TAXATION

Diploma stage
December 2005

MARKING SCHEME

Question 1

(a)

		£	£	
Pre-tax profit per accounts			594,330	½
Add:	Legal fees (£2,500 + £8,000 + £2,700)		13,200	*1*
	Entertaining (£3,270 + £4,800)		8,070	½
	Gift Aid donations		2,000	*1*
	Royalties payable		-	½
	Motor expenses		-	½
	Car hire (£3,300 - (£3,300 x 13.5/15))		330	*2*
	Amortisation (£5,000 - (£8,200 x 6/12))		900	*2*
	Depreciation		113,340	½
	Loss on disposal of equipment		2,820	½
	Interest payable		-	½
			734,990	
Less:	Decrease in general provision	500		½
	Profit on disposal of motor car	440		½
	Royalties receivable	-		½
	Profit on sale of freehold property	105,000		½
	Profit on sale of shares	12,000		½
	UK dividends received	43,110		½
	Interest receivable	14,840	175,890	½
Schedule D Case I profit (before capital allowances)			559,100	

(13)

(b) Capital allowances on plant and machinery:

		Pool	Expensive car	SLA	Total	
y/e 31/3/05						
WDV b/f		89,600	14,200	2,400		*1*
Additions		9,250				½
		98,850				
Disposals		4,450	15,800	1,100		*1*
		94,400				
Balancing charge			(1,600)		(1,600)	*1*
Balancing allowance				1,300	1,300	*1*
Additions			28,600			½
WDA 25%		23,600			23,600	½
WDA restricted			3,000		3,000	*1*
		70,800				
Additions	60,900			4,700		½
FYA 50%	30,450	30,450		2,350	32,800	*1*
WDV c/f		101,250	25,600	2,350		
Total allowances					59,100	

(8)

(c) Building sold September 1998

	£	
Disposal proceeds	310,000	½
Less: Cost	125,000	½
	185,000	
Less: Indexation allowance		
(164.4 – 91.94)/91.94 = 0.788 x £125,000	98,500	1
	86,500	
Less: Rolled-over gain	71,500	1
Chargeable gain (£310,000 - £295,000)	15,000	

Building sold October 2004

	£	
Disposal proceeds	400,000	½
Less: Base cost (£295,000 - £71,500)	223,500	1
	176,500	
Less: Indexation allowance		
(187.4 – 163.0)/163.0 = 0.150 x £223,500	33,525	1
Chargeable gain	142,975	

Shares in Bodmin plc

S104 Holding

	No. of shares	*Cost*	*Indexed cost*	
		£	£	
Bought April 1987	10,000	40,000	40,000	½
Indexation to October 1991				
(135.1 – 101.8)/101.8 x £40,000			13,084	1
Bought October 1991	10,000	55,000	55,000	½
	20,000	95,000	108,084	
Indexation to June 1995				
(149.8 – 135.1)/135.1 x £108,084			11,760	1
Bought June 1995	10,000	85,000	85,000	½
	30,000	180,000	204,844	
Indexation to January 2005				
(188.6 – 149.8)/149.8 x £204,844			53,057	1
			257,901	
Sold January 2005	10,000	60,000	85,967	1
c/f	20,000	120,000	171,934	

The shares were sold for £52,000, so there is an unindexed loss of £8,000. This is also the allowable loss, since indexation allowance cannot be used to increase an unindexed loss. *1*

(12)

(d) Corporation tax computation:

	£	
Schedule D Case I	559,100	
Less: Capital allowances	59,100	
	500,000	*½*
Chargeable gains (142,975 – 8,000 – 96,215)	38,760	*1 ½*
Schedule D Case III	14,840	*½*
	553,600	
Less: Charges	1,500	*1*
PCTCT	552,100	
FII £43,110 + £4,790	47,900	*1*
Profits	600,000	
Corporation tax due:		
£552,100 @ 30%	165,630	
Less: Marginal relief:		
11/400 x (£1,500,000 - £600,000) x £552,100/£600,000	22,774	
	142,856	*2*

This corporation tax is due for payment on 1 January 2006. *½*

(7)

(40)

Question 2

(a) With a salary of £45,000, Robert has already used up the whole of the income tax starting rate and basic rate bands. Similarly, his income exceeds the NICs upper earnings limit. Therefore any further pay will suffer a combined income tax and NICs rate of 41%. *1 ½*

If he accepts the payrise, the only effect will be that his net pay will rise by £2,360 (£4,000 @ 59%). *½*

With an emission rating of 192 g/km, the car's appropriate percentage for benefits-in-kind purposes is 24% (15% + 9%). If Robert accepts the car, there will be a car benefit of £4,128 (24% of £17,200) and a fuel benefit of £3,456 (24% of £14,400). Total benefits will be £7,584. These are subject to income tax at 40% but are not subject to Class 1 NICs. The tax increase would be £3,033.60 (£7,584 @ 40%). *3*

If he accepts the car, Robert will lose the mileage allowance of £1,200 (with no tax consequences), so his net pay would fall by a total of £4,233.60. However, he would save £6,500 in motor expenses, so he would be £2,266.40 better off overall. *1 ½*

On balance, Robert might be advised to accept the payrise, since this is worth £93.60 more to him (£2,360 - £2,266.40) than the company car. *½*

(7)

(b) The main tests which are used to distinguish employment from self-employment are as follows:

- Control
- Financial risk
- Provision of equipment
- Work performance and correction
- Holidays and sickness
- Exclusivity

½ mark for identification of each test + further 1/2 mark for relating to Rita's case (6)

(c)

	James	**Jean**	
	£	**£**	
Pensions	17,360		½
Building society interest:			
£4,160 x 100/80	5,200		½
£2,160 x 100/80		2,700	½
Schedule F:			
£1,710 + £190	1,900		½
£4,230 + £470		4,700	½
	24,460	7,400	
Personal allowance:	4,745	4,745	
Taxable income	19,715	2,655	

Income tax due:

James £	Jean £		James £	Jean £	
2,020	2,020	@ 10%	202	202	
10,595		@ 22%	2,331		
5,200		@ 20%	1,040		
1,900	635	@ 10%	190	64	
19,715	2,655		3,763	266	*2*
Less: MCA £5,030 @ 10%			503		*1*
			3,260	266	
Less: Tax credits attached to dividends			190	266	*½*
			3,070	0	
Less: Tax deducted at source from BSI			1,040	540	*½*
Tax payable (before deducting PAYE)			2,030	(540)	

Notes:

(i) James is entitled to the age 65-74 personal allowance of £6,830, but his income exceeds the limit by £5,560, so he must lose £2,780 in personal allowances. £2,085 is deducted from his own personal allowance of £6,830, reducing this to £4,745. The remaining £695 is deducted from the MCA, reducing this to £5,030. *2 ½*

(ii) Jean is under 65 throughout 2004/05 and so may claim only the basic personal allowance of £4,745. *½*

(iii) Jean may not claim payment of the tax credits on dividends which cannot be set against her tax liability on those dividends (i.e. £204). *½*

(10)

(d) The main features of the PAYE system are as follows:

- Employers deduct income tax and NICs from employees when paying their wages and salaries. The sums deducted in a tax month (together with the employer's secondary NICs) must be paid over to the Inland Revenue within 14 days of the end of that month.

- The PAYE system applies to all payments assessable as employment income, including "payments" taking the form of assets which are readily convertible into cash.

- Each employee is issued with a tax code by the Inland Revenue. This code reflects the employee's entitlement to allowances and reliefs. The tax code may be adjusted to collect tax due on benefits-in-kind or to account for tax under-paid or over-paid in previous years.

- The system is cumulative in nature. With the aid of tax tables provided by the Inland Revenue, the employer uses the tax code to determine the amount of tax-free pay to which an employee is entitled for the tax year to date. This amount is then subtracted from the employee's gross pay to date, giving the taxable pay to date. A further table look-up then determines the amount of tax due for the year to date. The tax already paid for the year (if any) is then subtracted, giving the tax due for the current week or month.

- The aim is that, at any time of year, the tax paid so far during the year should accord with the amount due so far for that year. At the end of the year, the system should have automatically collected the correct amount of tax and it should not be necessary to issue the employee with a further tax demand or make a tax repayment.

- At the end of each tax year, employers are required to submit an end-of-year return to the Inland Revenue, summarising all employees' gross pay and tax paid for the year. A certificate of gross pay and tax deducted must also be provided to each employee at the end of the tax year on form P60.

- The system as originally designed revolves around the use of printed tax tables and forms. However, many employers now run computer-based payroll systems in which disk files have replaced the printed tables. Similarly, there is an increasing trend for end-of-year PAYE returns to be submitted to the Inland Revenue by electronic means.

1 mark for each valid point up to a maximum of (7)

(30)

Question 3

(a)

	y/e 30/6/03	**1/7/03 to 31/3/04**	**y/e 31/3/05**	
	£	**£**	**£**	
Schedule D Case I	2,050,000	260,000	-	*1*
Schedule D Case III	51,600	39,000	28,700	*1*
Chargeable gains	-	-	8,700	*2*
	2,101,600	299,000	37,400	
Less: Charges	10,000	8,000	5,000	*1*
PCTCT and profits	2,091,600	291,000	32,400	

Notes:

(i) Capital losses carried forward at 30 June 2003 are £35,300 (£67,300 - £32,000). Therefore net chargeable gains for the year to 31 March 2005 are £8,700 (£47,000 - £35,300 - £3,000).

(ii) For the 9 months to 31 March 2004, the lower and upper small company rate limits are £225,000 (£300,000 x 9/12) and £1,125,000 (£1,500,000 x 9/12) respectively. *1*

	y/e 30/6/03	**1/7/03 to 31/3/04**	**y/e 31/3/05**	
	£	**£**	**£**	
Corporation tax @ 30%	627,480	87,300		*½*
Corporation tax @ 19%			6,156	*½*
Less: Marginal relief				
11/400 x (£1,125,000 - £291,000)		22,935		*1*
19/400 x (£50,000 - £32,400)			836	*1*
Corporation tax liability	627,480	64,365	5,320	

(9)

(b)

	y/e 30/6/03	1/7/03 to 31/3/04	y/e 31/3/05	
	£	£	£	
Schedule D Case I	2,050,000	260,000	-	
Schedule D Case III	51,600	39,000	28,700	
Chargeable gains	-	-	8,700	
	2,101,600	299,000	37,400	*1*
Less: s393A(1)(a) relief			37,400	*1*
Less: s393A(1)(b) relief	525,400	299,000		*3*
	1,576,200	-	-	
Less: Charges	10,000	-	-	*½*
PCTCT and profits	1,566,200	0	0	

The revised corporation tax liability for the year to 30 June 2003 is £469,860 (£1,566,200 x 30%). The liability for the other two periods is zero. *1*

Notes:

(i) Only three months of the year to 30 June 2003 fall into the 12 months prior to the loss-making period. Therefore s393A(1)(b) relief in this year is restricted to £525,400 (£2,101,600 x 3/12).

(ii) Charges are lost in the latter two accounting periods. *½*

(iii) Trading losses c/f under s393(1) are £33,200 (£895,000 - £37,400 - £299,000 - £525,400). *1*

(8)

(c) The reduction in the corporation tax liability for the year to 30 June 2003 is £157,620 (£627,480 - £469,860).

Therefore the total amount of corporation tax saved in consequence of the loss relief claims is £227,305 (£157,620 + £64,365 + £5,320). *(2)*

(d) The main factors which a company should take into account when deciding how to relieve a trading loss are as follows:

- the likelihood and expected amount of future profits arising from the same trade as that in which the loss was incurred
- the company's cash flow situation (a cash shortage may dictate that loss relief should be obtained as soon as possible)
- the rates of corporation tax it has paid in earlier accounting periods and the expected rates in future periods
- the possibility that relief for trading losses may reduce the chargeable profits of an accounting period to such an extent that the rate of corporation tax payable for that period is reduced
- the possibility that charges may be unrelieved

- in general, the desire to maximise the tax saved as a result of loss relief claims.

(6)

(e) In percentage terms, a tax saving of £227,305 in relation to trading losses of £861,800 (£895,000 - £33,200) means that tax relief on the losses is obtained at approximately 26.4%. This is quite respectable and if the claims under s393A(1) are made there would be a fairly immediate flow of cash into the company in the form of a corporation tax refund (with interest). *2*

However, if the claims are not made and the losses are instead carried forward under s393(1), the percentage rate at which loss relief is obtained may improve. The company expects "a sizeable trading profit" in future years. If these profits materialise in the year to 31 March 2006, the company could possibly save tax at 30% or 32.75% by carrying forward this year's trading losses. *2*

The company has until 31 March 2007 to make any desired s393A(1) claims. So unless there is a pressing need for an immediate tax refund, it would perhaps be advisable to wait until the trading profit for the year to 31 March 2006 is determined before making a final decision. *1*

(5)

(30)

Question 4

(a) A company which makes wholly taxable supplies (whether at the standard rate, lower rate or zero rate) must generally register for VAT if its turnover exceeds a prescribed threshold and may register voluntarily even if turnover does not exceed this threshold. However, a company which is making wholly zero-rated supplies may apply to be exempted from registration. *1*

Having registered, the company will charge VAT (at the appropriate rate) to its customers and must account for this "output tax" to Customs and Excise. The company will also be able to reclaim the "input tax" which it suffers on the goods and services which it buys. *1*

A company which makes only exempt supplies is not making taxable supplies and cannot register for VAT. The company must not charge VAT to customers and cannot reclaim input tax. *1*

Examples of zero-rated supplies include most foods, water and books. Examples of exempt supplies include postal services supplied by the Post Office and insurance services. *1*

(4)

(b) A company which makes both taxable supplies and exempt supplies is a "partially exempt" company and may recover only part of the input tax which it suffers. The amount of input tax which may be recovered for a tax period is the amount which is "attributed to taxable supplies". This amount is usually calculated as follows:

– Input tax suffered on goods and services which are used exclusively for the purpose of making taxable supplies is attributed to taxable supplies and is recoverable in full. *1*

– Input tax suffered on goods and services which are used exclusively for the purpose of making exempt supplies is not attributed to taxable supplies and cannot be recovered at all. *1*

– A proportion of any remaining input tax (on goods and services used for making both taxable and exempt supplies) is attributed to taxable supplies and may be recovered. This proportion is normally equal to the ratio of taxable supplies to total supplies. *1*

However, if the total amount of input tax not attributed to taxable supplies does not exceed £625 per month (on average) and is also no more than 50% of all input tax suffered, it is treated as being attributed to taxable supplies and is recoverable in full. *1*

(4)

(c) Output tax is £74,260 x 17.5/117.5 = £11,060 and so standard-rated supplies (excluding VAT) are £63,200. Total taxable supplies, including zero-rated supplies, are £80,000 and total supplies of all types, including exempt supplies, are £92,500. Rounded up to the nearest whole number, taxable supplies are 87% of total supplies. Therefore the calculation of the VAT liability for the three months to 31 March 2005 is as follows: *2*

	£	£	
Output tax:			
Standard-rated supplies		11,060	
Zero-rated supplies		0	
Fuel scale charge		32	*1*
		11,092	
Input tax:			
Attributed to taxable supplies:			
Purchase of motor car	-		*½*
Petrol for motor car	180		*½*
Other input tax attributed to taxable supplies	3,320		*½*
Unattributed tax:			
Customer entertaining	-		*½*
Other unattributed input tax:			
£1,850 x 87%	1,610		*1*
Attributed to exempt supplies:			
£860 + £1,850 x 13%	1,100	6,210	*1*
Payable to HM Customs and Excise		4,882	

The £1,100 of input tax which is attributed to taxable supplies is less than £625 per month and is also no more than 50% of all input tax suffered. Therefore it is treated as being attributed to taxable supplies and is recoverable in full. *1*

However, the above calculation is provisional since the situation will be reviewed at the end of the year. If the input tax attributed to exempt supplies for the year exceeds £7,500 or is more than 50% of the total input tax for the year, this input tax will not be recoverable from Customs and Excise. *1*

(9)

(d) A local authority supplies a range of goods and services, many of which are not made in the course of business and so fall outside the scope of VAT. But some of the activities of a local authority are treated as business activities (eg the letting of sports facilities) and therefore do fall within the scope of VAT. *½*

In general, it is not possible to recover input tax incurred in connection with non-business activities. However, a special scheme permits local authorities (and certain other statutory bodies) to recover such input tax. This scheme ensures that VAT does not become a financial burden on such bodies. *1*

A local authority will be partially exempt if its business activities involve the making of both taxable supplies and exempt supplies. Such a local authority may recover input tax incurred in connection with its business activities as follows:

– Input tax which is attributable to taxable supplies is recovered in full. *½*

– Input tax which is attributable to exempt supplies may be recovered if it does not exceed £625 per month or if it is less than 5% of all the input tax incurred by the authority. *1*

(3)

(e) **(i)** direct taxes and indirect taxes

(ii) taxes levied on income, wealth, capital gains, expenditure etc.

(iii) progressive, regressive and proportional taxes

(iv) taxes based on weight/size of the tax base or on monetary value.

1 mark for explaining each classification
+ further ½ mark for correctly classifying VAT (6)

(f) The main features of a "good" tax are:

– equity (or fairness)

– certainty

– efficiency

– low administrative cost.

1 mark for explaining each feature (4)

(30)