

**IIT 2010/11 ASSOCIATE EXAMINATION
PAPER IV – POTENTIAL SOLUTION**

Question 1

Downton Abbey

1	Nil	no consideration	Sch3, para 1 FA 2003
2	£40,000	no MV rule for connected individuals	S 55(1) FA 2003
3	£40,000	normal	S 55(1) FA 2003
4	£48,000	Transfer to Ltd and connected persons	S 53(1) & (1A) FA 2003
5	Nil	Intra-group transfer	S 62 & Sch 7, para 1(1) FA2003
6	£40,000	normal	S 55(1) FA 2003
7	Nil	no consideration	Sch3, para 1 FA 2003
8	Nil	special partnership rules	Sch 15, paras 10-12 FA 2003
9	Nil	MV rule over-ridden	S 53(4) FA 2003
or			
9	£60,000/£48,000	connected persons	S 53(1) & (1A) FA 2003
10	£6,500	grant of a lease	S 56 & Sch 5, para 2 FA 2003

Question 2

Group Loss Relief

(a) Group 1

C Ltd / D Ltd / E Ltd

Group 2

A Ltd / C Ltd / E Ltd / Q Inc / F Ltd

D Ltd is not part of the group as its ownership is 72%.

P Inc is not part of a group as it is resident outside EU

E Ltd is part of a group as its ownership is 81%

B Ltd is not part of any group for loss relief

A company must own 75% of a subsidiary to claim the relief

A company must own 75% of the total of a subsidiary

Q Inc is part of a group as it is resident in the UK – CTA 2010, s107

(b)

Company	Marginal Rate of Tax
A Ltd	28%
B Ltd	-
P Inc	-
Q Inc	21%
C Ltd	-
D Ltd	21%
E Ltd	28%
F Ltd	29.75%
G Ltd	21%

There are 8 associates and therefore profits between £37,500 and £187,500 are chargeable at 29.75%. Those below £37,500 are chargeable at 21% above £175,500 are chargeable at 28%. – 1 mark for correct marginal bands and rates.

C Ltd can offset losses to A Ltd, D Ltd, E Ltd, F Ltd and Q Inc.

The company with the highest marginal rate of tax is F Ltd.

F Ltd was purchased on 1 January 2010 and therefore cannot offset the entire years profits as it was not part of the group for the entire period

The common period is 1 January 2010 to 30 June 2010 in which losses of C Ltd were £25,000 and profits of F Limited were £40,000 – Maximum to offset = £21,250

Therefore C Ltd would surrender £21,250 to F Ltd leaving £28,750 to be offset.

The next highest marginal rate relief is A Ltd or E Ltd

Therefore C Ltd would surrender the remaining £28,750 to A Ltd or E Ltd

B Ltd cannot offset losses to any other company as it does not form part of a 75% group

2.

To qualify for the relief the surrendering company must be chargeable to tax under the law of an EEA state.

Relief will be available where either:

- (i) the surrendering company is a 75% subsidiary of the claimant company and the claimant company is resident in the United Kingdom, or
- (ii) both the surrendering company and the claimant company are 75% subsidiaries of a third company that is resident in the United Kingdom.

S111 – the company must be carrying a trade

The losses to be surrendered must meet the following conditions, CTA 2010, s.113

(a) the **equivalence condition**; it is a type of loss eligible for group relief; CTA 2010, s.114

(b) the **EEA tax loss condition**; a loss arises under the laws of the EEA state; CTA 2010, s.115, CTA 2010, s.116

(c) the **qualifying loss condition**; the loss cannot be used in current, past or future accounting periods by the company or a third party; and CTA 2010, s.117-119

(d) the **precedence condition**; losses are to be used first by intermediate holding companies in other member states.

CTA 2010, s.121

Once it has been established that a loss exists under the above conditions it must be **re-computed using UK rules**.

The maximum loss that can be surrendered is the EEA loss. If re-computing the loss gives an income figure then no loss can be claimed. If a lower loss results, this is the maximum that can be claimed.

Losses cannot have been utilised elsewhere

With regard to qualifying loss condition, the rules require that the loss cannot be taken into account in calculating any profits, income or gains which arise to the company

or

any other person in the current period or any previous period, and are chargeable to tax for the current period or any previous period. In addition

they require that the amount of loss cannot be relieved in the current period or any previous period by the payment of a credit, by the elimination or reduction of a tax liability, or by any other means of any kind.

All steps must be taken to claim all relief available.

In looking at the precedence condition in (d) above it is only necessary to consider intermediate holding companies where there is a 75% link.

To recalculate the loss under UK rules certain assumptions have to be made about the residency of the company and its sources of income.

The company is treated as UK resident from the start of the loss making accounting period.

Question 3

1. Overkill Ltd

We are not told who the directors of Overkill Ltd are or whether any of the shareholders are employed by the company. To qualify then during the 12 months prior to a qualifying disposal the company must be the taxpayer's personal trading company meaning that the shareholder must:-

- Hold 5% of the ordinary share capital and 5% of the votes
- Be an officer or employer of the company although HMRC manuals confirm there is no criteria to be satisfied in respect of level of remuneration and hours worked

For the shares to qualify the company must be a trading company. A trading company is defined as carrying on trading activities whose activities do not include, to a substantial extent, activities other than trading activities. HMRC consider substantial to mean more than 20% of total activities (turnover, value, employee time, asset base etc) when looked at in the round.

Entrepreneur Relief (ER) extends to associated disposals where, in addition the shares, qualifying shareholders dispose of an asset that has been used in the business for at least 12 months. Relief is restricted where the asset is only partly used in the business throughout its period of ownership or denied in full if a full commercial rent has been charged.

Each individual has a lifetime limit of gains up to £1million, rising to £5million in 2010/11. Trustees can claim relief where a qualifying beneficiary has an interest in the business concerned and qualifies for ER in their own right.

Assuming that the criteria are satisfied then only Irene will qualify for ER in her own right, although as the company is worth £5 million she may have a gain in excess of the £1m limit. As neither Eddie nor Phil has 5% they do not qualify although as Eddie is non-UK resident he is not liable to capital gains tax. The trust does not qualify as it is discretionary in nature. As Ian does not have 5% of the ordinary voting shares then he will not qualify for ER in respect of the securities he holds in the company such as the preference shares. The debenture stock may also amount to a security although that will need to be investigated.

The associated disposal rules will not be available in respect of either the Harlow or Stevenage premises because a market rent is paid, although there are further complications as far as Ian and the trustees are concerned in terms of not having entitlement on the sale of the shares in any case.

2. Planning opportunities

Ceasing to charge a rent would enable Entrepreneurs' relief to be claimed on the Harlow property under the associated disposal rules, although Irene may have extinguished the £1million limit on the sale of shares

It would be sensible for Irene to transfer some shares to Phil to ensure that they have a minimum shareholding of at least 5% of the ordinary shares. As the qualifying period is 12 months any sale should be delayed accordingly

Ian's position is more complex and while a gift of shares from Irene would resolve the Entrepreneur relief issue consideration should be given to converting the preference shares and/or the debenture stock into ordinary shares.

As far as the Kilmister Discretionary trust is concerned consideration should be given to granting Phil a life interest in order to achieve qualification for ER, although the income and income tax positions should be reviewed.

Ensure that all shareholders are employees and officers of the company.

3. Phil's residency

The UK has only partial statutory residence tests and otherwise relies on case law going back 120 years augmented by the non-binding HMRC 6 guidance.

When determining whether an individual leaving the UK has broken UK residence, the UK Tax Authorities distinguish between two scenarios; those individuals who leave the UK permanently or indefinitely (usually for an intended period of at least 3 years, which is something more than occasional residence abroad) and those who leave for work abroad. While both scenarios envisage some time spent in the UK, the former is subjective, while latter has a defined Tax Authority interpretation which arguably makes it easier to comply with. In view of Phil's intended employment duties abroad consideration should be given to Phil trying to break residence in this manner.

Where an individual leaves the UK for full time employment overseas, they are treated as non resident and not ordinarily resident from the day after the day of their departure to the day prior to their return, provided that:-

- They are leaving to work abroad under a full time contract of employment for at least a whole tax year (6 April to 5 April)

- They have actually physically left the UK to begin their employment abroad and not, for example, to have a holiday prior to the commencement of their employment. If there is a delay in taking up the employment the period of non-residency commences when the employment commences
- They will be absent from the UK for at least a whole tax year (6th April to 5th April)
- Their visits to the UK after they have left to begin their overseas employment will

total less than 183 days in any tax year, and average less than 91 days a tax year. This average is taken over the period of absence up to a maximum of four years – Any days spent in the UK because of exceptional circumstances beyond their control, for example an illness are not counted for this purpose.

In these circumstances the guidance requires that the employment duties are in substance performed outside of the UK and the only duties of the employment performed in the UK are duties which are merely incidental to the duties performed outside of the UK.

Where the duties are more than incidental, then there could be doubts over whether Phil will have broken residency.

Assuming that Phil does break residency:-

An individual resident in the UK is liable to UK tax on their worldwide income and capital gains whereas a non-UK resident is liable to UK income tax only on UK source income. A non-resident is not liable to UK capital gains tax even on gains arising in the UK unless the gain relates to the disposal of an asset connected to a permanent business establishment in the UK.

Once Phil has broken UK residence he will be exempt from UK capital gains tax, however should he resume UK residence within 5 complete tax years following the year of departure, then any assets held prior to departure and disposed of in the interim will be taxable in the year of his return. To avoid having to rely on a concession, it is recommended that Phil does not dispose of any capital assets ahead of the 5 April following his departure. If Phil returns within 5 years and the sale of Overkill Ltd shares happens in the interim he will be liable for tax in the year of return with possible Entrepreneurs' relief available.

As Phil has gone abroad to work the period will count as a period of owner occupation for Principal Private Residence relief provided that he re-occupies the property upon return and no other property has qualified as his PPR in the interim.

Assuming that any employment duties in the UK are incidental then Phil's emoluments for the period that he is non-UK resident are not liable to tax in the UK and the company should apply for an appropriate PAYE code number.

Phil's rental income will be liable to UK tax and he should register with HMRC as a non-UK resident landlord to receive his rental income gross.

Question 4

Alice and Wonderland Ltd

		Aliter*****
1 APE 31 December 2010	NIL*	Nil
APE 31 December 2011	£30,000**	£30,000
APE 31 December 2012	Nil***	Nil
APE 31 December 2013	£100,000****	Nil
APE 31 December 2014	£150,000*****	£250,000

* Although a bonus is paid out, the initial contribution to the EBT is Capital and therefore cannot be allowable. The bonus to Mrs "Red" Queen therefore never effectively attracts corporation tax relief.

** The first "income" contribution of £50,000 is paid in APE 31 December 2011 and the £30,000 bonus paid to Mr Hatter on 30 September 2011 is in that year and so allowed in that year.

*** No bonus is paid in the APE 31 December 2012 nor within nine months of 31 December 2012.

**** £ 60,000 + £40,000 bonuses are paid on 30 September 2014, which is the last day that the £150,000 contribution paid for the APE 31 December 2013 can be relieved in the APE 31 December 2013.

***** Alice's bonus paid in February 2015 is within 9 months of 31 December 2014 and can be relieved in the APE 31 December 2014.

***** Arguably the question might mean that it was not possible for the bonuses voted on 30 September 2014 in the set question to be paid by the end of the day and therefore Mr Rabbit's and Mr Hatter's bonuses would be relieved only in APE 31 December 2014.

2	Mr Rabbit	Mr Hatter
2010-11	£100,000	£90,000
2011-12	£100,000	£120,000 90K + 30K
2012-13 100K+ (10K x 5%)	£100,500	£90,500 90K + (10K x 5%)
2013-14 100K+ (10K x 5%)	£100,500	£90,500 90K + (10K x 5%)
2014-15 100K+ 40K +(10K x 5%)	£140,500	£150,500 90K + 60K +(10K x 5%)

3	Interest Net tax deducted	Rent due	Total	@50%	Tax
2013-14	5,500	9,000	14,500	7,250	1,100 6,150
2014-15	7,000	19,000	26,000	13,000	1,400 11.600

The deposit interest is not UK source and is therefore not liable to UK income tax

Question 5

Aurora

Briefing Paper

To: Mr Ian McCloud, Managing Director, Aurora

VAT issues

1. The transfer of the assets will be a TOGC – No supply for VAT purposes as per Sec 49 VAT Act 1995, and Reg 5 of VAT Special Provisions 1995. SI 1995/1268. PN 700/9 refers.
2. The anti-avoidance rules Reg 5 Para 2 and 2A require Nimbus to Opt to Tax the building and confirm that its Option will not be disapplied by Para 12 of Schedule 10 of the VAT Act 1994, otherwise the property cannot form part of the TOGC. The Option to Tax must be notified to HMRC prior to the building being transferred.
3. The “Control” requirements (for VAT Grouping and for the definition of “connected with” in Sch 10 para 15(3)(b) of the Anti-avoidance rules) are met because Aurora owns over 50% of the shares in Nimbus and Mr Ian McCloud controls them both.
4. Nimbus will need to become VAT registered as from 1.3.11 as its turnover will have exceeded the VAT registration threshold as a result of the VAT Registration requirements in Reg 6 of the VAT Regulations 1995 (SI 1995/2518)
5. Aurora and Nimbus could form a VAT group if it would be convenient in that transactions between the two companies could then be ignored for VAT purposes. However due to the involvement of Cirrus, Nimbus may not want to have joint and several liability for any VAT debts of Aurora.
6. If Nimbus do not Opt to Tax, the sale of the premises by Aurora will not form part of the TOGC and output tax will have to be charged, as it will be compulsorily standard rated (Item 1(ii) Group 1, Sch 9 VAT Act 1994)
7. The reduction in the rent may be regarded as being part of a barter transaction. However, HMRC will not need to impose an Open Market valuation under Item 1 of Sch 6 VAT Act, as even though the parties are connected, the recipient of the supply (Cirrus) would be fully entitled to deduct all their input tax.

Direct Taxes

8. Branch is not a separate legal entity and so all profits from the two trades of Aurora (Garden centre & wooden products) are taxed in the same company.
9. A rental profit will be calculated in Aurora. A rental profit is added to other trading profits and capital gains and taxed in year. A rental loss is deducted from trading profits and the net amount taxed. If the property loss cannot be used it can be carried forward and used against future rental profits. There is no loss carry back available.
10. Capital allowances will be available on qualifying items of plant and machinery within the building and are claimed by the entity who holds the buildings. Rates of writing down allowances are currently 20% (general pool) and 10% (integral fixtures). Claims can be made retrospectively, but if an available claim has not yet been made, consideration should be given to the timing of the claim given that the building will be under different ownership following the hive down.
11. There will be no corporation tax relief available in either Aurora or Cirrus for the investment they make in the shares of Nimbus, but provided that they hold the shares for twelve months prior to any sale and all remain trading companies following a sale, no taxable gain should arise due to the availability of Substantial Shareholding Exemption (a 10% holding is required).
12. Profits distributed by dividend from Nimbus to Aurora and Cirrus will be outside the charge to corporation tax in those companies.
13. When the transfer of the assets from Aurora to Nimbus takes place as Nimbus is a 75% subsidiary they can be transferred at tax written down value therefore not creating a balancing charge or allowance in Aurora. This is classed as a hive down.
14. There will be no capital gain or no capital loss on the assets transferred from Aurora to Nimbus as it is a 75% subsidiary. If Nimbus was to leave the group within 6 years of the transfer (either by an outright sale or further investment by Cirrus so that Nimbus was not a 75% subsidiary of Aurora) the gain or loss originally calculated on the market value of assets at the date of transfer will come back into charge. The companies could choose to not claim this relief and take advantage of the capital loss on the building as this will be netted off against profits in Aurora in the year. Doing this however would realise a lower base cost for chargeable gains purposes (£700,000) in Nimbus.
15. Were Nimbus to sell the property, its base cost for chargeable gains purposes would still be £750,000 (assuming that the election to transfer it at tax written down value had not originally been waived). As it is in a gains group with Aurora (it being a 75% subsidiary), it can jointly elect for any gain or loss on disposal to be assessed in Aurora.
16. Aurora holds more than 51 % of the shares in Nimbus and thus it will be an associated company for corporation tax purposes. The number of associated

companies reduces the tax bands (£300,000 & £1,500,000) when calculating the CT payable. Cirrus' number of associated companies should not be affected as based on its shareholding, it cannot affect control over Nimbus.

17. There is a potential restriction on Annual Investment Allowances (capital allowances) available to Nimbus and Aurora (as associated companies) if they are deemed to be carrying on the same class of trade.
18. As Nimbus is a 75% subsidiary of Aurora losses can be surrendered to each other (group relief). Group relief for losses between the 3 companies is not available as Nimbus is not a 75% subsidiary, consortium relief could be considered.
19. As the property is transferring to a 75% subsidiary group relief should apply for SDLT. Therefore no SDLT payable. It is assumed that Cirrus has subscribed for shares in Nimbus directly (as opposed Aurora purchasing them and selling them on), therefore no Stamp Duty is payable on the transaction.
20. Staff issues to consider – creation of new PAYE reference for Nimbus and transfer of staff under TUPE

Question 6

Capital Allowances

A) Mr Cut

He is not entitled to any allowances. There are more than four months between the date on which payment is required to be made and the date the obligation to pay became unconditional.

B) Mr Inky

Y/e 28 February 2010	AIA @100%	FYA@40%	General Pool	Allowances
	£	£	£	£
Tax wdv b/fwd			17,325	
Additions:				
Air conditioning	35,000			
Partitions	6,500			
Printing Press	<u>8,500</u>	<u>6,500</u>		
	50,000	6,500	17,325	
AIA@100%	(50,000)			50,000
FYA@40%		(2,600)		2,600
WDA@20%			(3,465)	3,465
Transfer to pool		<u>(3,900)</u>	<u>3,900</u>	
Wdv c/fwd	Nil	Nil	17,760	<u>56,065</u>

Workings

The AIA is to be allocated in the order detailed below:

- 1) The air conditioning unit is not eligible for FYAs at 40%, as it is expenditure which would otherwise qualify for the special rate pool of 10%.
- 2) The partitions were acquired pre 6 April 2009 and would not, therefore qualify for FYAs at 40%. Therefore, by default, they would qualify for WDAs at 20%.
- 3) Printing press, which would qualify for FYAs at 40%, up to a total of £50,000.

The balance of the cost of the printing press, which exceeds the £50,000 AIA limit, is eligible for 40% FYAs.

C) The individual might wish not to “waste” their personal tax-free allowances

The trader might have higher taxable profits in the next year so the allowances might be obtain a higher rate of relief.

The trader might wish to reduce the trading loss carried forward which is not as useful as a current year trading loss in the future.

D)

FAO Partner
From Advisor
Subject Flat Conversion allowances

This tax relief is available for expenditure incurred converting the upper storeys of commercial buildings into flats.

For a commercial building to be considered a ‘qualifying building’, it has to have been built before 1980, have less than four upper storeys which were originally intended to be used for residential purposes, and all or most of its ground floor must be authorised for certain types of business use (including shops, offices, food outlets etc.).

A ‘qualifying flat’ must be in a ‘qualifying building’, not be accessed through the business part of the ground floor, have no more than four rooms (excluding kitchens, bathrooms, halls etc.), not be a ‘high value’ flat (by reference to a table of notional rents) and be suitable for and held for the purpose of short-term letting. Short term letting is defined as being offered for a period of not more than 5 years.

The notional rent limits are as follows:

Number of rooms in flat	Flats in Greater London	Flats elsewhere
1 or 2 rooms	£350 per week	£150 per week
3 rooms	£425 per week	£225 per week
4 rooms	£480 per week	£300 per week

The tax relief provides a 100% initial allowance in the year the expenditure is incurred. If only part of this initial relief is claimed then the remaining allowances are claimed at 25% per annum on a straight line basis.

The flat must remain a qualifying flat for seven years after the first time it is suitable for letting. Otherwise, there will be a balancing adjustment. You do not have to consider rent limits after the time that the expenditure is incurred.

E)

31 March 2011

	General Pool £	VW Expensive Car £	Nissan £	Total CAs £
WDV bfwd	12,000	20,000		
Addition Nissan			30,000	
Disposal		<u>(15,000)</u>		
		5,000		
Balancing Allowance		(5,000)	@ 55%	2,750
WDA @ 20%	(2,400)			2,400
WDA @ 10%			(3,000) @ 55%	1,650

Question 7

Business Advice LLP

Tax Excellence LLP

Briefing note

From: D Johnson, Tax Assistant Manager

To: K Boyles, Partner

Regarding: Transfer Pricing

The purpose of the transfer pricing regime is to ensure that companies which are connected to each other do not gain a tax advantage by conducting transactions with each other at non-arms length prices.

For the transfer pricing regime to apply the first test that must be passed is that one company is participating in the management, control or capital of the other. There are different types of participation but one such is where one company controls the other.

Both Unigroup Ltd and Otherworld Ltd own the entire share capital of all their subsidiaries so this test is met.

Unigroup Ltd

Unigroup Ltd has engaged in transactions with BuildersScotland Ltd and Builders Inc. We must consider whether the actual provision between Unigroup Ltd and the group companies differs from the arm's length provision.

The OECD has published certain principles as to how the arm's length provision is to be determined and these should be consulted before any conclusion is reached. However, in this case we note that Unigroup Ltd is selling goods to both of its subsidiaries at prices significantly below the price that would be charged on an arm's length basis. Therefore the actual provision and the arm's length provision would appear to be different.

The next consideration is whether Unigroup Ltd has obtained a tax advantage in relation to its transactions with its subsidiaries. A tax advantage is obtained where as a result of a non arm's length provision a smaller amount is taken into account in calculating the taxable profits of a company. In this case if Unigroup Ltd uses non arm's length provisions then its taxable profits will be smaller. Accordingly it appears to have obtained a tax advantage.

It should be noted that the transfer pricing regime extends to transactions with other UK companies under Unigroup's control. However, BuildersScotland Ltd may be entitled to claim a corresponding compensating adjustment.

The compensating adjustment is calculated using the arm's length provision and should permit BuildersScotland Ltd to claim a larger deduction when computing its own taxable profits.

BuildersScotland Ltd is permitted to make a balancing payment to Unigroup Ltd as compensation for the extra tax deduction which it will enjoy. There is no tax consequence to either company if this is done.

Uniman Ltd

Uniman Ltd is a dormant company and consequently enjoys an exemption from the transfer pricing regime. There is therefore no requirement to make a transfer pricing adjustment in respect of the interest free loan.

Otherworld Ltd

Otherworld Ltd is currently operating a non-arm's length provision in its transactions with ToysUnited Ltd and is thereby gaining a tax advantage.

Ordinarily an exemption from the transfer pricing regime is made for small enterprises, defined as those companies or groups of companies with less than 10m Euro turnover, less than 10m Euro balance sheet assets and less than 50 employees. Otherworld Ltd meets these criteria.

However, the exemption does not apply where the other party to the transaction is resident in a non-qualifying territory. A non-qualifying territory is any territory other than a qualifying territory. A qualifying territory means the UK or any territory with which the UK has a Double Taxation Treaty with a non-discrimination article.

Utopia has no Double Taxation Treaty with the UK so the exception does not apply.

Therefore Otherworld will be required to self assess a transfer pricing adjustment.

Advance Pricing Agreement

In order to remove uncertainty about what transfer pricing adjustments need to be made a company may enter into an Advance Pricing Agreement (APA) with HMRC. An APA is not compulsory but it is binding once entered into.

An application for an APA should be made in writing and should set out the transactions which the APA should cover, why those transactions would be subject to transfer pricing adjustments and what the company proposes to do about them.

APAs will have effect for a specific period. The company should set out what it thinks that period should be but HMRC have indicated that they envisage a minimum of three and a maximum of five years.

Once an APA is in place the assumptions laid out in the APA should be monitored and reviewed to ensure that there have not been any critical changes that lead the agreement to become obsolete.