MARK PLAN AND EXAMINER'S COMMENTARY

The marking plan set out below was that used to mark this question. Markers were encouraged to use discretion and to award partial marks where a point was either not explained fully or made by implication. More marks were available than could be awarded for each requirement. This allowed credit to be given for a variety of valid points which were made by candidates.

Question 1

Total Marks: 40

General comments

Question 1 was a multi tax case study scenario.

Part 1 required the candidate using Exhibit 1 to

a) Identify and explain the tax implications for Cabbage plc of the incorporation of its overseas PEs. Your answer should include relevant calculations and a recommendation as to whether either, neither or both PEs should be incorporated.

   You should also consider any anti avoidance provisions which may apply.

b) Advise on the corporation tax implications of the restructuring of the loan to Frost Ltd.

Part 2 required the candidate to respond to Alisha's email (Exhibit 2).

Part 1

Incorporation of overseas PEs

Either PE could be incorporated by setting up or acquiring a new company locally and Cabbage plc transferring the PE's net assets to the company in exchange for shares.

The assessment of the advantages of incorporation can be made for each PE on an individual basis and does not affect any future PEs which Cabbage Ltd may set up.

When an overseas PE is incorporated, balancing adjustments and capital gains or losses will arise on branch assets transferred to the non-UK company.

Instead of incorporating the PEs, Cabbage plc could make an irrevocable election to exempt the profits of all of its overseas PEs. However, this would apply to all PEs, including future PEs and would also mean losses of those PEs would not be allowable. Given this could have adverse tax consequences for future PEs, this might be inadvisable. In addition, the Eastland PE would continue to suffer a tax rate which was 5% higher than the tax rate for overseas subsidiaries in Eastland.

Eastland

On incorporation of the Eastland PE a balancing charge on the P&M of £20,000 will arise, subject to corporation tax at 19% as part of trading profits.

Additionally, the following gains/profits and losses would arise on chargeable assets:

		£
Office building	(£400,000-£500,000)	(100,000)
Warehouse	(£150,000-£100,000)	50,000
Goodwill	(Post 1 April 2002 IFA profit)	2,000,000
Net gains/IFA profit		£1,950,000

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Tutorial note:

The gains postponement and the IFA postponement are two separate elections. The learning materials refer only to similar treatment for IFA's in respect of postponement of gains on incorporation. The majority of candidates added the profits to the gains. Credit was given for this approach and also where the candidate dealt with the gains and the IFA profit separately. Follow through marks were then given for either approach where the amount of gain postponed affected the crystallisation of the gain on the warehouse.

Corporation tax is payable if the gains/IFA profit are not postponed.

The tax can be postponed to the extent that the consideration for the transfer is securities, provided that:

- All the assets of the PE apart from cash are transferred;
- Cabbage plc owns at least 25% of the ordinary share capital of the new company; and
- A claim for relief is made.

If 20% of the trade is transferred to the Eastland managers, 20% of the gains/IFA profits deferred on incorporation will become chargeable to corporation tax immediately.

Gains/IFA profits of £390,000 will be chargeable to corporation tax, and gains/IFA profits of £1,560,000 will be deferred.

If the warehouse is then sold as expected within six years of incorporation, gains deferred relating to the warehouse will become chargeable as follows (assuming Cabbage plc owns 80% of the business):

1,560,000 x (50,000/2,050,000) = £38,049 [being balance of net gain deferred x (gain on asset at incorporation / gross gains at incorporation)].

Westland

The PE in Westland is managed and controlled from the UK and there is no double tax treaty between the UK and Westland, therefore even if the PE is transferred to a company incorporated in Westland, the company would still be resident in the UK and subject to UK corporation tax.

Provided Cabbage plc owns at least 75% of the Westland company on incorporation, assets will be transferred at nil gain/nil loss between the two companies.

In relation to the office in the UK, there is an exemption from SDLT where assets are transferred between companies in a 75% group.

Double tax relief will be given in the same way as it is currently given, for profits of the PE.

If the central management and control moves from the UK after incorporation, the company will be deemed to have disposed of and re-acquired all of its assets at market value immediately before becoming non-UK resident.

Assuming values at exit from the UK are the same as current values, a UK corporation tax charge of £114,000 (£600,000 x 19%) would arise on the goodwill.

As the migration would take place after 1 January 2020 no election to defer IFA profit on the goodwill can be made.

No exit charge will arise on the office building because it is located in the UK. If the company sells the office building, a UK corporation tax charge on the gain will arise at that point.

Westland imposes a 10% withholding tax on dividends. When added to the corporation tax rate of 12%, this results in an overall tax rate of 208% on profits transferred to Cabbage Ltd, which is higher than the UK corporation tax rate, therefore it would not seem worthwhile to incorporate the Westland PE.

Controlled Foreign Companies

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If incorporated, profits of Westland and Eastland, as foreign companies controlled by Cabbage Ltd, would potentially be apportioned to Cabbage Ltd to the extent that they pass through the 'gateway' unless one of the exemptions applies.

Profits pass through the gateway unless:

- The company has not been party to arrangements, one of the main purposes of which is to reduce UK or overseas tax.
- None of the company's assets are managed or controlled from the UK to any significant extent at any time in the accounting period, or the branch has the commercial capability to run the business if UK managed assets and risks were no longer being managed from the UK.

The incorporation of either PE may constitute an arrangement whose main purpose is to reduce UK tax, because management have stated that the purpose of incorporation is to minimise UK tax liabilities is to save tax, therefore it is likely that profits would pass through the gateway.

Additionally, as Westland is managed and controlled from the UK its profits would also pass through this gateway.

The exemptions include:

- Excluded territories exemption – this is unlikely to apply as neither Eastland nor Westland are high tax jurisdictions.
- Profits under £50,000 – this would apply to Westland, based on profit in the year to 30 June 2021.
- Profit margin less than 10% of operating expenditure – it appears that this would apply to both Eastland (profit margin 5.6%) and Westland (profit margin 3.3%), although further information is needed as amounts paid to related parties and the cost of goods not used locally need to be excluded from operating expenditure.
- Low tax exemption – 75% of the UK tax rate is 14.25%. Therefore, this exemption would not apply to Eastland as the Eastland corporation tax is only 10%.

Westland would meet the low profit exemption, however, profits may rise in the future. Eastland might meet the profit margin exemption.

<u>Summary</u>

	Election to exempt profits of overseas PEs	**Incorporation - Eastland**	**Incorporation - Westland**
Immediate tax cost	None	- £3,800 CT on £20,000 balancing charge - No CT on transfer of assets if claim for relief is made and consideration is wholly securities. - £74,100 CT on gain of £390,000 if 20% of the trade is transferred to the Eastland managers	None, but £114,000 CT on emigration of company.
Annual tax saving	£28,800 (40k @ 7%) + (650k @ 4%)	£58,500 (650k @ 9%)	None
Drawbacks	- Election is irrevocable and will apply to future PEs. If loss-making, losses will not be allowable.	- Gains postponed on incorporation crystalise when shares are sold or the non-UK resident co.	- New company would remain UK resident unless management is moved out of the UK.

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	- Administrative cost of identifying the amount subject to exemption.	disposes of assets within 6 years - CT on gain of £38,049 when warehouse is sold by Eastland co will be £7,229 - If CFC exemption does not apply, any tax saving will be wiped out by the CFC charge.	- Westland charges withholding tax on dividends, therefore if profits are paid to a UK parent co. by a Westland co. the overall tax rate is higher than the UK CT rate.

Recommendation

An election to exempt the profits of overseas PEs will save £28,800 tax p.a., however when Cabbage plc sets up future PEs the election will also apply to them and it is irrevocable, meaning any future PE losses are not allowable.

A larger saving of £58,500 p.a. can be made by incorporating the Eastland PE (due to the lower CT rate in Eastland compared to the tax rate on the earnings of foreign-owned PEs).
This comes at a cost of £3,800 corporation tax on the balancing charge when the trade ceases, plus corporation tax on gains if 20% of the business is transferred to the local management, and on sale of the warehouse. However, this cost will be outweighed within two years by annual tax savings.

It would not be worth incorporating the Westland PE. While it remains managed from the UK, the Westland company would be UK tax resident in any case. If the company emigrates to Westland there would be no tax saving on profits paid to the UK because Westland imposes a withholding tax on dividends.

Therefore, provided it is confirmed that the CFC exemption does apply, it is recommended that the board should consider the incorporation of the Eastland PE.

After incorporation profits of £650,000 pa will be taxed in Eastland and not in the UK, at 10%, resulting in an overall CT saving of £58,500 p.a. (9% x £650,000)

Frost Ltd

When the existing loan is replaced with one which is interest free, it would not reduce the tax losses going forward. This is because transfer pricing rules apply where the transactions between connected companies are not priced on an arm's length basis, which require the arm's length price to be applied for tax purposes. Cabbage plc would therefore be taxed on the interest which it would charge to Frost Ltd in an arm's length situation. Frost Ltd can then claim a 'corresponding deduction' of that amount, but this will just add to the trading losses. Because Frost Ltd is wholly owned, there would be group relief available in any event.

If Frost Ltd has more debt than could be supported on an arm's length basis (including the interest free debt, which for these purposes would be assumed to carry the arm's length interest), then that deduction could be restricted under the thin capitalisation rules. However, if this is the case then it may be possible to argue that part of the loan is quasi-equity and would not be interest bearing at all in an arm's length situation, meaning that both the deemed deduction in Frost Ltd and the deemed income in Cabbage plc would be reduced.

We should also consider whether Frost Ltd is thinly capitalised at present, as if it is the interest on the loan from Cabbage plc may not be tax deductible. If this is the case, Cabbage plc should be able to claim a corresponding deduction to reduce its taxable income.

Most candidates recognised the implications of incorporation of a PE and competently explained the deferral relief. Often, the fact that the CFC legislation may be in point, was missed with the poorer candidates wasting time describing the possible group structure and providing very generic explanations on the difference between PE's and subsidiaries. A high number of candidates mentioned Business Asset Disposal relief as a way of mitigating tax; clearly a fundamental misunderstanding and confusion between individuals making disposals and corporate entities.

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In relation to the loan to Frost Ltd, the higher scoring candidates recognised that the thin capitalisation / transfer pricing rules were relevant and therefore scored good marks. Again, there was lots of confusion between the rules on close company loans and corporate avoidance, with a number of candidates explaining the rules on beneficial rules to participators and the s455 penalty.

Total possible marks	**39.5**
Maximum full marks	**30**

Part 2

Sale of Paintings

Alisha is UK resident in the current tax year (2021/22), because she is living and working full-time in the UK. As a UK resident, Alisha is taxable on her worldwide income and gains.

Alisha is not UK domiciled, as she does not have a UK domicile of origin and intends to return to Eastland as her permanent home.

However, as she has been in the UK for at least 15 out of the previous 20 years (since 2000) she is deemed to have UK domicile for income tax and CGT and cannot claim the remittance basis as she did in 2015. The gain on the sale of the two paintings will therefore be subject to UK CGT on an arising basis.

Provided the conditions are met for rebasing, the gain is calculated using market value on 5 April 2017.

Alisha is a qualifying individual because she paid the remittance basis charge in 2015, does not have a UK domicile of origin, has not previously been domiciled in the UK, and has been deemed domiciled in the UK since 2017/18.

The paintings were owned by Alisha on 5 April 2017, are disposed of after that date, and appear to not have been situated in the UK between 16 March 2016 and 5 April 2017, Therefore, rebasing will apply to the sale.

Painting 2 is standing at a loss, therefore Alisha could elect not to use market value at 5 April 2017 and instead use actual cost. However, because of exchange rate movements this election would not be beneficial: actual cost is £126,667 (190,000/1.5) and value at 5 April 2017 is £128,571 (180,000/1.4), therefore actual cost should be used.

Alisha will make gains on the sale of the two paintings as follows:

	Painting 1 (£)	**Painting 2 (£)**
Proceeds	181,818 (200,000/1.1)	109,091 (120,000/1.1)
Cost	114,286 (160,000/1.4)	128,571 (180,000/1.4)
Gain (loss)	67,532	(19,480)

CGT will be due as follows:

	£
Gain on painting 1	67,532
Loss on painting 2	(19,480)
Net gain	48,052
Less AEA	(12,300)
Chargeable gain	£35,752
CGT @ 20%	£7,150

Bringing funds to the UK

Alisha has previously claimed the remittance basis. If income or gains for which the remittance basis was claimed are brought to the UK in any later year in which she is UK resident, they will be subject to tax in the year remitted.

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However, if the income or gains brought to the UK are loaned to an unquoted UK resident trading company, they will not trigger a tax charge as remitted income provided they meet the following conditions:

- Funds are invested within 45 days of being brought into the UK;

- if the loan is repaid the proceeds must be removed from the UK within 45 days or reinvested in a qualifying asset within 90 days

- Alisha does not benefit as a result of the investment.

It appears that Alisha may be able to meet these conditions when she makes a loan to her friend's company.

If Alisha remits overseas funds to the UK which have already been subject to UK tax, there is no further tax charge regardless of what the funds are used for.

A significant number of candidates correctly identified that Alisha was a deemed UK domicile, which was very encouraging to note. Accurate calculations and explanations of the rebasing election were contained in candidates answers. The investment in the unquoted trading company with remitted income was an area of the question which was done exceptionally well. Candidates are clearly comfortable with this type of question.

The weaker answers did not identify the relevance of the deemed domicile rules and instead either explained the conditions of residency and domicile – without taking into account the details in the scenario; or simply offered alternative calculations comparing remittance v non remittance basis user. Whilst the deemed domicile rules are still relatively new, the amount of candidates who missed the relevance of them, was disappointing.

Total possible marks	**16**
Maximum full marks	**10**
Total possible marks	**55.5**
Maximum full marks	**40**

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Question 2

Total Marks: 30

General comments

This was a 30 mark question which focussed on ethics, employment status and employment benefits. The requirements were:

Part 1 Identify the ethical implications of Sam's comment in relation to Ele Ltd (Exhibit 1) and the actions your firm should take.

Part 2

a) Using the information in Exhibit 2, identify whether each of the two proposed course presenters (Andrew and Marie) would be considered to be employed or self-employed for tax purposes. Your advice should be accompanied by explanations.

b) Based on your decision in 2.2 a) above, prepare calculations of:

- the after-tax cash receivable by each of Andrew and Marie; and

- the cost, to BetterYou Ltd, of each course presenter.

c) Identify and explain the tax implications for both BetterYou Ltd and the course presenters if the course presenters provided their services through personal service companies.

Part 3

Provide advice to Sam about the tax consequences, for both BetterYou Ltd and for Jamie, of each alternative incentive scheme (Exhibit 3). Your answer should provide a recommendation about which alternative should be chosen.

Part 1

One of the five fundamental ethical principles for accountants is confidentiality.
Sam is asking the firm to breach this principle.

The firm cannot disclose information relating to a client unless:

- Disclosure is permitted by law and is authorised by the client; or
- Disclosure is required by law.

In this case, disclosure could only be made if authorised by the client.

Safeguards should be in place to ensure confidentiality is not breached.

General safeguards would include staff training, and the firm should also consider introducing specific safeguards to ensure that information is not disclosed to Sam, such as having different staff working on matters relating to each client, with no access to the records of the other client.

Before accepting Ele Ltd as a client, the firm would have evaluated whether there were any questionable issues associated with it.

I should not disclose the information requested.

I should ensure that my colleagues are aware of the dispute between Ele Ltd and Sam.

Answers to ethics questions have steadily improved over past sittings. Candidates often produced answers focussing on conflict of interest and identifying the need for separate engagement teams. However, a surprising number did not question the integrity of the information or the confidentiality aspects

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of disclosure and use of the information. Candidates should be encouraged to try to make their answers very specific to the scenario set.

Total possible marks	**6**
Maximum full marks	**5**

Part 2

Whether an individual is employed or self-employed is determined based on a number of factors which come from case law built up over time, essentially the test is whether the individual is in business on their own account, or whether they are providing their service to the employer. Factors considered include the level of control exercised, the ability to provide a substitute, and whether the worker is taking any financial risk.

Andrew Day

It is likely that he would be considered to be self-employed. He is providing services to BetterYou Ltd as part of an existing business, and is able to provide a substitute, which is a strong indicator that the contract is for the provision of a service, rather than of Andrew's service personally.

That he is paid a fixed amount per presentation, from which he covers his own expenses, is a further indicator that he is self-employed.

Marie Knight

Marie would appear to be an employee. She is contracted for a set number of hours, paid an hourly rate, and must carry out work personally, these are all factors which are consistent with employment. She does not bear any financial risk.

A lack of holiday, sick pay and other benefits would be an indicator of self-employment, but if overall the contract is one of employment, then BetterYou Ltd will have to provide statutory benefits in line with employment rules.

HMRC provide an online tool (CEST) which gives a view of whether somebody is employed or self-employed which HMRC have committed to stand by, provided the information entered accurately reflects the contract.

If course presenters are employed, BetterYou Ltd must pay Class 1 secondary NIC.

Based on a salary of £60,000 pa, the NI cost to BetterYou Ltd would be (60,000 – 8,788) x 13.8% = £7,067.

Additionally, BetterYou Ltd must set up pensions for employees and contribute a percentage of salary. Employment costs are deductible for corporation tax; the overall tax and NI cost to BetterYou Ltd is £54,324 (£67,067 x 81%)

If course presenters are self-employed, the cost to BetterYou Ltd is simply the amount invoiced, which again is eligible for corporation tax relief. Therefore, the cost is £48,600 (£60,000 x 81%)

Tax and NI for course presenters:

	Employed	**Self-employed**
	£	**£**
Total earned	60,000	60,000
Personal allowance	(12,500)	(12,500)
	-----------	----------
Taxable income	47,500	47,500
Income tax payable:		
37,500 x 20%	7,500	7,500
10,000 x 40%	4,000	4,000
	---------	-------
	11,500	11,500

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National Insurance		
Class 1 primary:		
50,000 – 9,500 x 12%	4,860	
60,000 – 50,000 x 2%	200	
	5,060	
Class 2 £3.05 x 52		159
Class 4:		
50,000 – 9,500 x 9%		3,645
60,000 – 50,000 x 2%		200
		3,845
Total tax and NI	16,560	15,345
Net cash	43,440	44,655

Tutorial note:

The question stated that Andrew had other clients. If candidates assumed that the personal allowance had already been used in relation to Andrew's other self-employment income, or that it could potentially have been fully abated given the level of the fee from Better You Ltd, full credit was given. This would have also resulted in a different amount for NIC. The alternative net cash position would have been as follows:

	Self-employed
	£
Total earned	60,000
Personal allowance	NIL

Taxable income	60,000
Income tax payable:	
37,500 x 20%	7,500
22,500x 40%	9,000

	16,500
National Insurance	
Class 1 primary:	
50,000 – 9,500 x 12%	
60,000 – 50,000 x 2%	
Class 2 £3.05 x 52	159
Class 4 £60,000 x 2%	1,200
	1,359
Total tax and NI	17,859
Net cash	42,141

Marie being employed costs BetterYou Ltd an additional £5,724 per year in tax and national insurance compared to Andrew, before taking into account other obligations such as pension contributions and statutory leave.

Additionally, Marie's take-home pay is lower than Andrew's.

The additional costs are due to national insurance. Class 1 secondary NI is due on salary but not on payments made to the self-employed. Additionally, Class 1 NI is charged to employees at 12% on earnings below the upper earnings limit (£50,000) compared to 9% for the self-employed.

BetterYou Ltd

If the presenters provide their services via a personal service company then BetterYou Ltd will have no obligation to consider their employment status. It will be the responsibility of the presenters under the IR35 legislation to consider if they are deemed to be employed by BetterYou Ltd.

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Therefore, the cost to BetterYou Ltd of the contracts with Alicia and Michael will be the same as the cost of the contract with Andrew, being the £60,000 paid (less corporation tax relief). No employer NI will be due and BetterYou Ltd will not have additional obligations to presenters.

Andrew Day

As Andrew is self-employed, if he were to work through a personal service company the IR35 legislation would not apply to him.

His company would pay corporation tax on its profits, and Andrew would be free to distribute post-tax profits as dividends, taxed at the dividend rates of 7.5% / 32.5% / 38.1%

Marie Knight

If Marie provides her services through a PSC the IR35 legislation would apply, because the contract would be one of employment were it not for the presence of the intermediary company. Therefore, Marie's PSC would bear the cost of employer NI, instead of BetterYou Ltd.

Any amount earned from the engagement by Marie's PSC and not paid to her by the PSC as salary is treated as a deemed employment income payment on 5 April of the tax year, and subject to tax and NI even if it is not actually paid.

A 5% deduction is allowed to cover expenses of running the company.

Any dividends paid out of the deemed employment payment are treated as reduced by the amount taxed as deemed employment income, so that they are not taxed twice.

Tax and NI for Marie would be as follows:

	£
Employment income	60,000
Less 5% allowable deduction	(3,000)
	57,000
Less employer NIC (57,000 – 8,788) x 13.8/113.8	(5,846)

Deemed employment income	51,154
PA	(12,500)

Taxable	38,654
37,500 x 20%	7,500
1,154 x 40%	462

Income tax due:	7,962
50,000 – 9,500 x 12%	4,860
51,154 – 50,000 x 2%	23

NI due:	4,883
Corporation tax on company TTP of £3,000	570
Total tax and NI (7,962 + 4,883 + 5,846 + 570)	19,261
Net cash (60,000 less total tax and NI)	40,739

By working through a PSC Marie would lose out as she would have net cash of £40,739 compared to £43,440 as an employee. Additionally, she would lose out on employee benefits such as employer pension contributions.

However, BetterYou Ltd would save £5,724 per year (£54,324 - £48,600) before taking into account the cost of additional savings on obligations of having an employee compared to paying a worker through a PSC.

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Candidates were very comfortable explaining the employment status indicators and the majority concluded that Andrew was self-employed and Marie was employed. Only a small number of candidates considered the cost to Better You of either status. Often candidates jumped straight to the conclusion in the first part of their answers that IR35 would apply and explained the tax implications of this. Whilst this was relevant in part c of part 2, a lot of marks were missed from the direct comparison of employed v self-employed and the resulting calculations. The requirements were broken down in such a way to try to guide candidates to adopt a step by step approach, but this was often ignored and as a consequence, candidates missed out on several marks.

Total possible marks	**31**
Maximum marks	**18**

Part 3

Cash Incentive

Assuming you achieve your sale price of £5 million, 4% of this would be a cash incentive for Jamie of £200,000.

This would be taxed at additional rate as Jamie's salary is £150,000, so he would receive £106,000 after 45% tax and 2% NI (£200,000 x 53%)

BetterYou Ltd would pay Class 1 Secondary NI of £27,600 (£200,000 x 13.8%)
Total cost to BetterYou Ltd after tax relief is £184,356 (£227,600 x 81%)

Share Options
Assuming the company is currently valued at £1 million the value of the options to be granted is £40,000 (subject to any discount due to the low percentage owned).

If options are granted other than through a tax-advantaged scheme the tax consequences will be the same as if Jamie receives cash: there will be no tax when the options are granted, but assuming options are exercised on the sale of the company and are sold immediately by Jamie, he will be subject to income tax and NI on exercise of the value of the share options, through PAYE as the shares are readily convertible to cash. BetterYou Ltd will again pay Class 1 secondary NI.

As the options are to be issued for no consideration, they cannot be issued under either the CSOP or SAYE schemes, and are over the maximum value which can be awarded in a SIP, which would also need to be open to all employees.

The EMI scheme can be used.

The company would need to have under 250 employees (to be checked) and would appear to have gross assets under £30 million.

At £40,000 the value of the options granted to Jamie will be within the maximum of £250,000.

There is no tax when the options are granted.

The advantage of the EMI scheme is that at exercise Jamie will pay income tax on the difference between the market value at grant (£40,000) and the exercise price (zero) rather than on the market value at exercise (£200,000).

When Jamie then sells the shares, the proceeds above the amount already charged to income tax will be subject to capital gains tax, at up to 20% rather than the 45% charged on income.

Another advantage is that gains on EMI shares qualify for Business Asset Disposal Relief (BADR) with no requirement to hold 5% of shares, and the two-year holding period runs from the grant of the option.

Assuming the options have been held for two years and BADR applies, if the EMI scheme is used Jamie's tax position would be:

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	£
Income tax and NI on exercise of options (£40,000 x 47%)	18,800
Plus capital gains tax:	
Proceeds	200,000
Cost	(40,000)
Gain	160,000
AEA	(12,300)
Taxable gain	147,700
CGT@ 10%	14,770
Total tax paid	33,570
Net cash	166,430
Additional cash received through EMI compared to cash bonus	60,430

For BetterYou Ltd there would be some additional administrative costs in awarding EMI shares, however the cost of providing shares under the EMI scheme is allowable for corporation tax, as BetterYou Ltd is not a subsidiary company.

Employer NI at 13.8% would be due on the £40,000 taxed as employment income rather than on £200,000, so £5,520 employer NI will be due rather than £27,600.

Therefore, it would be preferable from the point of view of both Jamie and BetterYou Ltd to award Jamie EMI options rather than cash.

The tax consequences of the cash incentive did not cause any problems for candidates and the income tax and NIC calculations were for the most part, very accurate.

The share option incentive was less well done with a number of candidates choosing to list the conditions needed for the various schemes including CSOP, EMI and SIP. The scenario had been designed so that only the EMI scheme was relevant to guide candidates to discuss the actual specific tax implications relating to the scenario set.

Total possible marks	**12.5**
Maximum marks	**7**
Total possible marks	**49.5**
Maximum full marks	**30**

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Question 3

Total Marks: 30 marks

General comments

Part 3 was a question focussing on income tax, owner managed business CGT and IHT issues, together with an ethics issue.

The requirements were:

Part 1
Identify and explain the tax consequences of each of the three alternatives for letting Sunny Cottage outlined in the Exhibit. Make a recommendation about the most tax efficient alternative that Jennifer should choose to let Sunny Cottage.

In this part of the question you should ignore inheritance tax planning.

Part 2
Identify and explain the tax consequences of each strategy to mitigate inheritance tax, that Jennifer is considering. Recommend which strategy should be adopt and identify the ethical implications of offering this tax advice.

Part 1

Alternative 1
The rental profit is chargeable to income tax. No NICs are payable on property income.

Finance costs are not deductible as an expense, but instead relief is given at 20% as a tax reducer.

Jennifer is a higher rate taxpayer. Tax due would be £8,000 (being £12,000 [£30,000 x 40%], less 20% tax reducer of £4,000 [£20,000 x 20%]).

After paying interest, Jennifer's profit is £10,000 pa, therefore the tax rate is very high at 80%, and net cash received only £2,000 pa.

Alternative 2
Incorporation would have tax implications as follows:

CGT
As furnished holiday accommodation, the disposal of the property qualifies for business asset disposal relief or gift relief.

Rollover relief is not available as Jennifer is not purchasing a qualifying asset for the gain to be rolled into.

Incorporation relief is not available unless the property has been 'actively managed', which is not the case as work is outsourced and only amounts to two hours per week.

If Jennifer gifts the property to Sunny Cottage Ltd and claims gift relief, there will be no CGT payable.

The base cost of the property for the company will be the same as Jennifer's base cost, which is:

50% of £360,000	180,000
50% of £750,000	375,000
	555,000

On any future sale of the property, the company will be liable to corporation tax on the proceeds over £555,000 and the proceeds will then be taxed again when extracted from the company.

As business asset disposal relief (BADR) is available to Jennifer, she may be better off paying tax now on the gain.

Jennifer and her company are connected, so the property would transfer at market value.

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Primary residence relief (PRR) is available for the period that the house was Jennifer's main residence plus the last 9 months of ownership.

CGT due would be:

	£
Proceeds (MV)	1,100,000
Cost:	
50% of £360,000	180,000
50% of £750,000	375,000
	555,000

Gain	545,000
Less PRR:	
(120 months + 9 months / 252 months x 545,000)	(278,988)
Gain chargeable	266,012
Less AEA	(12,300)
	253,712
CGT @ 10%	25,371

The company would receive the property at its current market value, which will be reflected either in the value of Jennifer's shares, or owed to Jennifer by the company.

SDLT

SDLT will apply to the transfer between Jennifer and her company even if the property is gifted for no consideration.

As Sunny Cottage Ltd is a company and the value of the property is over £500,000, the rate is 15%.

SDLT payable by Sunny Cottage Ltd will be £1,100,000 x 15% = £165,000

ATED

Sunny Cottage Ltd would be subject to ATED as a company with an interest in a UK dwelling worth more than £500,000.

Relief is given for rental businesses so there would be no annual charge, however an annual return would need to be submitted.

Corporation Tax and extraction of profits

Finance costs are allowable for companies.

Therefore, the company would pay Corporation Tax of £1,900 on an annual profit of £10,000.

The remaining £8,100 could be extracted by Jennifer either as dividend or salary.

Salary would be taxable at 40%. Dividends would be taxed at 0% on the first £2,000 and 32.5% on the remainder, therefore Jennifer would be better off with dividends and would receive net cash after tax of £6,118 (£8,100 – [£6,100 x 32.5%])

Alternative 3

CGT due on the sale of Sunny Cottage would be £25,371 as above.

No rollover relief is available on the purchase of the new property, as it is not being let as FHA.

However, by selling Sunny Cottage now Jennifer can take advantage of BADR, which will no longer be available if Sunny Cottage is let long term.

As Jennifer will have no mortgage, she will not be affected by the restricted relief for finance costs. Income tax on profit would be £8,000 (£20,000 x 40%), leaving Jennifer with net cash of £12,000 per year.

Jennifer would receive more after-tax cash under alternative 3. I recommend she opts for this alternative. The SDLT cost under alternative 2 is significant and under alternative 1, the fact that the deductibility of finance costs are restricted means that alternative 3 is the most effective.

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Candidates dealt with the first alternative well. However, answers to the following two alternatives were poor. In relation to the incorporation, candidates did not consider the significant stamp duty cost or the ATED rules. Time was also wasted explaining incorporation relief when the scenario had clearly given the facts that there was no active management and thus, incorporation relief was irrelevant. A high proportion of candidates thought that rollover relief would apply in alternative 3. Again, the scenario had made clear that this was a move away from furnished holiday accommodation into the long term letting market – the latter not being a "business" in the same way as FHA. The availability of PRR was also ignored, with only the stronger answers considering its availability.

Total possible marks	**22**
Maximum full marks	**18**

Part 2

As Sunny Cottage is not currently actively managed by Jennifer, it does not in any case qualify as Relevant Business Property for Business Property Relief and would be subject to IHT even as FHA.

Option 1

This would be a Gift With Reservation Of Benefit (GWROB) because Jennifer continues to benefit from the rental income generated by the property.

The initial transfer to Jennifer's daughter is a PET.

As long as Jennifer continues to receive the rental income, the property is also treated as part of her estate.

If Jennifer retains the benefit until her death, Sunny Cottage will be treated as part of her death estate and charged to IHT accordingly at its value at the time.

If Jennifer stops benefiting from the rent before her death, she is treated as making a further PET at that time.

This means there may be two charges to IHT, only the event which results in the higher amount of IHT being payable will actually be chargeable.

Option 2

An outstanding loan from the company would reduce the value of Jennifer's assets at death, however the receivable would increase the value of her shares in Sunny Properties Ltd by a corresponding amount, so there would be no IHT benefit from this idea.

Sunny Properties Ltd will be a close company. If it lends money to Jennifer, a participator, the company will need to pay notional tax of 32.5% of the loan outstanding. If the loan is interest free, Jennifer will have to pay tax on the benefit of the cheap loan.

Option 3

A gift of cash to her daughter will be PET.

However, as Jennifer will benefit from the rent on a property bought with money she has gifted to her daughter, this will fall under the Pre-Owned Asset Tax (POAT).

The POAT is an income tax charge on the amount of the benefit received by the transferor.
The amount treated as additional income of Jennifer is the rent that could be expected from letting the property to an unconnected person.

Therefore, Jennifer's daughter will be taxed on the actual rent received, as she owns the property, and additionally Jennifer will be taxed on the rent under the POAT.

Jennifer can elect out of the POAT rules and instead use the GWROB treatment if an election is made by 31 January following the tax year in which the POAT charge first applies.

Ethical Implications

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PCRT states that accountants should not be involved in tax planning arrangements that either aim to achieve results that were clearly not intended by Parliament, or are highly artificial and seek to exploit loopholes in the legislation.

PCRT advises that tax planning is legal and taxpayers are entitled to enter into transactions that reduce tax.

Tax avoidance is not illegal. Tax evasion involves seeking to mislead HMRC and is illegal.

There is no indication that Jennifer is seeking to mislead HMRC or hide information.

However, as she is seeking to reduce her tax payable, we should take particular care to ensure that transactions undertaken are acceptable.

The GAAR applies to transactions where tax avoidance was one of the main purposes, and the transaction is inconsistent with the principles on which the tax provisions are based, cases where there are contrived or abnormal steps, and transactions intended to exploit shortcomings in the legislation.

Jennifer's proposals do appear to involve contrived or abnormal steps so could be considered abusive.

Where the GAAR applies, just and reasonable adjustments are made to counteract the tax advantage obtained.

Most candidates picked up that the gift with reservation of benefit rules were relevant under option 1. Only a small number of candidates identified the close company beneficial rules for option 2 with a lot of answers simply focussing on the deductibility of interest. Option 3 generated a diverse range of answers – some were excellent, identifying the pre-owned asset tax charge whilst the poorer answers explained in great depth the difference between PET's and CLT's displaying general confusion.

Total possible marks	**17.5**
Maximum full marks	**12**
Total possible marks	**39.5**
Maximum full marks	**30**

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