contribution of £20,000 to the basic rate band limit of £37,400.

CHAPTER 12

National insurance contributions

Contents

1	Class 1 NICs
2	Class 1A NICs
3	Class 2 NICs and Class 4 NICs

Class 1 NICs

- The scope of Class 1 NICs
- The calculation of primary and secondary Class 1 NICs
- The calculation of directors' Class 1 NICs

1 Class 1 NICs

1.1 The scope of Class 1 NICs

If an **individual is employed**, he is personally liable to Class 1 primary NI 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).

These are commonly referred to as employee's NICs and employer's NICs.

Both Class 1 primary and Class 1 secondary contributions are paid to HMRC under the PAYE system. The employer acts as a collector of taxes on behalf of HMRC and deducts the primary contributions from the employee's salary/wages before payment.

The due date of payment for Class 1 primary and secondary NICs is the 19th of every month (i.e. 14 days after the end of each tax month, which is defined as the 6th of one month to the 5th of the following month).

Class 1 secondary contributions paid by the employer are part of the total cost of employing staff and are charged against profit in the financial accounts. The contributions are incurred wholly and exclusively for the purposes of the trade and are therefore allowable deductions in the employer's adjustment of profit computation.

Employees and employers are assessed to Class 1 primary and secondary contributions:

- on a cash receipts basis
- for an earnings period
- based on the employee's cash earnings
- if they are within the appropriate age limit.

Cash receipts basis

Taxing an employee on a cash receipts basis means that the employee and employer are assessed to NICs in the week or month in which the cash is paid to the employee.

Earnings period

If an employee is paid weekly, his NICs are calculated on a weekly basis using weekly limits and rates. If he is paid monthly, his NICs are calculated on a monthly basis using monthly limits and rates.

The weekly and monthly limits are calculated by dividing the annual limits by 52 weeks or 12 months. It is important to calculate NICs using the weekly or monthly rates where the employee's cash earnings are not received evenly throughout the year. For example, where an employee receives a weekly wage of £200 per week and a bonus in the Christmas week of £500, the calculation must be made for each week separately.

However in the examination, questions will require calculations to be made using the annual limits and rates. The appropriate limits and rates required for the examination questions will be given in the tax rates and allowances sheet.

Cash earnings

An employee's cash earnings are calculated as follows:

Cash earnings for Class 1 NICs	**£**
Salary/wages	X
Bonuses/commissions	X
Any other cash receipts and cash benefits (e.g. excess mileage allowance)	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 that can be converted into cash (e.g. gold bars, fine wines, shares, diamonds)	X
Cash earnings for Class 1 NICs	X

Note that cash earnings is not the same as the employment income assessment, as it is calculated before any allowable deductions (e.g. occupational pension scheme contributions, subscriptions).

Cash earnings also excludes the following:

- exempt benefits per employment income rules
- non-cash benefits (e.g. company car, fuel, living accommodation)
- business expenses reimbursed by the employer
- tips from third parties.

Appropriate age limit

Class 1 NIC liabilities are only payable if the employee is at least 16 years old. Liability to pay starts on the employee's 16th birthday and ends on the employee's 60th birthday for women and 65th birthday for men.

1.2 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

You do not need to learn these rates. The appropriate limits and rates required for any examination question will be given in the tax rates and allowances sheet.

Example

Peter and Paula are both aged 35 and are employed by Quality Games Ltd. Their remuneration for 2009/10 is as follows:

	Peter	Paula
	£	£
Salary	60,000	24,000
Bonus	8,000	Nil
Car benefit	3,450	Nil
Childcare vouchers	Nil	£60 per week for 46 weeks
Employer's pension scheme contribution	3,600	1,440
Employee's pension scheme contribution	2,400	960

Required

Calculate all of the Class 1 NICs payable by the employer to HMRC in respect of Peter and Paula for 2009/10 using the annual limits and rates.

Answer

(1) Calculate cash earnings

	Peter	Paula
	£	£
Salary	60,000	24,000
Bonuses	8,000	0
Childcare vouchers in excess of £55 per week: (£60 - £55) × 46 weeks	0	230
Cash earnings for Class 1 NICs	68,000	24,230

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 **employees' pension contributions** are ignored as pension deductions are not allowed for NIC purposes.

(2) Calculate the NICs for the employee and the employer

The requirement of the question is to calculate all the Class 1 NICs that the employer has to pay to HMRC. In addition to paying the employer's Class 1 secondary contributions, the employer also pays the employees' Class 1 primary contributions to HMRC on behalf of the employees, under the PAYE system.

	Peter		Paula		Total Class 1 NICs payable by Quality Games Ltd
	£		£		£
Class 1 primary contributions					
(£43,875 - £5,715) × 11%	4,198				
(£68,000 - £43,875) × 1%	241				
(£24,230 - £5,715) × 11%			2,037		2,037
	4,439				4,439
Class 1 secondary contributions					
(£68,000 - £5,715) × 12.8%	7,972				7,972
(£24,230 - £5,715) × 12.8%			2,370		2,370
	12,411	+	4,407	=	16,818

1.3 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, as senior management in an organisation, determine when employees will receive their remuneration, including their own. 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 nature of Class 1A NICs
- The basis of calculating Class 1A NICs

2 Class 1A NICs

2.1 The nature of Class 1A NICs

Class 1A NICs are payable by employers only, not employees.

They are charged on the non-cash benefits provided by the employer to higher paid employees (e.g. company cars, private fuel, living accommodation).

There is no liability for Class 1A NICs on benefits provided to lower-paid employees.

Note that non-cash benefits **exclude:**

- 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).

2.2 The basis of calculating Class 1A NICs

Class 1A NICs are charged at 12.8% on the amount of the benefit measured using the employment income rules.

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 contributions paid by the employer are part of the total cost of employing staff and are charged against profit in the financial accounts. The contributions are incurred wholly and exclusively for the purposes of the trade and are therefore allowable deductions in the employer's adjustment of profit computation.

Example

Robert is employed by Swain Products Ltd. In 2009/10 he received the following benefits from his employment:

(a) A new petrol-engined company car costing £16,500 with a list price of £17,600 and CO_2 emissions of 208 g/km. Robert contributes £40 per month for the use of the car.

(b) All fuel, which cost the company £4,440 for the year 2009/10.

(c) A car parking place at the work premises.

(d) Private medical insurance which cost the company £1,100.

(e) Private use of a video camera with a market value of £350 when first made available.

Required

Calculate the Class 1A NIC payable by Swain Products Ltd on 19 July 2010.

Answer

(1) Calculate the assessable benefits under the employment income rules

	g/km		Petrol %
CO_2 emissions (rounded down to nearest 5 g/km)	205		
Base level of CO_2 emissions	(135)		
	70	÷ 5	14
Minimum percentage			15
Appropriate percentage			29
	£		£
Manufacturer's list price	17,600	at 29%	5,104
Minus: Contribution for the use of the car (£40 × 12)			(480)
Car benefit			4,624
Private fuel benefit (£16,900 × 29%)			4,901
Parking space at workplace = exempt benefit			Nil
Private medical insurance (cost to employer)			1,100
Private use of video camera (£350 × 20%)			70
Total benefits liable to Class 1A NICs			10,695

(2) Calculate the Class 1A NICs at 12.8%

Class 1A NICs = £10,695 × 12.8% = £1,369

Class 2 NICs and Class 4 NICs

- Class 2 NICs
- Class 4 NICs
- The calculation of Class 4 NICs

3 Class 2 NICs and Class 4 NICs

3.1 Class 2 NICs

Class 2 NICs are paid by self-employed individuals (i.e. sole traders and each partner in a partnership).

For 2009/10 Class 2 NICs are 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).

However, they are only payable if the self-employed individual:

- has earnings in excess of £5,075, and
- is within the appropriate age limit.

Appropriate age limit

As for Class 1 NICs, an individual starts to pay Class 2 NICs on his/her 16th birthday. Liability to pay ends on the individual's 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.

Class 2 NICs are a personal tax on the self-employed individual, not the unincorporated business. Therefore if the Class 2 NICs are paid for by the business, they are not allowable as they are a personal expense of the owner and treated as an appropriation of profit. 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.

3.2 Class 4 NICs

Class 4 NICs are paid by self-employed individuals (i.e. sole traders and each partner in a partnership), **in addition to Class 2 NICs**.

Class 4 NICs are paid together 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 the individual is within the appropriate age limit.

Profits for Class 4 NICs purposes

The starting point for the profits calculation is the trading income assessment for the tax year, calculated in the normal way (e.g. by applying the CYB rule or the opening or closing year rules). This is adjusted as shown below to calculate profits for Class 4 purposes:

	£
Trading income assessment for the tax year	X
Minus Trading losses	(X)
Profits for Class 4 purposes	X

Appropriate age limit

Liability to pay Class 4 NICs depends on the age of the self-employed individual **at the start of the tax year**. The individual starts to pay if he is 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).

As is the case for Class 2 NICs, Class 4 NICs are a personal tax on the self-employed individual, not the unincorporated business. Therefore if the Class 4 NICs are paid for by the business, they are not allowable as they are a personal expense of the owner and treated as an appropriation of profit. 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.

3.3 The calculation of Class 4 NICs

The annual limits and rate for Class 4 NICs are as follows:

Profits	Rate for Class 4 NICs
	%
First £5,715	Nil
£5,716 - £43,875	8
Excess over £43,875	1

Example

Sarah is self-employed, aged 39, and has been trading for many years. Her results for the last two years are as follows:

Year ended	Adjusted profit after capital allowances
	£
31 May 2009	45,000
31 May 2010	43,000

Sarah has non-trading income of £600 (gross) each year.

Required

Calculate the Class 4 NICs Sarah is liable to pay for 2009/10.

Answer

(1) Calculate profits for Class 4 NIC purposes for 2009/10

	£
Trading income (CYB = y/e 31 May 2009)	45,000
Minus Trading losses	(Nil)
Profits for Class 4 purposes	45,000

(2) Calculate the Class 4 NICs

Class 4 contributions	**£**
(£43,875 - £5,715) × 8%	3,053
(£45,000 - £43,875) × 1%	11
	3,064

CHAPTER 13

Capital gains tax

Contents

1 Overview of the taxation of chargeable gains of an individual
2 The disposal of chargeable assets other than shares and securities by an individual
3 Transfers between spouses
4 Part disposals
5 Wasting assets and chattels
6 Insurance and compensation

Overview of the taxation of chargeable gains of an individual

- The basic charging rules
- The basis of assessment for capital gains tax
- Calculating the capital gains tax liability of an individual
- Proforma: capital gains tax computation
- Calculating the capital gains tax liability

1 Overview of the taxation of chargeable gains of an individual

1.1 The basic charging rules

Individuals are liable to:

- income tax on their taxable income, and
- capital gains tax (CGT) on their chargeable gains.

A chargeable gain arises if:

- a chargeable person
- makes a chargeable disposal
- of a chargeable asset.

A chargeable person is someone who is resident or ordinarily resident in the UK in the tax year in which the chargeable disposal is made. The meaning of residence was covered in Chapter 2. The ordinary residence of an individual is the country in which the individual normally lives. It is therefore possible for an individual to be resident, but not ordinarily resident in the UK.

A chargeable disposal is the **sale or gift** of the whole or part of an asset.

CGT is only charged on the disposal of capital assets during lifetime. No CGT is payable on the transfer of assets **due to the death of an individual**. Legacies on death are therefore exempt disposals for the purpose of CGT.

Exempt assets

The following list shows the most common examples of exempt assets:

- motor cars (including vintage cars and veteran cars)
- goodwill
- current assets (trade debtors, trading stock, cash).

If assets are exempt, they are ignored in the gain/loss computations:

- 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 for capital gains tax

An individual is taxed on his taxable gains in respect of chargeable disposals made in the **tax year** (i.e. 6 April to 5 April).

The date of disposal is the date on which the asset legally changes hands (i.e. when the contract of sale is legally binding), which is not necessarily the same as the payment date or delivery date.

1.3 Calculating the capital gains tax liability of an individual

The calculation of the capital gains tax liability of an individual is as follows:

- **Step 1: Calculate the gains or losses arising on the chargeable disposals.** A separate gain or loss calculation is needed for each chargeable asset that is disposed of in the tax year.
- **Step 2: Calculate and deduct any specific reliefs, if applicable.** Relief is available to reduce or defer the tax on some gains if certain conditions are satisfied.
- **Step 3: Aggregate the net chargeable gains arising in the tax year and deduct allowable capital losses (if any).**
- **Step 4: Deduct the annual exemption available to individuals.** Every individual can realise some gains tax-free each tax year. The 2009/10 annual exemption is £10,100.
- **Step 5: Calculate the capital gains tax liability of the individual.** Apply the rate of 18% to calculate the liability to capital gains tax.

1.4 Proforma: capital gains tax computation

Where several assets are disposed of, steps (1) and (2) above are usually shown as workings to an answer. These steps are explained in more detail later.

Steps (3) to (5) are shown in a summary capital gains tax liability computation 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

Note

If the individual's total net chargeable gains do not exceed £10,100, the unused annual exemption is lost.

1.5 Calculating the capital gains tax liability

Capital gains tax is levied on taxable gains at a flat rate of 18%, irrespective of the level of the individual's income.

Example

Terry realises taxable gains of £21,780.

Required

Calculate Terry's capital gains tax.

Answer

Terry's CGT liability is £3,920 (£21,780 at 18%).

The disposal of chargeable assets other than shares and securities by an individual

- Overview of the computation
- Treatment of capital losses
- Relief for trading losses against capital gains

2 The disposal of chargeable assets other than shares and securities by an individual

2.1 Overview of the computation

The first step in calculating the capital gains tax liability of an individual is the calculation of separate gains and allowable losses on every chargeable asset disposed of in the tax year, **after** taking account of specific reliefs (e.g. rollover relief and gift relief).

The proforma computation is as follows:

		£
Gross sale proceeds		X
Minus	Incidental costs of sale	(X)
Net sale proceeds		X
Minus	Allowable costs	
	Acquisition cost (including incidental costs)	(X)
	Enhancement expenditure	(X)
Gain/(loss) before specific reliefs		X/(X)
Minus	Reliefs (if applicable)	(X)
Gain after specific reliefs/(allowable loss)		X/(X)

Gross sale proceeds or full market value

The gross sale proceeds are used as the starting point of the computation where the asset is sold in a commercial arm's length transaction.

However, **the gross sale proceeds are replaced with the full market value** of the asset at the date of disposal if the asset is:

- gifted, or
- sold to anyone for less than its full market value, or
- sold to a **connected person**.

An individual is **connected** to the following persons:

- spouse or civil partner (i.e. same-sex partner recognised by a civil ceremony under the Civil Partnership Act)
- direct relatives and their spouses (brothers, sisters, ancestors and lineal descendants)
- spouse's direct relatives and their spouses
- business partners and their spouses and direct relatives.

The **net sale proceeds** from the disposal of a chargeable asset is the amount of the consideration received on the sale of the asset, after deducting any incidental selling costs.

Allowable costs consist of:

- the original purchase cost of the asset
- any incidental acquisition costs (see below)
- any enhancement expenditure (costs incurred in improving or enhancing the value of the capital asset).

Incidental selling costs and **incidental acquisition costs** both include estate agent fees, legal fees, commissions, auctioneer's fees, valuation fees, advertising costs, and stamp duty.

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 and additions), and
- is reflected in the state of the asset sold.

  (For example, if an extension to a property is built but later demolished, the cost of the extension is not allowable when the property is disposed of, because the proceeds from the sale relate to the property without the extension).

2.2 Treatment of capital losses

The treatment of capital losses depends on the type of loss. A summary of the rules for capital losses are as follows:

Type of capital loss:	**Explanation:**
Current year losses	▪ Must be set off against current year gains first. ▪ 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.

Type of capital loss:	Explanation:
Losses brought forward	▪ These are set off **after the deduction of** current year losses. ▪ Must be set off against the **first available** gains. (It is not possible for an individual to skip a year.) ▪ If deducting brought forward losses would reduce the **total net gains** below the annual exemption, the set off of these brought forward losses is restricted to the amount that brings the total net gains of the individual down to the annual exemption.
Losses on disposals to connected persons	▪ These can only be set against gains from disposals in the current or future years to the **same connected person**.
Relief of trading losses against capital gains under s261B TCGA 1992	▪ s261B trading losses are treated **as if they are current year capital losses.** ▪ s261B relief is explained later.

Example

Victoria has made a chargeable gain of £15,700 in respect of the disposal of an asset in 2009/10.

Required

Calculate Victoria's taxable gains for 2009/10 assuming the following alternative losses arise:

(a) current year loss of £14,500

(b) current year loss of £4,500 and brought forward losses of £10,000

Answer

Situation (a): Victoria

Capital gains tax computation – 2009/10

Gain	15,700
Minus capital loss	(14,500)
Net chargeable gain	1,200
Minus Annual exemption *(see note)*	(1,200)
Taxable gains	Nil

Note

Current year losses must be off set even if they result in the wastage of the annual exemption.

Situation (b): Victoria

Capital gains tax computation – 2009/10

Gain	15,700
Minus current year capital loss	(4,500)
	11,200
Minus brought forward capital loss (restricted)	(1,100)
	10,100
Minus Annual exemption	(10,100)
Taxable gains	Nil

Note

Brought forward capital losses must be set off against the first available gains, but not if they reduce the total net gains below £10,100.

Only £1,100 of the loss brought forward is set off, to leave total net gains of £10,100.

Victoria still has £8,900 of capital loss remaining to carry forward to the following tax year.

2.3 Relief for trading losses against capital gains

The relief for trading losses of an unincorporated business against income is the subject of an earlier chapter. Several options for relief are available, and the choices depend on whether the business is in its opening, closing or ongoing years.

However, regardless of whether an individual is in the opening, closing or ongoing years of an unincorporated business, he can always set trading losses against his total income in the tax year of the loss and/or the preceding year with a s64 claim.

In addition, after a s64 claim has been made in a particular tax year, an individual can make a claim to extend the relief and to set off some of the trading loss against gains under s261B TCGA 1992.

The rules for s261B

An individual can make a claim to set off trading losses against his gains:

- in the tax year of the loss, **and/or**
- in the preceding tax year,
- **but only if** a s64 claim against total income has been made in the **same** year first.

When setting off the trading loss under s261B in the current or preceding tax year, the following rules apply:

Rule:	Explanation:
Set off against gains	▪ Treat the trading loss as if it is a **current year capital loss**: i.e. s261B losses must be set off against current year gains.

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 current year's gains. ▪ An individual cannot restrict the set off to preserve the annual exemption. ▪ Loss relief may reduce the chargeable gains so that the relief for the annual exemption is lost.

The maximum amount of a s261B claim is calculated as follows:

			£
Lower of	(1)	The unrelieved trading loss **after** the s64 claim has been made	X
	(2)	Total gains for the year	X
		Minus: Total capital losses for the year	(X)
		All capital losses brought forward	(X)
Maximum amount			X

In this calculation, ignore the annual exemption, and deduct **all** capital losses in full.

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. the 31 January immediately prior to the second anniversary of the end of the tax year of the loss).

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.

Example

William prepares accounts to 31 August each year. In the year ended 31 August 2009 he incurred a trading loss of £32,000. He has provided the following information relating to 2009/10:

	£
UK rental income	17,150
Gains	22,800

William also has capital losses of £13,200 brought forward.

Required

Calculate William's taxable gains assuming that current year s64 and s261B claims are made. State the amount of any losses remaining unrelieved, if any.

Answer

The amount of s261B claim is the lower of:

		£
(1)	The unrelieved trading loss **after** the s64 claim has been made (£32,000 - £17,150)	14,850
(2)	Total gains for the year	22,800
	All capital losses (current year and brought forward)	(13,200)
	Maximum amount	9,600

William
Capital gains tax computation – 2009/10

	£
Total net chargeable gains	22,800
Minus s261B claim	(9,600)
	13,200
Minus capital loss brought forward (restricted)	(3,100)
	10,100
Minus: Annual exemption	(10,100)
Taxable gains	Nil

Notes

(1) The s261B claim is an all or nothing claim; therefore the maximum amount must be deducted from the current year's gains.

(2) Brought forward capital losses are then set off, but not to the extent that they reduce the total net gains below £10,100.

Losses remaining unrelieved

Trading losses	£
Trading loss in tax year	32,000
s64 current year claim	(17,150)
s261B current year claim	(9,600)
Trading loss c/f under s83	5,250

Capital losses	**£**
Capital loss brought forward	13,200
Current year set off	(3,100)
Capital loss c/f	10,100

Transfers between spouses

- Transfers between spouses

3 Transfers between spouses

3.1 Transfers between spouses

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.

Disposal consideration =	Allowable Cost (AC)

On the subsequent disposal of the asset by the spouse, a normal computation is required using a deemed acquisition cost 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

	£
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

Part disposals

- The problem with part disposals
- The part disposal formula

4 Part disposals

4.1 The problem with part disposals

Where only part of an asset is disposed of, it is necessary to allocate the allowable cost of the whole asset between:

- the part of the asset that is being disposed of, and
- the part of the asset that is being retained.

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.

4.2 The part disposal formula

When calculating the allowable cost:

- Any allowable costs that **relate to the whole asset** are allocated between the two parts on the basis of market values at the date of the part disposal as follows:

$$\text{AC re - part disposal} = \text{AC} \times \frac{\text{MV of part disposed of}}{\text{MV of part disposed of} + \text{MV of part retained}}$$

$$\text{AC re - part retained} = (\text{AC less AC re - part disposed of})$$

  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 a non-business 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	
Original cost (July 1985):	
$(£29{,}600 + £530) \times \frac{48{,}000}{48{,}000 + 105{,}000}$	(9,453)
Enhancement expenditure (July 1999):	
$(£14{,}200) \times \frac{48{,}000}{48{,}000 + 105{,}000}$	(4,455)
Gain	33,192

Subsequent disposal	**Mar 2010**
	£
Gross sale proceeds	147,500
Less Incidental selling expenses	(2,300)
Net sale proceeds	145,200
Less Allowable cost	
Original cost (July 1985):	
((£29,600 + £530) – £9,453)	(20,677)
Enhancement expenditure (July 1999):	
(£14,200 – £4,455)	(9,745)
Gain	114,778

Wasting assets and chattels

- The definition of wasting assets and chattels
- A summary of the consequences of the disposal of chattels
- Gains on the disposal of chattels
- Losses on the disposal of chattels
- The disposal of plant and machinery
- A summary of the consequences of the disposal of wasting assets

5 Wasting assets and chattels

5.1 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.

5.2 A summary of the consequences of the disposal of chattels

Chattels are treated as follows:

- **Wasting chattels** are **exempt** from capital gains tax.
- **Non-wasting chattels** are chargeable but the treatment depends on the amount of gross disposal consideration (i.e. sale proceeds or market value) and the allowable cost.

		Gross Disposal Consideration	
		£6,000 or less	**More than £6,000**
Cost	**£6,000 or less**	Exempt	5/3 rule applies
	More than £6,000	Deemed disposal for £6,000	Normal gain computation

5.3 Gains on the disposal of chattels

Where a chattel is sold for more than £6,000 but the item cost £6,000 or less, the gain is restricted to the lower of:

(i) the gain calculated applying the normal rules, and

(ii) (Gross sale proceeds – £6,000) × 5/3

Example

Teresa purchased an antique for £2,200 on 23 March 1987. She sold it for £7,600 on 16 October 2009.

Required

Calculate the chargeable gain arising in 2009/10.

Answer

Gain calculated applying the normal rules:	
	£
Sale proceeds	7,600
Less Acquisition cost	(2,200)
Gain	5,400
Marginal gain calculation:	
(£7,600 – £6,000) × 5/3	2,667

Decision:
The lower gain of £2,667 is taken.

5.4 Losses on the disposal of chattels

Where a chattel is sold for less than £6,000 but the item cost more than £6,000, the actual sale proceeds received are ignored and the allowable loss is calculated assuming the gross sale proceeds are £6,000.

Example

John purchased an antique for £7,200 on 23 March 1987. He sold it for £4,600 on 16 October 2009 and incurred £540 of incidental selling expenses.

Required

Calculate the allowable loss arising in 2009/10.

a **Answer**

	£
Deemed gross sale proceeds	6,000
Less Incidental selling expenses	(540)
Net sale proceeds	5,460
Less Allowable cost	(7,200)
Allowable loss	(1,740)

5.5 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, following the rules above, would therefore be exempt from capital gains tax.

However, not all plant and machinery is exempt. Special rules apply as follows:

- If the plant and machinery is **used in a trade** and **capital allowances can be claimed**:
  - they are chargeable assets and the 5/3 rule applies if sold at a gain
  - no allowable loss arises if sold at a loss.
- If there are **no capital allowances** available on the plant and machinery:
  - they are **exempt** if they are **chattels** (i.e. tangible and moveable), and
  - the rules for **wasting assets** are followed if they are not chattels.

5.6 A summary of the consequences of 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 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. Wasting assets are deemed to depreciate on a straight line basis.

When calculating the allowable cost, the net cost of the asset must be depreciated on a straight line basis as follows:

$$\text{Net cost} \times \frac{\text{Length of ownership by the seller (months)}}{\text{Expected life of the asset (months)}}$$

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.

Insurance and compensation

- The receipt of a capital sum due to the ownership of an asset
- Assets totally destroyed or lost
- Damaged assets

6 Insurance and compensation

6.1 The receipt of a capital sum due to the ownership of an asset

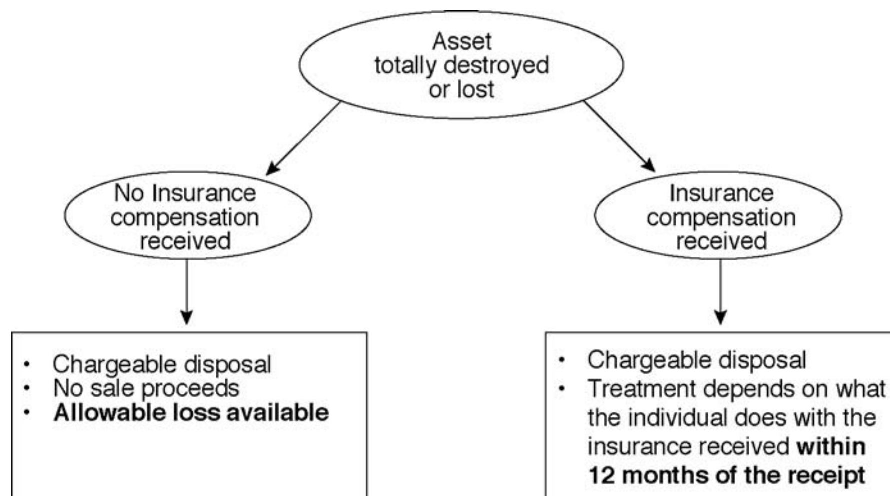
The receipt of a capital sum due to the ownership of an asset is a chargeable disposal for capital gains tax purposes. The receipt of compensation or insurance on making a claim due to the loss, destruction or damage to a capital asset is therefore a chargeable event.

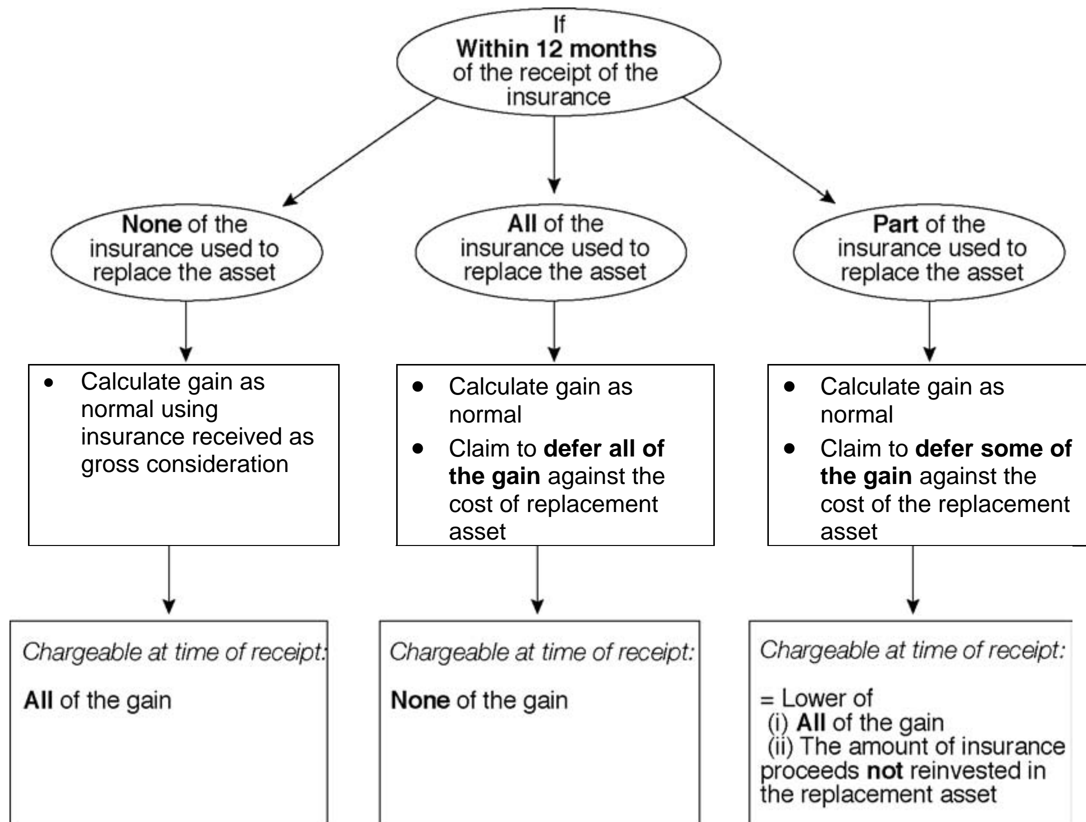
The treatment of the receipt depends on whether the asset is:

- totally destroyed/lost – i.e. a disposal of the asset, or
- damaged but not totally destroyed – i.e. a part disposal of the asset.

6.2 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

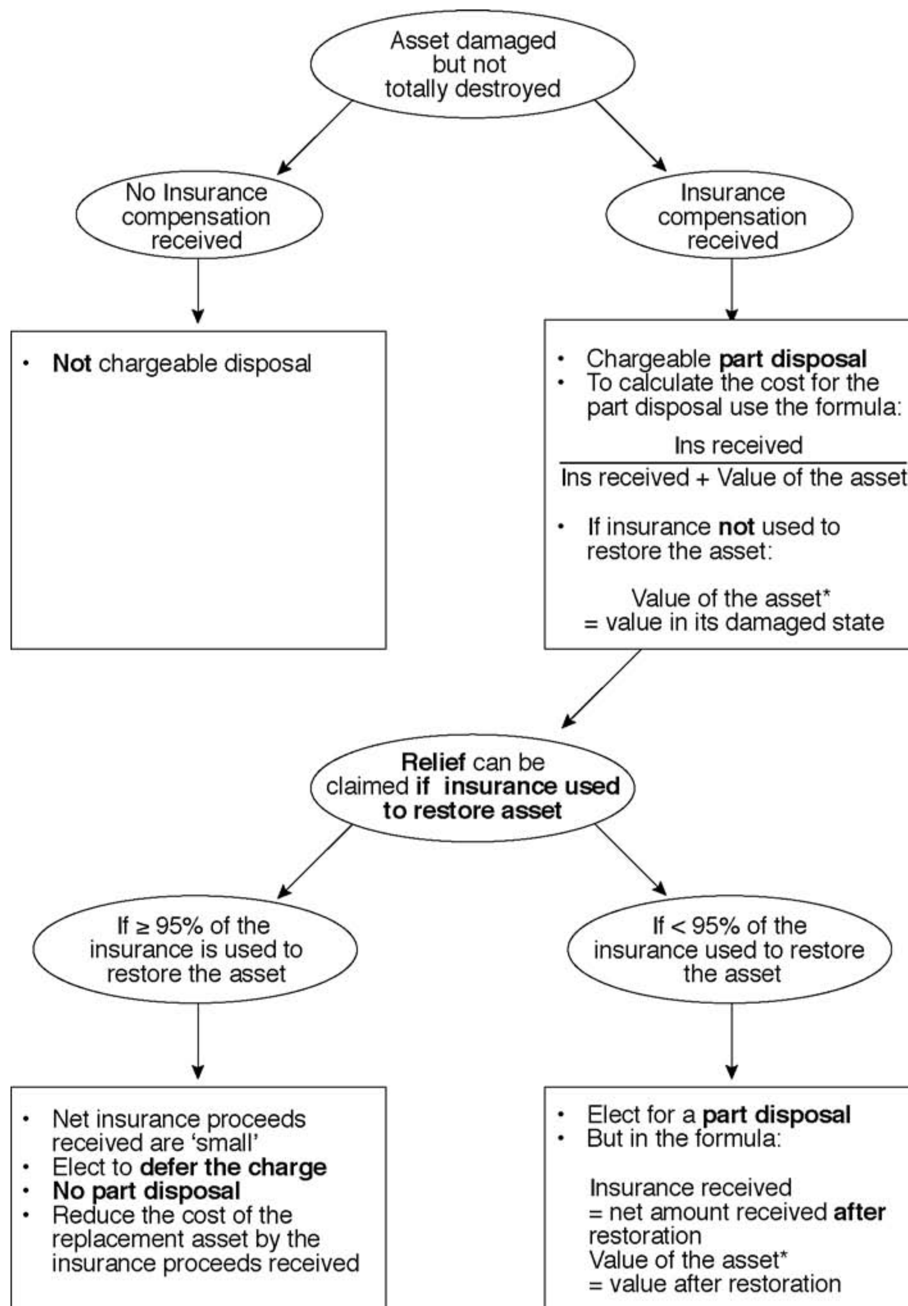
(a) If replacement cost £650,000		(b) If replacement cost £480,000	
Gain in 2009/10	£Nil	Gain in 2009/10	
		= Lower of	
		all of the gain	£320,000
		insurance not reinvested	£120,000
As all of the insurance proceeds are reinvested in a replacement painting, the whole gain can be deferred until the later disposal of the replacement painting		*Note:* The chargeable gain is assessed in 2009/10 (the tax year of the receipt of the 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

6.3 Damaged assets

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:

- the consequences are as explained above, but an election can be made to defer the charge to CGT
- if an election is made, no part disposal occurs, no CGT charge arises
- the base cost of the vase is:
  - reduced by the insurance proceeds received, and
  - increased by 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 restoration costs, and
  - looking at the value of the asset **after** restoration.

CHAPTER 14

CGT - Shares and securities

Contents

1 The disposal of shares and securities by an individual
2 The valuation rules for shares
3 The share identification rules for individuals
4 Bonus issues, rights issues, takeovers and reorganisations

The disposal of shares and securities by an individual

- Shares and securities that are chargeable to CGT

1 The disposal of shares and securities by an individual

1.1 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. However, they are not exempt assets for company disposals and corporation tax purposes.

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. They are usually called Treasury stock or Exchequer stock.

The valuation rules for shares

- The valuation rules for shares

2 The valuation rules for shares

When quoted shares and securities are gifted, or sold to a connected person for less than their market value, it is necessary to place a value on the disposal for CGT purposes.

Quoted shares are quoted by stock market dealers at two prices: a lower price at which they will buy the shares and a higher price at which they will sell them.

A transaction in quoted shares is known as a bargain.

Quoted shares are valued at the lower of two values, as follows:

Lower of	**pence**
(1) The quarter up rule	
Lower quoted price	X
Plus ¼ × (Higher quoted price less Lower quoted price)	X
	X
(2) The average of the highest and lowest marked bargains of that day (if any)	
½ × (Highest marked bargain + Lowest marked bargain)	X

Example

Andrew gifts his 2,000 ordinary shares in X plc to a friend. At the date of the gift the shares are quoted at 363p – 379p, with marked bargains on the day of 365p, 370p and 377p.

Required

Calculate the value of the shares gifted to Andrew's friend for capital gains tax purposes.

Answer

The X plc shares are valued at the lower of:	**pence**
(1) The quarter up rule	
363 plus ¼ × (379 *less* 363)	367
(2) The average of the highest and lowest marked bargains of that day	
½ × (377 + 365)	371
Here, the shares are valued at 367 pence.	
	£
Value of 2,000 shares = 2,000 × £3.67p	7,340

The share identification rules for individuals

- The share identification rules for individuals
- Acquisitions in the next 30 days
- The share pool

3 The share identification rules for individuals

3.1 The share identification rules for individuals

When purchasing shares, an individual must keep separate records for each different type and class of company shares purchased. For example X Ltd ordinary share purchase records are kept separate from Y Ltd ordinary share purchase records, which are kept separate from Y Ltd preference share purchase records, and so on.

To identify which shares have been disposed of, the share identification rules are applied. For the purpose of your examination, shares are 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 basis

(3) Shares in the share pool

3.2 Acquisitions in the next 30 days

The future 30-day rule exists as an anti-tax avoidance measure. It was introduced to prevent a scheme known as bed and breakfasting.

Prior to this ruling, individuals could deliberately sell shares one day and repurchase them the next day (or shortly afterwards) in order to:

- realise a gain, but pay no tax as the gain was covered by the annual exemption, and
- establish a higher base cost for the shares for the purpose of calculating the gain on future disposals.

3.4 The share pool

An individual with many investments in companies will need to construct a share pool **for each company and each class of share**.

The share pool is treated as a single asset, with shares disposed of at their average cost.

The working for the share pool is shown as follows:

	Number of shares	Original cost
		£
Acquisition 1	X	X
Acquisition 2	X	X
	X	X
Sale (at average cost)	(X)	(X)
Pool balance c/f	X	X

The appropriate proportion of cost to deduct when shares are sold is calculated as follows:

$$\text{Total cost to date} \times \frac{\text{Number of shares disposed of}}{\text{Number of shares held (before the disposal)}}$$

Example

Beth purchased shares in Y Ltd as follows:

		Cost
		£
16 May 1997	5,000 shares	34,500
27 March 2010	6,500 shares	37,700

On 13 March 2010 she sold 10,000 shares in Y Ltd for £96,000.

Required

Calculate the chargeable gains arising on the disposal of Beth's shares.

Answer

Matching rules	Number of shares held	Disposal 13 March 2010	Remaining shares
1. Acquisitions in the next 30 days			
27 March 2010	6,500	(6,500)	Nil
2. Pool shares	5,000	(3,500)	1,500
	11,500	(10,000)	1,500

The disposal value of each share was £96,000/10,000 shares = £9.60 per share.

(1) Chargeable gain on the disposal of shares acquired on 27 March 2010

	£
Gross sale proceeds (£96,000 ÷ 10,000) × 6,500	62,400
Minus Cost	(37,700)
Gain	24,700

(2) Chargeable gain on the disposal of shares in the share pool

Working:

	Number of shares	Original cost
		£
Purchase on 16 May 1997	5,000	34,500
Sale on 13 March 2010 (note)	(3,500)	(24,150)
Pool balance c/f	1,500	10,350

Note

Shares sold from the pool are removed at average cost. In this example, 3,500 shares out of 5,000 shares in the pool were sold.

Cost: £34,500 × 3,500/5,000 = £24,150

	£
Gross sale proceeds (£96,000 ÷ 10,000) × 3,500	33,600
Minus Cost (from pool, see working)	(24,150)
Gain	9,450

The total chargeable gains on the share disposal are therefore (1) £24,700 + (2) £9,450 = £34,150.

Bonus issues, rights issues, takeovers and reorganisations

- Bonus issues
- Rights issues
- Takeovers
- Reorganisations

4 Bonus issues, rights issues, takeovers and reorganisations

4.1 Bonus issues

Bonus issue shares are free shares issued to existing shareholders in proportion to the number of shares already held.

For example, a 1 for 3 bonus issue means that for every 3 existing shares held, 1 free share will be issued to each shareholder.

Bonus shares are treated as if they are acquired on the same day as the original shares to which they relate.

Example

On 23 August 1999 Carl purchased 3,000 ordinary shares in M plc for £45,000. On 6 April 2008 M plc made a 1 for 6 bonus issue.

On 31 December 2009 Carl disposed of 3,000 of his shares in M plc for £60,000.

Required

Calculate the chargeable gain arising on the disposal of shares.

Answer

Chargeable gain on the disposal of shares in the share pool

Working

	Number of shares	Original cost
		£
Purchase on 23 August 1999	3,000	45,000
Bonus issue	500	Nil
	3,500	45,000
Sale on 31 December 2009 (note)	(3,000)	(38,571)
Pool balance c/f	500	6,429

Note

Shares sold from the pool are removed at average cost:
£45,000 × 3,000/3,500 = £38,571

		£
Gross sale proceeds		60,000
Minus	Cost (from pool, see working)	(38,571)
Gain		21,429

4.2 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 they already hold. Shares in a rights issue are sold at an attractive price (i.e. for less than the current market value) to persuade shareholders to buy them.

For example, a 1 for 5 rights issue means that for every 5 existing shares they hold, the shareholders have the right to purchase 1 additional share at the attractive offer price.

Rights shares are treated as if they are acquired on the same day as the original shares to which they relate.

Example

The facts are the same as in the previous example involving Clive. However, it is a rights issue rather than a bonus issue that takes place on 6 April 2008. The rights issue is 1 for 6 at for £10 per share and Carl bought all the shares that were offered to him in the issue.

Required

Calculate the chargeable gains arising on the disposal of shares.

Answer

Chargeable gain on the disposal of shares in the pool

Working

	Number of shares	Original cost
		£
Purchase on 23 August 1999	3,000	45,000
Rights issue	500	5,000
	3,500	50,000
Sale on 31 December 2009 (note)	(3,000)	(42,857)
Pool balance c/f	500	7,143

Note

Shares sold from the pool are removed at average cost:
£50,000 × 3,000/3,500 = £42,857

		£
Gross sale proceeds		60,000
Minus	Cost (from pool, see working)	(42,857)
Gain		17,143

4.3 Takeovers

An examination question involving a takeover will only involve a paper-for-paper exchange, such as an exchange of shares in the acquired company for shares in the company making the acquisition. As a result the treatment for capital gains tax purposes is as follows:

- No chargeable gain or allowable loss arises at the time of the takeover.
- The new shares and securities received are deemed to be:
  - acquired on the same day as the original shares
  - for the same cost as the original shares.
- The original cost of the old shares is allocated to the new shares and securities received, in proportion to the market values of the consideration received.
- Pools for the new shares and securities are set up.

Example

David owns 3,000 ordinary shares in Z Ltd, which he bought for £16,600 on 23 June 1993.

On 15 March 2010 Z Ltd accepted a takeover bid from A plc. The takeover offer consisted of 1 ordinary share and 2 preference shares in A plc for every 3 shares held in Z Ltd.

At the date of the takeover, the market value of A plc shares was as follows:

Ordinary shares	£9 each
Preference shares	£6 each

Required

State the chargeable gain arising at the time of the takeover, and calculate the cost to be entered in the new pools for the A plc shares.

Answer

There is no chargeable gain at the time of the takeover as no cash consideration is received.

Takeover consideration received by David:

	Market value
	£
1,000 Ordinary shares in A plc (1,000 × £9)	9,000
2,000 Preference shares in A plc (2,000 × £6)	12,000
	21,000

Z Ltd: pool	Number of shares	Cost
		£
Balance at time of takeover	3,000	16,600

Allocation of the original cost of the Z Ltd shares	Cost
	£
1,000 Ordinary shares in A plc: 9,000/21,000 × £16,600	7,114
2,000 Preference shares in A plc: 12,000/21,000 × £16,600	9,486
	16,600

4.4 Reorganisations

A reorganisation is where a company reorganises its equity and debt capital 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 in proportion to the market values of the new shares.

The allocation of the 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 and securities on the date of the:**
Quoted shares	Reorganisation
Unquoted shares	First disposal

CHAPTER 15

Capital gains tax reliefs

Contents

1 Entrepreneurs' relief
2 Rollover relief
3 Gift relief
4 Tax consequences of incorporation
5 Principal private residence and letting relief

Entrepreneurs' relief

- Overview of entrepreneurs' relief
- Conditions

1 Entrepreneurs' relief

1.1 Overview of entrepreneurs' relief

Entrepreneurs' relief is a new 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%.

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.

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 Entrepreneurs' 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

1.2 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.

Rollover relief

- Overview of rollover relief
- Qualifying business assets
- How much gain can be deferred?
- What happens to the deferred gain?
- Non-business use

2 Rollover relief

2.1 Overview of rollover relief

A chargeable gain is usually taxed in the year of disposal. However, if a rollover relief claim is made, the gain is deferred to a later tax year.

Rollover relief (technically known as replacement of business asset relief) is a tax relief to encourage businesses to reinvest in capital assets and continue in business.

The relief is available if the sale proceeds received from the disposal are used to purchase a replacement asset and **all** the following conditions are satisfied:

- The asset being sold is a **qualifying business asset**.
- The replacement asset is a **qualifying business asset** (but it does not need to be the same type of asset as the asset being sold).
- Both assets are used for the purposes of the trade.
- The replacement purchase takes place in the **four-year period** running from 12 months before, to three years after, the date of disposal.
- The new asset is brought into business use at the time that it is acquired.
- A claim for relief is made within four years of the end of tax year in which the disposal takes place.

2.2 Qualifying business assets

The main examinable assets eligible for rollover relief are:

- Land and buildings used for the purposes of the trade
- Fixed plant and machinery (but not moveable plant and machinery such as fork lift trucks).
- Goodwill. (Note, however, that goodwill is not a qualifying asset if disposed of by a company.)

It is important to note that:

- rollover relief is never available on a gain arising from the disposal of shares, and
- the purchase of shares is not a qualifying replacement asset for rollover relief purposes.

2.3 How much gain can be deferred?

If **all** the sale proceeds are reinvested, it is presumed that the taxpayer will not have cash available to pay any tax on the gain. **All** the gain arising on the disposal can therefore be deferred and none of the gain is taxed immediately.

If some of the sale proceeds have been retained, it is presumed that the taxpayer does have some cash available to pay some tax on the gain. The amount of relief available is therefore restricted and some of the gain is taxed immediately. The amount that is taxed immediately is the lower of:

- all the gain, or
- the sale proceeds **not** reinvested in QBAs.

2.4 What happens to the deferred gain?

The treatment of the deferred gain depends on whether the **replacement** asset is a depreciating asset or a non-depreciating asset:

Type of QBAs purchased:	**Non-depreciating QBAs**	**Depreciating QBAs**
Expected life	More than 60 years.	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. Leasehold land and buildings with up to 60 years left on lease.
Mechanics of the deferral	▪ The gain to be deferred is deducted from the cost of the new asset to calculate the revised base cost of the replacement asset (i.e. the cost minus rollover relief). ▪ On the subsequent disposal of the replacement asset, the revised base cost is deducted in the gain computation instead of the original cost – thus increasing the gain chargeable on this disposal.	▪ 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. ▪ If sold, a normal computation of the chargeable gain on the replacement asset is made, using the original cost.
	▪ The original gain has therefore been rolled over (i.e. deferred) until the disposal of the replacement asset.	▪ In this situation, the deferred gain is sometimes referred to as a held-over gain, rather than a rolled over gain.

Rollover relief is an all or nothing relief. It is optional but, if claimed, the taxpayer must defer (roll over) the maximum amount of gain allowed by the legislation.

On the disposal of the replacement asset, the deferred gain becomes taxable, unless a further rollover relief claim can be made.

With good tax planning, gains on QBAs can be deferred potentially indefinitely, provided the conditions are satisfied at each disposal date.

Example

Ellen is self employed. She prepares her accounts to 31 March each year. On 30 November 2009 she sold a freehold warehouse for £230,000, which was purchased in August 1994 and gave rise to a gain (before considering reliefs) of £65,000.

On 24 January 2010 Ellen purchased a 70-year lease on a new warehouse for £218,000. She expects to sell the warehouse on 31 December 2011 for £550,000.

Required

Calculate Ellen's chargeable gains arising in 2009/10 and 2011/12.

Explain the difference in treatment if the replacement warehouse is a 40-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 November 2008 – 30 November 2012)	Yes
Have all the sale proceeds been reinvested in a QBA?	No

Gain arising in 2009/10

Lower of	
(1) The gain £65,000, and	
(2) The sale proceeds **not** reinvested in QBAs (£230,000 - £218,000) =	£12,000
Rollover relief = The rest of the gain (£65,000 - £12,000)	53,000

Base cost of replacement 70-year leasehold interest	**£**
Cost	218,000
Minus: Rollover relief	(53,000)
Base cost	165,000

Chargeable gain arising in 2011/12	**£**
Sale proceeds	550,000
Base cost	(165,000)
Gain	385,000

If the replacement had been in a 40 year leasehold interest

A 40-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.

- A record of the amount of rollover relief is kept and that amount is deferred for 10 years from the date of acquisition of the replacement 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, 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.

Chargeable gain arising in 2011/12	**£**
Sale proceeds	550,000
Base cost	(218,000)
Gain	332,000

2.5 Non-business use

If part of an asset is not used for trade purposes (for example, if 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 in the tax year in which the disposal occurs.

The rollover relief available on the business proportion of the gain is calculated in the normal way. However, consideration is only given to business usage. 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

Ian owned a three-storey building. He purchased it in January 1988 for £65,070 and sold it on 24 November 2009 for £200,000.

Ian used two floors for the purposes of his trade, but never occupied the ground floor. This was let out to another business which operated as a shoe shop.

In November 2009, Ian relocated. He purchased a new building for £128,000 on 1 October 2009 and plans to use it exclusively for the purposes of his trade.

Required

Calculate the chargeable gain arising in 2009/10 and the base cost of the new building.

Answer

	£
Gross sale proceeds (November 2009)	200,000
Cost (January 1988)	(65,070)
Chargeable gain before rollover relief	134,930

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 November 2008 – 24 November 2012)	Yes
Have all the sale proceeds been reinvested in a QBA?	No

Split of chargeable gain before rollover relief		**Business**	**Non-business**
	£	£	£
Chargeable gain before rollover relief (2/3:1/3)		89,953	44,977
Chargeable gain for the business element = Lower of:			
(1) the business proportion of the gain	89,953		
(2) the sale proceeds for the business proportion (= £200,000 × 2/3)	133,333		
Minus amount reinvested in QBAs for the business (= £128,000 × 100%)	(128,000)		
	5,333		
Lower =		(5,333)	
Rollover relief = the rest of the business gain (£89,953 – £5,333)		84,620	
Chargeable gains in 2009/10 =		5,333	+ 44,977
Total chargeable gains in 2009/10 =		£50,310	

Base cost of replacement building	£
Cost	128,000
Minus: Rollover relief	(84,620)
Base cost	43,380

When the replacement building is eventually disposed of, the chargeable gain will be calculated using this base cost, not its original cost.

Gift relief

- Overview of gift relief
- Qualifying assets for gift relief
- The mechanics of gift relief
- Sales at under-valuation
- Restriction of relief for assets not used wholly for the purposes of the trade

3 Gift relief

3.1 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 defined conditions are satisfied, the gain arising on the gift may be deferred if a gift relief claim is made.

Gift relief is available where:
- an individual makes a disposal of a qualifying business asset
- by way of an outright gift, or
- sale for less that its full market valuation.

Note that gift relief is available to individuals, but not to companies. (Rollover relief is the only capital gains relief available to companies.)

The relief is an optional relief, and if required, it must be claimed. It is not given automatically. A joint claim is required, and this must be signed by both the **donor** (i.e. the person making the gift) and the **donee** (i.e. the recipient of the gift).

A joint claim must be made within four years of the end of tax year in which the disposal takes place.

3.2 Qualifying assets for gift relief

Qualifying assets for gift relief purposes are as follows:
- assets used in a business carried on by the donor or by the donor's personal company
- unquoted trading company shares or securities
- quoted shares or securities, but only if they are shares or securities in the donor's personal company.

A personal company in this context means a company in which the individual has at least 5% of the voting rights.

3.3 The mechanics of gift relief

Where there is an outright gift of a qualifying business asset and gift relief is claimed:

- the whole 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 (see below)
- on the subsequent disposal of the asset by the donee, the deferred gain becomes chargeable: the lower deemed acquisition cost is used in the computation rather than the full market value of the asset at the date of the gift.

The deemed acquisition cost of the asset acquired by way of an outright gift is calculated as follows:

	£
Full market value of the asset at the date of the gift	X
Minus 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. It is optional, but if claimed, the maximum amount of gain allowed by the legislation must be deferred.

On the subsequent disposal of the asset by the donee, the gain is calculated using the base cost of the asset as calculated above.

Example

On 4 October 2009 Francis gave a business asset to his daughter which was worth £224,000. He bought the asset in July 1988 for £11,200. His daughter sold the asset in April 2010 for £245,000. The asset qualifies as a business asset for gift relief.

Required

Calculate the chargeable gains arising on the disposals, with and without a gift relief claim. State whether a gift relief claim is advisable.

Answer

	No gift relief claim	With a gift relief claim
October 2009 - gift to daughter	£	£
Market value at date of gift	224,000	224,000
Minus: Cost	(11,200)	(11,200)
Gain	212,800	212,800
Minus: Gift relief	(Nil)	(212,800)
Gain after relief	212,800	Nil

Deemed acquisition cost for the daughter		
Market value at date of gift		224,000
Minus: Gift relief		(212,800)
Base cost of the asset		11,200
April 2010 - sale of asset by the daughter		
Sale proceeds	245,000	245,000
Minus: Market value at date of gift / Base cost	(224,000)	(11,200)
Gain	21,000	233,800

	No gift relief claim	With a gift relief claim
Summary of chargeable gains	£	£
October 2009	212,800	Nil
April 2010	21,000	233,800
Total chargeable gains	233,800	233,800

The total chargeable gains remain the same whether or not a gift relief claim is made. However, the claim results in the payment of the tax being deferred until the date the donee disposes of the asset. The claim is therefore advisable from a cash flow point of view.

Before making a claim, however, it is also advisable to look at the full circumstances surrounding the disposal. For example:

- Is entrepreneurs' relief available to either the donor or the donee?
- Does either party have any capital losses available to offset against the gain?
- Is the annual exemption available to one party but not the other?

3.4 Sales at under-valuation

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.

If the sale proceeds received are:	Treatment:
Less than the original cost of the asset	▪ Full gift relief is available, i.e. all 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 the 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

Assume that the facts are the same as the previous example, except that Francis sold the asset to his daughter for £50,000 and a gift relief claim was made.

Required

Calculate the chargeable gains arising on the disposals.

Answer

	With a gift relief claim
October 2009 - sale at undervaluation to daughter	£
Gain (as in the previous example)	212,800
Note: Ignore the actual sale proceeds received. Full market value must be used as the consideration in the gain computation	
Minus: Gift relief (see working)	(174,000)
Gain after relief (see working)	38,800

Working:

Sale for less than full market value but more than the original cost	
Gain at the time of the sale:	£
Actual sale proceeds received	50,000
Original cost	(11,200)
Gain at the time of the sale	38,800
Gain	212,800
Gain at the time of the sale	38,800
Gift relief =	174,000

Deemed acquisition cost for the daughter	£
Market value at date of gift	224,000
Minus: Gift relief	(174,000)
Base cost of the asset	50,000
April 2010: Sale of asset by the daughter	
Sale proceeds	245,000
Minus: Base cost	(50,000)
Gain	195,000

3.5 Restriction of relief for assets not used wholly for the purposes of the trade

The calculation of gift relief has been explained where there is an outright gift and where there is a sale at undervaluation. However, the amount of relief available is restricted if the asset has not been used wholly for the purposes of the trade.

Where an individual qualifying business asset:	
(1) has been used partly for business and partly for non-business use (e.g. 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, 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 (i.e. the donor has more than a 5% interest in the company) and the company has investment assets	▪ The gain eligible for gift relief is the business proportion of the chargeable assets held by the personal company, as calculated below.

The gain eligible for gift relief relating to shares in a personal trading company is calculated as follows:

$$\text{Gain} \times \frac{\text{Market value of the chargeable business assets (CBAs) in the company}}{\text{Market value of the chargeable assets (CAs) in the company}}$$

CAs are the capital assets owned by the company that 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 that 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).

The restriction is calculated using the market values of these assets at the date of the gift of the shares by the donor.

Tax consequences of incorporation

- Overview of the consequences of incorporation
- Summary of the main CGT consequences of incorporation
- Incorporation relief for capital gains

4 Tax consequences of incorporation

4.1 Overview of the consequences of incorporation

When an unincorporated business (sole trader or partnership) incorporates its business into a limited company, there are many taxation consequences to consider.

These consequences are the same whether the business is sold to an existing company or a new company is established for the purpose 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.)

4.2 Summary of the main CGT consequences of incorporation

Chargeable gains arise on 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.

4.3 Incorporation relief for capital gains

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 total value as the value of the unincorporated business. Capital gains/losses will arise on the disposal of each chargeable asset to the company.

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 gains to be deferred are 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 claim entrepreneurs' relief, has capital losses or wishes to use his annual exemption).

A claim to dis-apply the relief must be made within two years 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 third anniversary of the end of the tax year).

Example

On 23 March 2010 Poppy sold her business to TY Ltd for £140,000, realising total gains of £45,000. She became 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 were received:

(a) 80,000 £1 ordinary shares

(b) Cash of £40,000 and 50,000 £1 ordinary shares in TY Ltd

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

Principal private residence and letting relief

- An overview of principal private residence relief
- Choice of principal private residence
- Actual and deemed occupation rules
- The mechanics of principal private residence relief
- Letting relief
- Restriction of relief for business use

5 Principal private residence and letting relief

5.1 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 for employment income purposes).

If these conditions are not met, a chargeable gain may arise on the disposal of the property. However, part of the gain may be exempt under the PPR relief rules.

In addition to PPR relief, letting relief is available if:

- the property has been the individual's PPR, and
- after PPR relief there is a gain remaining in charge to tax, and
- during the period of ownership part or all of the house was let to tenants.

5.2 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).

5.3 Actual and deemed occupation rules

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

In addition to periods of actual 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)
The 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

The two additional conditions, both of which must be satisfied, 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 it.

5.4 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.

Example

Barbara sold her house on 16 March 2010 for £850,000. She purchased the house on 16 April 1997 for £231,240.

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.

Answer

	£
Gross sale proceeds (March 2010)	850,000
Less Cost (April 1997)	(231,240)
Gain before PPR	618,760
Less PPR relief (W)	
£618,760 × (138/155)	(550,896)
Gain after PPR	67,864

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 other reason' rule.

(2) The last 36 months of ownership are always exempt, provided the property has been Barbara's PRP at some time.

The remaining 12 months 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. (Note that the concession does not apply as it only applies to periods of work-related absence.)

5.5 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) An amount equivalent to the 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 31 March 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 before PPR		314,621
Less	PPR relief (W1)	
	£314,621 × (249/264)	(296,745)
Gain after PPR		17,876
Less	Letting relief (W2)	(17,876)
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 – therefore exempt

(2) Working overseas – exempt as she occupied the property as her PPR **at some time before and after** this period of absence.

(3) Working elsewhere in the UK – periods totalling up to four years are exempt as she occupied the property as her PPR **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 reason' as the property is occupied as her PPR both before and after the period of absence.

(5) Owner occupied – therefore exempt.

(6) The property was not Judith's PPR for the 51 months before the sale – but the last 36 months are always exempt if the property has been the PPR at some time. The remaining period of 15 months can not be covered by the 'any reason' rule as the property is not Judith's PPR at that time and she does not reoccupy the property at some time after the period of absence. However, during this period the property is let to tenants and therefore letting relief is available for this period.

(7) Letting relief is not available in periods (2), (3) and (4) as these periods are already exempt under the PPR rules.

(2) Letting relief

Lowest 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

5.6 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
(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).

Example

Mary purchased a three storey house on 1 August 1999 to use as her main residence and sold it on 31 October 2009, giving rise to a gain before PPR relief of £295,000.

Required

Calculate the business portion of the gain which becomes chargeable assuming:

(a) Mary used the top floor for business purposes throughout the entire period of ownership

(b) Mary used the top floor for business purposes from 1 August 2003 to the date of sale.

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

As the top floor was **used as Mary's main residence at some time,** 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.

CHAPTER 16

Introduction to corporation tax

Contents

1 The scope of corporation tax
2 Overview of a corporation tax computation
3 The statement of profits chargeable to corporation tax (PCTCT)
4 The corporation tax liability
5 Special rules applying to the corporation tax liability

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 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
- 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 look at where the directors hold their regular board meetings.

Overview of a corporation tax computation

- The profits chargeable to corporation tax
- The chargeable accounting period
- Preparation of a corporation tax computation

2 Overview of a corporation tax computation

2.1 The profits chargeable to corporation tax

A company is liable to pay corporation tax on its profits chargeable to corporation tax (PCTCT) for a chargeable accounting period (CAP).

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.

Taxable income is listed in a Statement of PCTCT according to its nature and source. The rules for the preparation of this statement are explained later in this chapter.

2.2 The chargeable accounting period

A 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.

2.3 Preparation of a corporation tax computation

There are three steps in the preparation of a corporation tax computation as follows:

Step 1: Prepare a statement of PCTCT for the CAP

The first step is to prepare a statement listing all the income and capital gains that are chargeable to corporation tax in the CAP, and then deducting any gift aid payments.

Step 2: Determine the appropriate rate of corporation tax

The next step is to determine the appropriate rate of corporation tax that should be applied. The rate of tax applicable to a company is based on the amount of its profits compared with statutory limits fixed for the appropriate financial years.

Step 3: Calculate the corporation tax liability

The final step is to calculate the corporation tax liability on the PCTCT. In an examination, you may also be required to state the due dates of payment and the date for filing the corporation tax return with the tax authorities.

The statement of profits chargeable to corporation tax (PCTCT)

- Overview of the PCTCT statement
- Dividends

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 (a statement of PCTCT) 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 (excluding dividends)	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 rules are explained later.

3.2 Dividends

It is important to note the following points when preparing a PCTCT statement:

(1) Dividends received from non-associated companies

For the purpose of the F6 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.)

(2) 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'.

(3) Dividends paid

Dividends paid by the company to its own shareholders are excluded from the PCTCT statement.

Example

A Ltd is preparing its accounts for the year ended 31 December 2009. It has received income from various sources and made some payments, as listed below. All income is shown gross.

	£
Rental income from letting a warehouse in London	12,000
Dividends from a French company	3,600
Profits from the trade	460,000
Chargeable gain on the disposal of a showroom	23,500
Bank deposit interest	2,800
Dividends from a UK company	6,200
Debenture interest from a UK company	21,000
Gift Aid donation paid	4,000
Dividends paid to shareholders	5,500

Required

Prepare a PCTCT statement for A Ltd for the year ended 31 December 2009.

Answer

A Ltd: Corporation tax computation – year ended 31 December 2009

	£
Trading income	460,000
Interest income (£2,800 + £21,000)	23,800
UK property income	12,000
Net chargeable gains	23,500
	519,300
Gift Aid donation	(4,000)
PCTCT	515,300

Notes

(1) Both the French and the UK dividends are exempt from corporation tax and are therefore not included in the computation of PCTCT.

(2) The dividends paid by A Ltd are not deductible in calculating PCTCT.

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

4 The corporation tax liability

4.1 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.

4.2 The Financial Year

The government fixes the corporation tax rate for each Financial Year. A Financial Year (FY) runs from 1 April in one year to the following 31 March.

Financial Years are stated using the calendar year in which they start. For example, FY2008 means the period from 1 April 2008 to 31 March 2009. FY2009 runs from 1 April 2009 to 31 March 2010.

If a company has a chargeable accounting period (CAP) that falls entirely within a Financial Year, only one rate of tax applies to the chargeable profits for the CAP.

However, if a company has a CAP that falls into more than one Financial Year (i.e. the CAP straddles 31 March), the PCTCT of the company needs to be time-apportioned between the two Financial Years, and the appropriate rates of tax are applied to each time-apportioned part separately.

4.3 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 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. This deemed deduction applies irrespective of whether the dividend is received from a UK company or an overseas company. If the dividend is paid by an overseas company, any tax deducted at source in the overseas country is ignored.

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 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. where 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.

e

Example

For the year ended 31 March 2010 B Ltd has trading income of £200,000 and property income of £6,000. It received net dividends of £3,150 from a foreign company. Overseas tax at the rate of 15% was withheld from this dividend. B Ltd also received cash dividends of £7,200 from a non-associated UK company.

Required

Calculate the profits of B Ltd for the purpose of determining the appropriate rate of corporation tax.

a

Answer

B Ltd - Corporation tax computation – year ended 31 March 2010

	£
Trading income	200,000
UK property income	6,000
PCTCT	206,000
FII (£7,200 + £3,150) × 100/90	11,500
Profits for determining the rate of corporation tax	217,500

Note

UK and overseas dividends are ignored in calculating PCTCT as they are not taxable. However, they are grossed up at the rate of 100/90 and brought into the calculation of profits.

4.4 Determining the appropriate rate of corporation tax

To determine the appropriate rate of tax to apply to the PCTCT, the profits (for a 12-month period) are compared to annual statutory limits. The rules are set out 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 companies
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 in 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 £43,260 (= £206,000 × 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 the dividends it receives. FII is only included in the computation to determine the rate of tax applicable to the PCTCT.

4.5 Marginal relief

If profits fall into the marginal band of £300,000 – £1,500,000, the corporation tax on the PCTCT is initially calculated at the full rate, currently 28%. 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

5 Special rules applying to the corporation tax liability

5.1 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 a non-associated 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

5.2 Associated companies

The statutory annual limits apply to a single company operating on its own.

If the company has associated 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.

5.3 Accounting periods straddling 31 March

When a company's CAP straddles 31 March, it falls into two financial years. The corporation tax liability must therefore be calculated in two parts by time-apportioning the PCTCT and the figure of profits into the appropriate financial years.

Note that it is only the corporation tax liability that is affected. The calculation of the PCTCT and the figure of profits remain 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 paid	3,000
Dividends received from non-associated companies	72,000

The rates, limits and fraction for FY 2007 and FY 2008 are as follows:

	FY 2007	*FY 2008*
Full rate of corporation tax	30%	28%
Small companies rate	20%	21%
Lower limit	£300,000	£300,000
Upper limit	£1,500,000	£1,500,000
Marginal relief fraction	1/40	7/400

Required

Calculate the corporation tax liability for the year.

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 × $\frac{3}{12}$	32,775
Less: Marginal relief:	
$\frac{1}{40} \times (£1{,}500{,}000 - 517{,}000) \times \frac{437{,}000}{517{,}000} \times \frac{3}{12}$	(5,193)
	27,582
FY 2008 (9 months)	
Corporation tax at 28% on £437,000 × $\frac{9}{12}$	91,770
Less: Marginal relief:	
$\frac{7}{400} \times (1{,}500{,}000 - 517{,}000) \times \frac{437{,}000}{517{,}000} \times \frac{9}{12}$	(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).

CHAPTER 17

Profits chargeable to corporation tax

Contents

1 Trading income
2 Interest income
3 UK property income
4 Foreign income
5 Chargeable gains
6 Gift aid payments
7 Long periods of account

Trading income

- Overview of the PCTCT statement
- Trading income: overview
- Detailed proforma adjustment of profit computation

1 Trading income

1.1 Overview of the PCTCT statement

The proforma PCTCT statement, shown in the previous chapter, starts by listing taxable income from all sources. Each source of income has different rules for determining the amount that is chargeable to corporation tax.

This chapter begins by explaining the rules for each source of income and the workings that are usually required for each to prepare a corporation tax computation.

1.2 Trading income: overview

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, the following differences should be noted:

(1) 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.

(2) Capital expenditure specifically includes any costs incurred in issuing share capital. Costs of share issues are therefore not allowable. Any such costs, if deducted in arriving at the figure for profit before tax, must be added back as an adjustment of profit.

(3) As an exception to the general rule relating to capital expenditure, any incidental costs incurred in raising long-term finance such as debentures and loan stock are **specifically allowable** for trading purposes in the tax legislation. No adjustment for this expenditure is therefore required. These costs are allowable even if the long-term finance is not actually raised.

(4) Although the write off of **non-trade** debts such as a loan to a customer, supplier or an employee, must be adjusted for by adding back to the figure of profit before taxation, relief is given for any loss in respect of the write off of non-trade loans against **interest income** under the loan relationship rules.

(5) When calculating capital allowances, the full WDA/AIA is available for a company even if there is an element of private use of an asset by a director or employee (for example, a company car used for both business and private

mileage). The benefit of private use will be assessed on the individual as a benefit of employment; but this is irrelevant for calculating the corporation tax of the company.

1.3 Detailed proforma adjustment of profit computation

To calculate the adjusted profit before capital allowances figure in a trading income assessment, it is often necessary to produce a separate working. The proforma below sets out some of the adjustments that may be required.

(W1) Proforma computation: Adjustment of profit	**£**
Profit before taxation	X
Add Items of expenditure charged in the accounts that are not allowable for tax under the trading income rules	
Capital expenditure (may be eligible for capital allowances)	X
Legal or professional fees relating to capital expenditure (including leases, except fees relating to the renewal of a short lease)	X
Depreciation/amortisation charges for 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	X
Gifts to customers	X
(if > £50 and no advertisement, or if a gift of alcohol, food or tobacco)	
Fines and penalties	X
Entertaining expenses (except entertainment of employees)	X
	X
Minus Amounts credited in the accounts that are not taxable as trading income	
Income taxed under other assessment rules (e.g. income taxed as property income, interest income)	(X)
Exempt income (e.g. dividends)	(X)
Capital profits (may be assessed as a chargeable gain instead) (e.g. profit on the disposal of a non-current asset, profit on the sale of shares etc)	(X)
Minus Amounts not credited in the accounts that are allowable for trading income purposes	
Allowable deduction for short leases	(X)
Adjusted profits before capital allowances	X

Interest income

- Loan relationships
- Interest receivable
- Interest payable
- Proforma interest income computation

2 Interest income

2.1 Loan relationships

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).

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.

2.2 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. This means that no tax has been deducted at source.

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.

2.3 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 against 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. These items of interest are therefore allowable against trading income for the PCTCT statement, and are not deducted from interest income.

2.4 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. Knowledge of how to utilise any such loss is not required for the examination.

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 assessment 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.

UK property income

- Rental income
- Premiums received on the granting of a short lease
- UK property income losses

3 UK property income

3.1 Rental income

Rental income is assessed on an accruals basis for the company's CAP as follows:

- All **income accrued** (i.e. earned in the CAP) from any rental property is pooled, and
- All **allowable revenue expenditure** incurred in relation to the rental properties is deducted.

The actual dates of receipt of rent and the payment of expenses are not relevant as rental income assesses the rents and expenses incurred in the CAP.

In contrast to the position for income tax purposes, interest **payable** on any loan taken out to purchase the property is **not** an allowable deduction in calculating property income. Instead, it is treated as non-trading loan interest payable under the loan relationship rules and is deducted from interest income.

Example

L Ltd rented out two properties in the year ended 31 December 2009: Nos. 3 and 4 Belgravia Avenue.

No.3 is a furnished property which L Ltd purchased several years ago. It was let all year at a rent of £1,500 per month.

No. 4 was purchased on 1 October 2009. It was immediately let on a six-month agreement as unfurnished property at a rent of £800 per month. In order to purchase the property, L Ltd took out a £100,000 loan with a bank on 1 October 2009, with a fixed mortgage interest rate of 11%.

The following additional expenses relate to the year ended 31 December 2009:

	No. 3	No. 4
	£	£
Advertising for new tenants	Nil	420
Estate agent management fees	1,440	240
Council tax	360	50
Insurance	900	60
Repairs	3,200	Nil
New double garage	5,000	Nil

Required

Calculate L Ltd's property income assessment for the year ended 31 December 2009.

a

Answer

Property income – year ended 31 December 2009

	£	£
Rents accrued in y/e 31 December 2009		
(£1,500 × 12) + (£800 × 3)		20,400
Minus Allowable expenses		
Advertising	420	
Agents' management fees	1,680	
Council tax	410	
Insurance	960	
Repairs	3,200	
		(6,670)
Wear and tear allowance (furnished property only)		
10% × [Rents – Council tax]		
= 10% × [(£1,500 × 12) – (360)]		(1,764)
Property income assessment		11,966

Notes

(1) Interest payable on the bank loan to purchase No. 4 is not an allowable expense against property income. It is treated as non-trading interest payable and is an allowable deduction from interest income.

(2) The cost of the new garage is capital expenditure and therefore not an allowable expense against property income.

3.2 Premiums received on the granting of a short lease

The treatment of a premium is the same as for income tax purposes (see chapter 3).

e

Example

M plc owns a warehouse which is surplus to its requirements. Rather than selling the warehouse, M plc granted a 40 year short lease on the property to Q Ltd on 1 November 2009 for a premium of £75,000. It charges rent of £6,000 p.a payable in advance on a quarterly basis starting on 1 November 2009.

Required

Calculate the property income assessment of M plc for the year ended 31 March 2010.

Answer

	£
Premium received	75,000
Minus 2% × £75,000 × 39	(58,500)
Property income assessment on the premium received	16,500
Rental income accrued in CAP (£6,000 × 5/12)	2,500
Total UK property income assessment	19,000

3.3 UK property income losses

If several properties are let, income and expenses are pooled.

- Therefore any losses arising on a property are automatically set off against the profits of the other properties in this single pooled computation.
- If this computation produces an overall negative result (i.e. there is an overall net loss arising on all of the property lettings), the property income assessment in the PCTCT statement is technically £0 and a property business loss arises.

  However, the tax rules state that a property business loss must, if possible, be set against the other total profits (i.e. income and chargeable gains) of the company in that CAP.

  The inclusion of the negative property assessment figure in the PCTCT statement will automatically set off the property business loss against the other total profits. This is an acceptable method in the examination.

Any excess property business loss (= any property income loss exceeding the total profits of the company in that CAP) can be:

- group relieved to 75% subsidiaries (this is explained in a later chapter), and/or
- carried forward and set off against the first available total profits (i.e. income and chargeable gains) in a future CAP.

Foreign income

- Foreign income in the PCTCT statement
- Double taxation relief (DTR): overview

4 Foreign income

4.1 Foreign income in the PCTCT statement

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, 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.

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.

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

4.2 Double taxation relief (DTR): overview

Foreign income may be subjected to both UK corporation tax and foreign tax. If so, double taxation relief (DTR) is available in the corporation tax computation. Double taxation relief prevents the same profits being taxed twice.

The detailed computation of DTR is considered in a later chapter.

Chargeable gains

- Overview

5 Chargeable gains

5.1 Overview

A company pays corporation tax not only on its income but also on capital gains arising from the disposal of certain capital assets (i.e. capital assets which are not exempt).

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.

A separate chargeable gain or allowable loss computation is required for each capital disposal. As a result, additional workings are required to obtain the net chargeable gains assessment in a PCTCT statement.

The detailed computation of net chargeable gains is described in a later chapter.

Gift Aid payments

- Gift Aid payments
- Comprehensive examples

6 Gift Aid payments

6.1 Gift Aid payments

Companies can make payments to charities under the Gift Aid scheme. They are allowed to deduct the amount paid in the CAP from total profits.

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 tax purposes.

6.2 Comprehensive examples

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 (net of 25% overseas tax)	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.

a

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

Example

T Ltd has prepared its accounts for the year ended 30 April 2010 and has recorded a profit before taxation of £357,600 after taking account of the following income and expenditure:

	Notes	£
Income		
Sales		760,000
Bank deposit interest receivable	1	38,000
Rental income from let property		25,200
Dividends received from a UK company		68,400
Profit on the disposal of a warehouse	2	80,000
Expenditure		
Cost of sales		328,250
Wages and salaries		128,000
Depreciation		57,000
Motor expenses	3	16,800
Repair and maintenance	4	30,400
Donations and gifts	5	2,700
Interest on loan to purchase the property which is let		9,600
Loss on the sale of plant and machinery	2	2,500
Patent royalty paid		4,000
Non-trade debt written off		400
Legal and professional fees	6	22,800
Entertaining customers		550
Sundry allowable expenses		11,000

Notes

(1) The bank deposit interest actually received in the CAP was £30,000.

(2) The warehouse was sold for £375,000 and cost £295,000 some years ago. The disposal gave rise to a chargeable gain of £66,150. There is no allowable loss arising on the disposal of the plant and machinery.

(3) The motor expenses relate to company vehicles and include £4,500 in relation to the managing director's car which was used 70% for business purposes.

(4) Repairs and maintenance include £19,000 relating to the installation of a new canteen kitchen and £6,000 relating to the redecoration of the sales office.

(5) Donations consist of a donation of £1,000 paid to a charity under the Gift Aid scheme and a donation to the Labour party of £900. The gifts cost £800 and were Christmas hampers given to 40 customers. Each hamper carried an advert for T Ltd on the lid.

(6) The legal and professional fees consist of the following:

	£
Audit and accountancy fees	9,120
Legal fees re-the issue of debentures in the CAP	5,320
Legal fees re-the granting of a new 10 year lease on office space	8,360

(7) The capital allowances available for the CAP total £49,400.

Required

Calculate T Ltd's trading income assessment and PCTCT for the year ended 30 April 2010.

a

Answer

T Ltd: Trading income assessment – year ended 30 April 2010

		£
Profit before taxation		357,600
Add	Depreciation	57,000
	Installation of new canteen kitchen	19,000
	Gift Aid donation	1,000
	Political donation	900
	Interest on loan to purchase the property which is let	9,600
	Loss on the sale of plant and machinery	2,500
	Non-trade debt written off	400
	Gifts of food	800
	Legal fees relating to the new lease	8,360
	Entertaining customers	550
		457,710
Minus	Bank deposit interest receivable	(38,000)
	Rental income from let property	(25,200)
	Dividends received from a UK company	(68,400)
	Profit on the disposal of a warehouse	(80,000)
Adjusted profits before capital allowances		246,110
Minus	Capital allowances	(49,400)
Trading income assessment		196,710

Notes

(1) The motor expenses are allowable in full. Private use by an employee is irrelevant for the calculation of trading income.

(2) Redecoration costs are allowable. However, it has been assumed that the installation of the new kitchen is capital expenditure and not allowable.

(3) The donation under the Gift Aid scheme is not allowable against trading income. It is, however, allowed as a deduction in calculating PCTCT.

(4) The interest on the loan to purchase the property which is let and the non-trade debt written off are not allowable against trading income. They are allowable against interest income instead.

(5) Patent royalties payable are allowable against trading income.

(6) Legal fees relating to the issue of long-term finance are specifically allowable.

(7) Fees relating to leases are capital-related and therefore not allowable, unless they are incurred in relation to the **renewal** of a short lease.

T Ltd: PCTCT statement – year ended 30 April 2010	£
Trading income	196,710
Interest income (W1)	28,000
UK property income	25,200
Net chargeable gains	66,150
	316,060
Gift Aid donation	(1,000)
PCTCT	315,060

Working: Interest income	£
Bank interest receivable	38,000
Minus Interest on loan to purchase the property which is let	(9,600)
Non-trade debt written off	(400)
Interest income	28,000

Long periods of account

- The treatment of a long period of account
- The allocation of income, gains and payments between CAPs

7 Long periods of account

7.1 The treatment of a long period of account

As explained in the previous chapter, a CAP cannot exceed 12 months. Therefore if a company draws up a long period of account it 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 balance period.

Example

A company prepares a 17-month set of accounts from 1 June 2008 to 31 October 2009.

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 2009
- CAP 2: 5-month period ended 31 October 2009

For each CAP the following must then be produced:

- A separate PCTCT statement allocating the income, gains and Gift Aid payments 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.

7.2 The allocation of income, gains and payments between CAPs

The tax legislation requires income, gains and payments in a long period of account to be allocated to the separate CAPs as follows:

Item	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 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.

a

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).

CHAPTER 18

Chargeable gains of a company

Contents

1 Overview of the taxation of chargeable gains of a company
2 Disposal of chargeable assets other than shares and securities
3 Rollover relief
4 Disposal of shares and securities

Overview of the taxation of chargeable gains of a company

- The basic charging rules
- Calculating the net chargeable gains of a company

1 Overview of the taxation of chargeable gains of a company

1.1 The basic charging rules

A chargeable gain arises if a chargeable person (for example, a company) makes a chargeable disposal of a chargeable asset.

- A **chargeable disposal** is the sale or gift of the whole or part of an asset.
- A **chargeable asset** is any **capital asset** (tangible or intangible) except those specifically exempted from tax.

Exempt assets

Exempt assets for companies are the same as for individuals, but with one exception. Goodwill **is** an exempt asset in the hands of a company as it is dealt with under the intangible asset rules.

Liability to corporation tax for net chargeable gains

A company is liable to corporation tax on its total net chargeable gains in the CAP.

A chargeable gain or allowable loss is brought into a CAP according to the date of disposal (i.e. the date of sale of the asset). In other words, chargeable gains or allowable losses apply to the CAP in which the disposal occurs.

Note that, unlike individuals, companies do not receive an annual exemption.

1.2 Calculating net chargeable gains of a company

There are three steps in the calculation of the net chargeable gains of a company:

Step 1: Calculate the gains or losses arising on the chargeable disposals

A separate gain or loss calculation is needed for each individual chargeable asset that is disposed of in the CAP.

Step 2: Calculate and deduct any rollover relief, if applicable

Relief is available to defer the tax on some gains if certain conditions are satisfied. Rollover relief is explained later.

Step 3: Calculate the net chargeable gain to include in the PCTCT statement

Net chargeable gains are included in the PCTCT statement. The net chargeable gain is calculated as follows:

		£
Total chargeable gains arising on individual disposals in the CAP		X
Minus	Allowable losses arising on disposals in the CAP	(X)
	Allowable losses brought forward from previous CAPs	(X)
Net chargeable gains		X

If allowable losses exceed chargeable gains

Where allowable losses exceed the chargeable gains in the CAP, the following rules apply:

- The net chargeable gain in the PCTCT statement is £0.

  (It is not permitted to have a negative chargeable gain in a corporation tax computation. Capital losses cannot be set off against the company's other income in the CAP.)
- Excess allowable losses can be **carried forward** to future CAPs, but cannot be carried back to previous CAPs.
- Excess allowable losses **must** be set off against the **first available** net chargeable gains in future CAPs.

There is no choice in treatment. If a current period set off is possible, a company cannot choose to skip a CAP and wait to set off losses against a future period.

Example

A company had allowable losses in excess of its chargeable gains for its CAP to 31 December 2009.

- It cannot set these losses against any other taxable income for the year.
- It must carry the excess allowable loss forward to set off against chargeable gains in future CAPs. It cannot carry the losses back and set them against chargeable gains for the year to 31 December 2008.
- It must set off the excess allowable loss against the first available chargeable gains in future CAPs. For example, if there are sufficient chargeable gains for the year to 31 December 2010, it must set off the excess allowable loss against these gains, and cannot carry the loss forward to set off against the chargeable gains for the year to 31 December 2011 (or a later year).

Capital losses can only be set off against future net chargeable gains. They can not be set off against the company's other income in future CAPs.

Disposal of chargeable assets other than shares and securities

- Overview of a chargeable gain computation
- Incidental costs
- The indexation allowance

2 Disposal of chargeable assets other than shares and securities

2.1 Overview of a chargeable gain computation

The first step in calculating the net chargeable gain of a company is the calculation of separate chargeable gains and allowable losses on every chargeable asset disposed of in the CAP.

The computation for a company differs slightly from the computation for an individual as it includes an allowance for inflation, known as the indexation allowance.

The chargeable gain computation is as follows:

	£
Gross sale proceeds	X
Minus Incidental costs of sale	(X)
Net sale proceeds	X
Minus Allowable costs	
Acquisition cost (including incidental costs)	(X)
Enhancement expenditure	(X)
Unindexed gain/(loss)	X/(X)
Minus Indexation allowance (IA) (see 2.3 below)	
$\text{Cost} \times \frac{\text{RPI for month of disposal - RPI for month of expenditure}}{\text{RPI for month of expenditure}}$	(X)
Chargeable gain/(allowable loss) before rollover relief	X/(X)
Minus Rollover relief (if applicable)	(X)
Chargeable gain/(allowable loss)	X/(X)

2.2 Incidental costs

When calculating the chargeable gain for a company, it is important to keep incidental selling costs separate from acquisition costs because indexation allowance:

- is available on incidental acquisition costs, but

- is not available on incidental selling costs.

2.3 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 disposes of.

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 for an answer) 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

RPI

June 1990: 126.7

August 2000: 170.5

June 2009: 213.4

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		restricted	
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 can not 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.

Rollover relief

- Overview of rollover relief
- Qualifying business assets
- Non-business use

3 Rollover relief

3.1 Overview of rollover relief

Rollover relief is the only capital gains relief available to companies. It allows the deferral of the **indexed** gains arising on the disposal of qualifying business assets (QBAs).

3.2 Qualifying business assets

The definition of a qualifying business asset is the same as discussed earlier in relation to individuals, but with one exception. Goodwill is not a qualifying asset if disposed of by a company

Example

H Ltd prepares its accounts to 31 March each year. On 31 December 2009 it sold a freehold warehouse for £450,000, which gave rise to a chargeable gain (before considering reliefs) of £123,350.

On 24 February 2010 H Ltd purchased a 99-year lease on a new warehouse. It is anticipated that that the leasehold warehouse will be sold in September 2014 for £750,000.

Required

(a) Calculate the chargeable gain arising in the year ended 31 March 2010, assuming the lease was purchased for each of the following alternative amounts:

(i) £480,000

(ii) £418,000

(iii) £320,000

For each scenario, calculate the unindexed gain that is anticipated to arise in the year ending 31 March 2015.

(b) Explain the difference in treatment if the replacement warehouse were a 55 year leasehold interest.

Answer

Part (a)

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? (31 December 2008 – 31 December 2012)	Yes

	(i)	(ii)	(iii)
	£	£	£
Sale proceeds received	450,000	450,000	450,000
Cost of replacement	480,000	418,000	320,000
Sales proceeds not reinvested	-	32,000	130,000
Have all the sale proceeds been reinvested in a QBA?	Yes	No	No

	(i)	(ii)	(iii)
Chargeable gain arising in y/e 31 March 2010			
Lower of			
(1) All the gain			123,350
(2) The sale proceeds not reinvested in QBAs	0	32,000	
Rollover relief = the rest of the gain			
£123,350 / (£123,350 – £32,000) / £0	123,350	91,350	Nil
Base cost of replacement 99-year leasehold interest			
Cost	480,000	418,000	320,000
Minus: Rollover relief	(123,350)	(91,350)	(Nil)
Base cost	356,650	326,650	320,000
Unindexed gain arising in y/e 31 March 2015			
Sale proceeds	750,000	750,000	750,000
Base cost	(356,650)	(326,650)	(320,000)
Unindexed gain	393,350	423,350	430,000

Part (b): If the replacement had been in a 55-year leasehold interest

- A 55-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 the year ended 31 March 2010 would be the same as above for each scenario.
- However, the amount relieved with a rollover relief claim is not deducted from the cost of the replacement asset.
- A record of the amount of rollover relief is kept and that amount is deferred for a maximum of 10 years from the date of acquisition of the replacement warehouse. However, as the replacement asset is disposed of before 10 years have elapsed, the deferred gain becomes chargeable in y/e 31 March 2015 on the disposal of the replacement asset.

- In addition to the deferred gain on the original asset becoming chargeable, an unindexed gain of £430,000 arises on the disposal of the replacement asset itself. This is calculated in the normal way, using the actual cost of the leasehold interest with no rollover relief deduction (i.e. as in scenario (iii) above).

Disposal of shares and securities

- Overview of the gain computation for shares and securities
- The share identification rules
- The share pool
- Proforma: share pool for companies
- The chargeable gain on the disposal of shares from the pool
- Bonus issues
- Rights issues
- Takeovers

4 Disposal of shares and securities

4.1 Overview of the gain computation for shares and securities

If a company buys shares in another company and then **sells them all** at a later date:

- the chargeable gain computation is the same as for assets other than shares except that the indexation factor is not rounded to three decimal places, and
- rollover relief is not available.

However, if a company buys shares in another company over a period of time in a series of transactions, and then **disposes of some, but not all the shares**, the calculations of chargeable gains are more complex. In this situation:

- it is necessary first of all to **identify** which shares have been sold, before
- the appropriate gain can be calculated.

4.2 The share identification rules

When purchasing shares, a company must keep separate records for each different type and class of shares that it has purchased. For example, records for purchases of X Ltd ordinary shares are kept separate from the purchase records for Y Ltd ordinary shares, which are kept separate from Y Ltd preference share purchase records.

Share identification rules are applied to identify which of the shares have been disposed of. (These are also known as matching rules). **These rules are different to the identification rules that apply to disposals made by individuals.**

In the examination, shares are deemed to be disposed of in the following order:

(1) Acquisitions on the same day as the disposal

(2) Acquisitions in the previous nine days on a last-in-first-out basis

(3) Shares in the pool.

Shares in the first two categories never enter the pool and no indexation is available on their disposal.

4.3 The share pool

A company with many investments in other companies will need to construct a share pool **for each company and each class of share.**

Shares in the pool treated as a single source of shares, disposed of at their average cost.

A proforma share pool is shown on the next page.

Purchasing shares to increase the pool

When the company purchases shares:

- the number of shares acquired is entered in the number of shares column, and
- the cost of the shares acquired is entered in both the cost and indexed cost columns.

However, before recording any change in 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.

Selling shares from the pool

When the company sells some shares, the appropriate proportion of cost and indexed cost is deducted from the appropriate columns in the pool.

However, 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.

Summary: the working for the share pool

The IA available on shares is calculated on a piecemeal basis, **before** recording each operative event (for example, before recording a purchase of shares or a sale of shares).

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.

4.4 Proforma: share pool for companies

The share pool is constructed in chronological date order. 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 (a purchase that creates the pool). Original cost = indexed cost.	X	X	X
Second operative event (for example, a purchase)			
(i) Indexation allowance: From the previous operative event to this operative event. 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 (for example, a sale)			
(i) Indexation allowance: From the previous operative event to this operative event. 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

Construct the pool for shares in K Ltd to record these events.

Answer

Share 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			
$\frac{182.5 - 149.6}{149.6} \times £34,500$			7,587
(Do not round this indexation factor)			
(ii) Purchase of shares	6,500	37,700	37,700
	11,500	72,200	79,787
13 March 2010: sale of shares			
(i) IA: from September 2003 to March 2010			
$\frac{216.3 - 182.5}{182.5} \times £79,787$			14,777
(Do not round the indexation factor)			
			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

Note

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

4.5 The chargeable gain on the disposal of shares from the pool

The gain on the disposal of pool shares is calculated as follows:

		£
Gross sale proceeds		X
Minus	Incidental costs of sale (e.g. stockbrokers' commission)	(X)
Net sale proceeds		X
Minus	Allowable costs	
	i.e. The cost deducted from the cost column in the pool	(X)
Unindexed gain/(loss)		X/(X)
Minus	Indexation allowance (IA)	
	(indexed cost minus cost) see notes (1) and (2) below	(X)
Chargeable gain/(allowable loss)		X/(X)

Notes

(1) These are the figures obtained from the working for the pool that are calculated in relation to the sale.

(2) The IA must be shown separately because the IA deduction cannot create nor increase an allowable loss.

(3) Rollover relief is not available on the disposal of shares.

Example

Using the data in the previous example for shares held by J plc, we would calculate the chargeable gain arising on the disposal of shares as follows.

		£
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

4.6 Bonus issues

The treatment of a bonus issue for tax purposes is as follows:

For identification purposes	Treatment in the pool
Bonus shares are treated **as if** they are acquired on the same day as the original shares to which they relate.	▪ Bonus issues are not an operative event. ▪ Therefore do not calculate an IA before recording a bonus issue. ▪ Simply add the number of shares into the number of shares column. ▪ No entries are needed in the cost and indexed cost columns.

Example

On 23 August 1999 L Ltd purchased 3,000 ordinary shares in M plc for £45,000. On 6 April 2002 M plc made a 1 for 6 bonus issue. On 31 December 2009 L Ltd disposed of 2,000 of its shares in M plc for £40,000.

Required

Calculate the chargeable gain arising on the disposal of shares.

Answer

	£
Gross sale proceeds	40,000
Minus Cost (from the pool working below)	(25,714)
Unindexed gain	14,286
Minus IA (from the pool, working shown below) (£33,437 - £25,714)	(7,723)
Chargeable gain	6,563

Pool working	**Number of shares**	**Original cost**	**Indexed cost**
		£	£
23 August 1999: Initial purchase	3,000	45,000	45,000
6 April 2002 : Bonus issue	500	-	-
	3,500	45,000	45,000
31 December 2009: Sale of shares			
(i) IA: from August 1999 to December 2009			
$\frac{215.2 - 165.5}{165.5} \times £45,000$			13,514
(Do not round the indexation factor)			
			58,514
(ii) Sale of shares:			
(2,000/3,500) × £45,000	(2,000)	(25,714)	
(2,000/3,500) × £58,514			(33,437)
Pool balance c/f	1,500	19,286	25,077

4.7 Rights issues

The treatment of a rights issue for tax purposes is as follows:

For identification purposes	**Treatment in the pool**
Rights shares are treated as if they are acquired on the same day as the original shares to which they relate (i.e. the same as the treatment of a bonus issue).	▪ A rights issues is an operative event. ▪ An IA must therefore be calculated before recording the rights issue. ▪ Treat the event in exactly the same way as a normal purchase.

Example

On 10 May 1996 N Ltd purchased 8,000 shares in O plc for £16,000. On 25 July 2001 O plc made a 1 for 4 rights issue at £5 per share. N Ltd decided to take up the offer and purchased the shares to which it was entitled. On 31 December 2009 N Ltd disposed of 4,000 of its shares in O plc for £55,000.

Required

Calculate the chargeable gain arising on the disposal of shares.

Answer

	£
Gross sale proceeds	55,000
Minus Cost (from pool working, shown below)	(10,400)
Unindexed gain	44,600
Minus IA (from pool working, shown below) (£13,975 - £10,400)	(3,575)
Chargeable gain	41,025

Pool working	**Number of shares**	**Original Cost**	**Indexed cost**
		£	£
10 May 1996: Initial purchase	8,000	16,000	16,000
25 July 2001: Purchase in rights issue			
(i) IA: from May 1996 to July 2001			
$\frac{173.3 - 152.9}{152.9} \times £16{,}000$			2,135
(Do not round the indexation factor)			
(ii) Rights issue (1 for 4) at £5 per share	2,000	10,000	10,000
	10,000	26,000	28,135
31 December 2009: Sale of shares			
(i) IA: from July 2001 to December 2009			
$\frac{215.2 - 173.3}{173.3} \times £28{,}135$			6,802
(Do not round the indexation factor)			
			34,937
(ii) Sale of shares:	(4,000)		
(4,000/10,000) × £26,000		(10,400)	
(4,000/10,000) × £34,937			(13,975)
Pool balance c/f	6,000	15,600	20,962

4.8 Takeovers

Where shares are held in a company that is subsequently taken over by another company, the treatment of this event for tax purposes depends on the consideration received in exchange for the old shares.

For example, suppose that X Ltd owns shares in Y plc, and Y plc is taken over by Z plc. X Ltd will receive consideration from Z plc for the sale of its shares in Y plc to Z plc. If the purchase consideration is 100% cash, the chargeable gain is calculated in the normal way for a sale from the pool. However, the purchase consideration might not include cash, or might include some cash and some shares in Z plc.

In summary, the appropriate treatment is as follows:

Consideration: **Does not include cash**	**Includes cash**
For example, the consideration consists of shares or other securities, but *no* cash.	For example, the consideration consists of a mixture of shares (and/or other securities) and some cash.
This is not a chargeable disposal. (It is a paper-for-paper exchange) The new shares and securities received are deemed to be: ▪ acquired on the same day as the original shares ▪ for the same cost and indexed cost as the original shares. Therefore, at the time of the take-over, no chargeable gain or allowable loss arises. The original cost and the indexed cost of the old shares are allocated to the new shares and securities received in proportion to the market values of the consideration received. New pools for the new shares and securities are set up (one pool for each class of shares or securities received as consideration).	A chargeable gain may arise, but only in respect of the cash consideration received. The amount of cash consideration received is treated as the sale proceeds. The 'cost' of the cash is calculated by applying the part disposal formula to the cost (and indexed cost) of the original shareholding.

Example

P plc owns 3,000 ordinary shares in Q Ltd, which it bought for £6,600 on 13 June 2000.

On 5 July 2009 Q Ltd accepted a takeover bid from R plc. The takeover offer consisted of 1 ordinary share and 2 preference shares in R plc for every 3 shares held in Q Ltd.

At the date of the takeover, the market values of R plc shares were as follows:

Ordinary shares	£20 each
Preferences shares	£15 each.

Required

(a) State the chargeable gain arising at the time of the takeover.

(b) Calculate the cost and indexed cost to be entered in the new pools for the R plc shares.

Answer

(a) There is no chargeable gain at the time of the takeover as no cash consideration is received.

(b) Takeover consideration received by P plc:

	Market value
	£
1,000 Ordinary shares in R plc	20,000
2,000 Preference shares in R plc	30,000
	50,000

Q Ltd – Pool	No of shares	Original cost	Indexed cost
		£	£
13 June 2000			
Purchase	3,000	6,600	6,600
5 July 2009			
IA: from June 2000 to July 2009			
$\frac{213.4 - 171.1}{171.1} \times £6,600$			1,632
(Do not round the indexation factor)			
Balance at time of takeover	3,000	6,600	8,232

Allocation of the original cost and indexed cost of the Q Ltd shares	Original cost	Indexed cost
	£	£
1,000 Ordinary shares in R plc 20,000/50,000 × £6,600/£8,232	2,640	3,293
2,000 Preference shares in R plc 30,000/50,000 × £6,600/£8,232	3,960	4,939
	6,600	8,232

Two new pools should be set up, one for the ordinary shares in R plc and one for the preference shares in R plc, with an original cost and indexed cost for each pool as shown above.

CHAPTER 19

Company trading losses

Contents

1 Introduction
2 The carry forward of trading losses
3 Relief for trading losses against total profits
4 Tax planning

Introduction

- Calculation of trading losses

1 Introduction

1.1 Calculation of trading losses

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 , and
- is not the amount of the loss.

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. As several options are available, the company needs to consider the options and choose the one that gives it the optimum use of its trading loss.

The carry forward of trading losses

- Carrying forward trading losses: s393(1) ICTA 1988
- The rules of s393(1) ICTA 1988

2 The carry forward of trading losses

2.1 Carrying forward trading losses: s393(1) ICTA 1988

The rules for carrying forward trading losses are contained in section 393(1) of the Income and Corporation Taxes Act 1988. This is abbreviated to s393(1) 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.

2.2 The rules of s393(1) ICTA 1988

Trading losses can be carried forward and set off against the first available profits in the future from the trade that produced the loss. There is no time limit for carrying these losses forward to future CAPs.

These rules are explained in some further detail in the table below.

Trading loss must be set off against:	Explanation
▪ the first available	▪ The trading loss must be set off in the next CAP if possible. ▪ A company cannot choose to miss out a CAP, for example to obtain a better rate of tax relief in a later CAP.
▪ trading profits	▪ The set-off is against trading income assessments only. ▪ Trading losses carried forward cannot be set off against other sources of income and gains.
▪ of the trade that produced the loss	▪ If a company operates more than one type of trading activity, trading losses carried forward can only be set off against future profits from the activity that produced the loss. They cannot be set off against profits of a different trading activity.
▪ as much as possible	▪ In each future CAP, the maximum amount of trading loss must be set off until relief has been given for the total trading loss.

Trading loss must be set off against:	Explanation
	▪ The effect of this is that the loss to be relieved in any CAP is the lower of: - the loss available, or - the trading profit of the 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 losses are carried forward.

(b) Calculate the loss that is unrelieved, if any, at 31 March 2010.

Answer

(a) 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

(b) 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

Relief for trading losses against total profits

- Claiming relief for losses against total profits under s393A ICTA 1988
- Proforma corporation tax loss relief computation
- The temporary extension of relief
- The effect of a short CAP in the 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

Instead of carrying forward its trading losses, a company may choose to claim relief for the losses against total profits under section 393A ICTA 1988:

- 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 under s393A, the following rules apply:

- A claim for loss relief under s393A is optional.
- If relief is claimed, the trading loss is set off against total profits in the current CAP as much as possible. Any loss that cannot be relieved against total profits in the current CAP may be carried back another 12 months.
- **Any trading losses left unrelieved are automatically carried forward** and set off under the rules of s393(1).
- The claim must be made within two years of the end of the loss making CAP.

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	▪ 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.)

3.2 Proforma corporation tax loss relief computation

The following proforma should be used to set out computations to calculate trading loss relief. In this proforma, it is assumed that a trading loss occurs in CAP 2.

Name of company:
Corporation tax computations

		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	(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

Calculate the PCTCT for each year assuming losses are relieved under s393A.

a

Answer

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

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.

3.3 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.

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.

3.4 The effect of a short CAP in the 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:

- Losses carried back should be set off against total profits on a last-in first-out (LIFO) basis.
- The losses can be carried back against total profits in the previous 12 months.
- The losses must be carried back for the full 12-month period.
- The length of the loss-making CAP does not affect how far it can be carried back.

These rules are explained in further detail in the table below.

Rule:	Explanation
Set off the losses on a LIFO basis	The trading loss is carried back on a last-in-first-out basis, in reverse date order. The loss is set off against total profits in the previous CAP first, and then the CAP before that.
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, but no more than 12 months. Therefore, the total profits of the earliest CAP must 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.

Rule:	Explanation
The length of the loss making period does not affect how far the loss can be carried back	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 month 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).

These rules also apply to the temporary extension to the carry back rules and to terminal losses (see next section). However, as regards the extended carry back, the length of the loss making accounting period does affect the computation of the maximum £50,000 carry back.

Example

U Ltd prepared its accounts to 30 September until 2007 when 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
Property 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

Calculate the PCTCT for each CAP assuming losses are relieved as soon as possible.

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	(77,750)
	321,000	60,000	Nil	45,250
Property 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	99,750
Minus s393A claim				

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**
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)			
Extended carry back (max)	(50,000)			
	31,750	Nil	Nil	99,750
Minus Gift Aid	(1,500)	Nil	lost	(1,500)
PCTCT	30,250	Nil	Nil	98,250

Working

Record of trading losses	**y/e 31 December 2008**	**y/e 31 December 2009**
	£	£
Trading loss b/f		77,750
Set off under s393(1)		(77,750)
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)	
Extended carry back (maximum)	(50,000)	
Trading loss c/f	77,750	Nil

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 extended carry back applies because the loss making accounting period ends on 31 December 2008, which is in the period 24 November 2008 to 23 November 2010.

(3) As the loss making accounting period covers a full 12 months, a maximum of £50,000 can be carried back under the extended carry back rules. As the whole of this £50,000 can be set off during the year ended 30 September 2007, the loss cannot be carried back any further.

3.4 Terminal loss relief

When a company ceases to trade, it will have no future trading profits. If it has trading losses it can only claim s393A relief. However, s393A relief on the cessation of trade is more generous than normal ongoing trading 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.
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).

The rules for the relief of a terminal loss are very similar to those for the extended carry back relief. However, there is no restriction on the amount of loss that can be carried back to the earliest two accounting periods. Anti-avoidance rules therefore deny terminal loss relief where the cessation of trade results from the transfer of trading activities to a person who is not chargeable to corporation tax and the main purpose of this arrangement is to gain access to terminal loss relief.

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

(a) Calculate the PCTCT for each CAP, assuming losses are relieved as soon as possible.

(b) Explain how your answer would have differed had V plc not ceased trading.

Answer

(a) (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

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
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 CAP/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

(b) If V plc had continued trading, relief would have been restricted to the normal s393A and the extended carry back. This would have resulted in the following amount of loss being carried forward under s393(1):

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)
Extended carry back (max)			(50,000)	
	133,000	54,000	41,000	Nil
Minus: Gift Aid	(600)	Nil	(600)	lost
PCTCT	132,400	54,000	40,400	Nil

Working **Record of trading losses**	**y/e 31 December 2009**
	£
Trading loss in y/e 31.12.09	278,500
Set off under s393A:	
In the loss-making CAP	(0)
Carry back 12 months:	
- y/e 31.12.08	(83,500)
Extended carry back to y/e 31.12.07 (maximum)	(50,000)
Trading loss carried forward under s393(1)	145,000

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 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**		
	FY07	**FY08**	**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% calculated 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 therefore 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.

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:

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 31.3.08 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	(note) 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%).

Note:
The tax saving in the current period will only be £1,680 (£8,000 × 21%) as the company has PCTCT of £8,000. However, as the loss must be set off before the deduction of the Gift Aid payments, £9,000 of the loss must be used to achieve this tax saving.

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 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

Loss relief under s393A is an all or nothing relief; if claimed, a company must set off the maximum amount possible. Making a claim under s393A may save some tax at 29¾%, but losses may first have to be matched against profits taxed at 21%.

S393A requires the whole of the trading loss to be relieved (i.e. the adjusted loss **including** capital allowances). However, a company does not have to claim **all** its capital allowances. It can claim any amount up to the maximum capital allowances available. Therefore, it may sometimes be advantageous to reduce a trading loss by not claiming 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.

Note, however, that in the examination you should always calculate the maximum capital allowances available, unless the question tells you to do otherwise.

CHAPTER 20

Overseas aspects of corporation tax

Contents

1 Overview of the treatment of foreign income and gains
2 Consequences of establishing trading operations abroad
3 Double taxation relief (DTR)
4 Treatment of intra-group transactions with overseas subsidiaries

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. DTR is provided for in the computation of the UK corporation tax liability.

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

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

A 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, a separate record is maintained of the branch trading income as opposed to 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 and the rules for relief of trading losses are applied.

- 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 a 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 WHT suffered.
- The overseas subsidiary 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 be set off against profits of a 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.

Double taxation relief (DTR)

- Overview of double taxation relief
- Treaty relief
- Unilateral relief
- The effect of deductions from total profits

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 an **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 WHT suffered.

The amount of unilateral DTR is then calculated as the lower of:

(1) overseas WHT 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, in other words 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 company and has not received any 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 a property in Germany (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 a property in Germany (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

			Overseas income	
	Total profits	UK profits	Branch profits (WHT 15%)	Rental income (WHT 25%)
	£	£	£	
Trading income (W1)	25,000	Nil	25,000	
Interest income	22,500	22,500		
Foreign rental income (W1)	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 (W2)	(17,850)	n/a	(2,100)	(15,750)
Corporation tax payable	Nil	Nil	Nil	Nil

Workings

(W1) Overseas income

Branch profits (£21,250 × 100/85) = £25,000
Rental income (£56,250 × 100/75) = £75,000

(W2) DTR

	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%))

Treatment of intra-group transactions with overseas subsidiaries
■ An explanation of the problem
■ The transfer pricing provisions

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 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) has been introduced to prevent the manipulation of profits in this way.

4.2 The transfer pricing provisions

The transfer pricing rules apply to transactions between 50% group companies. 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 a later 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 the **arm's length principle** 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.

Group companies falling within the rules are allowed to deal with intra-group transactions in one of two ways:

(1) charge and account for intra-group transactions on an arm's length basis in their financial accounts, or

(2) charge and account for the transactions at any desired price, then make an adjustment in the UK company's adjustment of profit computation to reflect all intra-group transactions with that company at an arm's length price.

CHAPTER 21

Group corporation tax

Contents

1 Associated companies
2 Group loss relief
3 Group chargeable gain provisions

Associated companies

- Introduction
- Definition of an associated company
- Consequences of being associated

1 Associated companies

1.1 Introduction

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.

When dealing with an examination question involving a group, your starting point should be to determine the number of associated companies.

1.2 Definition of an associated company

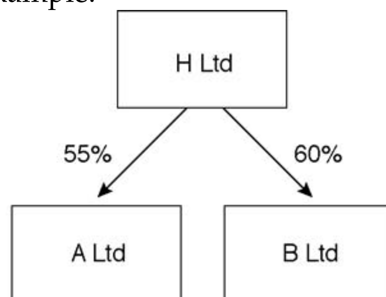
Companies are associated if:

- 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.

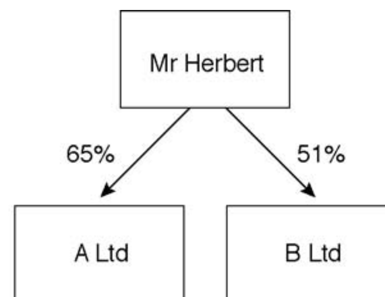
Control in this context means an interest of more than 50% in:

- 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

Where a group relationship exists, the companies are under the common control of the holding company and therefore they are associated for corporation tax purposes.

Companies within a group are associated if the company has been part of the group relationship **at any time** in the CAP. The definition of associated company therefore 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).

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 has three associated companies.

Required

Calculate the corporation tax liability of I Ltd for the year ended 31 March 2010.

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 of 28% applies (since profits are above £375,000)

Corporation tax liability

£400,000 × 28%	**£112,000**

Note

I Ltd has three associated companies, therefore the statutory limits must be divided by four (i.e. I Ltd plus 3).

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 recipient company's point of view
- Tax planning and group loss relief

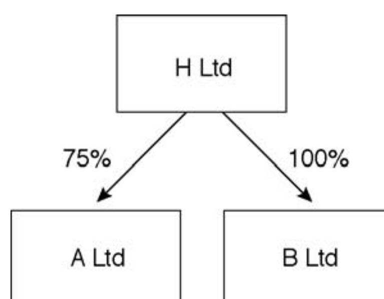
2 Group loss relief

2.1 Definition of a 75% group for group 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.

Directly-owned 75% subsidiaries will be part of a loss relief group. For example:

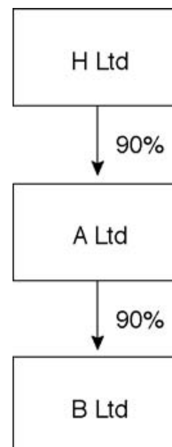


Both A Ltd and B Ltd are directly owned 75% subsidiaries of H Ltd for group loss purposes.

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.

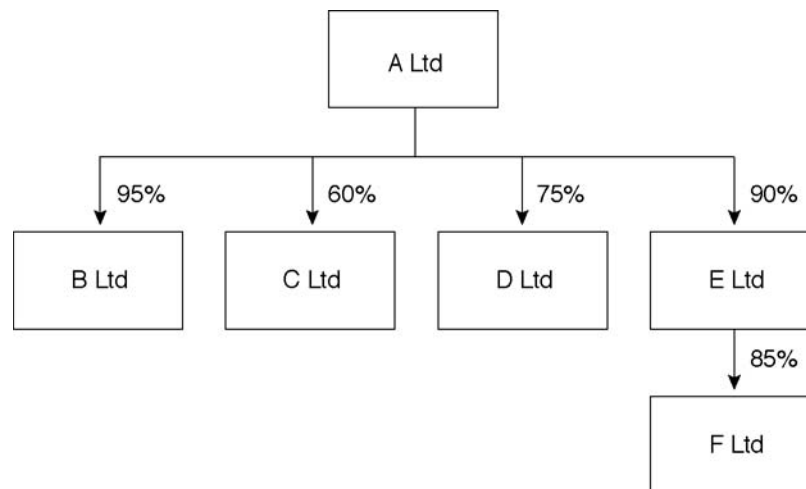
The composition of a loss relief group

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.

However, under the group loss relief provisions, it is only possible to move losses between the UK companies in the group.

A company can be the 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 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 the claim against total profits for the current period)
- unrelieved Gift Aid donations.

It is important to note that **capital losses cannot be surrendered** (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 recipient company can not utilise them all against its own available profits.

2.4 The rules for group relief from the recipient company's point of view

The recipient 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 recipient 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, a current period s393A claim **must** be deducted 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 recipient company were part of the same group).

If both companies have the same CAPs and are part of the group for the whole CAP the position is straightforward. The maximum group relief claim = Lower of:

- the loss of the surrendering company, or
- the available profits of the recipient 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 recipient 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.

It is necessary to compare each company's profits of the appropriate CAP to the relevant limits to decide the rate of tax applicable.

The relevant limits are the statutory limits divided by the number of associated companies. In the case of a CAP of less than 12 months, the amount should also be time-apportioned to match the length of the period.

As explained in the earlier chapter on loss relief, the effective marginal rates of tax and therefore the optimum order of set-off are 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

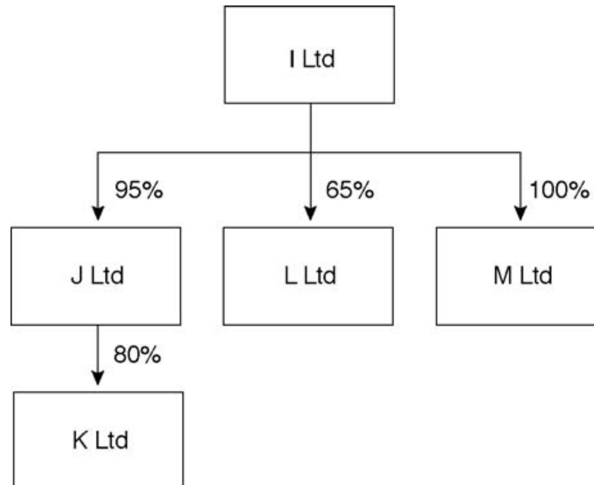
As the primary aim is to minimise the overall group tax liability, the optimum use of losses is to surrender them to the group companies in the following order.

- 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 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:

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%). 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, I 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

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
■ Electing to make maximum usage of capital losses
■ Tax planning: using capital losses

3 Group chargeable gain provisions

3.1 Definition of a 75% group for the group chargeable gain provisions

Where one company owns, directly or indirectly, at least 75% of the ordinary share capital of another company, the group chargeable gains provisions will apply.

Indirect sub-subsidiaries can also be part of the gains group. provided that 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

		Workings for answer	
	$\geq$ 75% direct holding test	**$\geq$ 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?

a

Answer

There are **four associated companies**, because at each link there is a more than a 50% interest.

Group 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: (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. (2) A company can be a member of more than one loss group.	Notes: (1) C Ltd cannot be grouped with H Ltd for group gains purposes. (2) B Ltd and C Ltd cannot form another gains group as a company can not be a member of more than one gains group.

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 companies.

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.

e

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. N Ltd had purchased the warehouse on 30 August 1999 for £120,000.

On 25 March 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.

a

Answer

Year ended 30 June 2004: Intra-group 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 March 2009	
$\frac{211.3-182.5}{182.5} = 0.158 \times £132,360$	(20,913)
Chargeable gain arising in O Ltd	146,727

3.4 Claiming group rollover relief

For the purposes of rollover relief (replacement of business asset 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. (If all the sale proceeds are reinvested, all the gain can be deferred, etc).

3.5 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 and ensures that any net chargeable gains are taxed in the company 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.

3.6 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 in the company 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 in effect be transferred in any direction to any other group company (or several companies).

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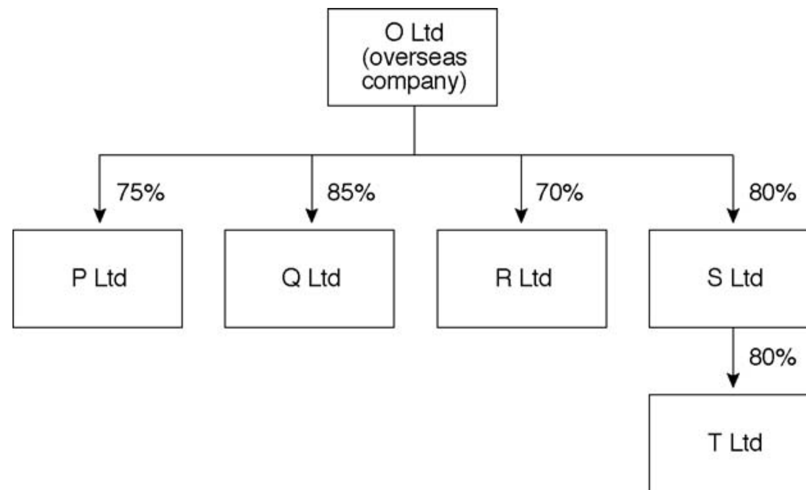
Example



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, assuming 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 chargeable gains reliefs are only possible between the UK resident companies (i.e. P Ltd, Q Ltd, S Ltd and T Ltd). Therefore, electing to transfer 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 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%.

CHAPTER 22

Self assessment and PAYE

Contents

1	Notification of chargeability
2	Filing returns
3	Amendments, enquiries and appeals
4	Payment of tax
5	The PAYE system

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 comes within the scope of income tax or capital gains tax, or acquires a new source of 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 of income or gain arose. For example, for 2009/10, HMRC must be notified by 5 October 2010.

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.

The individual is required to complete the summary form and the appropriate supplementary pages in full. As regards the completion of the tax calculation section:

- If the return is filed on-line, the tax calculation section is automatically completed as part of the filing process.
- If a paper return is filed, HMRC will do the tax calculation for the individual if he so wishes, provided the return is filed on time.

If the taxpayer wishes to submit his return on-line, the normal due date for filing the return 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 31 October 2010), or
- 3 months after the issue of the return.

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) a taxpayer's return within 9 months of the date of receipt, if there are obvious errors or omissions (such as arithmetical errors and missing pages).

The taxpayer's right to amend

The taxpayer has the right to amend their return within 12 months of the due 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 a taxpayer believes he has overpaid tax, 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 right to enquire into a return to check for completeness and accuracy.

A return may be investigated:

- because information is received by HMRC that 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 to the company. However, they must give written notice before commencing an enquiry, within 12 months of the date of receipt of the return.

Normally, if HMRC does not issue an enquiry notice within the appropriate 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 their self assessment as required by HMRC.

If the taxpayer refuses to amend their 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.

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 also 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 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 assessments

When a taxpayer does not file their return by the filing date, HMRC may estimate 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 assessments

Where a taxpayer did file their return on time but HMRC did not enquire into the return within the permitted 12 months, HMRC can raise a discovery assessment where they suspect that full disclosure has not been made.

The time limits for making a discovery assessment depend on the circumstances of the case:

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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

A company must keep its records for at least six years from the end of the relevant accounting period.

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 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 are simply required to keep adequate records to support their tax return.

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:

$$\text{Estimated corporation tax liability} \times \frac{\text{3 months}}{\text{Number of months in the accounting period}}$$

- 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 income tax, Class 4 NICs and capital gains tax

Capital gains tax is collected under self assessment and is due in one single payment by 31 January following the end of the tax year (i.e. for 2009/10, by 31 January 2011).

Income tax that is not collected under PAYE or at source **and** Class 4 NICs (if applicable) are usually paid in three instalments, as follows:

	Due date	**For 2009/10**
Two equal payments on account:		
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

The amount of each payment on account

The amount of each payment on account (POA) is calculated as follows:

POA = ½ × Tax paid by self assessment in the preceding tax 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
Minus: tax deducted at source	(X)
Minus: PAYE	(X)
	X

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.

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. He must state the grounds for the reduction and HMRC cannot dispute the claim.

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. However, if the individual deliberately reduced the payments fraudulently or negligently, penalties will be levied in addition to interest payments.

Example

Graham has provided the following information:

	2008/09	2009/10
	£	£
Income tax liability	21,450	31,200
Class 4 NICs	2,430	2,560
Capital gains tax liability	5,600	3,200
PAYE	12,550	17,890
Deducted at source	3,250	4,780

Required

Calculate the tax payable under self assessment for 2009/10 and state the due dates of payment.

Answer

2008/09 (= preceding tax year)	**£**
Income tax liability	21,450
Plus Class 4 NICs	2,430
Total tax liability	23,880
Minus: tax deducted at source	(3,250)
Minus: PAYE	(12,550)
	8,080

This amount of £8,080 is more than £1,000 and more than 20% of the total tax liability (= 20% × £23,880 = £4,776). Therefore, payments on account are required in 2009/10.

2009/10:	£
Income tax liability	31,200
Plus: Class 4 NICs	2,560
Total tax liability	33,760
Minus: Tax deducted at source	(4,780)
Minus: PAYE	(17,890)
Amount payable	11,090

Due dates of payment and amounts of each payment:

	Due date		Amount
			£
Payments on account	31 January 2010	½ × £8,080	4,040
	31 July 2010	½ × £8,080	4,040
			8,080
Balancing payment	31 January 2011	£11,090 – £8,080	3,010
Income tax and Class 4 NICs			11,090
Capital gains tax	31 January 2011		3,200

Note

On 31 January 2011, in addition to the balancing payment for 2009/10, the first POA of £5,545 (½ × £11,090) for 2010/11 is also due.

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

Isabel made the following self assessment payments in relation to 2008/09:

	Amount paid	Paid on
1st POA	£1,750	31.1.2009
2nd POA	£1,750	30.9.2009

The balancing payment was £1,500.

Required

Calculate the surcharges arising if Isabel paid the balancing payment on the following alternative dates:

(a) 16 February 2010

(b) 31 March 2010

(c) 9 September 2010.

a

Answer

The second POA is paid late (on 30.9.2009 instead of 31.7.2009). However surcharges are not levied on POAs.

The due date for the balancing payment is 31 January 2010.

Surcharges due:

Date paid	How late?	Surcharge
(a) 16 February 2010	Less than 28 days	Nil
(b) 31 March 2010	More than 28 days	5% × £1,500 = £75
(c) 9 September 2010	More than 6 months	10% × £1,500 = £150

4.4 Interest on underpaid and overpaid tax

Interest on underpaid tax

HMRC charges interest on any underpaid tax. This interest runs:

- **from** the date the tax should have been paid
- **to** the day before the tax is actually paid to HMRC.

Interest runs to the day before the date the tax is paid because on the date of payment, the tax is no longer overdue.

Interest may also be payable on surcharges and where a self assessment is amended or a discovery assessment is raised.

In the examination, the annual rate of interest on underpaid tax is given in the tax rates and allowances sheet (as 2.5%).

e

Example

Helen made the following self assessment payments in relation to 2008/09:

	Amount paid	Paid on
1st POA	£6,500	20 March 2009
2nd POA	£6,500	25 September 2009
Balancing payment	£5,000	16 February 2010

Required

State how interest will be calculated on any tax paid late.

a

Answer

Interest will be calculated as follows:

		Due date	Day before date paid
1st POA	£6,500 × 2.5%	from 31.1.2009	to 19.3.2009
2nd POA	£6,500 × 2.5%	from 31.7.2009	to 24.9.2009
Balancing payment	£5,000 × 2.5%	from 31.1.2010	to 15.2.2010

Interest on overpaid income tax

Interest on overpaid income tax (i.e. repayment interest) runs **to** the date the tax is repaid by HMRC. Interest 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.

The PAYE system

- Overview of the PAYE system
- Notice of coding

5 The PAYE system

5.1 Overview of the PAYE system

The Pay-as-you-earn (PAYE) system deals with payments for employed individuals of:

- income tax and
- Class 1 primary NI contributions

by deduction from the employee at source.

It also deals with Class 1 secondary contributions and Class 1A contributions paid by the employer.

Payment at source means that the employer deducts the payments from the employee's wages or salary, and makes the payments to HMRC.

PAYE income tax and Class 1 primary and secondary NICs are paid to HMRC on a monthly basis. The income tax and Class 1 NICs in relation to a month are paid to HMRC on the 19th of the following month (i.e. the liabilities in relation to March 2010 are paid to HMRC on 19 April 2010).

- Employers with more than 250 employees must make the monthly payments electronically and must do so by the 22nd of each month.
- If the average monthly total of PAYE tax and NICs is not in excess of £1,500, payments can be made quarterly on 19 January, 19 April, 19 July and 19 October.

PAYE is applied to the following payments:

- Salary/wages
- Bonuses/commissions
- Any other cash receipts and cash benefits (e.g. mileage allowances that exceed the authorised mileage allowance rates)
- Cash and non-cash vouchers, excluding vouchers exempted under the benefit rules (e.g. childcare vouchers up to £55 per week)
- Receipts of marketable assets that can be converted into cash (e.g. gold bars, fine wines, shares, diamonds).

In order to calculate the correct amount of tax, the employer must use the individual's tax code.

5.2 Notice of coding

HMRC produce a notice of coding (a Form P2) for every employee each tax year and send a copy to both the employee and the employer.

The form details the allowances and deductions available to that employee in that tax year and gives the individual a tax code.

A tax code is quoted as a number followed by a suffix or preceded by a prefix.

- The number in the PAYE tax code shows the tax-free allowance the individual employee is entitled to.
- The suffix or prefix shows the main personal circumstances of the employee.

The most common suffix for a tax code is L. This denotes that the taxpayer is entitled to the personal allowance only (as opposed to the higher allowances available to older taxpayers). The most common prefix is K which denotes that the deductions exceed the allowances and therefore the tax code is a negative number.

The tax code is calculated as follows:

Calculation of an individual's tax code	**£**
Allowances	
The personal allowance	6,475
Allowable expenses	X
	X
Deductions	
Assessable benefits of employment	(X)
Adjustment for underpaid tax	
(Underpaid tax × 100/20 or 100/40) (see below)	(X)
Net allowances	X
Tax code = 1/10 × Net allowances, rounded down to a whole number	

For example, a tax code of 523 indicates net allowances of £5,230 (up to £5,239).

If an employee has underpaid tax, the underpayment is usually accounted for under self assessment, as explained earlier. However, where the underpayment is less than £2,000, he can request on his tax return that the payment is collected via PAYE by reducing his tax code. A paper return must be filed by 31 October or an on-line return by 30 December for the unpaid tax to be collected in this way.

The adjustment for underpaid tax is calculated as the amount of underpayment grossed up at:

- 100/20 if the individual is a basic rate taxpayer and
- 100/40 if a higher rate taxpayer.

e

Example

John earns £63,200 a year. He is provided with a company car with a benefit of £3,965. He pays professional subscriptions of £360. He has an underpayment of tax of £450 which he has requested to be collected via PAYE. John is single and has no other source of income.

Required

Calculate John's tax code.

a

Answer

Allowances	**£**
The personal allowance	6,475
Allowable expenses	360
	6,835
Deductions	
Assessable benefits of employment	(3,965)
Adjustment for underpaid tax (£450 × 100/40)	(1,125)
Net allowances	1,745

Tax code = 1/10 × 1,745 = **175L**

CHAPTER 23

Value Added Tax

Contents

1	Overview of Value Added Tax
2	VAT registration
3	Accounting for VAT
4	Schemes for small businesses
5	The administration of VAT
6	VAT penalties

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 in this context is 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**.

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.

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

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 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. 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 believe that the taxable turnover in the next 30 days **in isolation** will exceed £68,000.

(2) **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).

(3) HMRC must be notified **within** the 30-day period in which it is thought that the threshold will be exceeded.

(4) The newly-registered business/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 from which 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**.

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.

The advantage of exemption from registration is that the business does not have to incur the administrative burden and costs of accounting for VAT. However, the disadvantage is that it will be unable to recover any input VAT suffered.

A taxable person is therefore only likely to claim the exemption if they do 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

A person who makes taxable supplies below the VAT threshold is not required to register for VAT. However, they can choose to register voluntarily.

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 competitor businesses 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 it **ceases 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 cease or an agreed later date.

Voluntary deregistration

Voluntary deregistration is allowed if at any time:

- there are reasonable grounds for a registered person to estimate that its 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.

In this situation, deregistration will be effective from the date on which the request for deregistration is made or an agreed later date.

The deregistration threshold is given in the tax rates and allowances in the examination.

Consequences of deregistration

On deregistration there is a **deemed supply** of all of the business 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

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 1997, 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.

Accounting for VAT

- Principles of VAT accounting and payment dates
- Output VAT
- Input VAT
- Tax point
- Relief for impairment losses on trade debts
- Proforma computation: VAT accounting
- Impact of VAT on the trading income assessment

3 Accounting for VAT

3.1 Principles of VAT accounting and payment dates

For each return period, every business liable to charge VAT:

- charges output VAT on its taxable supplies
- recovers input VAT on its raw material purchases and other expenses
- completes a VAT return and submits it to HMRC
- accounts to HMRC for any VAT payable if there is excess output VAT (if output VAT exceeds input VAT) for the return period
- claims a repayment of excess input VAT (if input VAT exceeds output VAT) for the return period.

The VAT return must be completed and submitted to HMRC (with payment if necessary) by **the last day of the month following the end of the return period**. For example, a quarterly return to 31 July 2009 must be submitted by 31 August 2009.

Any repayment due from HMRC will normally be repaid **within 14 days of the end of the return period**. However, HMRC will not refund VAT that was originally paid more than four years earlier. (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.)

Most businesses account for VAT on a quarterly basis. 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.

Large businesses with an annual liability of more than £2 million **must pay VAT by instalments** as follows:

Payment date	Nature of the payment	Amount of the payment
At the end of the second month in a quarter	Payment on account	1/24th of the total VAT liability for the previous year
At the end of the last month in a quarter	Payment on account	1/24th of the total VAT liability for the previous year
At the end of the first month in next quarter	Balancing payment	Balancing amount for the quarter

3.2 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 by 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 (see below).

- **Discounts:** 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.

3.3 Input VAT

Input VAT can usually be recovered if the:

- goods or services purchased are used for business purposes, and
- 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 according to the rules explained below.

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 its output and cannot recover any input VAT.
Partly taxable/partly exempt supplies	This person is a partially exempt trader and special rules apply for the recovery of input VAT. These rules are outside the syllabus for this examination.

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 three years prior to registration 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 six months before the date of registration.

3.4 Tax point

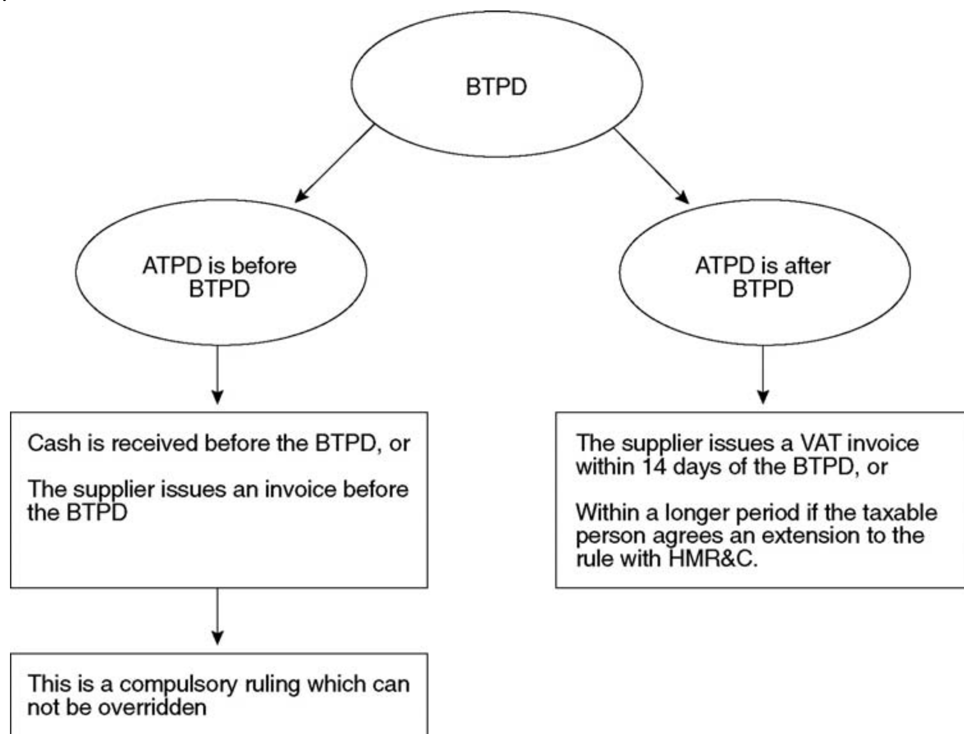
The tax point date (TPD) is important for two reasons:

- Accounting for VAT is based on a return period. Output VAT is accounted for in the return period in which the TPD of the supply falls. Input VAT can be recovered in the return period in which the TPD of the purchase occurs. The definition of the TPD is therefore important in determining in which return the VAT is accounted for.
- VAT is charged at the rate in force on the TPD. The definition of the TPD is therefore important if there is a change in the rate of VAT.

The basic tax point date (BTPD) is as follows:

- for goods: the date the goods are despatched or otherwise made available to the customer
- for services: the date the service is completed.

However, the actual tax point date (ATPD) can be before or after the BTPD as follows:



Many businesses agree a **month-end invoicing rule**. This allows the business to invoice all sales at the month end and treat the invoice date as the TPD.

3.5 Relief for impairment losses on trade debts

Output VAT is accounted for on the TPD of the supply. 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 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 debt 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.

3.6 Proforma computation: VAT accounting

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 sales of capital assets apart from 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	(X)
(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)	
Bad debt relief	(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 who had gone into liquidation. The debt 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)
Bad debt relief (£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 bad 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.

3.7 Impact of VAT on the trading income assessment

Adjustment of profit computation

In the adjustment of profit computation of the business, adjustments are made using whatever amount is **charged** in the profit and loss account.

If the business is VAT-registered:

- expenses are usually VAT-exclusive as the associated input VAT is recoverable 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 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.

Schemes for small businesses

- Overview of the schemes available for small businesses
- The cash accounting scheme
- The annual accounting scheme
- The flat rate scheme

4 Schemes for small businesses

4.1 Overview of the schemes available for small businesses

There are three schemes available to help small businesses account for VAT. They all aim to simplify VAT accounting, reduce administration and help cash flow.

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

Under the cash accounting scheme, small businesses account for VAT when cash is paid and received, rather than on the tax point dates.

As a result, the business does not have to pay VAT until it has received the cash from its customers. It therefore receives automatic bad debt relief if a customer does not pay.

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

Under the annual accounting scheme, small businesses submit only one VAT return each year and spread their payments of VAT 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.
- 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.

A business can apply to make quarterly POAs of 25% of the total estimated liability at the end of the 4th, 7th and 10th month, rather than making monthly POAs. The balancing payment will 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 2005. 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 assuming the final VAT liability is agreed at £20,250.

Answer

POAs: 1/10th × £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 4th month	1,595
POA 2	31 January 2010	Last day of 5th month	1,595
POA 3	28 February 2010	Last day of 6th month	1,595
POA 4	31 March 2010	Last day of 7th month	1,595
POA 5	30 April 2010	Last day of 8th month	1,595
POA 6	31 May 2010	Last day of 9th month	1,595
POA 7	30 June 2010	Last day of 10th month	1,595
POA 8	31 July 2010	Last day of 11th 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 continues to issue VAT invoices to VAT registered customers and to charge all customers for VAT at the normal rates (e.g. standard, reduced or zero-rated)
- However, at the end of the return period, the taxable person pays to HMRC the following amount:

  Appropriate flat rate × VAT inclusive turnover

Notes

1 The business cannot recover any input tax on its purchases and expenses.

2 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 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 its 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.

Example

In the quarter ended 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.

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

The administration of VAT

- VAT returns and records
- VAT invoices

5 The administration of VAT

5.1 VAT returns and records

VAT return periods are usually quarterly, unless an application has been made to account on a monthly basis or the business is a member of the annual accounting scheme.

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 book, bank statements, paying in slips
- VAT accounts and returns
- Annual profit and loss accounts and balance sheets.

5.2 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.

To be valid, a **VAT invoice** must contain the following information:

(1) invoice date and invoice number

(2) type of supply

(3) quantity and description of the goods supplied

(4) name and address of the supplier

(5) name and address of the customer

(6) details of any prompt payment discounts offered

(7) VAT registration number

(8) tax point date

(9) rate of VAT for each supply

(10) VAT-exclusive amount for each supply

(11) total VAT-exclusive amount

(12) amount of VAT payable.

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).

A **retailer's VAT invoice** must contain the following information:

(1) name and address of the retailer

(2) VAT registration number

(3) tax point date

(4) quantity and description of the goods supplied

(5) rate of VAT for each supply

(6) consideration for the supply

(7) rate of VAT in force.

VAT penalties

- Default surcharge
- Default interest
- Errors in a VAT return

6 VAT penalties

6.1 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 if it is less than £400. However, there is a minimum charge of £30 at the 10% and 15% rates.

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.

a

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 for the quarters ended 31 March 2009, 30 June 2009, 30 September 2009 and 31 December 2009 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.

6.2 Default interest

Default interest is charged on any unpaid amount from the date the VAT should have been paid to the date of payment.

6.3 Errors in a VAT return

If a taxpayer notices a misdeclaration or error before an investigation by HMRC, and the net effect of the misdeclaration/error does not exceed the higher of £10,000 or 1% of the turnover for the VAT period, the trader is allowed to correct the mistakes in the next VAT return. No separate disclosure is required.

If the net effect exceeds the higher of £10,000 or 1% of the 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 previous chapter.)

Q&A

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1 Angela

For 2009/10 Angela received a salary of £35,000, building society interest of £2,400, UK dividends of £9,000 and a premium bond prize of £150.

Required

Calculate Angela's income tax liability for 2009/10.

2 Brian

Brian has the following income and payments in 2009/10:

		£
Income	Self employment profits	20,000
	Employment income	25,660
	Bank deposit interest	4,100
	Income from an ISA (Individual Savings Account)	260
	Dividends received from UK companies	1,890
	National Lottery winnings	140
Payments	Gift Aid donation	480
	Allowable interest	200

Income tax of £8,287 was deducted from Brian's employment income under the PAYE system.

Required

Calculate the income tax payable by Brian for 2009/10.

3 Paul

Paul owns a furnished house which he rents out.

The annual rent was £8,000, but was increased to £8,800 per year with effect from 6 January 2010. It is payable in advance by equal monthly instalments on the 6th of each month. The tenants paid all the rent on time with the exception of that due for 6 March 2010, which was not received until 2 May 2010.

Paul incurred the following expenditure on the property during 2009/10:

Council tax	£960
Water rates	£380
Agent's fees	£780
Re-decoration costs	£1,250
New central heating system	£2,400
Mortgage interest	£2,500

Required:

(a) Calculate the amount of property income assessable on Paul for 2009/10.

(b) Outline the conditions that Paul would have to fulfil for the letting to be classed as a furnished holiday letting.

4 Flash plc

During 2009/10 Flash plc provided the following benefits to its employees:

(1) Arthur was provided with a new diesel-powered company car on 6 August 2009. The car had a list price of £13,500 and an official CO_2 emission rate of 137 g/km. Arthur made no capital contribution towards the car and makes no regular contributions to its use. Arthur was provided with fuel for private use.

(2) Benny was provided with a new petrol-powered company car throughout 2009/10. The car had a list price of £20,800 and an official CO_2 emission rate of 203 g/km. Benny contributed £4,400 towards the purchase of the car. Benny was provided with fuel for private use.

(3) Charlotte was provided with a new petrol-powered company car throughout 2009/10. The car had a list price of £22,600 and an official CO_2 emission rate of 264 g/km. Charlotte paid Flash plc £1,200 during 2009/10 for the use of the motor car. Charlotte was provided with fuel for private use and paid Flash plc £600 towards the cost of private fuel, although the actual cost of her private fuel was £1,000.

(4) Flash plc does not provide Daphne with a company car, but reimburses her with 30p per mile for the use of her own 1,800 cc car on business journeys. During 2009/10 Daphne drove 12,000 miles in the performance of her duties. The relevant HMRC authorised mileage allowances are 40 pence per mile for the first 10,000 miles, and 25 pence per mile thereafter.

(5) Ernest was provided with a new diesel-powered company van on 6 May 2009. The van had a list price of £18,600 and an official CO_2 emission rate of 240 g/km. Ernest is provided with fuel for private use.

Required

Calculate the benefits assessable on the employees of Flash plc in 2009/10.

5 Richard

Richard is the finance director of RS plc. In addition to an annual salary of £56,000 he is entitled to a bonus calculated on a formula applied to the company's annual audited profits. The company prepares accounts to 31 January each year: the bonus is paid to Richard four months later.

Recent bonuses have been:

	£
y/e 31 January 2008	20,000
y/e 31 January 2009	22,000
y/e 31 January 2010	18,500

Richard also received the following benefits.

(1) Overnight expense allowance of £60 for three nights staying away in London on a business trip.

(2) Annual staff party which cost the company £75 a head.

(3) A loan of £30,000 to help him buy a boat. Richard repaid £5,000 of the loan on 6 July 2009. The company charged him £525 interest.

Richard paid his annual subscription of £150 to the ACCA and made a donation of £100 to charity via the company's approved payroll giving scheme.

Assume the official rate of interest is 4.75% and calculate the beneficial loan benefit using both the average and the strict basis.

Required

Calculate Richard's employment income for 2009/10.

6 Colin

Colin started to trade on 1 July 2009. He prepared accounts for the period to 31 January 2010 which show the following:

	£
Sales	316,000
Cost of sales	(162,000)
Gross profit	154,000
Expenses	(86,250)
Net profit	67,750

Included in expenses are the following items:

	£
Depreciation	26,000
Colin's income tax and National Insurance	6,400
Hire charge	5,600
Royalties payable	2,000
Legal fees relating to the collection of debts	1,260
Write off of a loan to a customer	2,250
Car expenses	3,400

During the period items of stock were taken out of the business by Colin for his own private use. The items cost £60 and have a market value of £120. No entry has been made in the accounts in respect of this transaction.

The hire charge relates to a car with a list price of £20,000 and CO_2 emissions of 175 g/km. The car was used by the sales manager.

Half of the car expenses relate to Colin's car and half to the sales manager's car. Colin uses his car 80% for business purposes. The sales manager's private mileage amounts to 10% of the total mileage.

Required

Calculate the adjusted profits for the period ended 31 January 2010.

7 Ashley and Cheryl

(a) Ashley started to trade on 1 July 2009. He prepared accounts for the period to 31 January 2010.

On 1 July 2009 Ashley spent £140,000 on an automated production line with an expected life of 20 years. He also purchased a car on 1 December 2009 for £11,000 for the use of his sales manager. The car has CO_2 emissions of 130 g/km. The manager's private mileage amounts to 10% of the total mileage.

Required

Calculate the capital allowances available for the period ended 31 January 2010.

(b) Cheryl prepares accounts to 31 March each year.

On 1 April 2009 the tax written down values of plant and machinery were as follows:

	£
General pool	113,420
Jaguar car	22,880
Short life asset	3,410

In the year ended 31 March 2010, Cheryl undertook the following transactions:

8 May 2009	Sold the Jaguar car for £38,280
	(The Jaguar car originally cost £36,960)
17 June 2009	Purchased a small Renault car for £11,000
	(The Renault has CO_2 emissions of 127 g/km)
11 August 2009	Sold the short life asset for £500
25 August 2009	Purchased some IT equipment for £7,370

Required

Calculate the capital allowances available for the year ended 31 March 2010.

8 Daniel

Daniel prepared accounts for the 15 month period to 30 June 2010 as follows:

	£
Sales	245,000
Cost of sales	(97,500)
Gross profit	147,500
Sundry income	8,000
	155,500
Expenses	(61,000)
Net profit	94,500

Included in expenses are the following:

(1) Depreciation of plant and machinery of £10,000.

(2) Motor expenses relating to Daniel's car of £3,750.

(3) A fine of £5,000 imposed for the breach of environmental health regulations.

(4) Computer software of £2,100 relating to a programme acquired with the new computer system on 3 May 2009. The estimated useful life of the computer and software is three years.

(5) Payment of a premium of £6,000 on 1 April 2010 for a 12 year lease on a workshop granted to Daniel by E Ltd, an unconnected trading company.

(6) Sundry income represents building society interest of £2,000 and rental income of £6,000 from the renting of an office which is surplus to Daniel's requirements.

Daniel also incurred the following on capital purchases:

		£
3 May 2009	New computer system	15,000
16 August 2009	Plant and machinery	28,000

On 11 September 2009 Daniel sold his car for £9,800 and purchased a new car for £16,000. The new car has CO_2 emissions of 173 g/km. Both cars are used 75% for the purposes of the trade.

On 1 April 2009 the tax written down value of Daniel's general pool was £78,000 and Daniel's car was £6,400.

Required

Calculate Daniel's adjusted profit after capital allowances for the period ended 30 June 2010.

9 Industrial building

ST Ltd is the owner of a manufacturing business. The company has always prepared its accounts to 31 March. It purchased a small factory complex from its builders on 30 June 2008 and put it into use on 1 August 2008.

The purchase price was analysed as follows:

	£
Building	
Manufacturing area	169,000
Warehouse	42,000
Showroom	4,000
Drawing office	2,000
Canteen	3,000
Accounts office	19,000
Land	60,000
Site preparation	1,000
	300,000

ST Ltd sold the building on 1 February 2011 for £280,000 (including £50,000 for the land).

Required

Compute the industrial buildings allowances available to ST Ltd for all years concerned.

10 Hannah

Hannah started trading on 1 May 2007 and prepared her first accounts to 31 August 2008. Her adjusted profits after capital allowances were:

	£
Period to 31 August 2008	60,000
Year to 31 August 2009	84,000
Year to 31 August 2010	90,000

Required

(a) Calculate Hannah's trading income assessments for the first four tax years and the overlap profits arising.

(b) Assume Hannah ceased to trade on 30 April 2011 and her adjusted profits after capital allowances for the final period were agreed at £70,000.

Calculate Hannah's trading income assessment for the final tax year.

11 Ian

(a) Ian started to trade on 1 February 2006 and prepared accounts to 31 May each year until 2009 when he changed his accounting date by preparing a long set of accounts to 30 September 2009. His adjusted profits after capital allowances are as follows:

	£
Period ended 31 May 2006	8,280
Year ended 31 May 2007	10,440
Year ended 31 May 2008	38,840
Period ended 30 September 2009	57,825
Year ended 30 September 2010	61,030

Required

Calculate the trading income assessments arising from these profits, and state how much overlap profits are carried forward for relief in the future.

(b) Assume Ian ceases to trade on 31 January 2012. His adjusted profits after capital allowances for the final two periods are as follows:

	£
Year ended 30 September 2011	46,120
Period ended 31 January 2012	10,100

Required

Calculate Ian's trading income assessment for the final tax year.

12 Trading loss

Martin is a self-employed builder. His tax adjusted profits/(losses) after capital allowances have been as follows:

	£
Year to 31 May 2007	8,200
Year to 31 May 2008	6,600
Year to 31 May 2009	(9,410)
Year to 31 May 2010	6,800

Martin's other income and payments are as follows:

	2007/08	**2008/09**	**2009/10**	**2010/11**
	£	£	£	£
Dividends (including tax credit)	600	600	600	500
Allowable interest paid	100	100	100	100

Assume the 2009/10 tax rates and allowances apply throughout.

Required

Calculate the taxable income for each tax year assuming losses are relieved as soon as possible.

13 Loss relief in the opening years

Nathan started to trade on 1 July 2009. Agreed results for the first two years were as follows:

		£
Year to 30 June 2010	Loss	(28,800)
Year to 30 June 2011	Profit	6,000

Before starting to trade Nathan had been a full-time employee of a local company. Earnings resulting from this employment in recent years had been:

	£
2008/09	14,083
2007/08	26,520
2006/07	22,848

Nathan had other assessable income of £9,600 pa (gross) for many years.

Assume tax rates and allowances for 2009/10 apply throughout.

Required

(a) Calculate Nathan's trading income assessments for the first three tax years.

(b) State the amount of loss relief available under s64 and s72, and against which years a claim can be made.

(c) Calculate Nathan's taxable income for all relevant years if relief is claimed under s72.

14 Terminal loss relief

Oscar had carried on a trade as a self-employed management consultant for many years. The business had prospered for a time but recently profits started to decline as clients turned to larger, well-known firms of consultants, and losses began to be incurred. As a consequence of this Oscar decided to cease trading and retire on 30 June 2010.

Recent agreed tax-adjusted profits after capital allowances have been as follows:

	£
Year to 31 December 2006	40,000
Year to 31 December 2007	33,000
Year to 31 December 2008	20,000
Year to 31 December 2009	(32,000)
Period to 30 June 2010	5,000

Oscar received dividends of £261 (net) each year on his holding of preference shares and paid allowable interest of £300. His overlap profits not yet relieved total £6,200.

Required

Calculate Oscar's taxable income for all tax years affected, assuming a terminal loss relief claim is made. Assume the 2009/10 tax rates and allowances apply for all years.

15 Partnership profit

Eric, Fred and George have been in partnership for many years, sharing profits and losses in the ratio 3:2:1 respectively. The partnership prepares accounts to 31 December each year.

The agreed profits for the year to 31 December 2009 amounted to £60,000. The profit-sharing arrangement was revised with effect from 1 May 2009 by introducing an annual partner salary for Eric of £20,000 and changing the profit-sharing ratio 2:2:1.

Required

Show how the partnership profit for the year to 31 December 2009 would be allocated between the partners for income tax purposes.

16 Change in partnership

Jacob, Ken and Lesley have been in partnership for many years, preparing accounts to 30 June each year and sharing profits and losses equally.

Recent agreed adjusted profits after capital allowances have been:

	£
Year to 30 June 2008	24,000
Year to 30 June 2009	32,400
Year to 30 June 2010	43,200

On 1 February 2009 Mike joined and Ken retired from the partnership. Ken's overlap profits are £2,000. Profits and losses continue to be shared equally.

Required

Calculate the trading income assessments of each partner for each of the years 2008/09 to 2010/11, and calculate Mike's overlap profits.

17 Partnership loss

Peter and Paul have been in partnership for many years and have the following partnership agreement:

	Peter	**Paul**
Salary per annum	£16,000	£28,000
Profit-sharing ratio	65%	35%

On 1 January 2010 Mary joined the partnership. The new partnership agreement states that no salary will be allocated to any partner and profits and losses are to be shared in the ratio 2:2:1 (Peter, Paul, Mary respectively).

The adjusted loss of the partnership after capital allowances for the year ended 31 March 2010 was £101,600.

Required

(a) Allocate the partnership loss between the partners.

(b) State the loss relief options available to each partner.

(c) Explain whether the loss relief options would be different if Peter, Paul and Mary had a limited liability partnership and their partner capital balances were £100,000/£25,000/£10,000 respectively.

18 Stephen Honiton

Stephen Honiton is employed by International Megabytes plc at a gross salary of £32,000 before deduction of pension contributions of 5% to the company's occupational pension scheme. International Megabytes plc contributes an additional 7% into the scheme on Stephen's behalf. In 2007 he transferred to the Newcastle office to supervise the installation of a new reporting system. The assignment in Newcastle is expected to last for three years.

During his stay in Newcastle he is living in a company house which cost £72,000 in 2004, the gross annual value being £1,700. The company paid certain household bills, which for 2009/10 were as follows:

	£
Electricity	280
Gas	410
Gardener	240
Redecoration	680

The company furnished the house at a cost of £6,400. Stephen pays the company £70 per month as a contribution toward the cost of accommodation.

The company provides him with an Audi car (CO_2 emissions level 164 g/km), list price £16,400 new in 2008. His mileage in 2009/10 was 24,500, of which 75% represents business mileage. He pays for all petrol and claims re-imbursement for the petrol cost relating to business miles. For the duration of his stay in Newcastle, his wife has been provided with a Ford Fiesta car (CO_2 emission level 138 g/km), costing £6,200 in 2008. His wife pays for all her petrol.

Other benefits provided include:

(1) Medical insurance costing £480 per annum.

(2) Meals in the staff dining room. The dining room is open to all staff. It provides subsidised lunches. The subsidy is estimated to be worth £360 per annum.

(3) The Newcastle office runs a nursery attended by Stephen's daughter. The cost to the company is £2,000 per annum.

In July 2009 Stephen and his family won a holiday as a prize in the company's productivity incentive scheme. The cost to the company was £1,200.

The company operates a staff loan scheme at 2% per annum interest. In December 2008 Stephen borrowed £3,000 for personal expenditure. There is to be no repayment of capital in the first three years. The company decided to write off the loan on 31 March 2010.

Required

Calculate Stephen Honiton's employment income for 2009/10.

19 Pension contributions

Hamish has trading profits of £350,000 for 2009/10. He paid a premium of £250,000 (gross) into his personal pension scheme.

Required

Calculate Hamish's income tax liability for 2009/10.

20 Class 1 NICs

Vanessa aged 46 is employed by VW plc. In 2009/10 she was paid a salary of £45,000 and provided with the following benefits:

	£
Company car	6,450
Private fuel	4,320
Living accommodation	1,800
Employer's pension contribution	1,600
Donation under payroll giving scheme	200

Required

Calculate the Class 1 and Class 1A contributions payable in respect of Vanessa for 2009/10, using the annual limit and rates.

21 Class 4 NICs

William is a self-employed builder. His trading income for 2009/10 was £25,000. In addition, William has gross savings income of £580.

William's wife, Wendy, is a self-employed consultant. Her trading income for 2009/10 was £50,000. In addition, Wendy has gross savings income of £8,800.

Required

Calculate the Class 4 NICs that William and Wendy are liable to pay for 2009/10.

22 Val

In 2009/10 Val disposed of the following assets:

(1) A 30% shareholding in Garnet Ltd, an unquoted trading company. The shares were acquired in June 2001 for £10,000 and sold in May 2009 for £55,000.

(2) A 1% shareholding in Ruby plc, a quoted trading company. The shares were acquired in July 1988 for £6,000 and sold in June 2009 for £66,000.

(3) A holiday cottage. The cottage was purchased in May 1992 for £17,000 and sold in November 2009 for £128,000.

Val is not an employee of either Garnet Ltd or Ruby plc, and has taxable income of £21,500 for 2009/10.

Required

Calculate Val's capital gains tax liability for 2009/10 and state the due date for payment.

23 Anthony

Anthony disposed of the following assets in 2009/10:

(1) On 18 April 2009 Anthony gave 40,000 £1 ordinary shares in R plc, a quoted trading company, to his daughter. The shares had a market value of £4.50 per share on 18 April 2009.

Anthony purchased 50,000 shares in the company on 16 October 1996 for £75,000. On 10 August 2007 R plc made a 1 for 10 rights issue for £6 per share.

He bought a further 11,000 shares on 22 April 2009 for £36,000. Anthony's shareholding represents a 2% interest in the company.

(2) A plot of investment land. Anthony purchased the land on 20 September 1998 for £14,000. He sold the land on 12 February 2010 for £10,000.

(3) 6,500 shares in S Ltd, an unquoted trading company. Anthony purchased 10,000 shares in S Ltd on 27 September 2009 for £36,600. On 14 March 2010 he sold 6,500 shares for £5 per share.

Anthony has capital losses brought forward of £16,150.

Required

Calculate Anthony's capital gains tax liability for 2009/10.

24 Barry

Barry made the following disposals in 2009/10:

(1) Sale of 6,000 GH Ltd unquoted trading company shares to his son for £45,000 on 10 June 2009. The shares had a market value of £15 per share on that date. Barry purchased the shares for £6,000 on 14 April 2001.

(2) Sale of a non-business asset on 14 July 2009. This gave rise to a gain of £17,650.

Barry has capital losses brought forward of £4,610.

Barry prepares accounts to 31 March each year. In the year ended 31 March 2010 he incurred a trading loss of £28,500. His total income in 2009/10 is £19,400 and he decides he would like to make a s.64 claim against total income and extend the claim against chargeable gains in 2009/10.

Required

Calculate Barry's capital gains tax liability for 2009/10. State the amount of losses, if any, remaining unrelieved.

25 AB Ltd

AB Ltd prepares accounts for the year end 31 March 2010 and provides the following information:

	£
Property income from renting a warehouse in the UK	160,000
Dividends received from unconnected UK companies	72,000
Trading income	448,000
Dividends received from an unconnected German company	18,000
Dividends paid	45,000
Interest income	24,000
Gift Aid donation – gross amount paid	4,000

AB Ltd disposed of some shares held as an investment on 30 June 2009 and realised a chargeable gain of £242,000.

Required

Calculate the PCTCT and corporation tax liability for AB Ltd for the year ended 31 March 2010.

26 EF Ltd

EF Ltd produced accounts for the four-month period ended 31 December 2009. Its PCTCT totalled £168,450, and it received dividends of £2,790 from an unconnected UK company on 25 November 2009.

Required

Calculate the corporation tax liability of EF Ltd for the four-month period.

27 GH Ltd

GH Ltd provides the following information for the year ended 31 March 2010:

	Notes	£
Income		
Adjusted trading profits		226,000
Interest receivable on £60,000 12% debentures	(1)	7,200
Premium received on the granting of a lease	(2)	60,000
Dividends from an unconnected UK company		8,100
Expenditure		
Interest payable on £80,000 8% loan stock	(3)	6,400
Interest on underpaid corporation tax		5,800
Gift Aid donation		2,500
Dividends paid to shareholders		50,000

Notes

(1) Debenture interest actually received in the period was £6,000.

(2) GH Ltd granted a 35 year lease to I plc on 30 March 2010.

(3) Loan stock interest actually paid in the period was £5,760. The loan was used to finance the trade.

(4) GH Ltd disposed of a capital asset which gave rise to an allowable capital loss of £16,000.

Required

Prepare a statement of profits chargeable to corporation tax for GH Ltd and calculate the corporation tax liability for the year ended 31 March 2010.

28 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 an unconnected 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

Calculate IJ plc's corporation tax liabilities for the 15 months ended 30 June 2009, and state the due dates of payment.

29 Trading income statement

K Ltd produced accounts for the year to 31 March 2010 and has supplied the following information:

	Notes	£
Profit before taxation per financial accounts		202,640
This figure is		
– after charging the following items:		
Depreciation		109,880
Gifts and donations	(1)	3,400
Repairs and renewals	(2)	141,000
Professional fees	(3)	13,600
Other expenses	(4)	469,620

	Notes	£
– after crediting the following items:		
Profit on the sale of a warehouse	(5)	85,910
Loan interest	(6)	13,560

Notes

(1) **Gifts and donations** were as follows:

	£
Donation to a national charity under the Gift Aid scheme	660
Donation to a national charity *not* under the Gift Aid scheme	275
Gifts to customers	1,600
Gifts to staff at Christmas	865
	3,400

All the gifts to customers displayed KL Ltd's name. The gifts were 18 bottles of champagne costing £40 each and 16 cut glass decanters costing £55 each.

(2) **Repairs and renewals**

	£
Maintenance of plant and machinery	62,000
Extension to the workshop	53,100
Rebuilding a chimney damaged in a storm	25,900
	141,000

(3) **Professional fees** were as follows:

	£
Accountancy and audit fees	5,950
Legal fees: court case for breaching health and safety legislation	950
Debt collection fees	2,050
Legal fees: renewal of a 60 year lease on a warehouse	1,450
Legal fees: the issue of new debentures	3,200
	13,600

(4) **Other expenses**

Other expenses include £100,000 spent on a staff Christmas party, interest on overdue tax of £3,600 and a pollution fine of £16,000. The remaining expenses are all allowable.

(5) **Profit on the sale of a warehouse**

A chargeable gain of £56,160 arose on the disposal.

(6) **Loan interest**

The loan interest represents interest receivable in the period and relates to a loan made to another company on 1 January 2010. The loan was made for a non-trading purpose.

(7) **Capital allowances**

The capital allowances claim for the year ended 31 March 2010 was £45,035.

Required

For KL Ltd for the year ended 31 March 2010, calculate the:

(a) trading income assessment

(b) PCTCT

(c) corporation tax liability.

30 Adjustment of profit and PCTCT

MN Ltd prepares accounts to 30 September annually. The profit before taxation for the year to 30 September 2009 was £5,125,000 after taking account of the following income and expenditure:

	Notes	£000
Income		
Sales revenue		510,900
Bank deposit interest		160
Dividends received from UK companies		40
Royalty income		100
Expenditure		
Cost of sales		458,970
Rent and rates		2,740
Lighting and heating		1,120
Office salaries		18,660
Repairs to premises	(1)	2,620
Motor expenses		740
Depreciation – vans		2,800
Depreciation – equipment		750
Amortisation of lease		120
Loss on sale of equipment		40
Professional charges	(2)	375
Sundry expenses	(3)	770
Staff salaries		14,000
Directors' salaries		2,130

Notes

(1) **Repairs to premises**

	£000
Alteration of floor to install new display stands	1,460
Decoration	475
Re-plastering walls damaged by damp	685
	2,620

(2) **Professional charges**

	£000
Accountancy	200
Court action – breach of customs regulations	110
Legal costs – acquiring a new lease	20
Debt collection	45
	375

(3) **Sundry expenses**

	£000
Fine for breach of customs regulations	250
Trade subscription	50
Donation to police welfare fund	20
Entertaining customers	300
Paperweights bearing firm's name sent to 4,000 customers	120
Royalties payable	15
Miscellaneous allowable expenses	15
	770

(4) On 25 June 2009 MN Ltd had been granted a 21 year lease by Turin plc on new premises at a premium of £12.6 million. This has been recognised in the leasehold property account on the balance sheet.

(5) MN Ltd's capital allowances for the year ended 30 September 2009 total £460,000.

Required

Prepare an adjustment of profit computation and PCTCT statement for MN Ltd, based on the accounts to 30 September 2009.

31 OP Ltd

OP Ltd has been trading for many years, preparing accounts to 31 March annually. The tax written down value on the general pool at 1 April 2009 was £12,000. In the year to 31 March 2010 the following fixed asset transactions took place:

2 April 2009	purchased plant costing £6,000
23 April 2009	sold two vans for £8,450 each and bought two replacement vans for £5,200 each
11 August 2009	purchased two cars costing £6,100 each. These had CO_2 emissions of 143 g/km. One of the cars is used to the extent of 30% by the company secretary for private motoring
15 November 2009	purchased two cars for use by salesmen, one car costing £12,500, the other costing £14,500. The first car has CO_2 emissions of 175 g/km. The second car has CO_2 emissions of 110 g/km
19 January 2010	purchased second-hand computer equipment at a cost of £3,000

Required

Calculate the capital allowances available for the year to 31 March 2010.

32 RS plc

RS plc, which has no associated companies, has traded for many years in Deeside, making up accounts to 31 March annually. Its profit and loss account for the year to 31 March 2010 is as follows.

	Notes	£		Notes	£
Salaries and wages		229,248	Gross profit		723,884
Directors' remuneration		99,819	Interest on War Loan		700
Rates, electricity and insurance		2,629	UK dividends (including tax credits)		12,000
Travelling expenses		1,791			
General expenses	(1)	18,052	Gain on sale of shares	(3)	4,700
Repairs	(2)	3,480	Royalty income	(4)	2,000
Audit and accountancy		11,210			
Royalties payable	(4)	5,000			
Debenture interest		5,000			
Depreciation		21,170			
Profit before tax		345,885			
		743,284			743,284

Notes

(1) **Analysis of general expenses**

	£
Stationery, postage and telephone	332
Legal expenses	
Rights issue of shares	3,150
Collection of trade debts	750
Gift Aid payments	
Oxfam	500
Save the Children Fund	500
Staff Christmas party (200 employees)	3,140
Contribution to Deeside Enterprise Agency	1,000
Director's relocation expenses	4,000
Sundry expenses	4,680
	18,052

(2) Repairs are all allowable.

(3) The taxable capital gain arising on the sale of these shares was calculated as £500.

(4) All royalties were received from and paid to other UK companies.

(5) The written down value of plant at 1 April 2009 was £14,240.

During the year to 31 March 2010 the following transactions in fixed assets took place:

		£
30 June 2009	Sale of plant (cost £750)	780
1 July 2009	New car purchased (CO_2 emissions of 150 g/km)	8,616
1 August 2009	Car purchased for the managing director (CO_2 emissions of 110 g/km, private use 30%)	27,000

(6) The company paid a dividend of £220,000 on 30 September 2009.

Required

Compute the corporation tax liability of RS plc for the year to 31 March 2010.

33 Net chargeable gain

VW plc made the following capital disposals in its year ended 31 March 2010:

(1) In December 2009 a building held for investment purpose and bought in July 1992 was sold for £95,000. Legal fees and estate agent's costs on disposal amounted to £2,450. The cost of the cottage was £28,000 plus £1,460 legal fees and estate agent's costs. Immediately on acquisition £2,000 was spent on installing central heating. In August 1996 £1,500 was spent on redecorating the exterior of the property and a new bathroom was added in the same month at a cost of £5,600.

(2) An area of land was bought in August 1988 for £25,000 and sold in February 2010 for £75,000, legal fees on disposal being £400. £5,000 was spent on improving drainage in August 1990.

(3) In December 2009 a car used by the managing director was sold for £12,000. This had been purchased in May 2002 for £12,900.

VW plc has capital losses brought forward on 1 April 2009 of £8,450.

Required

Calculate the net chargeable gain to include in VW plc's PCTCT statement for the year ended 31 March 2010.

34 Replacement office building

XY Ltd sold a freehold office building on 15 August 2009 for £600,000. The building cost £220,000 on 14 July 1994. On 30 June 2009 XY Ltd purchased a smaller replacement office building for £540,000. XY Ltd does not expect to sell the replacement building until 2027. XY Ltd prepares accounts to 31 August each year. Both buildings were used for the purposes of the trade of XY Ltd.

Required

(a) Calculate the chargeable gain arising on the disposal of the original office building and the base cost of the new office building, assuming any available relief is claimed.

(b) Explain the difference in treatment if XY Ltd were to purchase fixed plant and machinery instead of the replacement office building.

35 Bonus issue and share disposal

On 1 January 2010 ZA plc sold 1,500 shares in Y plc for £7,500. The company's previous transactions in these shares have been as follows:

January 1999	Bought 1,500 shares for £2,000
July 2001	Bonus issue of 1 for 4

Required

Calculate the chargeable gain or allowable loss on the disposal of shares on 1 January 2010.

36 Rights issue and share disposal

BC plc has the following dealings in ordinary shares of X plc:

January 1986	Bought 1,000 shares for £3,000
July 1989	Bought 600 shares for £2,000
February 1992	X plc made a 1 for 2 rights issue for £2 per share
March 2010	Sold 2,200 X plc shares for £14,960

Required

Calculate the chargeable gains arising on the disposal of X plc shares.

37 Takeover and share disposal

DE plc bought 10,000 shares in S plc for £37,000 in August 1998. On 15 March 2005 H plc took over S plc and all shareholders in S plc received

- ten ordinary shares in H plc; and
- two preference shares in H plc

for every five shares they held in S plc.

Immediately after the takeover the ordinary shares were quoted at £3.80 each, and the preference shares at £2 each.

Required

Calculate the chargeable gain or allowable loss arising if DE plc were to sell half its ordinary shares in H plc for £5 per share on 1 March 2010.

38 FG Ltd: loss relief

FG Ltd's results for recent accounting periods have been as follows:

	Year to 31 December 2008	Year to 31 December 2009	Period to 31 March 2010
	£	£	£
Trading profit/(loss)	326,400	88,800	(220,800)
Interest income	10,000	10,000	10,000
Chargeable gains	28,800	30,720	33,600
Gift Aid donations	(2,400)	(2,400)	(2,400)

Required

Calculate the PCTCT of FG Ltd for each accounting period assuming losses are relieved as soon as possible, and calculate the loss left to carry forward, if any.

39 HI Ltd: loss relief

HI Ltd prepared its accounts to 30 November each year until 30 November 2007. It then changed its accounting date to 31 March by preparing a four month set of accounts to 31 March 2008. HI Ltd has supplied the following information:

	Year ended 30 Nov 2007	Period to 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)	Nil	(1,170)	(1,170)

Required

(a) Calculate the PCTCT for each CAP assuming losses are relieved in the most tax-efficient manner.

(b) Calculate the losses available to carry forward, if any, at 31 March 2010.

40 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 R Inc, 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.

41 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.

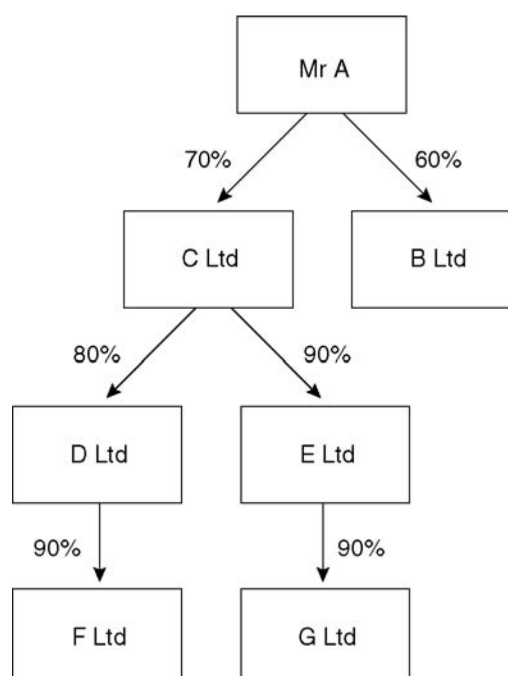
LM Ltd expects the overseas operation to be very profitable, and anticipates regular remittances back to the UK. LM Ltd does not currently have any associated companies.

Required

Contrast the key consequences of operating overseas via a branch or a non-UK resident subsidiary.

42 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

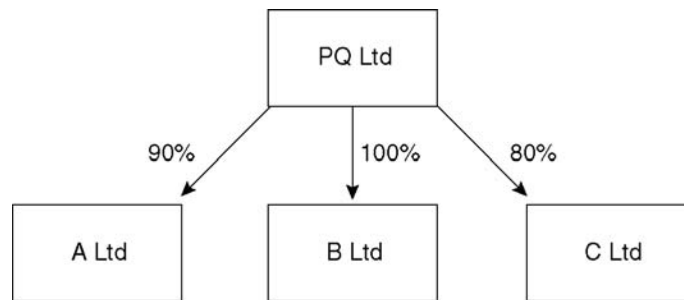
(a) Calculate the statutory thresholds for corporation tax purposes which will apply for each of the above companies for the year to 31 March 2010 to determine the appropriate rates of corporation tax.

(b) Identify, with explanations, the groups which are present in the above structure for the purposes of surrendering and receiving trading losses.

(c) Calculate the corporation tax saving made on the assumption that group relief is claimed in the most efficient manner.

(d) Calculate the PCTCT for each company based on your advice in part (c).

43 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 June 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.

44 Payment of tax

TU Ltd has a 31 May year end. For the year ended 31 May 2009 its corporation tax liability was £389,400.

Required

State the amounts payable by TU Ltd and the due dates of payment for the year ended 31 May 2009 assuming that TU Ltd:

(a) does not pay tax at the full rate of corporation tax

(b) does pay tax at the full rate of corporation tax.

45 Candice

Candice has provided the following information:

	2008/09	2009/10
	£	£
Income tax liability	17,000	20,000
Class 4 NICs	700	880
Capital gains tax liability	Nil	4,600
Tax deducted at source	3,500	4,000

Required

(a) Calculate the tax payable under self assessment for 2009/10 and state the due dates for payment.

(b) State how interest would be calculated assuming Candice made the following payments:

	Amount	Paid in
	£	
1st POA	7,000	14 February 2010
2nd POA	7,000	18 August 2010
Balancing payment	2,880	28 January 2011

46 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 from which date she should charge VAT on her invoices.

(b) Explain whether Deborah will be able to recover any pre-registration input tax suffered.

47 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

Calculate the VAT payable for the quarter ended 31 March 2010 and state the due date for payment.

Q&A

Answers to practice questions

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1 Angela

Angela income tax computation: 2009/10

	Total income	Other income	Savings income	Dividend income
	£	£	£	£
Earned income				
Employment income	35,000	35,000		
Savings income (gross)				
Building society interest (£2,400 × 100/80)	3,000		3,000	
UK dividends received (£9,000 × 100/90)	10,000			10,000
Total Income	48,000	35,000	3,000	10,000
PA	(6,475)	(6,475)		
Taxable income	41,525	28,525	3,000	10,000

Income tax liability		Income	Tax rate	Tax
Basic rate band	Other income	28,525	× 20%	5,705
	Savings	3,000	× 20%	600
	Dividends	5,875	× 10%	588
		37,400		
Higher rate band	Dividends	4,125	× 32.5%	1,341
		41,525		
Income tax liability				8,234

Note: Premium bond prizes are exempt from income tax.

2 Brian

Brian income tax computation: 2009/10

	Total income	Other income	Savings income	Dividend income
	£	£	£	£
Earned income				
Trading income	20,000	20,000		
Employment income	25,660	25,660		
Savings income (gross)				
Bank deposit interest (£4,100 × 100/80)	5,125		5,125	
UK dividends received (£1,890 × 100/90)	2,100			2,100
	52,885	45,660	5,125	2,100
Minus: Allowable interest	(200)	(200)		
Net income	52,685	45,460	5,125	2,100
PA	(6,475)	(6,475)		
Taxable income	46,210	38,985	5,125	2,100

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Income tax liability		Income	Tax rate	Tax
		£	£	£
Basic rate band	Other income	38,000	× 20%	7,600
Extended basic rate band (W1)		38,000		
Higher rate band	Other income	985	× 40%	394
	Savings	5,125	× 40%	2,050
	Dividends	2,100	× 32.5%	682
		46,210		
Income tax liability				10,726
Minus Tax credits/deducted at source				
Dividend income: (£2,100 × 10%)				(210)
Savings income: (£5,125 × 20%)				(1,025)
PAYE				(8,287)
Income tax payable				1,204

Notes

(1) Gift Aid donations are paid by an individual net of 20% income tax. The basic rate band is extended by the gross amount of the Gift Aid donation.

(2) National lottery winnings and income from ISAs are exempt from income tax.

Working: Extension of basic rate band	
	£
Basic rate band limit	37,400
Gift Aid donation: (£480 × 100/80)	600
Extended basic rate band	38,000

3 Paul

(a)

	£	£
Rent receivable (accruals basis):		
April–December – 9/12 × £8,000	6,000	
January–March – 3/12 × £8,800	2,200	8,200
Expenditure:		
Council tax	960	
Water rates	380	
Agent's fees	780	
Decoration	1,250	
Interest	2,500	
Wear and tear		
(£8,200 - £960 – £380) × 10%	686	(6,556)
Assessable amount		1,644

The new central heating system is capital expenditure and therefore not deductible.

(b) 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 to the same person).

As Paul's property appears to be let on an annual basis to the same tenant, it does not currently qualify as a furnished holiday letting.

4 Flash plc

Benefits assessed in 2009/10

Company cars

	Arthur	Benny	Charlotte	Arthur	Benny	Charlotte
				%	%	%
CO_2 emissions (rounded down to nearest 5 g/km)	135	200	260			
Base level	(135)	(135)	(135)			
	Nil	65	125	Nil	13	25
Minimum percentages				18	15	15
Appropriate percentages (restricted to maximum 35%)				18	28	35
Number of months car is available in 2009/10				8	12	12

Arthur's benefits

	£		£
Car benefit			
Manufacturer's list price	13,500	× 18% × 8/12	1,620
Fuel benefit	16,900	× 18% × 8/12	2,028
Total assessable benefits for Arthur			3,648

Benny's benefits

	£		£
Car benefit			
Manufacturer's list price	20,800		
Minus: Capital contributions (not restricted, since below maximum of £5,000)	(4,400)		
	16,400	× 28%	4,592
Fuel benefit	16,900	× 28%	4,732
Total assessable benefits for Benny			9,324

Charlotte's benefits

	£		£
Car benefit			
Manufacturer's list price	22,600	× 35%	7,910
Minus: Contribution towards use of car			(1,200)
			6,710
Fuel benefit	16,900	× 35%	5,915
Total assessable benefits for Charlotte			12,625

Note

Contributions towards private fuel costs are not an allowable deduction.

Daphne's benefits

		£	£
Mileage allowance received	12,000 × 30p		3,600
Statutory mileage allowance	10,000 × 40p	4,000	
	2,000 × 25p	500	
			(4,500)
			(900)

Daphne does not have an assessable benefit. Instead, due to the shortfall of allowance received, Daphne can deduct £900 from her employment income.

Ernest's benefit:

Company van: £3,000 × 11/12 = £2,750.

Fuel: £500 x 11/12 = £458**.**

5 Richard

Richard: Employment income 2009/10	**£**
Salary	56,000
Bonus (paid 31 May 2009)	22,000
Assessable benefits	
Overnight expense allowance	60
Annual staff party (exempt, because below £150 per head)	Nil
Beneficial loan (see working)	722
	78,782
Allowable deductions:	
Subscription to professional body	(150)
Donation under payroll giving scheme	(100)
Employment income	78,532

Note

The full amount of the overnight expense allowance is taxable as it exceeds £5 a night.

Working: beneficial loan

(1) Average method	**£**
Average amount = (£30,000 + £25,000)/2 =	27,500
Interest at the official rate: £27,500 × 4.75%	1,306
Interest paid	(525)
Assessable benefit, average method	781

(2) Strict method	**£**
Interest at the official rate:	
From 6 April 2009 to 6 July 2009 (3 months): £30,000 × 4.75% × 3/12	356
From 6 July 2009 to 5 April 2010 (9 months): £25,000 × 4.75% × 9/12	891
	1,247
Interest paid	(525)
Assessable benefit	722

Note

Richard should insist on the strict method being used, because this gives a lower taxable benefit.

6 Colin

Colin: computation of adjusted profits
Seven months ending 31 January 2010

		£
Net profit		67,750
Add	Depreciation	26,000
	Owner's personal income tax and NICs	6,400
	Hire charge (W1)	840
	Write off of loan to customer	2,250
	Car expenses (W2)	340
	Goods taken out for own use (see note)	120
Adjusted profit		103,700

Notes

The full market value of goods taken out of the business by the owner must be added to profit, as no entry at all has been made in the accounts of the business.

The sales manager's expenses are fully allowable for the business. Private use by an employee is not relevant. The sales manager will be assessed on the private use of his company car in his income tax computation.

W1: Hire of car with CO_2 emissions over 160 g/km	**£**
Disallowable element of hire charge £5,600 × 15%	840

W2: Car expenses	£
Colin's car expenses: ½ × £3,400	1,700
Add to profit the private % of these expenses: £1,700 × 20%	340

7 Ashley and Cheryl

(a) **Capital allowances, 7 months ended 31 January 2010**

		Main pool	Total allowances
		£	£
Acquisitions not qualifying for AIAs			
Car for manager			
WDA: (£11,000 × 20% × 7/12)		11,000	
		(1,283)	1,283
		9,717	
Additions qualifying for AIA			
Production line	140,000		
AIA (50,000 × 7/12)	(29,167)		29,167
	110,833		
FYA (110,833 x 40%)	(44,333)	66,500	44,333
TWDV c/f		76,217	
Total allowances			74,783

Notes

(1) The private use of the car by the sales manager is irrelevant. The sales manager will be assessed on the private use of his company car in his income tax computation. As the car's CO_2 emissions are between 111 and 160 g/km, it is put in the main pool.

(2) The automotive production line is not a long-life asset as it has an estimated useful life of less than 25 years.

(b) **Capital allowances computation – y/e 31 March 2010**

		Main pool	Jaguar car	Short-life asset	Total allowances
	£	£	£	£	£
TWDV b/f		113,420	22,880	3,410	
Additions qualifying for AIAs					
IT equipment	7,370				
AIA	(7,370)	Nil			7,370
Additions not qualifying for AIAs					
Renault car		11,000			
Disposals –					
Lower of cost or sale proceeds			(36,960)	(500)	
		124,420	(14,080)	2,910	

	Main pool	Jaguar car	Short-life asset	Total allowances
Balancing charge		14,080		(14,080)
Balancing allowance			(2,910)	2,910
WDA (20%)	(24,884)			24,884
TWDV c/f	99,536			
Total allowances				21,084

8 Daniel

Daniel: computation of adjusted profits after capital allowances
15 month period ending 30 June 2010

		£
Net profit		94,500
Add	Depreciation	10,000
	Motor expenses (25% × £3,750)	937
	Fine for breach of health regulations	5,000
	Computer software (capital)	2,100
	Premium for granting of lease (capital)	6,000
		118,537
Minus	Building society interest	(2,000)
	Rental income	(6,000)
	Allowable deduction for short lease	(98)
Adjusted profit before capital allowances		110,439
Minus	Capital allowances (W3)	(63,550)
Adjusted profit after capital allowances		46,889

Notes

(1) The computer software is disallowable capital expenditure. However, capital allowances are available on the cost of the software with the cost of the new computer system.

(2) The premium paid to purchase the leasehold interest is disallowable capital expenditure. However, an annual allowance is available for part of the cost of the lease if the building is used for the purpose of Daniel's trade.

Workings

W1: Allowable deduction for short lease

	£
Premium paid	6,000
Minus: 2% × £6,000 × 11 years	(1,320)
Property income assessment on E Ltd	4,680
Annual allowable deduction for Daniel (£4,680 ÷ 12 years)	£390

Daniel owned the leasehold interest for 3 months in the accounting period. Therefore the allowable deduction for the period ending 30 June 2009 is:

£390 × 3/12 = **£98**.

Note

The allowable deduction is apportioned by 3/12 because the figure of £390 is the annual (i.e. 12 month) deduction.

W2: Capital allowances

		Main pool	P/U car 1	P/U car 2		Total allowances
		£	£	£		£
TWDV b/f		78,000	6,400			
Additions qualifying for FYA						
Computer system	15,000					
Software	2,100					
Plant and machinery	28,000					
	45,100					
AIA	(45,100)	Nil				45,100
Additions not qualifying for FYA				16,000		
Disposals			(9,800)			
		78,000	(3,400)	16,000		
			× 75%			(2,550)
WDA: 15/12 × 20%		(19,500)				19,500
WDA: 15/12 × 10%				(2,000)	× 75%	1,500
TWDV c/f		58,500		14,000		
Total allowances						63,550

Notes

(1) The computer system and software have an expected useful life of three years. However, it is not beneficial to make a short-life asset election as their cost is fully covered by the AIA.

(2) The accounting period is more than 12 months. The WDA must therefore be adjusted by × 15/12 to allow for the 15-month accounting period.

9 Industrial building

ST Ltd: Industrial buildings allowances

		Qualifying cost
		£
Building		
Manufacturing area	Allowable	169,000
Warehouse	Allowable	42,000
Showroom	See working below	4,000
Drawing office	Allowable	2,000
Canteen	Allowable	3,000
Accounts office	See working below	19,000
Land	Not allowable	Nil
Site preparation	Allowable	1,000
		240,000

Working

25% × Total cost of all buildings on the site (excluding land)

= 25% × (£300,000 – £60,000) = £60,000

Cost of showroom and accounts office = (£4,000 + £19,000) = £23,000.

Therefore costs of showroom and accounts office qualify.

Allowances

	Allowances claimed
	£
y/e 31 March 2009	
WDA (3% x 240,000)	7,200
y/e 31 March 2010	
WDA (2% × £240,000)	4,800

y/e 31 March 2011
No allowances due as not in use at end of accounting period.
No balancing charge as building disposed of after 21 March 2007.

10 Hannah

(a) **Trade starts: 1 May 2007. This is in the tax year 2007/08**

Tax year	Basis of assessment	Basis period	Workings	Trading income assessment
				£
2007/08	Actual	1.5.07– 5.4.2008	11/16 × £60,000	41,250
2008/09	12 months ending in 2nd year	1.9.2007 – 31.8.2008	12/16 × £60,000	45,000

Tax year	Basis of assessment	Basis period	Workings	Trading income assessment
2009/10	12 months ending in 3rd year	Year ended 31.8.2009		84,000
2010/110	CYB	Year ended 31.8.2010		90,000
Overlap profits	1.9.2007 – 5.4.2008		7/16 × £60,000	26,250

(b) **Trade ceases: 30 April 2011. This is in the tax year 2011/12**

	£
Penultimate tax year = 2010/11: CYB year ended 31.8.2010	90,000
Final tax year = 2011/12	
Profits not yet assessed	70,000
Minus: Overlap profits	(26,250)
Closing year trading income assessment	43,750

11 Ian

(a) **Trade starts: 1 February 2006. This is in the tax year 2005/06**

Tax year of change = Earlier of the first tax year when the accounts are:

(1) prepared to the new accounting date (i.e. 2009/10), and

(2) not prepared to the old accounting date (i.e. also 2009/10).

Tax year	Basis of assessment	Basis period	Workings (nearest month)	Trading income assessment
				£
2005/06	Actual	1.2.2006 – 5.4.2006	2/4 × £8,280	4,140
2006/07	First 12 months trading	1.2.2006 – 31.1.2007	£8,280 + (8/12 × £10,440)	15,240
2007/08	12 months ending in third year	y/e 31.5.2007		10,440
2008/09	CYB	y/e 31.5.2008		38,840
2009/10	See working			53,385
2010/11	CYB	y/e 30.9.2010		61,030

Overlap profits

		£
Opening years		
1.2.2006 – 5.4.2006	(2/4 × £8,280)	4,140
1.6.2006 – 31.1.2007	(8/12 × £10,440)	6,960
		11,100
On change of accounting date: amount relieved		(4,440)
Overlap profits to carry forward		6,660

Note

The overlap profits in the opening years = 10 months' profits.

Working

Gap period = 1.6.2008 – 30.9.2009

Gap period is more than 12 months. Assess the profits of the gap period and deduct overlap relief.

		£
Profits of the gap period (1.6.2008 – 30.9.2009)		57,825
Minus: Overlap relief	£11,100 × (16 – 12)/10	(4,440)
		53,385

(b) **Ceased to trade: 31 January 2012. This is in the tax year 2011/12**

	£
Penultimate tax year = 2010/11: CYB year ended 30.9.2010	61,030
Final tax year = 2011/12	
Profits not yet assessed	
Year ending 30.9.2011	46,120
Period ending 31.1.2012	10,100
	56,220
Minus: Overlap profits	(6,660)
Closing year trading income assessment	49,560

12 Trading loss

Year ended	Basis of assessment	Tax year	Trading income assessment
			£
31 May 2007	CYB	2007/08	8,200
31 May 2008	CYB	2008/09	6,600
31 May 2009	CYB	2009/10	Nil
31 May 2010	CYB	2010/11	6,800

2009/10 is the tax year of the loss.

Martin: Income tax computations

	2007/08	2008/09	2009/10	2010/11
	£	£	£	£
Trading income	8,200	6,600	Nil	6,800
Minus: Additional loss relief	(2,310)	Nil	Nil	Nil
	5,890	6,600	Nil	6,800
Dividend income	600	600	600	500
	6,490	7,200	600	7,300
Allowable interest	(100)	(100)	(100)	(100)
Total income before relief	6,390	7,100	500	7,200

Martin: Income tax computations

	2007/08	2008/09	2009/10	2010/11
Minus: s64 loss relief	-	(7,100)	-	-
	6,390	Nil	500	7,200
PA	(6,390)	(wasted)	(500)	(6,475)
Taxable income	Nil	Nil	Nil	725

Record of trading losses

	2009/10
	£
Trading loss in tax year	9,410
S64 loss relief claimed	
- in 2008/09	(7,100)
	2,310
Additional loss relief in 2007/08	(2,310)
Carried forward	Nil

Note

No s64 claim would be made in 2009/10 as the income is covered by the personal allowance.

13 Loss relief in the opening years

(a) Trade starts: 1 July 2009. This is in the tax year 2009/10.

Tax year	Basis of assessment	Basis period	Workings (nearest month)		Trading income to assess
				£	£
2009/10	Actual	1.7.2009 – 5.4.2010	9/12 × £28,800 loss	(21,600)	Nil
2010/11	12 months ending in 2nd year	Year ended 30.6.2010	Loss in period	(28,800)	
			Loss already used in calculation	21,600	
				(7,200)	Nil
2011/12	12 months ending in 3rd year	Year ended 30.6.2011		6,000	6,000

(b) **Loss relief available**

Tax year of loss	Amount of loss	Loss relief available against total income	
	£	**Under s64 in:**	**Under s72 in:**
2009/10	21,600	1. 2009/10 and/or 2. 2008/09 - in either order	1. 2006/07 and then 2. 2007/08 and then 3. 2008/09 - in that strict order

Tax year of loss	Amount of loss	Loss relief available against total income	
2010/11	7,200	1. 2010/11 and/or 2. 2009/10 - in either order	1. 2007/08 and then 2. 2008/09 and then 3. 2009/10 - in that strict order
	28,800		

(c) **Nathan: income tax computations**

	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12
	£	£	£	£	£	£
Trading income				Nil	Nil	6,000
Minus: s83 trading loss b/f				(Nil)	(Nil)	(Nil)
				Nil	Nil	6,000
Employment income	22,848	26,520	14,083			
Other income	9,600	9,600	9,600	9,600	9,600	9,600
Total income before loss relief	32,448	36,120	23,683	9,600	9,600	15,600
s72 relief						
- 2009/10 loss	(21,600)					
- 2010/11 loss		(7,200)				
Total income after losses	10,848	28,920	23,683	9,600	9,600	15,600
PA	(6,475)	(6,475)	(6,475)	(6,475)	(6,475)	(6,475)
	4,373	22,445	17,208	3,125	3,125	9,125

14 Terminal loss relief

Oscar: income tax computations

	2006/07	2007/08	2008/09	2009/10	2010/11
	£	£	£	£	£
Trading income (W1)	40,000	33,000	20,000	Nil	Nil
Minus: terminal loss	-	(Nil)	(19,700)	(Nil)	(Nil)
	40,000	33,000	300	Nil	Nil
Dividend income (£261 × 100/90)	290	290	290	290	290
	40,290	33,290	590	290	290
Allowable interest	(300)	(300)	(300)	(300)	(300)
	39,990	32,990	290	Nil	Nil
PA	(6,475)	(6,475)	(290)	(wasted)	(wasted)
	33,515	26,515	Nil	Nil	Nil

Workings

(W1) Trading income assessment

Ceased to trade: 30 June 2010. This is in the tax year 2010/11.

	£
Final tax year = 2010/11	
Profits not yet assessed	
Period ending 30 June 2010	5,000
Minus: Overlap profits	(6,200)
Net loss	(1,200)
Final tax year assessment	Nil

(W2) Terminal loss

	£	£
Overlap profits not yet relieved		6,200
Last tax year		
Actual loss (6.4.2010 – 30.6.2010): 3/6 × £5,000 profit - ignore		Nil
12 months before cessation to 5 April before cessation		
1.7.2009 to 5.4.2010 = 9 months		
Actual loss		
Period 1.7.2009 – 31.12.2009: (6/12 × £32,000 loss)	(16,000)	
Period 1.1.2010 – 5.4.2010: (3/6 × £5,000 profit)	2,500	
Net loss	(13,500)	13,500
Terminal loss of last 12 months trading		19,700

This loss is carried back against trading income on a LIFO basis. Therefore all £19,700 will be relieved in 2008/09 against the trading income of £20,000.

15 Partnership profit

Partnership allocation: year ending 31 December 2009

	Total	**Eric**	**Fred**	**George**
	£	£	£	£
4 months to 30 April 2009				
Balance of profits (3:2:1) (4/12 × £60,000)	20,000	10,000	6,667	3,333
8 months to 31 December 2009				
Salary (£20,000 × 8/12)	13,333	13,333		
Balance of profits (2:2:1)	26,667	10,667	10,667	5,333
	40,000	24,000	10,667	5,333
12 months to 31 December 2009				
Total profit allocation	60,000	34,000	17,334	8,666

16 Change in partnership

Allocation of partnership profits

	Total	Jacob	Ken	Lesley	Mike
	£	£	£	£	£
Year to 30 June 2008					
Profits shared equally	24,000	8,000	8,000	8,000	-
Year to 30 June 2009					
Profits shared equally					
1.7.2008 – 31.1.2009	18,900	6,300	6,300	6,300	-
(7/12 × £32,400)					
1.2.2009 – 30.6.2009					
(5/12 × £32,400)	13,500	4,500	-	4,500	4,500
	32,400	10,800	6,300	10,800	4,500
Year to 30 June 2010					
Profits shared equally	43,200	14,400	-	14,400	14,400

Trading income assessments of Jacob and Lesley (continuing partners)

Tax year	Basis of assessment	Trading income assessment
		£
2008/09	CYB y/e 30.6.2008	8,000
2009/10	CYB y/e 30.6.2009	10,800
2010/11	CYB y/e 30.6.2010	14,400

Trading income assessments of Mike (new partner)

		£
Share of profits:	5 months to 30.6.2009	4,500
	y/e 30.6.2010	14,400

Started to trade: 1 February 2009. This is in the tax year 2008/09

Tax year	Basis of assessment	Basis period	Workings (nearest month)	Trading income assessment
				£
2008/09	Actual	1.2.2009 – 5.4.2009	2/5 × £4,500	1,800
2009/10	First 12 months trading	1.2.2009 – 31.1.2010	£4,500 + (7/12 × £14,400)	12,900
2010/11	12 months ending in 3rd year	Year ended 30.6.2010		14,400

Mike's overlap profits

Opening years		£
1.2.2009 – 5.4.2009	(2/5 × £4,500)	1,800
1.7.2009 – 31.1.2010	(7/12 × £14,400)	8,400
		10,200

Trading income assessments of Ken (retiring partner)

Ceased to trade: 1 February 2009. This is in the tax year 2008/09.

	£
Penultimate tax year = 2007/08: CYB year ended 30.6.2007	
Final tax year = 2008/09	
Profits not yet assessed	
Year ending 30.6.2008	8,000
Period ending 31.1.2009	6,300
	14,300
Minus: Overlap profits	(2,000)
Closing year trading income assessment	12,300

17 Partnership loss

(a) **Allocation of partnership loss: year ending 31 March 2010**

	Total	Peter	Paul	Mary
	£	£	£	£
9 months 1 April to 31 December 2009				
Salary (£16,000 or £28,000 × 9/12)	33,000	12,000	21,000	-
Balance of the loss (65%:35%)	(109,200)	(70,980)	(38,220)	-
	(76,200)	(58,980)	(17,220)	-
Period 1 January 2010 to 31 March 2010				
Balance of the loss (2:2:1)	(25,400)	(10,160)	(10,160)	(5,080)
Allocation of loss	(101,600)	(69,140)	(27,380)	(5,080)

(b) **Loss relief options**

Peter and Paul (continuing partners)

Tax year of the loss = 2009/10
Peter and Paul have the following options with their share of the loss:

- Claim s64 relief against total income in:
  - 2009/10 and/or
  - 2008/09
- Extend the claim against capital gains in the same years.
- Claim additional relief against trading profits of 2007/08 and 2006/07.
- Carry forward the loss against future trading profits under s83.

Peter and Paul will make their own decisions independently, according to their own personal circumstances. They are not both obliged to make the same claims.

Mary (new partner)

Opening year loss = 2009/10

Actual loss 1.1.2010 – 31.3.2010 = £5,080.

Mary has the following options with her share of the loss:

- Claim s64 relief against total income in:
  - 2009/10 and/or
  - 2008/09
- Extend the claim against capital gains in the same years.
- Claim s72 relief against total income in:
  - 2006/07 and then
  - 2007/08 and then
  - 2008/09.
- Carry forward the loss against future trading profits under s83.

(c) **Limited liability partnership restriction**

	Peter	Paul	Mary
	£	£	£
Partner's share of loss	69,140	27,380	5,080
Partner's contribution (i.e. capital balance)	100,000	25,000	10,000

Peter and Mary have losses below the level of their contributions. Therefore their loss relief options are not restricted.

Paul can only claim £25,000 of his share of the loss against non-partnership income.

His claims against total income under s64 and extension claim against capital gains under s261B are therefore restricted.

The remaining loss of £2,380 (£27,380 - £25,000) can only be carried forward and set against future partnership income.

18 Stephen Honiton

Stephen Honiton: Employment income 2009/10	£
Salary	32,000
Assessable benefits	
Employer pension contributions (7%) = exempt	Nil
Living accommodation (W1)	3,750
Car benefits (W2)	4,210
Medical insurance – cost to employer	480
Subsidised meals – exempt	Nil
Workplace nursery – exempt	Nil
Holiday prize – cost to employer	1,200
Staff loan scheme	Nil
Write-off of loan	3,000
	44,640

Allowable deductions:	
Employee pension contributions (£32,000 × 5%)	(1,600)
Employment income	43,040

Notes

1. There is no private fuel benefit as Stephen pays for his petrol and is reimbursed for business travel only. Therefore the company does not pay for any private fuel. Stephen's wife pays for all her petrol.
2. There is no beneficial loan charge as the sum borrowed does not exceed £5,000.

Workings

(W1) Living accommodation	£	£
Capital benefit = annual value		1,700
Expensive accommodation benefit		Nil
(= Not applicable as the property cost less than £75,000)		
Revenue benefit		
Electricity	280	
Gas	410	
Gardener	240	
Re-decoration	680	
		1,610
Provision of furniture: (£6,400 × 20%)		1,280
		4,590
Minus: Contribution towards benefit (£70 × 12)		(840)
Total living accommodation benefits		3,750

(W2) Car benefits	Stephen's car	Wife's car		Stephen's car	Wife's car
				petrol %	petrol %
CO_2 emissions (rounded down to nearest 5 g/km)	160	135			
Base level	(135)	(135)			
	25	Nil	÷ 5	5	Nil
Minimum percentages				15	15
Appropriate percentages				20	15

	£		£
Stephen's car			
Manufacturer's list price	16,400	× 20%	3,280
Wife's car			
Manufacturer's list price	6,200	× 15%	930
			4,210

19 Pension contributions

As Hamish has earnings in excess of his contribution, all of his contribution will qualify for tax relief. The premium will have been paid net of basic rate tax. Higher rate relief will be given by extending the basic rate band by the amount of the contribution.

However, there will be a tax charge of 40% on the amount by which the contribution exceeds the annual allowance.

Herbert's income tax liability will therefore be as follows:

Trading income		350,000
Less:	Personal allowance	(6,475)
	Taxable income	343,525

Income tax liability

		£
On	287,400 @ 20%	57,480
	56,125 @ 40%	22,450
		79,930
Excess contribution charge (250,000 – 245,000) × 40%		2,000
		81,930

Basic rate band	37,400
Add: Gross value of pension contributions.	250,000
	287,400

20 Class 1 NICs

Class 1 primary and secondary contributions are based on cash earnings.

Salary = Cash earnings = **£45,000**.

Note

Cash earnings exclude all the benefits received by Vanessa. The donation under the payroll giving scheme is ignored as expense deductions are not allowed for NIC purposes.

	£
Class 1 primary contributions	
(£43,875 – £5,715) × 11%	4,198
(£45,000 – £43,875) × 1%	11
	4,209
Class 1 secondary contributions	
(£45,000 – £5,715) × 12.8%	5,028

Class 1A contributions

Class 1A contributions are based on the benefits received by Vanessa, but excluding the employer's pension contributions as these are exempt.

	£
Car benefit	6,450
Fuel benefit	4,320
Living accommodation	1,800
Total benefits liable to Class 1A NICs	12,570
Class 1A NICS (£12,570 × 12.8%)	1,609

21 Class 4 NICs

	William	Wendy
	£	£
Class 4 NICs		
(£25,000 – £5,715) × 8%	£1,543	
(£43,875 – £5,715) × 8%		3,053
(£50,000 – £43,875) × 1%		61
		3,114

22 Val

Val: Capital gains tax liability	Gains
	£
Garnet Ltd shares (W1)	45,000
Ruby plc shares (W2)	60,000
Holiday cottage (W3)	111,000
	216,000
Minus: Annual exemption	(10,100)
Taxable gain	205,900
Capital gains tax at 18%	37,062

Due date for payment: 31 January 2011

Workings

(W1) Garnet plc shares	£
Gross sale proceeds (May 2009)	55,000
Minus: Cost (June 2001)	(10,000)
Gain	45,000

(W2) Ruby plc shares	£
Gross sale proceeds (June 2009)	66,000
Minus: Cost (July 1988)	(6,000)
Gain	60,000

(W3) Holiday cottage	£
Gross sale proceeds (November 2009)	128,000
Minus: Cost (May 1992)	(17,000)
Gain	111,000

23 Anthony

Anthony: Capital gains tax liability	Gains
	£
Shares purchased 22 April 2009	13,500
Pool shares	75,136
Shares in S Ltd	8,710
Investment land	(4,000)
Net gains for the year	93,346
Minus capital losses b/f	(16,150)
Total net gains	77,196
Minus: Annual exemption	(10,100)
Taxable gain	67,096
Capital gains tax at 18%	12,077

Workings

(W1) R plc shares

Matching rules	Number of shares held	Disposal 18 April 2009	Remaining shares
1: Acquisition in following 30 days			
22 April 2009	11,000	(11,000)	Nil
2: Pool shares	50,000		
Rights issue (1 for 10)	5,000		
	55,000	(29,000)	26,000
		(40,000)	26,000

Chargeable gain on the disposal of shares acquired on 22 April 2009 (11,000 shares)	
	£
Market value (11,000 × £4.50)	49,500
Minus: Cost of shares	(36,000)
Gain	13,500

No gift relief is available as the shares are not qualifying assets for gift relief purposes. Gift relief is only available on quoted shares if the donor owns at least a 5% interest in the company.

Chargeable gain on the disposal of shares in the pool (29,000 shares)

	£
Market value (29,000 × £4.50)	130,500
Minus: Cost (from pool)	(55,364)
Gain	75,136

Pool

	Number of shares	Original cost
		£
16 October 1996	50,000	75,000
10 August 2007		
Rights issue (5,000 × £6)	5,000	30,000
	55,000	105,000
18 April 2009		
Gift to daughter	(29,000)	(55,364)
Pool balance c/f	26,000	49,636

Shares from the pool are removed at average cost:
£105,000 × 29,000/55,000 = £55,364

(W2) Plot of investment land

	£
Gross sale proceeds (February 2010)	10,000
Minus: Cost (September 1998)	(14,000)
Loss	(4,000)

(W3) S Ltd shares – 6,500 shares

	£
Gross sale proceeds (March 2010) (6,500 × £5)	32,500
Cost (September 2009) (£36,600 × 6,500/10,000)	(23,790)
Gain	8,710

24 Barry

Barry: Capital gains tax liability	Gains
	£
GH Ltd shares (W1)	39,000
Non-business asset	17,650
Net gains for the year	56,650

s261B loss claim (W2)	(9,100)
Minus capital losses b/f	(4,610)
Total net gains	42,940
Minus: Annual exemption	(10,100)
Taxable gain	32,840
Capital gains tax at 18%	5,911

Trading losses

	£
Trading loss in tax year	28,500
s64 current year claim	(19,400)
S261B current year claim	(9,100)
Trading loss c/f under s83	Nil

Capital losses

	£
Capital loss brought forward	4,610
Current year set off	(4,610)
Capital loss carried forward	Nil

Workings

(W1) Sale at undervaluation – GH Ltd shares

	£
Market value (6,000 × £15)	90,000
Minus: Cost	(6,000)
Gain before specific reliefs	84,000
Gift relief (see below)	(45,000)
Gain after specific reliefs	39,000

Gift relief

	£
Actual sale proceeds received	45,000
Original cost	(6,000)
= Gain	39,000
Gift relief (£84,000 – £39,000)	45,000

(W2) s261B trading loss relief – 2009/10

	£
Amount of relief available under s261B – Lower of:	
(1) Unrelieved trading loss after s64 claim (£28,500 – £19,400)	9,100

(W2) s261B trading loss relief – 2009/10	£
(2) Total gains for the year (£39,000 + £17,650)	56,650
Minus: Capital losses in year	(Nil)
Capital losses brought forward	(4,610)
Maximum amount	52,040

25 AB Ltd

AB Ltd
Corporation tax computation – year ended 31 March 2010

	£
Income	
Trading income	448,000
Interest income	24,000
UK property income	160,000
Chargeable gain	242,000
	874,000
Gift Aid donations	(4,000)
Profits chargeable to corporation tax (PCTCT)	870,000

	£
PCTCT	870,000
FII: (dividends received × $^{100}/_{90}$ = £72,000 + £18,000 × 100/90)	100,000
Profits	970,000

Small companies rate	Lower limit	300,000
	Upper limit	1,500,000

Rate of corporation tax decision: Tax rate =28% less marginal relief

Corporation tax liability	£
Corporation tax liability (PCTCT × 28%) (£870,000 × 28%)	243,600
Minus Marginal relief: (1,500,000 – 970,000) × 870,000/970,000 × 7/400	(8,319)
Corporation tax liability	235,281

Note

Dividends received from both UK and foreign companies are not taxable income and so do not appear in the computation of PCTCT. They are, however, classed as franked investment income and are taken into account in determining the level of profits.

26 EF Ltd

EF Ltd: Corporation tax liability computation – 4 months ending 31 December 2009

			£
PCTCT			168,450
FII: (£2,790 × 100/90)			3,100
Profits			171,550
Small companies rate	Lower limit	300,000 × $^{4}/_{12}$	100,000
	Upper limit	1,500,000 × $^{4}/_{12}$	500,000

Rate of corporation tax decision: Tax rate = 28% less marginal relief

Corporation tax liability	**£**
Corporation tax liability (£168,450 × 28%)	47,166
Minus Marginal relief: (500,000 – 171,550) × 168,450/171,550 × 7/400	(5,644)
Corporation tax liability	41,522

27 GH Ltd

GH Ltd
Corporation tax computation – year ended 31 March 2010

	£
Income	
Trading income	226,000
Interest income (W1)	1,400
UK property income (W2)	19,200
Capital gains	
Net chargeable gains (see note)	Nil
	246,600
Gift Aid donation	(2,500)
Profits chargeable to corporation tax (PCTCT)	244,100

Note

The capital disposal in the period gave rise to a capital loss. Capital losses can not be set against other profits. Capital losses can only be carried forward and set against future capital gains.

		£
PCTCT		244,100
FII: (£8,100 × 100/90)		9,000
Profits		253,100
Small companies rate	Lower limit	300,000
	Upper limit	1,500,000

Rate of corporation tax decision: Tax rate = 21%

Corporation tax liability	**£**
Corporation tax liability (PCTCT × 21%) (£244,100 × 21%)	51,261

Note

Ignore dividends paid to shareholders.

Workings

(W1)	**Interest income**	**£**
	Debenture interest receivable	7,200
	Minus: Interest on underpaid corporation tax	(5,800)
	Interest income	1,400

Notes

(1) The amount of debenture interest *actually* paid in the CAP is not relevant. Interest income is assessed on an accruals basis.

(2) Loan stock interest *payable* which is incurred for trading purposes is treated as an allowable deduction from trading income and is not deducted from interest income. The question gives the adjusted trading profits, therefore no further adjustment is required.

(W2)	**UK property income – Premium received on the granting of a short lease**	**£**
	Premium received	60,000
	Minus 2% × £60,000 × 34 years	(40,800)
	Property income assessment	19,200

28 Change of accounting date

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

IJ plc: Corporation tax computations	12 months ending 31 March 2009	3 months ending 30 June 2009
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.

29 Trading income statement

(a)

KL Ltd: Trading income assessment – year ended 31 March 2010		**£**
Profit before taxation		202,640
Add	Depreciation	109,880
	Gift Aid donation	660
	Donation to national charity not under Gift Aid	275
	Gifts of champagne to customers	720
	Gifts of decanters (cost in excess of £50 each)	880
	Extension of workshop	53,100
	Legal fees in relation to breaching health and safety legislation	950
	Legal fees in relation to renewal of long lease	1,450
	Interest on overdue tax	3,600
	Pollution fine	16,000
		390,155
Minus	Loan interest receivable	(13,560)
	Profit on the disposal of a warehouse	(85,910)
Adjusted profits before capital allowances		290,685
Minus	Capital allowances	(45,035)
Trading income assessment		245,650

Notes

(1) The extension of the workshop is capital expenditure and not an allowable deduction from trading income.

(2) Rebuilding the chimney will be an allowable trading expense provided it replaces the existing chimney and there is no capital improvement.

(3) Legal fees relating to the 60 year lease are not allowable as this is not the renewal of a *short* lease.

(4) Legal fees in relation to the raising of long-term finance are specifically allowable against trading income.

(5) All of the costs of providing the staff party is allowable for the company, regardless of the cost per head. However, if the party costs more than £150 a head, the employees will be assessed to income tax on the excess as a benefit of their employment.

(b)

KL Ltd **Corporation tax computation – year ended 31 March 2010**	**£**
Income	
Trading income	245,650
Interest income (see working)	9,960
Capital gains	
Chargeable gain	56,160
	311,770
Gift Aid donation	(660)
Profits chargeable to corporation tax (PCTCT)	311,110

(c)

		£
PCTCT		311,110
FII		Nil
Profits		311,110
Small companies rate	Lower limit	300,000
	Upper limit	1,500,000

Rate of corporation tax decision: Tax rate = 28% less marginal relief

Corporation tax liability	**£**
Corporation tax liability (£311,110 × 28%)	87,111
Minus Marginal relief: (1,500,000 – 311,110) × 7/400	(20,806)
Corporation tax liability	66,305

Working: Interest income	**£**
Loan interest receivable	13,560
Minus: Interest on overdue tax	(3,600)
Interest income	9,960

30 Adjustment of profit and PCTCT

MN Ltd: Trading income assessment – y/e 30 September 2009		£000
Profit before taxation		5,125
Add	Alteration to floor to install display stands	1,460
	Depreciation – vans and equipment (£2,800 + £750)	3,550
	Amortisation of lease	120

MN Ltd: Trading income assessment – y/e 30 September 2009		£000
	Loss on sale of equipment	40
	Breach of Customs regulations and fine (£110 + £250)	360
	Legal fees in relation to acquiring new lease	20
	Donation to police welfare fund	20
	Entertaining customers	300
		10,995
Minus	Bank deposit interest	(160)
	Dividends received	(40)
	Allowable deduction for short lease (see working)	(90)
Adjusted profits before capital allowances		10,705
Minus	Capital allowances	(460)
Trading income assessment		10,245

Notes

(1) Decoration and re-plastering walls will be treated as revenue expenditure and the cost is therefore allowable.

(2) Donation to the police welfare fund is not allowable as it is a donation to a national association.

(3) The gifts to customers are allowable as they bear an advertisement for the firm and cost less than £50 per customer.

(4) Royalties payable are treated as an allowable trading expense. Royalty income is treated as trading income.

MN Ltd

PCTCT statement – year ended 30 September 2009	£000
Income	
Trading income	10,245
Interest income	160
Profits chargeable to corporation tax (PCTCT)	10,405

Working: Allowable deduction for short lease	£000
Property income assessment on Turin plc	
Premium paid to Turin plc	12,600
Minus: 2% × £12,600,000 × 20 years	(5,040)
Property income assessment on Turin plc	7,560
Annual allowable deduction against profit (£7,560,000 ÷ 21 years)	360
Allowable deduction for year ended 30 September 2009: (leased for three months of MN Ltd's CAP) (£360,000 × $^{3}/_{12}$)	90

31 OP Ltd

OP Ltd - Capital allowances –y/e 31 March 2010		Main pool	Special rate pool	Total allowances
	£	£		£
TWDV b/f		12,000		
Additions qualifying for AIAs				
Plant: (2 April 2009)	6,000			
Vans: (23 April 2009)	10,400			
Computer equipment: (19 January 2010)	3,000			
	19,400			
AIA	(19,400)			19,400
		Nil		
Acquisitions not qualifying for AIAs		12,200	12,500	
Disposals		(16,900)		
		7,300		
Writing down allowance: 20%/10%		(1,460)	(1,250)	2,710
		5,840	11,250	
Low emission car	14,500			
FYA (100%)	(14,500)			14,500
		Nil		
TWDV c/f		5,840	11,250	
Total allowances available				36,610

Note

Private use of the car by the company secretary is irrelevant.

32 RS plc

RS plc Corporation tax computation	£
Income	
Trading income (working 1)	322,384
Interest income	700
Net chargeable gains	500
	323,584
Gift Aid donations	(1,000)
PCTCT	322,584

Rate of corporation tax		£
PCTCT		322,584
FII: (question quotes dividend including tax credit)		12,000
Profits		334,584
Small companies rate	Lower limit	300,000
	Upper limit	1,500,000

Rate of corporation tax decision: Tax rate = 28% less marginal relief

Corporation tax liability	**£**
Corporation tax liability (£322,584 × 28%)	90,324
Minus Marginal relief: (1,500,000 – 334,584) × 322,584 / 334,584 × 7/400	(19,663)
Corporation tax liability	70,661

Workings

Trading income assessment		**£**
Profit before taxation		345,885
Add	Legal fees in relation to rights issue of shares	3,150
	Gift Aid payments (£500 + £500)	1,000
	Depreciation	21,170
		371,205
Minus	Interest on War Loan	(700)
	UK dividends received	(12,000)
	Gain on sale of shares	(4,700)
Adjusted profits before capital allowances		353,805
Minus	Capital allowances (working 2)	(31,421)
Trading income assessment		322,384

Notes

(1) Royalties payable are an allowable trading expense. Royalty income is taxable trading income. Therefore no adjustment of profit is required in respect of royalties.

(2) Debenture interest payable is an allowable trading expense.

(3) Dividends paid are not an allowable trading expense.

(W2) Capital allowances

		Main pool (TWDV)	**Total allowances**
	£	£	£
TWDV b/f		14,240	
Acquisitions **not** qualifying for AIAs			
Car		8,616	
		22,856	
Disposals (restrict to cost)		(750)	
		22,106	
Writing down allowance: (20%)		(4,421)	4,421
		17,685	

		Main pool (TWDV)	Total allowances
Acquisitions qualifying for FYAs			
Low emission car	27,000		
FYA (100%)	(27,000)		27,000
		Nil	
TWDV c/f		17,685	
Total allowances available			31,421

Note

Private use of low emission car by managing director is irrelevant.

33 Net chargeable gain

VW plc: Net chargeable gains for y/e 31 March 2010	£
Investment building (W1)	35,913
Area of land (W2)	16,120
Managing director's car (W3)	-
	52,033
Minus: Allowable losses brought forward	(8,450)
Net chargeable gains	43,583

Workings

Working 1: Investment building	£
Gross sale proceeds (December 2009)	95,000
Minus: Incidental expenses	(2,450)
Net sale proceeds	92,550
Minus: Allowable costs	
July 1992 (£28,000 + £1,460 + £2,000)	(31,460)
August 1996	(5,600)
Unindexed gain	55,490
Minus: Indexation allowance	
July 1992 to December 2009	
[(215.2 – 138.8)/138.8] = 0.550 × £31,460	(17,303)
August 1996 to December 2009	
[(215.2 – 153.1)/153.1)] = 0.406 × £5,600	(2,274)
Chargeable gain	35,913

Note

Redecorating costs are not capital expenditure and are therefore not an allowable deduction in the capital gain computation.

Working 2: Area of land	**£**
Gross sale proceeds (February 2010)	75,000
Minus: Incidental expenses	(400)
Net sale proceeds	74,600
Minus: Cost (August 1988)	(25,000)
Enhancement (August 1990)	(5,000)
Unindexed gain	44,600
Minus: Indexation allowance	
August 1988 to February 2010	
[(216.0 – 107.9)/107.9] = 1.002 × £25,000	(25,050)
August 1990 to February 2010	
[(216.0 – 128.1)/128.1] = 0.686 × £5,000	(3,430)
Chargeable gain	16,120

(3) Managing director's car

Cars are exempt assets.

34 Replacement office building

(a)

XY Ltd: Chargeable gain on the disposal of the original office building	**£**
Sale proceeds (August 2009)	600,000
Minus: Cost (July 1994)	(220,000)
Unindexed gain	380,000
Minus: Indexation allowance	
July 1994 to August 2009	
[(214.4 – 144.0)/144.0] = 0.489 × £220,000	(107,580)
Chargeable gain before rollover relief	272,420
Minus: Rollover relief (see working)	(212,420)
Chargeable gain – y/e 31 August 2009	60,000

The deferred gain of £212,420 becomes chargeable on the sale of the replacement office block: (expected in 2027).

Base cost of the replacement office building	**£**
Cost of new office building	540,000
Minus: Rollover relief	(212,420)
Base cost	327,580

Working

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 (15 August 2008 to 15 August 2012)?	Yes
Have all the sale proceeds been reinvested in a QBA?	No

Chargeable gain arising in y/e 31 August 2009 – Lower of:	**£**	**£**
(1) All the gain	272,420	
(2) Sale proceeds not reinvested in a QBA (£600,000 - £540,000)	60,000	
Rollover relief = £272,420 - £60,000		212,420

(b) If XY Ltd was to purchase fixed plant and machinery instead of the smaller office building:

- Fixed plant and machinery is a depreciating QBA.
- XY Ltd will still have a chargeable gain of £60,000 in the year ended 31 August 2009.
- £212,420 of the gain will be deferred, but not by deducting from the base cost of the plant and machinery.
- The gain is held over (i.e. a separate record of the gain is kept) and becomes chargeable on the earliest of:
  - (1) 10 years after the acquisition of the replacement asset (30 June 2019)
  - (2) the date the replacement asset ceases to be used in the business
  - (3) the date the replacement asset is sold.
- As XY Ltd does not expect to sell the asset until 2027, the deferred gain will become chargeable on 30 June 2019.

35 Bonus issue and share disposal

Chargeable gain on the disposal of Y plc shares	**£**
Gross sale proceeds	7,500
Minus: Cost (from pool working)	(1,600)
Unindexed gain	5,900
Minus: Indexation allowance (from pool working) (£2,111 – £1,600)	(511)
Chargeable gain	5,389

Share pool	Number of shares	Original cost	Indexed cost
		£	£
January 1999			
Purchase	1,500	2,000	2,000
July 2001			
Bonus issues (1 for 4)	375	Nil	Nil
	1,875	2,000	2,000
January 2010			
IA: from January 1999 to January 2010			
£2,000 × (215.6 – 163.4)/163.4			639
(Do not round this indexation factor)			
			2,639
Sale of shares	(1,500)	(1,600)	(2,111)
	375	400	528

36 Rights issue and share disposal

Chargeable gain on the disposal of X plc shares	£
Gross sale proceeds	14,960
Minus: Cost (from pool working)	(6,050)
Unindexed gain	8,910
Minus: Indexation allowance (from pool working) (£11,940 – £6,050)	(5,890)
Chargeable gain	3,020

Share pool	Number of shares	Original cost	Indexed cost
		£	£
January 1986			
Purchase	1,000	3,000	3,000
July 1989			
(1) IA: from January 1986 to July 1989			
£3,000 × (115.5 – 96.25)/96.25			600
(Do not round this indexation factor)			
(2) Purchase	600	2,000	2,000
	1,600	5,000	5,600
February 1992			
(1) IA: from July 1989 to February 1992			
£5,600 × (136.3 – 115.5)/115.5			1,008
(Do not round this indexation factor)			
(2) Rights issue (1 for 2) at £2 per share	800	1,600	1,600
	2,400	6,600	8,208

March 2010			
(1) IA: from February 1992 to March 2010			
£8,208 × (216.3 – 136.3)/136.3			4,818
(Do not round this indexation factor)			
			13,026
Sale of shares	(2,200)	(6,050)	(11,940)
	200	550	1,086

37 Takeover and share disposal

There is no chargeable gain at the time of the takeover as no cash consideration is received.

Takeover consideration received by DE plc	Market value
	£
(10,000/5) × 10 = 20,000 ordinary shares in H plc at £3.80	76,000
(10,000/5) × 2 = 4,000 preference shares in H plc at £2.00	8,000
	84,000

S plc: Share pool	Number of shares	Original cost	Indexed cost
		£	£
August 1998			
Purchase	10,000	37,000	37,000
March 2005			
IA: from August 1998 to March 2005			
£37,000 × (190.5 – 163.7)/163.7			6,057
(Do not round this indexation factor)			
Balance at time of takeover	10,000	37,000	43,057

Allocation of original cost and indexed cost of S plc shares	Original cost	Indexed cost
	£	£
20,000 ordinary shares: (£76,000/£84,000) × £37,000 or £43,057	33,476	38,956
4,000 preference shares: (£8,000/£84,000) × £37,000 or £43,057	3,524	4,101
	37,000	43,057

H plc: Share pool	Number of shares	Original cost	Indexed cost
		£	£
March 2005			
Balance at time of takeover	20,000	33,476	38,956
March 2010			
(1) IA: from March 2005 to March 2010			
£38,956 × (216.3 – 190.5)/ 190.5			5,276
(Do not round this indexation factor)			

H plc: Share pool	Number of shares	Original cost	Indexed cost
Balance at time of takeover	20,000	33,476	44,232
(2) Sale of shares	(10,000)	(16,738)	(22,116)
Balance carried forward	10,000	16,738	22,116

Chargeable gain on the disposal of 10,000 ordinary shares in H plc	£
Sale proceeds, March 2010: (10,000 × £5)	50,000
Minus: Cost (from pool, see above)	(16,738)
Unindexed gain	33,262
Minus: Indexation allowance (from pool working)	
(£22,116 – £16,738)	(5,378)
Chargeable gain	27,884

38 FG Ltd: loss relief

FG Ltd: Corporation tax computations	Year to 31 December 2008	Year to 31 December 2009	Period ended 31 March 2010
	£	£	£
Trading income	326,400	88,800	Nil
Interest income	10,000	10,000	10,000
Net chargeable gains	28,800	30,720	33,600
Minus: s393A claim	365,200	129,520	43,600
– current loss-making CAP			(43,600)
– carry back to previous 12 months		(129,520)	
- additional loss relief	(47,680)		
	317,520	Nil	Nil
Minus: Gift Aid	(2,400)	Lost	Lost
PCTCT	315,120	Nil	Nil

Working: Record of trading losses	£
Loss in CAP	220,800
Set off under s393A	
– in loss-making CAP	(43,600)
– in carry back CAP	(129,520)
Additional relief	(47,680)
Trading loss c/f under s393(1)	Nil

39 HI Ltd: loss relief

(a) **HI Ltd: Corporation tax computations with optimum loss relief**

	Y/e 30 Nov 2007	P/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)	(Nil)
	850,380	146,800	Nil	85,940
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	96,620
Minus: s393A claim				
– current loss-making CAP			(10,680)	
– carry back 12 months				
p/e 31 March 2008		(176,360)		
y/e 30 November 2007	(169,420)			
	740,140	Nil	Nil	96,620
Minus: Gift Aid	(1,170)	Nil	Lost	(1,170)
	738,970	Nil	Nil	95,450

(b) **Losses available to carry forward at 31 March 2010**

Record of trading losses	£
Loss in CAP	356,460
Set off under s393A	
– in loss-making CAP	(10,680)
– period ending 31 March 2008	(176,360)
– year ending 30 November 2007 (the balance of the loss)	
(which cannot exceed $^{8}/_{12}$ × £909,560 = £606,373)	(169,420)
Trading loss c/f under s393(1)	Nil

Capital loss

There is an allowable capital loss of £14,000 available to carry forward to the next CAP.

40 DTR

JK plc: Corporation tax computation
Year ended 31 March 2010

	Total profits	UK profits	Overseas income: Rental income	Overseas income: Interest income
	£	£	£	£
Trading income	10,000	10,000		
Foreign rental income (W1)	20,000		20,000	
Foreign interest (W2)	36,300			36,300
	66,300	10,000	20,000	36,300

	Total profits	UK profits	Overseas income: Rental income	Overseas income: Interest income
Gift aid donation	(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%

	Total profits	UK profits	Rental income	Interest income
Corporation tax liability	12,033	210	4,200	7,623
DTR (W3)	(8,623)	n/a	(1,000)	(7,623)
Corporation tax payable	3,410	210	3,200	Nil

Workings

W1: Foreign rental income

	£
Amount received	19,000
WHT ($^5/_{95}$ × £19,000)	1,000
Gross foreign rental income	20,000

W2: Foreign dividend income

	£
Amount received	25,410
WHT ($^{30}/_{70}$ × £25,410)	10,890
Gross foreign interest income	36,300

W3: DTR	**Rental income**	**Interest income**
Lower of:	£	£
(1) Overseas tax suffered (see W1 and W2)	1,000	10,890
(2) UK tax on that source of foreign income	4,200	7,623
	= 1,000	= 7,623

41 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.

	Operating as a branch	Operating as a non-UK resident company
Remittances to the UK	The amount of remittances to the UK is irrelevant.	Remittances to the UK will be in the form of dividends.
	All branch profits are assessed on LM Ltd regardless of the amount remitted to the UK.	Dividends received from a subsidiary are classed as group income and are ignored. They are not subject to UK corporation tax.
Availability of capital allowances	Capital allowances on overseas branch purchases are available according to UK rules.	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.

42 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.

The 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**

	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
Rate of tax	28%	28% less marginal relief	28% less marginal relief	21%	21%	21%

Tax planning points

Loss of F Ltd

Deal with this loss first as the possibilities for relief are the most restricted.

F Ltd will not want to claim s393A relief against its current year profits as this would utilise £5,000 of the loss, achieve a tax saving of only £210 (£1,000 x 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 will not want to claim s393A relief against its current year profits as this would utilise £6,000 of the loss, achieve a tax saving of only £210 (£1,000 x 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)	28,000	× 29¾%	8,330
(after loss of F Ltd has been surrendered)			
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

Note

The balancing £8,000 loss of G Ltd could have been surrendered to C Ltd or D Ltd as well as E Ltd.

43 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: Intra-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 [(192.2 – 152.4)/152.4] = 0.261 × £260,000	(67,860)
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 June 2009 [(213.4 – 192.2)/192.2] = 0.110 × £327,860	(36,065)
Chargeable gain arising in A Ltd before considering rollover relief	136,075

As the office building is a QBA and PQ Ltd has purchased a QBA within a four-year time period (14 June 2008 to 14 June 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	£136,075
(2) Sale proceeds not reinvested in QBAs (£500,000 - £480,000)	£20,000
Rollover relief claim = £136,075 - £20,000	£116,075

The chargeable 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 transfer the gain to B Ltd, because tax will be charged on the chargeable gain of £20,000 at a rate of only 21%.

44 Payment of tax

TU Ltd: Corporation tax payments

If TU Ltd does not pay corporation tax at the full rate

Due date: (9 months and 1 day after the end of the CAP): 1 March 2010

Payment amount = £389,400

If TU Ltd does pay corporation tax at the full rate

Quarterly instalment	14 days after end of	Due date	Amount
			£
1	6th month	14 December 2008	97,350
2	9th month	14 March 2009	97,350
3	12th month	14 June 2009	97,350
4	15th month	14 September 2009	97,350
			389,400

45 Candice

(a) Candice: Self assessment payments

2008/09

	£
Income tax liability	17,000
Class 4 NICs	700
Total tax liability	17,700
Minus: Tax deducted at source	(3,500)
Tax payable by self assessment	14,200

This £14,200 is:

(1) more than £1,000

(2) more than (20% × £17,700) = £3,540.

Therefore payments on account are required in 2009/10.

2009/10

	£
Income tax liability	20,000
Class 4 NICs	880
Total tax liability	20,880
Minus: Tax deducted at source	(4,000)
Tax payable by self assessment	16,880

Due dates of payment			**£**
POAs	31 January 2010	½ × £14,200	7,100
	31 July 2010	½ × £14,200	7,100
			14,200
Balancing payment	31 January 2011	(£16,880 – £14,200)	2,680
Income tax and Class 4 NICs			16,880
Capital gains tax	31 January 2011		4,600

In addition, on 31 January 2011 the first POA of £8,440 (½ × £16,880) for 2010/11 is due.

(b) **Interest on underpaid tax**

	£	from	To
1st POA	7,000	31 January 2010	13 February 2010
	100	31 January 2010	27 January 2011
2nd POA	7,000	31 July 2010	17 August 2010
	100	31 July 2010	27 January 2011
Balancing payment	2,880	No interest as paid before due date	

46 Registration

(a) Compulsory registration

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 tax

Deborah will be able to recover the pre-registration input VAT incurred on the purchase of goods or fixed assets used for business purposes if still held at the date of registration and purchased within three years of registration.

She will also be able to recover the input VAT on services supplied to her in the six months before the date of registration.

47 WX Ltd

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.

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