THE CHARTERED INSURANCE INSTITUTE

AF2

Advanced Diploma in Financial Planning

Unit AF2 – Business financial planning

October 2013 examination

SPECIAL NOTICES

All questions in this paper are based on English law and practice applicable in the tax year 2013/2014, unless stated otherwise in the question, and should be answered accordingly.

It should be assumed that all individuals are domiciled and resident in the UK unless otherwise stated.

Instructions

- Three hours are allowed for this paper.
- **Do not begin writing until the invigilator instructs you to.**
- **Read the instructions on page 3 carefully before answering any questions.**
- Provide the information requested on the answer book and form B.
- You are allowed to write on the inside pages of this question paper, but you must **NOT** write your name, candidate number, PIN or any other identification anywhere on this question paper.
- The answer book and this question paper must **both be handed in personally by you** to the invigilator before you leave the examination room. **Failure to comply with this regulation will result in your paper not being marked and you may be prevented from entering this examination in the future.**

Unit AF2 – Business financial planning

Instructions to candidates

Read the instructions below before answering any questions

- **Three hours** are allowed for this paper which carries a total of 160 marks as follows:

  - Section A: 80 marks
  - Section B: 80 marks

- You are advised to spend approximately 90 minutes on Section A and 90 minutes on Section B.

- You are strongly advised to attempt **all** questions to gain maximum possible marks. The number of marks allocated to each question part is given next to the question and you should spend your time in accordance with that allocation.

- Read carefully all questions and information provided before starting to answer. Your answer will be marked strictly in accordance with the question set.

- You may find it helpful in some places to make rough notes in the answer booklet. If you do this, you should cross through these notes before you hand in the booklet.

- It is important to show all steps in a calculation, even if you have used a calculator.

- If you bring a calculator into the examination room, it must be a silent, battery or solar-powered, non-programmable calculator. The use of electronic equipment capable of being programmed to hold alphabetic or numerical data and/or formulae is prohibited. You may use a financial or scientific calculator, provided it meets these requirements.

- Tax tables are provided at the back of this question paper.

- Answer each question on a new page and leave six lines blank after each question part.

Subject to providing sufficient detail you are advised to be as brief and concise as possible, using note format and short sentences on separate lines wherever possible.

SECTION A

This question is compulsory and carries 80 marks

Question 1

James, aged 53, and Chris, aged 51, are partners in a firm of Quantity Surveyors which has been providing cost and project management services for the last 20 years. They have expanded in recent years and are no longer the sole providers of professional services within the firm. They are consequently becoming increasingly concerned about their own personal liability in relation to claims against the business.

They have a partnership agreement in place that includes an automatic accrual arrangement. As part of the arrangement, they both put in place level term, own life policies, to age 65, for £100,000, written under trust for their respective beneficiaries. You have discovered that James's policy had lapsed and has not been replaced. The agreement confirms the equity and profit sharing ratios with James holding 60% and Chris 40%.

Their main priorities are that the business can continue should one of them die, and that the deceased partner's beneficiaries should be fully compensated for their share of the partnership, and the money they have invested over the years. They have both built up estates in excess of the Inheritance Tax nil rate band in addition to their business assets, and would like any arrangements on death to be as tax efficient as possible.

James and Chris have provided you with financial information about the business and extracts from these financial statements are summarised below:

Year ended	Partnership Profit (£)
30/09/2009	50,000
30/09/2010	90,000
30/09/2011	120,000
30/09/2012	160,000
30/09/2013	200,000

Extract from Balance Sheet

Cost & Project Management Partnership Balance Sheet as at 30 September 2013		
	2013 (£)	**2012 (£)**
Fixed assets		
Premises	120,000	120,000
*Goodwill	480,000	450,000
	600,000	570,000
Net current assets	100,000	90,000

**Goodwill has built up over the years through acquisitions*

The firm's accountant has drawn up a forecast estimating the taxable profits to 31 March 2014 will be £116,000. He has also confirmed that the business has overlap profits of £20,000 from the change to the current year basis in 1997. James has made personal pension contributions of £15,000 gross in the current tax year.

Questions

*To gain maximum marks for calculations you **must** show **all** your workings and express your ans... to **two** decimal places.*

(a) James and Chris are considering setting up a limited company and transferring the trading and assets of the existing partnership to the new company. Their accountant has recommended that changes are made to coincide with the tax year end 2014.

(i) Explain briefly how transferring their business to a limited company would address their concern about personal liability. **(5)**

(ii) Calculate, **showing all your workings**, the potential Income Tax liability for James should the partnership be dissolved on 31 March 2014. **(12)**

(iii) Explain the Capital Gains Tax consequences for James and Chris of dissolving the existing partnership. **(8)**

(b) The partners have only considered a limited company but you have suggested they consider a Limited Liability Partnership (LLP).

Explain to James and Chris how conversion to an LLP could help to mitigate the tax implications on cessation and address their major concern about personal liability. **(12)**

(c) Comment on the suitability of the automatic accrual agreement and protection policies currently in place in relation to:

(i) the partners priority for the business to continue should one of them die; **(3)**

(ii) how their beneficiaries would be compensated on their death. **(7)**

(d) James and Chris have decided to proceed with converting the partnership to an LLP.

(i) Explain to James and Chris why they should consider putting an LLP agreement in place for the new arrangement. **(7)**

(ii) Explain to James the implications of transferring employees from the old partnership to the new arrangement and whether or not this provides an opportunity to amend terms and conditions of employment. **(6)**

(e) Outline, giving your reasons, your recommendations for partnership protection arrangements for James and Chris on conversion to an LLP with specific reference to:

(i) the arrangement that would best suit their needs; **(7)**

(ii) the selection of suitable life policies, including the basis for calculating the sum assured and treatment of premiums; **(7)**

(iii) how any trust arrangements should be structured. **(6)**

Total marks available for this question: 80

Questions continue over the page

SECTION B

Both questions in this section are compulsory and carry an overall total of 80 marks

Question 2

Ryan and his sister Stella are shareholding directors in ABD Ltd, a private limited company. Ryan owns 60%, and Stella owns 40% of the shares in the company. The company started as a property development business but, since the financial crisis of 2007, has diversified and now is most active in the green energy sector.

The company year end was 30 September, and the company accountant has provided three years accounts, including the management accounts for 2013. Your analysis of the accounts has produced the following:

	2013	**2012**	**2011**
Working capital ratio (current ratio)	1.18	1.11	1.12
Quick ratio	0.67	0.55	0.47
Gearing ratio	-204.51%	388.35%	346.39%
Solvency ratio	-58.45	15.37	14.82
Interest cover	2.02	2.39	2.10

The gearing ratio has fallen dramatically, because, some land the company holds has been deemed unfit for development and a recent valuation, as requested by the auditor, has seen its value drop by 80%.

The business has a loan with Hightown Bank of £2,500,000 which is secured as a qualifying floating charge on the assets of the company. The condition of the bank loan is that the company maintains a solvent balance sheet. Both directors provided a joint personal guarantee to the bank of £1,000,000 and Hightown Bank provides all the short term credit and banking facilities to the business.

Ryan has built up considerable personal wealth outside of the business, currently valued at £1,300,000, with no liabilities. Stella has assets valued at £1,200,000, mainly property. She also has personal liabilities of £900,000. Stella had initially provided the personal guarantee to the bank before the property crash when her assets were valued much higher.

You have also spoken to Charles, aged 54, the longest serving employee who has been with the company for the last 25 years. He started working for Ryan and Stella's father when he initially set up the business. Given the current economic conditions, Charles is concerned about what would happen to him if the business was to fail.

Questions

To gain maximum marks for calculations you ***must*** *show* ***all*** *your workings and express your answers to* ***two*** *decimal places.*

(a) Using the ratios provided, comment on the current financial health of the business. **(8)**

(b) Ryan and Stella have been called to a meeting with their bank to discuss the company's credit facilities which are now due for renewal. They have been asked to provide a copy of the most recent management accounts.

(i) Explain to Ryan and Stella how the bank may react to the information in the latest set of management accounts, and the possible implications for the company. **(6)**

(ii) Explain the personal implications for Ryan and Stella if the bank were to start liquidation proceedings. **(8)**

(iii) Explain, giving your reasons, a course of action you would recommend to Ryan and Stella to avoid compulsory liquidation. **(10)**

(c) Charles has asked about his entitlement to redundancy pay. His current weekly earnings are £585. Calculate, **showing all your workings**, the amount of statutory redundancy pay he would be entitled to if the business were to wind up. **(6)**

Total marks available for this question: 38

Questions continue over the page

Question 3

BDK Ltd, a VAT registered private company that manufactures and distributes premium paint brushes and rollers, was founded by Basil and David 10 years ago. Katie has recently joined the board and their respective shareholding and positions are as follows:

Name	Position	Salary (£)	Shares of BDK Ltd (%)
Basil	Managing Director	150,000	60
David	Technical Director	130,000	30
Katie	Sales & Marketing Director	100,000	10

BDK Ltd currently lease the unit from which they operate for £28,000 per annum, which is now too small for their requirements. A suitable property has recently come on the market and they have agreed a purchase price of £450,000. They have obtained an independent valuation which has confirmed the purchase price and has also advised that the property is subject to VAT, and has a rental valuation of 8.8%. They have estimated the legal and ancillary costs of the purchase to be £9,000.

The business has a strong balance sheet and a sound credit rating. They have £750,000 cash in the bank, but are concerned about liquidity if they were to tie up a large percentage of this cash in a property. Their bank has advised that they would lend the business a maximum of 70% loan-to-value ratio to purchase the property, at a fixed rate of interest of 5.75%, with an arrangement fee of 1.5%.

The directors have accumulated pension funds as follows:

	Current Transfer Value (£)	Total contributions paid by BDK Ltd			
		2013/14 (£)	2012/13 (£)	2011/12 (£)	2010/11 (£)
Basil	350,000	50,000	50,000	40,000	30,000
David	230,000	30,000	30,000	10,000	20,000
Katie	125,000	10,000	10,000	10,000	10,000

The pension contributions for the current tax year have been paid by the company and are included in the transfer values quoted. The input periods for pension contributions commence on 6 April each year.

Basil has advised that he intends to retire in five years time and wishes to keep his pension funds liquid.

In addition to the board members BDK Ltd employs 45 people. All of the employees are full time, and aged from 19 to 58. The company has never provided a formal pension arrangement for staff, but does pay 5% of basic salary into various personal pensions for senior staff.

Questions

*To gain maximum marks for calculations you **must** show **all** your workings and express your answers to **two** decimal places.*

(a) Based on the size of the workforce, the directors have been advised that they will have to comply with the new pensions legislation by August 2015.

Outline the minimum requirements for them to meet the employer's obligations for 'automatic enrolment'. **(8)**

(b) The directors have asked for your advice in relation to the options available to them for financing the purchase of the commercial property.

(i) Calculate, **showing all your workings**, the total initial net outlay to the company if they were to purchase the property using the finance offer from the bank. **(8)**

(ii) Explain the advantages to the business of buying the property directly using the finance offered by the bank compared to buying the property outright through a pension arrangement. **(8)**

(c) The directors would like to consider the feasibility of using a small self-administrated scheme (SSAS) to purchase a property. Basil does not want to participate and this has resulted in a shortfall of £220,325, on the purchase costs of the property and the cost of setting up a SSAS. They have confirmed that the company would not make any further pension contributions.

(i) State **two** options for making up the shortfall and explain the maximum amount of each that can be used in these circumstances. **(14)**

(ii) Calculate, **showing all your workings**, the optimal way to make up the shortfall keeping David and Katie's contributions to a minimum. **(4)**

Total marks available for this question: **42**

The tax tables can be found on pages 11-15

INCOME TAX

RATES OF TAX	2012/2013	2013/
Starting rate for savings*	10%	10%
Basic rate	20%	20%
Higher rate	40%	40%
Additional rate	50%	45%
Starting-rate limit	£2,710*	£2,790*
Threshold of taxable income above which higher rate applies	£34,370	£32,010
Threshold of taxable income above which additional rate applies	£150,000	£150,000
Child benefit charge from 7 January 2013:		
1% of benefit for every £100 of income over	£50,000	£50,000

**restricted to savings income only and not available if taxable non-savings income exceeds starting rate band.*

MAIN PERSONAL ALLOWANCES AND RELIEFS

Income limit for Personal Allowance §	£100,000	£100,000
Personal Allowance (basic if born after 5 April 1948) §	£8,105	£9,440
Personal Allowance (if born between 6 April 1938 and 5 April 1948) §	£10,500	£10,500
Personal Allowance (if born before 6 April 1938) §	£10,660	£10,660
Married/civil partners (minimum) (if born before 6 April 1935) at 10% †	£2,960	£3,040
Married/civil partners (if born before 6 April 1935) at 10% †	£7,705	£7,915
Income limit for age-related allowances	£25,400	£26,100
Blind Person's Allowance	£2,100	£2,160
Enterprise Investment Scheme relief limit on £1,000,000 max	30%	30%
Seed Enterprise Investment relief limit on £100,000	50%	50%
Venture Capital Trust relief limit on £200,000 max	30%	30%

§ the Personal Allowance reduces by £1 for every £2 of income above the income limit irrespective of age (under the income threshold).
† where at least one spouse/civil partner was born before 6 April 1935.

Child Tax Credit (CTC)		
- Child element per child (maximum)	£2,690	£2,720
- family element	£545	£545
Threshold for tapered withdrawal of CTC	£15,860	£15,910

NATIONAL INSURANCE CONTRIBUTIONS

Class 1 Employee	**Weekly**	**Monthly**	**Yearly**
Lower Earnings Limit (LEL)	£109	£473	£5,668
Primary threshold	£149	£646	£7,755
Upper Accrual Point	£770	£3,337	£40,040
Upper Earnings Limit (UEL)	£797	£3,454	£41,450

Total earnings £ per week	**CLASS 1 EMPLOYEE CONTRIBUTIONS**	
	Contracted-in rate/contracted-out (money purchase)	**Contracted-out rate (final salary)**
Up to 149.00*	Nil	Nil
149.01 – 770.00	12%	10.6%
770.01 – 797.00	12%	12%
Above 797.00	2%	2%

**This is the primary threshold below which no NI contributions are payable. However, the lower earnings limit is £109 per week. This £109 to £149 band is a zero rate band introduced in order to protect lower earners' rights to contributory State benefits e.g. Basic State Pension.*

Total earnings £ per week	**CLASS 1 EMPLOYER CONTRIBUTIONS**		
	Contracted-in rate	**Contracted-out rate**	
		Final salary	*Money purchase*
Below 148.00**	Nil	Nil	Nil
148.01 – 770.00	13.8%	10.4%	13.8%
770.01 – 797.00	13.8%	13.8%	13.8%
Excess over 797.00	13.8%	13.8%	13.8%

*** Secondary earnings threshold.*

Class 2 (self-employed)	Flat rate per week £2.70 where earnings exceed £5,725 per annum.
Class 3 (voluntary)	Flat rate per week £13.55.
Class 4 (self-employed)	9% on profits between £7,755 - £41,450 2% on profits above £41,450.

PENSIONS

TAX YEAR	**LIFETIME ALLOWANCE**	**ANNUAL ALLOWANCE**
2006/2007	£1,500,000	£215,000
2007/2008	£1,600,000	£225,000
2008/2009	£1,650,000	£235,000
2009/2010	£1,750,000	£245,000
2010/2011	£1,800,000	£255,000
2011/2012	£1,800,000	£50,000
2012/2013	£1,500,000	£50,000
2013/2014	£1,500,000	£50,000

ANNUAL ALLOWANCE CHARGE
20% - 45% member's tax charge on the amount of total pension input in excess of the annual allowance.

LIFETIME ALLOWANCE CHARGE
55% of excess over lifetime allowance if taken as a lump sum.
25% of excess over lifetime allowance if taken in the form of income, which is subsequently taxed under PAYE.

INHERITANCE TAX

RATES OF TAX ON DEATH TRANSFERS	2012/2013	20
Transfers made after 5 April 2013		
- Up to £325,000	Nil	Nil
- Excess over £325,000	40%	40%
- Lifetime transfers to and from certain trusts	20%	20%

**For deaths after 5 April 2013, a lower rate of 36% applies where at least 10% of deceased's net estate is left to charity.*

MAIN EXEMPTIONS		
Transfers to		
- UK-domiciled spouse/civil partner	No limit	No limit
- non-UK-domiciled spouse/civil partner (from UK-domiciled spouse)	£55,000	£325,000
- UK-registered charities	No limit	No limit
Lifetime transfers		
- Annual exemption per donor	£3,000	£3,000
- Small gifts exemption	£250	£250
Wedding/civil partnership gifts by		
- parent	£5,000	£5,000
- grandparent	£2,500	£2,500
- other person	£1,000	£1,000

100% relief: businesses, unlisted/AIM companies, certain farmland/building
50% relief: certain other business assets

Reduced tax charge on gifts within 7 years of death:

- Years before death	0-3	3-4	4-5	5-6	6-7
- Inheritance Tax payable	100%	80%	60%	40%	20%

CAR BENEFIT FOR EMPLOYEES

The charge for company car benefits is based on the carbon dioxide (CO_2) emissions. There is no reduction for high business mileage users.

For 2013/2014:
- Cars that cannot emit CO_2 have a 0% charge.
- The percentage charge is 5% of the car's list price for CO_2 emissions of 75g/km or less.
- For cars with CO_2 emissions of 76g/km to 94g/km the percentage is 10%.
- For cars with CO_2 emissions of 95g/km to 99g/km the percentage is 11%.
- Cars with CO_2 emissions of 100g/km have a percentage charge of 12% and thereafter the charge increases by 1% for every complete 5g/km to a maximum of 35% (emissions of 215g/km and above).

There is an additional 3% supplement for diesel cars not meeting Euro IV emission standards. However, the maximum charge remains 35% of the car's list price.

Car fuel The benefit is calculated as the CO_2 emissions % relevant to the car and that % applied to a set figure (£21,100 for 2013/2014) e.g. car emission 100g/km = 12% on car benefit scale. 12% of £21,100 = £2,532.

1. **Accessories** are, in most cases, included in the list price on which the benefit is calculated.
2. **List price** is reduced for capital contributions made by the employee up to £5,000.
3. **Car benefit** is reduced by the amount of employee's contributions towards running costs.
4. **Fuel scale** is reduced only if the employee makes good **all** the fuel used for private journeys.
5. **All car and fuel benefits** are subject to employers National Insurance Contributions (Class 1A) of 13.8%.

PRIVATE VEHICLES USED FOR WORK

	2012/2013 Rates	2013/2014
Cars		
On the first 10,000 business miles in tax year	45p per mile	45p per mile
Each business mile above 10,000 business miles	25p per mile	25p per mile
Motor Cycles	24p per mile	24p per mile
Bicycles	20p per mile	20p per mile

MAIN CAPITAL AND OTHER ALLOWANCES

	2012/2013	2013/2014
Plant & machinery (excluding cars) 100% annual investment allowance (first year)	£25,000	£250,000
Plant & machinery (reducing balance) per annum	18%	18%
Patent rights & know-how (reducing balance) per annum	25%	25%
Certain long-life assets, integral features of buildings (reducing balance) per annum	8%	8%
Energy & water-efficient equipment	100%	100%
Zero emission goods vehicles (new)	100%	100%
Qualifying flat conversions, business premises & renovations	100%	100%

Motor cars: Expenditure on or after 01 April 2013 (Corporation Tax) or 06 April 2013 (Income Tax)

CO_2 emissions of g/km:	95 or less*	96-130	131 or more
Capital allowance:	100% first year	18% reducing balance	8% reducing balance

*If new

Research & Development:	Capital expenditure	100%

MAIN SOCIAL SECURITY BENEFITS

		2012/2013	2013/2014
		£	£
Child Benefit	First child	20.30	20.30
	Subsequent children	13.40	13.40
	Guardian's allowance	15.55	15.90
Employment and Support Allowance	Assessment Phase		
	Age 16 – 24	Up to 56.25	Up to 56.80
	Aged 25 or over	Up to 71.00	Up to 71.70
	Main Phase		
	Work Related Activity Group	Up to 99.15	Up to 100.15
	Support Group	Up to 105.05	Up to 106.50
Attendance Allowance	Lower rate	51.85	53.00
	Higher rate	77.45	79.15
Retirement Pension	Single	107.45	110.15
	Married	171.85	176.15
Pension Credit	Single person standard minimum guarantee	142.70	145.40
	Married couple standard minimum guarantee	217.90	222.05
	Maximum savings ignored in calculating income	10,000.00	10,000.00
Bereavement Payment (lump sum)		2,000.00	2,000.00
Widowed Parent's Allowance		105.95	108.30
Jobseekers Allowance	Age 16 - 24	56.25	56.80
	Age 25 or over	71.00	71.70
Statutory Maternity, Paternity and Adoption Pay		135.45	136.78

CAPITAL GAINS TAX

EXEMPTIONS	2012/2013	2013/
Individuals, estates etc	£10,600	£10,900
Trusts generally	£5,300	£5,450
Chattels proceeds (restricted to five thirds of proceeds exceeding limit)	£6,000	£6,000

TAX RATES		
Individuals:		
Up to basic rate limit	18%	18%
Above basic rate limit	28%	28%
Trustees and Personal Representatives	28%	28%
Entrepreneurs' Relief* – Gains taxed at:	10%	10%
Lifetime limit	£10,000,000	£10,000,000

*For trading businesses and companies (minimum 5% employee or director shareholding) held for at least one year.

CORPORATION TAX

	2012/2013	2013/2014
Full rate	24%	23%
Small companies rate	20%	20%
Small companies limit	£300,000	£300,000
Effective marginal rate	25%	23.75%
Upper marginal limit	£1,500,000	£1,500,000

VALUE ADDED TAX

	2012/2013	2013/2014
Standard rate	20%	20%
Annual registration threshold	£77,000	£79,000
Deregistration threshold	£75,000	£77,000

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