CIPFA

TAXATION

Diploma stage examination

10 December 2007

MARKING SCHEME

AT THE HEART OF YOUR CAREER

Question 1

(a)

	£	£	
Net profit per accounts		1,490,000	*1*
Less: non trading income			
Dividends receivable	18,000		*1*
Debenture interest receivable	15,000		
Bank interest receivable	14,000		*1*
Income from property	26,000		*1*
Profit on sale of investments	17,500		*1*
		90,500	
		1,399,500	*1*
Add: disallowed expenses			
Depreciation		74,000	*1*
		1,473,500	*1*
Less: capital allowances		37,250	*1*
		1,436,250	

Notes

1. Dividends receivable are Franked Investment Income and so do not form part of the company's chargeable profits (but are included in profits for the purposes of determining the rate of taxation). *1*
2. Bank interest receivable is assessed on the accruals basis. Therefore the amount assessed under Schedule D Case III will be £14,000, to include the accrual for interest not yet paid. *1*
3. The debenture interest payable and the patent royalties are for trade purposes and are therefore allowable expenses. *2*

(13)

(b) Chargeable profits:

	£	
Schedule D Case I	1,436,250	*1*
Schedule D Case III (15,000+14,000)	29,000	*2*
Schedule A	24,200	
Chargeable gain	6,420	*1*
	1,495,870	
Less: Schedule A losses	6,000	*1*
Profits Chargeable to Corporation Tax (PCTCT)	1,489,870	*1*

Workings:

1. Schedule A income:

Schedule A income (16,000 + 10,000)	£26,000	
Less: reduction in premium (£10,000 x [2% x 9])	£1,800	*2*
	£24,200	

Premiums receivable on a short-lease (<50 years) are assessed to corporation tax but reduced by 2% for every year of the lease except the first. *2*

2. Calculation of chargeable gain:

Asset 1

Sale proceeds	£10,500		
Cost	£4,250		
	£6,250		*1*
Less: Indexation Allowance			
(195.8-170.5)/170.5 x £4,250	£629		*1*
Chargeable gain		£5,621	*1*

Asset 2

Sale proceeds	£21,250		
Less: part cost	£17,000		
[£21,250/(£21,250 + £10,000)] x £25,000			
Unindexed gain	£4,250		*1*
Less: Indexation Allowance			
(197.8-164.4)/164.4 = 0.203 x £17,000	£3,451		*1*
Chargeable gain		£799	*1*
Total chargeable gains		**£6,420**	

(16)

(c) Corporation tax liability:

Corporation tax on £1,489,870 @ 30% = £446,961 *1*

Profits are £1,489,870 + £20,000 (£18,000 x 10/9) = £1,509,870 *2*
and therefore fall outside the small companies' upper limit *1*

(4)

(d) The tax liability is due nine months and one day after the end of the accounting period, that is on 1 October 2007. *1*

Interest on underpaid corporation tax runs from the date on which the tax should have been paid until the date on which it is actually paid. *1*

The rate at which the interest is calculated rises and falls in line with base rates. *1*

HMRC uses a denominator of 366 when calculating interest in underpaid tax. *1*

The tax was paid on 31 December 2007, 91 days late. *1*

Assuming an official rate of interest of 5%, interest would be charged as follows:

£446,961 x 5% x 91/366 = £5,556 *2*

(7)

(40)

Question 2

(a)

	Total	Non-savings	Savings	Dividends	
	£	**£**	**£**	**£**	
Employment income:					
Salary	65,000	65,000			
Benefits-in-kind (W1)	34,609	34,609			
Income from property (W2)	10,215	10,215			
Bank/building society interest (W3)	11,125		11,125		
NSB interest (W4)	3,330		3,330		
Dividends (W5)	8,000			8,000	
	132,279	109,824	14,455	8,000	
Less: personal allowance	5,035	5,035			½
Taxable income	127,244	104,789	14,455	8,000	1

Income tax due:	£	£	
Starting rate band: non-savings	2,150 @ 10%	215.00	½
Basic rate band: non-savings	31,150 @ 22%	6,853.00	½
Higher rate band: non-savings	71,489 @ 40%	28,595.60	½
: savings	14,455 @ 40%	5,782.00	½
: dividends	8,000 @ 32.5%	2,600.00	½
Tax borne		44,045.60	
Less: tax credits on dividends		800.00	½
Tax payable		43,245.60	
Less: tax deducted at source on savings income		2,225.00	½
Tax payable		41,020.60	½

Workings:

1. Benefits-in-kind

a) company car			
List price when new	£27,000		
Applicable percentage			
15% + [(195-140)/5 x1%] = 26%	x 26%		1
Assessable benefit	£7,020		½
Plus fuel benefit (£14,400 x 26%)	£3,744	£10,764	1
b) Beneficial loans			
Interest-free loan £2,500 x 5%	£125		½
Personal loan £4,000 x (5% - 4%)	£40	£165	½
The loans total more than £5,000 in aggregate and so give rise to assessable benefits			
c) Accommodation benefit			
Annual value	£8,300		½
Add: 5% x (£250,000 + £17,000 - £75,000)	£9,600		1
	£17,900		
Ancillary services: (£1,400 + £975 + £625 + £1,080)	£4,080		1
Furniture benefit 20% x £8,500	£1,700	£23,680	½
Total assessable benefits-in-kind		£34,609	½

2. Income from property

Rents for the year (£650 x 46 weeks)			£29,900	½
Less: deductible expenses				
Allowed in full: advertising		£2,399		½
Apportioned: gardening	£5,200			
insurance	£8,000			
council tax	£2,300			
repairs	£890			
46/52 x	£16,390	£14,499		*1*
Wear and tear allowance				½
[10% x (£29,900-(£2,300 x 46/52))]		£2,787		
			£19,685	
			£10,215	

3. Bank and Building Society interest

Paid net, so gross up to include in computation

£6,800 + £2,100 = £8,900 x 100/80 = £11,125 *1*

4. NSB interest

First £70 of ordinary account interest is exempt

£3,400 - £70 = £3,330 *1*

5. Dividends

Paid net of tax credit, so gross up to include in computation

£7,200 x 10/9 = £8,000 *1*

The liability on the dividends will exceed the tax credits, which are therefore reclaimable in full

(18)

(b)

	Total £	**Non-savings** £	**Savings** £	
Employment income				
Salary	34,600	34,600		½
Benefits-in-kind (W1)	1,879	1,879		
NSB investment a/c (W2)	560		560	½
Statutory total income	37,039	36,479	560	
Less: personal allowance	5,035	5,035		½
Taxable income	32,004	31,444	560	*1*

Income tax due:		£	
Starting rate band: non-savings	2,150 @ 10%	215.00	½
Basic rate band: non-savings	29,294 @22%	6,444.68	½
: savings	560 @ 20%	112.00	½

Tax borne/payable	6,771.68	½

Workings:

1. Benefits-in-kind

	£	£	
a) Mileage Allowance			
Actual allowance (12,300m x 48p)	5,904		½
Less: Tax free allowance ([10,000m x 40p] + [2,300 x 25p])	4,575		*1*
Taxable mileage allowance		1, 329	
b) Private medical insurance		550	½
Total benefits-in-kind		1,879	

2. NSB ordinary account interest
Fully chargeable – on ordinary account only first £70 is exempt. ½

(7)

(c) Class 1 NICs – primary, payable by Miranda

Monthly earnings	£	
9.4% x (£2,375)	223.25	½
1% x (£2,883.33-£2,795)	0.88	½
	224.13	½

Annual £224.13 x 12 = £2,689.56

Class 1 NICs – secondary, payable by Miranda's employer

Monthly earnings	£	
9.3% x (£2,375)	220.88	½
12.8% x (£2,883.33-£2,795)	11.31	½
	232.19	½

Annual £232.19 x 12 = £2,786.28

Class 1A NICs – payable by Miranda's employer

Benefits-in-kind assessed on Miranda £1,879 x 12.8% = £240.51 *1*

Total NICs payable by Miranda's employer £2,786.28 + £240.51 = £3,026.79 *1*

(5)

(30)

Question 3

(a) Disaggregation or business splitting occurs when a business which would otherwise have to register for VAT by virtue of having a taxable turnover in excess of the registration threshold divides itself into two or more smaller businesses, owned by different people, in the hope of avoiding registration. This would mean that supplies could be made without charging VAT and the administrative costs of VAT registration could be avoided. In these cases, HMRC may direct that the persons running the split business should be treated as a single taxable person for VAT. This may be applied even if the split businesses have never in fact been operated as a single unit, if HMRC believes that only one business actually exists.

1 mark per point up to a maximum of (4)

(b) A person may join the VAT cash accounting scheme provided:

- Their taxable turnover, excluding sales of capital items, is not expected to exceed £660,000 in the next 12 months.
- Their VAT returns are up-to-date.
- All amounts due to HMRC have been paid/arrangements made for such payments to be made.
- They have not been convicted of a VAT offence or assessed to a penalty for VAT evasion involving dishonest conduct within the last 12 months.
- New businesses may join at commencement.

A person belonging to the cash accounting scheme must withdraw from the scheme at the end of a tax period if taxable turnover for the 12 months to date has exceeded £825,000. They can remain on the scheme only if it can be demonstrated to HMRC that the large turnover was unlikely to recur and that taxable turnover for the next 12 months would not exceed £660,000.
Registered persons belonging to the scheme account for output tax in the tax period in which payment is received from the customer and reclaim input tax in the tax period in which payment is made to the supplier. The tax point is ignored when allocating inputs and outputs to tax periods.
Joining this scheme allows a registered person to delay the payment of output tax to HMRC until the tax has actually been received from customers, which improves cashflow if customers are given extended credit. The scheme also provides automatic bad debt relief. However, input tax cannot be reclaimed until the tax has actually been paid. The scheme cannot be used for supplies of goods or services which are uninvoiced before the supply is made or for supplies where payment is not due for more than six months after the date of the invoice.

1 mark per point up to a maximum of (8)

(c)

	£	£	
Output tax			
Standard-rated supplies £58,000 @ 17.5%		10,150.00	½
Scale charges on supply of private fuel		75.66	*1*
		10,225.66	½
Input tax			
Standard-rated purchases	27,200		½
Motor repairs and expenses	2,150		*1*
Other expenses	6,400		½
Plant and machinery	2,400		*1*
	38,150 @17.5%	6,676.25	½
Payable to HMRC		3,549.91	½

Comments:

a) all of the exports are zero-rated
b) insurances are exempt
c) wages and salaries are exempt
d) input tax on entertaining expenses may not be reclaimed
e) input tax on a motor car may not be reclaimed
f) input tax on plant and machinery may be reclaimed.

1 mark per comment up to a maximum of 6

(12)

(d) (i) Motorcycle crash helmets are zero-rated. VAT is calculated at 0% on the taxable supply. A person making these supplies must therefore register when their taxable turnover exceeds the prescribed threshold, and may then reclaim input tax.

(ii) Contraceptive products (purchased from a pharmacy without prescription) are lower-rated taxable supplies. VAT is charged, but at the lower rate of 5%. A person making these supplies must therefore register for VAT in the usual way when the threshold is exceeded.

(iii) Gold purchased as an investment is exempt. VAT cannot be charged on an exempt supply. A person making only exempt supplies cannot register for VAT, charges no output tax, and cannot reclaim input tax.

½ mark for identifying VAT status of each item and ½ mark for explaining implications up to an overall maximum of (6)

(30)

Question 4

(a) Direct taxes are those which are assessed on and collected from the individual and organizations intended to bear them. They are taxes whose formal and effective incidences are intended to be the same. The main UK direct taxes are:

- Income tax – paid by individuals on income from employment, profits from a business, income from property and savings.
- Inheritance tax – paid by individuals on inherited assets.
- Capital Gains tax – paid by individuals on net chargeable gains made on the sale of assets.
- Corporation tax – paid by companies on their income and gains.

Direct taxes can be related to the circumstances of the persons or organizations on which the incidence falls, and can therefore be used by governments to redistribute income or wealth. This is not usually possibly with indirect taxes, which are those where the formal and effective incidences of a tax are designed to be different from each other. The main UK indirect tax is VAT, which is levied on and paid by those who add value at the various stages of production of a good or service. The effective incidence of the tax, however, is on the final consumer. Other indirect taxes are stamp duties and customs and excise duties.

1 mark per point up to a maximum of (10)

(b) Tax avoidance relates to the legitimate activities undertaken by taxpayers to organize their financial affairs in such a way that their tax burden is minimised. For example, moving funds from a bank account which pays taxable interest into a tax-free account.
Tax evasion is illegal and refers to evading payment of tax by dishonestly misleading HMRC, by providing information which is incorrect or incomplete, for example by concealing a source of income. Evading income tax was established as a statutory offence by the Finance Act 2000, and is punishable by up to seven years in prison and/or an unlimited fine.
Tax advisers often devise very complex and ingenious schemes to exploit loopholes in the tax legislation. To reduce the loss of tax revenue from these, and to reduce their effectiveness, a disclosure regime has been introduced which requires the following:

- Those who promote and market such schemes are required to provide HMRC with details of each scheme, including details of its tax consequences. The scheme is then registered by HMRC and given a registration number.
- Taxpayers using such a scheme are required to quote the registration number in their tax returns.

These rules are intended to provide HMRC with advance warning of tax avoidance schemes, so enabling swifter and more effective investigation and counteraction.

The courts have also been used in an attempt to reduce avoidance and evasion. Important case law includes the following:

- CIR v Duke of Westminster (1935), which set a precedent that the tax consequences of legal transactions should be allowed to stand, even if those transactions had been carried out entirely for tax avoidance purposes.
- WT Ramsay Ltd v CIR (1981), which developed the previous ruling by determining that a circular set of self-cancelling transactions with no other effect than tax avoidance should be disregarded for tax purposes.
- Furniss v Dawson (1984), which reinforced the decision in Ramsay that the tax avoidance effect of a set of transactions preconceived with the specific aim of avoiding tax should be disregarded, even where they were not self-cancelling and had an actual commercial effect.

1 mark per point up to a maximum of (10)

(c) UK public sector organizations provide many goods and services which are excludable and depletable, and can therefore be described as private goods. Examples are: passports, library books, places at a local state school, hip operations. In theory, it is possible for these public sector bodies to identify a price for the private goods and services they supply and levy it on those who receive them. The arguments for doing so are as follows:

- Charging reflects one of the criteria of a good tax – that is, the principle of equity – in relating payment to the value of benefits received.
- Goods and services funded out of tax revenues and provided free to users may be oversupplied, as users will not fully value them unless they pay for them. Charging can therefore act as a rationing mechanism.
- Charging for goods and services may develop better accountability between the provider and the recipient, since the user of a service is more likely to complain when it has been paid for directly.

The argument against charging is that it contravenes another principle of equity – that what people pay should be related to their means. This is particularly relevant in the public sector, where there is a strong moral argument that services should be made available to people regardless of their ability to pay. Nonetheless, there could be ways of charging whilst taking this into account, for example through a voucher system, although these could be prohibitively complex to administer.

1 ½ marks per point up to a maximum of (10)

(30)