ICAEW

PROFESSIONAL LEVEL

TUESDAY 7 SEPTEMBER 2021

2.5 HOURS

BUSINESS PLANNING: TAXATION

This exam consists of **three** questions (100 marks).

Marks breakdown

Question 1	40 marks
Question 2	30 marks
Question 3	30 marks

Assume that the Finance Act 2020 rates and allowances as set out in the ICAEW Learning Materials for exams in 2021 will continue to apply for 2020/21 and future years unless you are specifically instructed otherwise.

The link to the ICAEW bookshelf can be found in each question above the word processing area.

Important Information:

1. Please read the instructions carefully before you begin your exam.

Starting and ending the exam

2. Click on the **right arrow** in the header to begin the exam. The exam timer will begin to count down.

3. A warning is given five minutes before the exam ends. When the exam timer reaches zero, the exam will end. To end the exam earlier, navigate to the last question and click the right arrow button. Click the **Submit** button to close the exam.

Encountering issues during the exam

4. If you encounter any issues during the delivery of the exam you should alert the invigilator (or online chat support if you are sitting remotely). Neither the invigilator nor the online chat support can advise you on how to use the software.

Preparing your answers

5. Respond directly to the exam question requirements. Do not include any content of a personal nature, this includes your name or any other identifying content.

6. You may use a pen and paper for draft workings. Any information you write on paper will not be read or marked.

7. The examiner will take account of the way in which your answers are structured. You must make sure your answers and workings are clearly visible in the word processing area when you submit your exam. **Only your answer in the word processing area will be marked.** You must copy over any data from the spreadsheet area to the word processing area for marking. The examiner will **not** be able to expand rows or columns where content is not visible.

After the exam

8. If you are sitting in an exam centre and believe that your performance has been affected by any issues which occurred during the exam, you must inform your invigilator at the time of occurrence and follow up with ICAEW directly after your exam. You will then need to submit a special consideration application to ICAEW if you wish us to consider such issues, as per our published policy. If you are sitting remotely please submit your special consideration application referring to anything of note which occurred and will have been recorded, for use as evidence to support your case.

9. A student survey is provided post-exam for feedback purposes.

Question 1

You are an ICAEW Chartered Accountant, working in practice as a tax adviser. The Cabbage plc group of companies and Cabbage plc's sales director, Alisha Hussain, are both tax clients of your firm.

Background information

Cabbage plc

Cabbage plc is an online retailer of sportswear, with a turnover of £15 million pa and more than 1,000 employees.

Cabbage plc has two overseas permanent establishments (PEs), based in non-EEA countries. One PE is based in Eastland and the other in Westland. Cabbage plc may set up further overseas PEs in the future, as part of its expansion strategy.

Cabbage plc also has one wholly-owned UK subsidiary, Frost Ltd.

For the year ended 30 June 2021, Cabbage plc has tax-adjusted trading profits of £1.35 million and Frost Ltd has tax-adjusted trading losses of £127,500.

At a recent meeting, the management of Cabbage plc discussed two proposed transactions:

- incorporation of the two overseas PEs; and
- restructuring of a loan made by Cabbage plc to Frost Ltd.

Details of these two proposed transactions are in a file note (**Exhibit 1**).

Alisha Hussain

Alisha Hussain, the sales director of Cabbage plc, is originally from Eastland, but has lived in the UK since 6 April 2000. She has sent you an email requesting tax advice (**Exhibit 2**).

Requirements

1. Using the information in Exhibit 1, prepare notes for your manager 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 any anti avoidance provisions which may apply. Include a recommendation on whether each of the PEs should be incorporated for tax purposes.

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

2. Respond to Alisha's email (Exhibit 2).

Total 40 marks

Exhibit 1

File Note:
Cabbage plc - details of two proposed transactions:

(1) Incorporation of overseas PEs

The management of Cabbage plc is considering incorporating its overseas PEs, on 1 October 2021, to minimise its tax liabilities.

In order to decide if incorporating the PEs will reduce UK tax payable, Cabbage plc has provided the following information:

Cabbage plc and its PEs have always been profitable. Profits are expected to continue at their current levels for the foreseeable future.

The calculation of taxable profits in both Eastland and Westland is similar to the calculation of taxable profits in the UK. Neither Eastland nor Westland has a double tax treaty with the UK.

Tax rates in Eastland and Westland are as follows:

	Eastland	**Westland**
Corporation tax rate	10%	12%
Tax on earnings of foreign-owned PEs	15%	12%
Withholding tax on dividends	None	10%

Eastland PE

The Eastland PE was set up in 2010.

The management of the PE live in Eastland and make decisions locally.

It has been agreed that on incorporation of this PE, the local management of the PE would purchase 20% of the shares in the company.

In the year ended 30 June 2021, operating expenditure was £11 million, with profits of £650,000.

The following information on the PE's assets has been provided. All assets are located in Eastland:

	Cost plus indexation to December 2017	**Estimated market value on 1 October 2021**
	£	**£**
Plant and machinery (Note 1)	50,000	20,000
Office building	500,000	400,000
Warehouse (Note 2)	100,000	150,000
Internally generated goodwill	NIL	2,000,000

Note 1

- Plant and machinery is made up of many small items, each with a cost and current market value of less than £6,000.
- Tax written down value of the plant and machinery as at 30 June 2021 was Nil.

Note 2
The warehouse will be sold in the next 18 months.

Westland PE

The PE in Westland was set up in 2008 and is managed from the UK, with local workers implementing decisions made by UK management.

If the Westland PE is incorporated, Cabbage plc will consider transferring the management, in terms of the key decision making, to a team working for the incorporated company in Westland. This will be done in the next 12 months.

In the year ended 30 June 2021, operating expenditure was £1.2 million with profits of £40,000.

The following information has been provided about the PE’s assets:

	Cost plus indexation to December 2017	**Estimated market value on 1 October 2021**
	£	**£**
Internally generated goodwill	0	600,000
UK office building	100,000	110,000

(2) Restructuring loan made to Frost Ltd

Frost Ltd is having trading difficulties and has been making trading losses. The company has an existing long-term, floating rate loan from Cabbage plc.

The chances of repaying this loan are low. However, instead of writing off this loan, Cabbage plc proposes making a new, interest-free loan to Frost Ltd, allowing the original, interest-bearing loan to be repaid. The new loan will be repayable on demand.

The directors of Cabbage plc believe that there will be no expense on Frost Ltd’s income statement in respect of the new loan and that this arrangement will prevent interest being charged as an expense to Frost Ltd. This would therefore reduce the amount of the tax-adjusted losses generated in future accounting periods.

Exhibit 2

Email from Alisha Hussain

To: Tax Adviser
From: Alisha Hussain
Date: 1 September 2021

I would like some advice on my personal tax position. Although I have been resident in the UK for a long time, I still consider Eastland to be my permanent home, and I intend to return there, eventually.

I own an extensive art collection in Eastland, which is displayed in the house I own there. I am considering selling two paintings from my art collection in November 2021. I previously sold a painting in 2015 and as I claimed the remittance basis in that tax year and paid the remittance basis charge, the gain on that sale was not taxed in the UK.

Eastland does not tax any gains made or proceeds from the sale of assets. Please confirm the UK tax implications of the proposed sale of two paintings.

Details of the two paintings I intend to sell, valued in Eastland dollars ($E), are:

	Painting 1	**Painting 2**
Cost ($E)	80,000	190,000
Current value ($E)	200,000	120,000
Value on 5 April 2017($E)	160,000	180,000
Exchange rate at purchase	$E1.5 to £1	$E1.5 to £1
Exchange rate on 5 April 2017	$E1.4 to £1	$E1.4 to £1
Current exchange rate	$E1.1 to £1	$E1.1 to £1

I would like to bring some of my overseas savings to the UK so that I can provide a loan to my friend’s company. The company is an unlisted UK resident trading company, and the loan will be made on a commercial basis. My friend believes that I could be entitled to a tax relief as a result of my investment. Please identify which tax relief I would be entitled to and explain the operation of the relief and the potential impact on my tax liabilities.

Question 2

You are an ICAEW Chartered Accountant working for a firm of ICAEW Chartered Accountants as a tax adviser.

BetterYou Ltd and its sole director and shareholder, Sam Brown, are clients of your firm.

Background information

BetterYou Ltd was incorporated in 2017 and provides digital marketing services to a range of clients.

In a telephone conversation, Sam set out her plans for the future of the business (**Exhibit 1**). Sam plans to sell the company within the next three years and expand the business by offering training courses in digital marketing. In order to do this, BetterYou Ltd needs to recruit course presenters. Details of the proposed contract to be offered to the two course presenters and of two potential candidates for the roles are included in **Exhibit 2**.

Sam is concerned that her plans to expand the business will fail without help from Jamie Layton, a key employee. As a result, Sam wants to ensure that Jamie does not leave the company in the next three years. She intends to offer Jamie a share of the sale proceeds on sale of the company as an incentive for him to remain with the company and has asked for your advice about the most tax efficient method of doing so (**Exhibit 3**).

Requirements

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

2. Prepare notes for a meeting with Sam Brown addressing the following issues:

    a) Using the information in Exhibit 2, identify and explain the tax status of the two proposed course presenters (Andrew and Marie).

    b) Based on your decision in 2a) 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.

3. Provide advice to Sam about the tax consequences, for both BetterYou Ltd and for Jamie, of each alternative incentive scheme (Exhibit 3).

Total: 30 marks

Exhibit 1
Notes of telephone conversation with Sam Brown

Sam Brown rang me to discuss her plans for the future of the BetterYou Ltd business:

BetterYou Ltd has built a strong reputation, is highly profitable and has lots of potential for growth. Sam wants to sell the company in the next three years and aims to increase its value by expanding and offering training courses in digital marketing.

To provide these training courses, BetterYou Ltd will need to recruit digital marketing experts to act as course presenters. The proposed contract for these course presenters and details of two potential candidates for the jobs were sent through to us by Sam (**Exhibit 2**).

In passing, Sam also mentioned our new client, Ele Ltd. As a result of Sam's recommendation, Ele Ltd became a new client of our firm, last year. Sam warned me that Ele Ltd may be in financial difficulties. Sam implied that Ele Ltd owed BetterYou Ltd a lot of money. Sam has asked us if we can help by intervening and asking Ele Ltd to pay what it owes to BetterYou Ltd.

Exhibit 2

Proposed contractual agreement with Course Presenters:

- Course Presenters will be required to attend various venues around the UK to present BetterYou Ltd's training.

- All arrangements relating to courses, such as communication with attendees, arranging venues, and providing course materials, will be handled by BetterYou Ltd.

- Presentations must be carried out to the standards set out by BetterYou Ltd and presenters will portray themselves as part of the organisation. All equipment needed will be provided by BetterYou Ltd.

- BetterYou Ltd will provide ongoing training to presenters in order to maintain the consistency and quality of presentations.

Details of two potential candidates for the course presenter jobs

Two candidates have applied for course presenter roles, Andrew Day and Marie Knight. It is expected they will start working for BetterYou Ltd from 6 April 2022.

Andrew Day
Andrew is an experienced presenter who currently provides training for several different organisations. He will be contracted to present a set number of courses and paid a fixed amount for each presentation. If Andrew is unable to carry out work personally, he will be permitted to supply a suitable substitute presenter, at his own expense.

Marie Knight
Marie will be contracted to work 30 hours per week for BetterYou Ltd and will be paid an hourly rate. The rate includes payment for training and time spent travelling to and from venues, but BetterYou Ltd will not pay any holiday pay, sick pay, or other similar benefits. Marie will be required to carry out all work personally.

It is expected that Marie’s hourly rate will equate to a payment of £60,000 gross pa, and the fees paid to Andrew will also equate to total of £60,000 pa.

Exhibit 3
Proposed incentive scheme for Jamie Layton

Jamie receives a salary of £150,000 pa from BetterYou Ltd.

In addition, on disposal of the company, in three years’ time, Sam is considering two alternative methods of paying Jamie a share of the sale proceeds received from the sale of the shares in BetterYou Ltd. It is estimated that 100% of the shares in BetterYou Ltd will be worth £5 million in three years’ time.

The two alternatives are:

- Cash bonus – Jamie would be paid a cash bonus on the successful sale of the company, provided that he was still employed by BetterYou Ltd at that time. The cash bonus would be 4% of the sale price of the company.

- Share option – Jamie would be granted an option over 4% of the company’s shares, which would be exercised just before the sale of the company. Jamie would then sell his shares to the company’s buyer. The share option would be awarded to Jamie in October 2021, for no consideration. BetterYou Ltd has a current market value of approximately £1 million.

Question 3

You are an ICAEW Chartered Accountant, working in practice as a tax adviser.

Your client, Jennifer Woodhouse, has requested tax planning advice in relation to a property she owns, Sunny Cottage.

Jennifer Woodhouse is 74 years old.

Sunny Cottage was purchased by Jennifer and her husband, Nick in September 2000 for £360,000. They owned Sunny Cottage jointly and lived in it as their main residence until Nick's death in September 2010. The market value of Sunny Cottage at the time of Nick's death was £750,000 and on his death his 50% share was transferred to Jennifer under the terms of his will.

Since October 2010, Jennifer has let Sunny Cottage as furnished holiday accommodation. Marketing, regular cleaning and maintenance is carried out by an agency and amounts to an average of two hours of work per week.

There is a mortgage of £400,000 outstanding on Sunny Cottage, on which interest of £20,000 pa is charged.

In addition to the letting income from Sunny Cottage, Jennifer receives pension income which uses all of her basic rate tax band.

Jennifer has emailed you asking for advice on her future plans to let the cottage (**Exhibit**).

Requirements

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

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

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

Total: 30 marks

Exhibit

Email from Jennifer Woodhouse
Subject: Sunny Cottage

Letting Sunny Cottage

Rental income from Sunny Cottage has been falling each year, due to increased competition in the holiday let market. I don't think it is worthwhile continuing to let Sunny Cottage as furnished holiday accommodation, so I am considering letting it for long-term lets instead. I am considering three alternative ways of doing this:

Alternative 1
I would cease furnished holiday lettings and instead let Sunny Cottage to long-term tenants.

Alternative 2
I would incorporate the rental business by transferring ownership of Sunny Cottage to a company, Sunny Cottage Ltd. I would be the sole shareholder and director. Sunny Cottage Ltd would then let the property to long-term tenants. My mortgage adviser has advised that the outstanding mortgage could be transferred to the company and interest would be charged at the same rate of 5% pa.

Alternative 3
I would sell Sunny Cottage, repay the mortgage, and buy a smaller property to let with the net proceeds. I believe that the current value of Sunny Cottage is £1.1 million.

Under either of alternatives 1 or 2, I would expect to make a rental profit of £30,000 pa, before mortgage interest and tax are taken into account.

Under alternative 3, I would expect to make a profit on the rental of the smaller property of £20,000 pa, before tax, with no mortgage interest to pay.

Inheritance Tax Planning

I recently read an article in a magazine which mentioned that furnished holiday accommodation was treated favourably for inheritance tax purposes. I am concerned that if Sunny Cottage no longer qualifies as furnished holiday accommodation, I will lose this inheritance tax advantage.

To mitigate this, I am considering one of the following three options, depending on which alternative I chose for letting:

- If I choose alternative 1, I will transfer ownership of the cottage to my daughter. I will still be responsible for managing the property and will continue to receive all rental income. I presume that after seven years the property will no longer be part of my estate for inheritance tax purposes.

- If I choose alternative 2, the property is transferred to Sunny Cottage Ltd. The company will pass the rental profit to me as a loan, rather than dividends. That way, when I die I will have a large debt owing to the company which will offset against the value of the Sunny Cottage Ltd shares in my estate.

- If I choose alternative 3, I will give the proceeds to my daughter as cash. She can then buy the new property in her name (rather than mine), but I would receive the rent from the new, smaller property.