

Chapter 26

TAX PLANNING STYLE QUESTIONS

1 Introduction

The TX-UK examining team have stated that they are attempting to “bridge the gap” between TX-UK and P6 and have therefore introduced some “new style” questions to the exams that attempts to recognise this goal.

One style is the introduction of multi tax questions where a scenario that involves more than one tax is tested rather than the traditional single tax computational problems of the past. Where this happens, however, the requirements are very specific to each tax issue being tested and you will be left in no doubt as to what the examiner is asking you to do.

For example when in lifetime a taxpayer gifts an asset to another person, you may be required to explain and compute both the CGT and IHT implications that may arise out of that transfer.

A further change away from the traditional “prepare the tax computation” style has been the requirement to give planning advice to the taxpayer. Don’t worry as again you will not be given a requirement such as – Advise (15 marks), but will be led through the question by individual requirements.

For example in advising whether or not a trader would be better off running their business as an unincorporated trade or as an incorporated trade, the question will ask you to compute the tax liabilities that will attach to each option based on a specific level of adjusted trading profit and profit extraction from that business. This will again involve a multi tax approach.

The introduction of both savings income and dividend income nil rate bands has made the question over the transferability of income producing assets from one spouse or civil partner to another a more interesting problem as compared to the main issue before this introduction of simply moving income producing assets from a higher rate taxpayer to a basic rate taxpayer or even from a basic or higher rate taxpayer to a spouse / civil partner who has not fully used their personal allowance.

2 Married Couples / Civil Partners

In Section 7 of Chapter 2 dealing with income producing assets owned jointly by spouse or civil partners, we illustrated the tax advantage to be gained from transferring ownership of an income producing asset, such as a rental property from a higher rate taxpayer to a spouse who was only a basic rate taxpayer, or even greater tax savings to be had when the transferee spouse was not even a basic rate taxpayer and was not therefore using some or all of their personal allowance. This would allow income that would have been taxed at 40% to now be taxed at 20% or indeed not taxed at all if the income fell within the available personal allowance of the transferee spouse.

The transferor spouse could transfer the entire ownership of the asset to the transferee spouse such that all future income would be taxed in the computation of the transferee spouse, or could transfer any part interest in the asset to make it jointly owned which would mean that the income would then be split 50:50 between the spouses.

In dealing with CGT and IHT we have since discovered that the transfer of ownership of the asset will also be achieved without any capital taxes implications. A transfer of a chargeable asset between spouses / civil partners will for CGT purposes be a no gain no loss transfer and will be an exempt transfer for IHT purposes.

We also saw when dealing with CGT and spouses that assets would be transferred between them on a no gain no loss basis prior to sale to the outside world, in order to utilise the AEA of each spouse and to ensure that any taxable gains would then arise upon the basic rate taxpayer spouse rather than the higher rate taxpayer spouse to ensure that the lowest available tax rate would then apply to their taxable gains.

The introduction of nil rate bands for savings income and dividend income has also created opportunities for spouses to reduce their overall charge to income tax and may even give an advantage to transferring such income from a basic rate taxpayer spouse to a higher rate taxpayer spouse!

ILLUSTRATION 1

Donald and Theresa are a married couple and have regular annual income as follows:

Donald	- Salary	£70,000
Theresa	- Salary	£18,000
	Interest	£2,000
	Dividends	£9,000

It is clear from the above information that Donald is a higher rate taxpayer with taxable income of £57,430 (70,000 – 12,570) and Theresa is a basic rate taxpayer with taxable income of £16,430 ((18,000 + 2,000 + 9,000) – 12,570).

In this situation it would normally be the case that for tax planning purposes it would be advisable to see if any investment income could be moved from the higher rate taxpayer to the basic rate taxpayer. This, however is not possible as Donald's only income is his salary.

The introduction of the nil rate bands, however, means that in the above example tax savings can be achieved if firstly, £500 of the interest income could be made by Donald and therefore use his savings income nil rate band of £500 that is currently being wasted. This income is being taxed at 20% on Theresa as she has savings income in excess of her nil rate band of £1,000 and she does not benefit from the 0% starting rate for savings income as she has more than £5,000 of taxable non savings income (salary 18,000 less PA 12,570 = 5,430). This would save £100 in tax.

The second transfer would be of sufficient shares to move up to £2,000 of dividend income from Theresa to Donald in order that both may use their dividend income nil rate bands of up to £2,000. Currently Theresa is being taxed at 7.5% on £7,000 of her dividend income, so a tax saving of £150 would be possible here.

Clearly in practice choosing the right amount of interest bearing securities and shares to transfer to Donald to allow usage of the available nil rate bands may be a little difficult to precisely achieve!!

In the above example it would be an even more interesting scenario if Donald in addition to his salary had annual property income of £10,000. In his computation this income would all be taxed at the higher rate of 40%.

Theresa, even before the transfer of some of her interest income and dividend income to utilise Donald's savings income and dividend income nil rate bands, only has £16,500 of taxable income and is therefore only a basic rate taxpayer.

If Donald was to transfer ownership of the property to Theresa the £10,000 property income would now be taxed at 20% instead of 40% and a tax saving of £2,000 would be achieved. Remember also that the transfer would be on a no gain no loss basis for CGT and would be an exempt transfer for IHT purposes so there would be no capital taxes problems arising from this transfer.

In terms of investment planning for taxpayers, their retirement is a key issue and a comfortable retirement will be influenced by what income producing assets are owned by the taxpayers and how that income will be taxed as seen above with savings and dividend income nil rate or starting rate bands, the use of ISA's and each spouse's PA and basic rate band.

The other key issue is the provision of a pension and it is essential for this purpose that you understand the tax implications of making contributions into a pension scheme, either occupational or more often examined, personal pension scheme as identified within Chapter 10.

3 Operating a business as an unincorporated trade or as a company (incorporated)

When an individual chooses to start their own business they have a choice of business structure decision to make, choosing between operating the business as an unincorporated trade, a sole trader or a partnership or an incorporated trade as a company. this decision will have important tax consequences.

If a business is run as an unincorporated trade then the owner of the business will be assessed to income tax on the tax adjusted trading profit of the business NOT the amount of cash (drawings) they have chosen to take from that business. These tax rates being 20%, 40% and 45% depending on the level of profit. The profit will also be assessed to class 4 NIC. Small Class 2 NIC payments will also be payable.

Tax will be collected through the self assessment system.

If the business is run as a company then the adjusted trading profit of the company will be subject to a single rate of corporation tax, currently 19%, whatever the level of profit. The individual will then only be chargeable to tax on what they take out of the company and profits are usually extracted as either salaries or dividends.

If owners pay themselves a salary then the cost of the salary (including employers' class 1 NIC) will be an allowable deduction to the company in computing its TTP chargeable to corporation tax. A dividend paid by a company however, is a distribution out of the taxed profits of the company and therefore achieves no corporate tax saving.

For the owner manager of the company any salary payments must be made through the PAYE system with both income tax and employee's class 1 NIC being deducted at source and paid over to HMRC. Dividends will be subject to their own income tax rates with tax being payable through the self assessment system above the dividend income nil rate band.

We may have to consider therefore the tax implications of a taxpayer choosing to incorporate their business and run it as a company rather than an unincorporated trade and the subsequent decision for an owner manager of a company as to whether to extract the profits of a company as either a salary or dividend payment.

ILLUSTRATION 2

If Boris had a tax adjusted trading profit from his sole trader business of £60,000, compute the total tax charges that would be payable assuming that this is his only source of income for the tax year and using the 2021/22 tax rates and allowances.

Income Tax Computation		<i>Non Savings</i>	<i>Total</i>
		£	£
Trading profit		60,000	60,000
PA		(12,570)	(12,570)
Taxable Income		<u>47,430</u>	<u>47,430</u>
Tax			
37,700 @ 20%		7,540	
9,730 @ 40%		<u>3,892</u>	
Income Tax Liability		<u>11,432</u>	
NIC			
Class 2 (52 x £3.05)	=	159	
Class 4 (50,270 – 9,568) x 9%	=	3,663	
(60,000 – 50,270) x 2%	=	<u>195</u>	
		<u>4,017</u>	<u>15,449</u>

If Boris had run his business as a company, Boris Ltd, instead of as a sole trader and the company had an adjusted trading profit of £60,000, compute the total tax charges that would be incurred by both Boris Ltd and Boris assuming that Boris Ltd had paid no salary to Boris but instead paid the maximum possible dividend from the company.

Boris Ltd

Corporation Tax Computation		£
Trading Profit		<u>60,000</u>
TTP		<u>60,000</u>
CT liability @ 19%		<u>11,400</u>

This will leave a distributable profit of £48,600 to be paid as a dividend after the corporation tax has been paid.

Boris

Income Tax computation		£	£
		<i>Dividends</i>	<i>Total</i>
Dividends		48,600	48,600
PA		(12,570)	(12,570)
Taxable Income		<u>36,030</u>	<u>36,030</u>
Tax			
Dividends			
2,000 @ 0%		0	
34,030 @ 7.5%		<u>2,552</u>	
		<u>2,552</u>	

No NIC would be payable by either Boris Ltd or Boris

The total combined tax liability will be £13,952 (11,400 + 2,552) and therefore a tax saving of £1,497 (15,449 - 13,952) would be achieved by running the business as a company.

Boris could also consider mixing the method of profit extraction from his company between the payment of a salary as well as the payment of a dividend. A salary payment would of course bring into consideration NIC that may have to be paid both by the employer Boris Ltd as well as by Boris the employee. This may be avoided however by keeping the salary level below the NIC thresholds for payment.

In our example let us now assume that Boris Ltd pays Boris a salary of £8,000 and then again removes all the distributable profit from the company in the form of a dividend,

Boris Ltd

Corporation Tax Computation	£
Trading Profit (60,000 – 8,000)	52,000
TTP	52,000
CT Liability @ 19%	9,880

This will leave a distributable profit to be paid as a dividend of £42,120 (52,000 – 9,880)

Boris

Income Tax Computation	<i>Non Savings</i>	<i>Dividends</i>	<i>Total</i>
	£	£	£
Salary	8,000		8,000
Dividends		42,120	42,120
	8,000	42,120	50,120
PA	(8,000)	(4,570)	(12,570)
Taxable Income	<u>0</u>	<u>37,550</u>	<u>37,550</u>

Tax Liability

Dividends

2,000 @ 0%	0
35,550 @ 7.5%	<u>2,662</u>

37,550	<u>2,662</u>
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A salary of £8,000 will not require any NIC to be paid.

The total combined tax liability will now be only £12,542 (9,880 + 2,662), an additional saving of £1,410 (13,952 - 12,542) compared to extracting the profits of the company entirely in the form of a dividend.

Incorporation will offer the prospect of even more considerable annual tax savings when the business profits rise, such that an unincorporated trader would suffer a significant 40% higher rate tax burden and even an additional rate charge at 45% as he is assessed on the tax adjusted trading profit of the business irrespective of the level of drawings made by the business owner. If the company makes a higher profit, however, it will only suffer tax at 19% on its profits, while the business owner will only suffer a personal tax charge on the amount of that profit that they choose to extract in the form of either a salary or dividend payment.

Thus the owner managed company may retain profits and allow the business owner to avoid the immediate higher rate tax charges that would otherwise have been charged if the business had been run as an unincorporated trade.

Incorporation however will inevitably involve higher compliance costs as compared to the freedoms of operation allowed to the unincorporated trade.

4 Multi tax scenarios

The examining team have made a conscious effort to try and narrow the gap between TX-UK and the Advanced Taxation Paper and one area where this has occurred is in questions that test all the taxes that may be relevant to a transaction or event rather than just asking for one specific tax that it is involved, for at the Advanced Taxation level most questions involve more than one tax.

We have already seen in this chapter examples of this, a simple example of income producing assets being transferred between spouses or civil partners, where although the main issue is income tax it is important to know that there are no capital taxes (CGT & IHT) implications.

A more challenging problem was the comparison of running a business as an unincorporated trader or incorporated trader, where we have to deal with the Corporation Tax implications for a company and the personal tax issues for the individual involving therefore both Income Tax and if necessary NIC.

When advising a client on the tax implications of running a business, then in addition to the tax points made above, the trader would also want advice on VAT, initially when the business must register for VAT and whether it should choose to do so earlier rather than later. This may then lead to a discussion of the various accounting schemes that may be available and advisable to be used such as cash, annual or flat rate.

If a taxpayer is to start their own business then he / she may want advice on the tax implications of buying and expensing a car or cars through the business either for themselves and / or employees and the different outcomes dependent upon the choice of business medium – unincorporated or incorporated.

When a car is purchased through the business what happens to the VAT incurred thereon along with the VAT suffered on the running expenses. What capital allowances are available on the purchase cost and is tax relief available on the running expenses of the car. If a car is made available to an employee what is the assessable benefit to be included in their employment income assessment and will there be any Class 1A NIC to pay by the employer in relation to such benefits.

We noted above the tax implications of spouses or civil partners transferring assets to one another and saw that in terms of the capital taxes there would be no impact as for CGT purposes such transfers are on a no gain no loss basis and for IHT purposes the transfers are exempt. A more interesting problem worthy of an examination question would be, what tax implications arise when assets are transferred to your children, usually by gift.

In Chapter 24 on IHT, illustration 1 demonstrated the IHT implications, which we can now review and also bring in the CGT implications.

ILLUSTRATION 3

A owns 60% of the shares in A Ltd an unquoted trading company. A Ltd has 100,000 £1 ordinary shares in issue all of which were subscribed for at par by the existing shareholders in 2004, from which date A has been the managing director of the company.

Share valuations have now been agreed as follows:

20%	£10 per share
40%	£15 per share
60%	£25 per share
80%	£40 per share

Advise A on the tax implications of gifting 20,000 of his shares to his daughter V.

The gift of the shares would have both IHT and CGT implications for both A and V.

For IHT purposes the gift would be a potentially exempt transfer (PET) and have no immediate tax implications. If A died within 7 years of the transfer the PET would become chargeable at either nil rate and / or 40% rate depending upon what other transfers had been made by A prior to this gift and when they were made.

If A survived for at least 3 years then any IHT computed would be reduced by taper relief. Any such IHT payable would be payable by the donee, V and should be paid within 6 months of the end of the month in which the death occurred.

The value of the PET that would become chargeable on death is computed using the transfer of value principle. This compares the value of the donor's estate before the transfer with the value after the transfer and would be computed as follows:

		£
Before: 60,000 shares @ £25 per share	=	1,500,000
After: 40,000 shares @ £15 per share	=	600,000
Transfer of value		900,000

If A survives for more than 7 years the transfer will be exempt and no IHT will be payable when A dies.

A chargeable gain arises where there is a chargeable disposal of a chargeable asset by a chargeable person. The gifting of an asset represents a chargeable disposal and as the shares are a chargeable asset, a chargeable gain must be computed for the tax year of the gift based on the open market value of the asset being gifted - in this case 20,000 shares.

The gain is computed as follows:

		£
Disposal consideration (20,000 @ £10 per share – note 1)	=	200,000
Cost (20,000 @ £1 per share – note 2)	=	20,000
Chargeable gain		180,000

Note 1

The shares being gifted represent a 20% interest in the company which have a value of £10 per share.

Note 2

The shares are £1 ordinary shares which were subscribed for at par, so the cost is £1 per share.

The gain that arises would be included in the net gains of the tax year from which the annual exempt amount would be deducted to derive the taxable gain.

The question then arises as to what tax rate would apply? Shares in unquoted trading companies are a qualifying business asset for purposes of business asset disposal relief and as A owns the minimum required 5% shareholding and is an employee of the company, a claim for business asset disposal relief is available and will result in a 10% tax rate (up to £1m) being applied to the taxable amount of the gain.

There is however another RELIEF that is available where such an asset is GIFTed! Yes gift holdover relief is available to be claimed, jointly by A and V, as shares in an unquoted trading company are qualifying business assets for gift holdover relief purposes.

This would allow the entire gain to be deferred, such that the donor, A, would not now be chargeable and the daughter, V would be deemed to acquire the shares at a cost of £20,000 instead of a cost of £200,000.

Without gift holdover relief the shares would be deemed acquired by V at their open market value of £200,000. With gift holdover relief, that cost is reduced by the amount of the deferred gain (£180,000) and thus a cost to V of £20,000 would then apply.

The question could be made more interesting if the shares were sold at undervalue to V rather than being gifted outright. Let us now assume therefore that A sold the shares to V for £4 per share. How would that now change our answer?

For IHT purposes the transfer of value must now be re-computed as follows:

	£
Before: 60,000 @ £25 per share =	1,500,000
After: 40,000 @ £15 per share =	(600,000)
Cash (20,000 @ £4 per share) =	<u>(80,000)</u>
Transfer of value	<u>820,000</u>

For CGT purposes the chargeable gain is still computed based on the open market value of the asset being gifted. The difference arises in the application of the gift holdover relief, if claimed. When a sale is made at undervalue the gift holdover relief is restricted by the extent that any actual proceeds (20,000 x £4) exceed cost, which part of the gain will remain chargeable on the donor.

	£
Disposal consideration (20,000 @ £ 10)	200,000
Cost (20,000 @ £1)	<u>(20,000)</u>
	180,000
Gift Relief	<u>(120,000)</u>
Chargeable Gain (80,000 – 20,000)	<u>60,000</u>

The base cost of the shares to the donee will again be computed as the market value less gift relief (200,000 – 120,000) = 80,000

For those taxpayers with both a capacity and a willingness to make gifts in lifetime and not just on death, the further guidance that they may request from you is whether to make such gifts in lifetime or wait and gift the assets upon their death. It is again a consideration of the capital taxes that is the key issue.

If assets are gifted on death there will be no CGT and the beneficiaries will acquire those assets at their then open market value, thus wiping out any accrued gains on those assets. The assets, however at their then open market value (probate value) will then be included within the chargeable estate at death, which being in excess of the available nil rate band will be charged to IHT at a rate of 40%.

Therefore to avoid IHT it would be better to gift in lifetime as when a PET is made there is no immediate charge to IHT and the PET will only become chargeable if the donor dies within 7 years. The further advantages for IHT of gifting in lifetime are that if the taxpayer at least survives for 3 years then taper relief will reduce any IHT payable, plus the value of the PET is “frozen” at the date of the transfer meaning that an appreciating asset will have a lower value charged to IHT than if it had been kept until death. Lifetime gifts will also benefit from annual exemptions.

The problem of course with gifting in lifetime as we have already seen is CGT, as a gift in lifetime is a chargeable disposal and a gain must be computed using the open market value of the asset. This, however will only happen if the asset is a chargeable asset so that exempt assets such as cash, chattels and cars could be gifted without any CGT arising.

If assets are chargeable assets then they may still be gifted if the gains arising each tax year do not exceed the

Tax Planning style questions

AEA, for example if the taxpayer gifts an asset valued at £50,000 and it cost £40,000, there will be a chargeable gain of £10,000 which will be covered by the AEA of the taxpayer. This will have removed £50,000 of value from the taxpayer's estate which at death may have been charged to 40% IHT.

If chargeable assets will give rise to more substantial gains then as we have seen above, if the asset is a qualifying asset for gift holdover relief then the gain may be deferred by a claim for relief. If the asset was the principal private residence of the taxpayer then private residence relief would be available to exempt any gain arising.

You will discover at ATX there are other issues and other reliefs to deal with in giving this advice, but the basic tax issues as noted here may be tested within the TX-UK paper.

You should now review the following technical articles written by the TX-UK examining team for exams from June 2022 to March 2023

Higher Skills

Finance Act 2021 update article examples 11 - 12