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Unit 18

**Preparing Business Taxation
Computations (BTC)**

Unit 19

**Preparing Personal Taxation
Computations (PTC)**

SUPPORT BOOKLET

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BTC AND PTC SUPPORT BOOKLET

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SECTION 1

Introduction

This support booklet will take you through the educational and teaching issues that surround the two tax units that form part of the Level 4 qualification within the AAT's accounting qualification.

It is not meant to cover every performance criteria within the current (2003) Standards, but will cover the most key aspects of each element within both units. The basis of this booklet is to provide guidance and support on the aspects that students find problem areas within the exams. This booklet has therefore been written using all the evidence from the first exams in December 2003 to, and including, the December 2005 exams. Various masterclasses have been held during that time, and will also help inform the content of this support booklet.

One of the reasons why students may have problems with these units is simply due to the fact that no taxation has previously been studied. For the three core units at Level 4, all students will approach these units with prior knowledge and comfort in the fact that they have already passed exams in these topics. For instance, they may start management accounting with trepidation, as it has always been their weak point, but they know that they have already succeeded in Unit 6 at Level 3. However, with taxation the majority of what you are going to cover is new - new concepts, new and unusual terminology, new ideas. Their comfort zone of familiarity experienced in the three core units will not exist here, and that is something that needs to be at least acknowledged and recognised before you start teaching these topics.

In terms of the content of this booklet, the biggest topic areas within each of the units is taken, and looked at separately. Suggestions will be made on how to tackle the teaching of these areas, and the problems faced by students on understanding them will be covered. Also, evidence of the errors and misunderstandings made by students under exam conditions will be looked at.

Preparing Business Taxation Computations BTC)

SECTION 2

Adjusted trading profits for sole traders and partnerships

Adjustment of trading profits will be covered in the exam in either Section 1 or Section 2 – but not both. A general rule in both tax units is that a topic will be assessed only once. Therefore, if adjustment of trading profits is assessed for a sole trader, or partnership, in Section 1, the figure for these profits will be given in Section 2.

In previous exams, this topic has been handled well. It is probably one of the first areas that you are going to teach when commencing Unit 18. Students will cover the principles for both types of businesses, and therefore should not experience great difficulties.

In terms of which adjustments should be covered, all the typical, common areas such as private usage, capital items, depreciation, provisions and drawings are obvious. There will not be items in the exam that would be classified as unusual or obscure. As with all tax topics, practice is vital. An easy way to give students as much practice as possible is to take a basic question and simply adjust one or two of the items to alter the answer. Changing private usage percentages or convert an allowable item to disallowable (repair v improvement) is straightforward.

Take, for instance, the June 2005 exam. Section 1 had the following data:

	£	£
Gross profit		63,846
Profit on sale of equipment		<u>310</u>
		64,156
Staff wages	13,220	
Salary – Philip	22,500	
His wife	6,000	
Depreciation	8,780	
Bad and doubtful debts (Note 1)	1,020	
Advertising	2,000	
Motor expenses (Notes 2)	7,630	
Sundry expenses (Note 3)	<u>680</u>	<u>61,830</u>
Net profit		<u>2,326</u>

Note 1: Bad and doubtful debts	£
Trade debts written off	500
Increase in specific provision	300
Increase in general provision	<u>220</u>
	<u>1,020</u>

Note 2: Motor expenses	£
Relating to motor van	2,000
Relating to motor car	<u>5,630</u>
	<u>7,630</u>

It was agreed with HM Revenue & Customs that 30% of the mileage for the motor car related to private usage.

Note 3: Sundry expenses	£
Parking fine incurred by employee	80
Entertaining customers	250
Cost of calendars at £3 each with company details clearly displayed	<u>350</u>
	<u>680</u>

You could have a question that accompanies this exam paper to read:

What is the adjusted profit when:

- a) the motor expenses have no private usage
- b) the motor expenses have 50% private usage
- c) the calendars do not bear the company's name
- d) the calendars are bottles of wine instead
- e) the parking fine was incurred by Philip

Each of these small adjustments to the exam paper will explore different aspects of this topic.

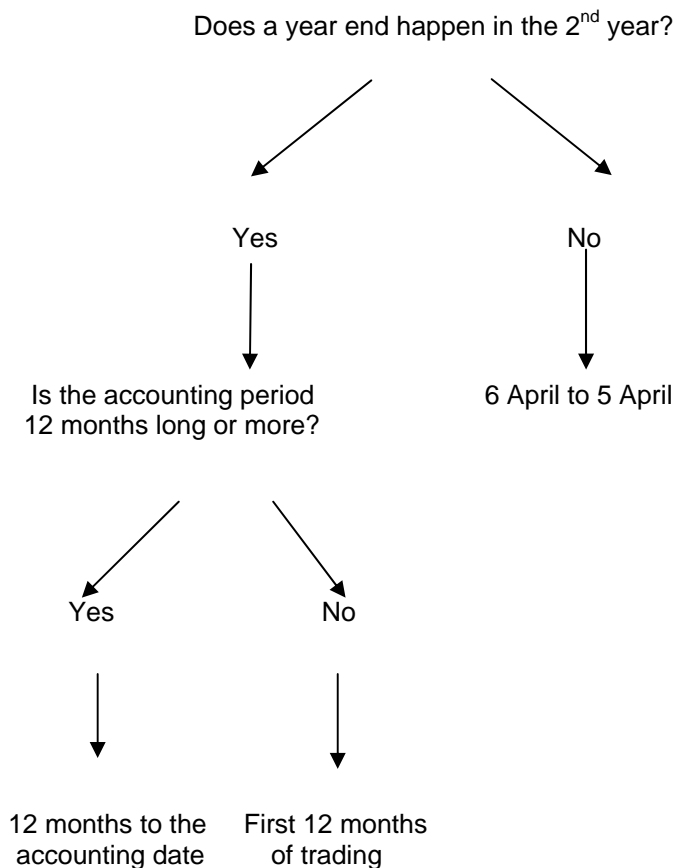
First, students need to learn the principles that underpin this topic, then the details of which items need adjusting. When a student understands the principles, they can use their knowledgeable judgement on whether or not an item needs adjusting, and can tackle any theory questions on the topic.

Students also need to be able to use an appropriate layout when tackling this topic. Whilst there is no definite layout prescribed, use of subtotals is vital and clear narrative of what the item being adjusted for is. Students **MUST** start this computation using the net profit from the accounts, and it is recommended that they first add disallowed items, then deduct allowable.

Basis of assessment

Once the adjusted profits have been determined, all students must thoroughly understand the principles of the basis of assessment. Opening years and cessation are vital, although students can struggle with the complexities of opening years.

The first year is quite straightforward – from date of commencement to 5 April. A flow chart approach can help the understanding of the second year:



This basis period for the third year is always the same: profits for the 12 months to the accounting date that falls within the third year.

Take an example of a business commencing on 1 January 2006. What are the relevant dates for the first three years of trading, assuming that the accounting periods are made up to:

- 31 May 2006, and yearly thereafter
- 31 May 2007, and yearly thereafter
- 31 January 2007, and yearly thereafter.

Question in flowchart	a) 31 May 2006	b) 31 May 2007	c) 31 January 2007
First	Yes	No	Yes
Second	No	N/a	Yes
Dates for:			
1 st Year	1 Jan 06 – 5 Apr 06	1 Jan 06 – 5 Apr 06	1 Jan 06 – 5 Apr 06
2 nd Year	1 Jan 06 – 31 Dec 06	6 Apr 06 – 5 Apr 07	1 Feb 06 – 31 Jan 07
3 rd Year	1 June 06 – 31 May 07	1 June 06 – 31 May 07	1 Feb 07 – 31 Jan 08
Overlap	1 Jan 06 – 5 Apr 06 1 June 06 – 31 Dec 06	1 June 06 – 5 Apr 07	1 Feb 06 – 5 Apr 06

It is vital the students can complete the exercise properly, as it is the key to understanding how to compute overlap profits. By being able to see the dates that are being used for the first three years of trading, the overlap dates are obvious and therefore easy to calculate.

SECTION 3

Adjusted trading profits for incorporated businesses

It is recommended that you teach this topic by starting with unincorporated businesses first, then move onto incorporated. The reason for this is that unincorporated is technically easier for students to understand.

A simple technique for approaching incorporated business is to take all the examples used for unincorporated businesses, and simply add Ltd to the title of the business. Students will quickly see a pattern emerging, with the core differences being obvious. You must ensure that you cover:

- a) private usage
- b) wages or salaries for owners/directors
- c) appropriation of profits

Take the above example from the June 2005 exam paper. Ask students the following questions, given that the business is now a limited company:

- a) How would you handle the information in Note 2?
- b) How would you handle the information on the parking fine if incurred by a director of the company?
- c) Assume that Philip is a director of the company – how would you handle his salary?

Both narrative and computational answers should be encouraged from these questions. It is well known that the majority of AAT students actively dislike answering written style questions, so the more practice they get the better. For instance, assume a student answered a) above. An answer of 'I would ignore it' would not be acceptable. You should encourage a full answer such as:

'The information in this note to the accounts would be ignored. This is because there is no adjustment to the profits for the private proportion of expenses, or the private usage of assets. As the users of such expenses or assets will be employees of the company, the taxation of the private element will usually be through the benefits in kind system.'

Whilst you are not expected to cover the benefits in kind system (though this shows a clear advantage of teaching both tax units), you would still need a more detailed explanation of why private usage is not taxable on the company, rather than just a dogmatic statement that it is not.

Losses

This topic has only really been assessed once, in the June 2005 exam. It was quite poorly done, yet it was a very straightforward question. This is first time that a prescribed layout has been used in an exam, yet it was felt that students would have struggled even more if it hadn't been provided.

The key aspect here is for students to adopt a suitable layout. One of the biggest problems faced by students in exam conditions is the use of a layout that enables them to work methodically through the answer. I refer to this as the 'Balance Sheet of Taxation' – learning and understanding the narrative column in a balance sheet is the first step to being able to competently complete a balance sheet. No accounting tutor would expect a student to correctly produce a balance sheet without first fully explaining the layout and structure – well, it is exactly the same for several areas of taxation. Where this principle appears later in this booklet, I will refer to this paragraph.

So, a recommendation is to start with a suggested layout. An example would be:

	Year 1	Year 2	Year 3	Year 4
	£	£	£	£
Trading Profits	X	X	-	X
S393(1) Loss				(X)
				X
Property Income	X	(X)	X	X
Capital Gains	X	-	-	X
Capital Losses				(X)
				X
TOTAL PROFITS	X	X	X	X
S393A(1)	(X)	(X)		
	X	X		
Charges on income	X	X	X	X
PCTCT	X	X	X	X

Accompanying this would be the basic explanations of how the losses for the three types of income would be handled. It must be remembered that this unit is at Level 4, and corporation tax losses are a very complex topic. Therefore, only basic loss scenarios will be assessed – the level in the June 2005 exam is indicative of what is required.

Therefore, the level of detail required for students is:

- a) Trading losses – carried forward indefinitely and automatically unless the company elects an alternative, (S393(1)). There are two basic alternatives – offset against total profits in the same period as the loss, or carry back 12 months against total profits, (S393A(1)). The latter can only be done if the company also makes a claim against the total profits in the period of the loss. It is not intended to ask questions that have accounting periods that are not 12 months in length.
- b) Property Income – the basic rule is that all profits and losses are dealt with in the year they arose. Therefore, the student simply has to place the relevant figure in the related year.
- c) Capital losses – these can only be relieved against other capital gains, arising either in the same accounting period, or future periods.

It is NOT a problem under exam conditions if students actually need to write out the layout and narrative on the left hand side before they start to fill in the numbers. If one of the items (say capital losses) is not needed, then it is just left blank. There will be no penalty in the exam if this method of approaching corporation tax losses is adopted.

Corporation tax payable

Whilst the computation of the tax payable has improved as time passes, students still struggle with this area. In all the Chief Assessor's reports from December 2003 to June 2005, I have reported that the task dealing with the corporation tax payable was the weakest answered in Section 2. However, there was a noticeable improvement in the December 2005 exam.

One of the biggest errors made by students is to calculate the correct SCMR, but then deduct it from the PCTCT, then apply the tax rate of, say, 30%. This area of tax definitely needs to use the concept of 'practice makes perfect' – it has repeatedly been commented on in the Chief Assessor's reports that centres must spend more time on this area.

Take the answer to Task 2.4b) in the June 2005 exam:

	£
£448,837 X 30%	134,651
SCMR –	
(750,000 – 448,837) x 11/400	<u>(8,282)</u>
CT Payable on 1 August 2005	<u>126,369</u>

There are several individual aspects to this answer that students need to understand. First, it is suggested that students compute the limits for all the rates. In this question, the company has an associated company, so all the limits are halved. In other scenarios, the period of account may not be 12 and/or there may be associated companies. In order to work out which rate of tax is applicable, students must first decide what the limits are for the company in the question. Once that has been achieved, they need to work out which is the applicable rate, and whether or not small company marginal relief is relevant. The 'formula' that they need to apply as above must simply be learnt.

In the above example, many good students lost an easy mark by failing to give the due date for payment. This is a recurring error in this task in many of the exam papers, and indicates a lack of reading of the task requirements. In addition, giving an answer of 'Nine months and one day' is not providing a date and will gain no mark.

SECTION 4

Capital allowances

Similar to the teaching of the adjusted profits, I would recommend that you start with unincorporated businesses. Again similar to adjusted profits, students will only need to do one capital allowances computation in the exam.

CAPITAL ALLOWANCES FOR PLANT AND MACHINERY

The key aspect here is for students to adopt a suitable layout. This is a clear case for the 'Balance Sheet of Taxation' approach discussed above.

An example of a suggested layout would be:

	General Pool	Asset 1	Asset 2	TOTAL
	£	£	£	£
WDV b/f	X	X	X	
Disposals			<u>X</u>	
BA/BC			<u>X</u>	(X)
Non FYA Additions	<u>X</u>			
	X			
WDA at 25%/restricted	<u>X</u>	<u>X</u>		X
	X	X		
40% FYA	X			
FYA	<u>X</u>	<u>X</u>		X
50% FYA	X			
FYA	<u>X</u>	<u>X</u>		<u>X</u>
WDV c/f	<u>X</u>			
Total allowances				<u>X</u>

Whilst the obvious technical areas of capital allowances, such as the handling of additions, disposals and the allowances, must be covered, time must be spent on the details. Short and long accounting periods must be addressed, private usage of assets, cars costing more than £12,000 and the key differences between unincorporated and incorporated businesses.

In the December 2003 paper, task 1.1 was on capital allowances. The first accounting period was for nine months only. The task stated that in March 2001, a car costing £13,800 was bought. It had 25% private usage. Typical answers given by students include the following five examples.

	Eg 1	Eg 2	Eg 3	Eg 4	Eg 5
P/e 30 Sept 01					
Addition	13,800	13,800	13,800	13,800	13,800
WDA	<u>3,000</u>	<u>2,250</u>	<u>3,450</u>	<u>1,688</u>	<u>2,250</u>
Y/e 30 Sept 02					
WDV	10,800	11,550	10,350	12,112	11,550
WDA	<u>3,000</u>	<u>3,000</u>	<u>2,588</u>	<u>2,250</u>	<u>2,888</u>
WDV	<u>7,800</u>	<u>8,550</u>	<u>7,762</u>	<u>9,862</u>	<u>8,663</u>

In terms of calculations, it is only the last column that is correct. As the car has a value over £12,000, the WDA is restricted to £3,000 per year. However, the first period is only nine months in length, so the WDA is also restricted to 9/12. This results in a written down value below £12,000, therefore the standard WDA is 25%. Obviously, in terms of the actual allowance deductible from profits, the private element must be removed. Therefore for the period ended 30 September 2001, the allowance deductible from profit would be £1,688, and for the year ended 30 September 2002, £2,166. A very common error with regard to the adjustment for the private usage can be seen in column 4, with students taking account of the private usage before deducting the WDV. When students make this error, it is indicative of them not understanding the fundamental principles that underpin capital allowances and the inter-relation with private usage.

In December 2004, the calculation for capital allowances revolved around the cessation of the business. This task, 1.1, was very disappointingly answered. It appeared that centres had not covered this topic at all, or, at best, very briefly. The balances brought forward in the pools were £7,330 and £9,570 for general and car respectively. Instead of simply adjusting for the proceeds or market value to arrive at the balancing charge and allowance, a very common answer looked like:

	General Pool £	Car £	30% PU	TOTAL £
WDV	7,330	9,570		
WDA at 25%	<u>1,833</u>	<u>2,393</u>	(718)	3,508
	5,497	7,177		
Proceeds/MV	<u>8,200</u>	<u>6,000</u>		
Balance	<u>2,703</u>	<u>1,177</u>	(353)	<u>(1,879)</u>
				<u>1,629</u>

Whilst handling the 25% deduction arithmetically correctly as above means that the total allowances are the same, during the exam students became confused over the handling of the proceeds and market value, routinely failing to understand the distinction between charges and allowances. Some failed to adjust the final balance for the car for the private usage and many did not understand that the market value of the car should be treated as proceeds.

As with adjusted trading profits, it is recommended that you start teaching capital allowances for unincorporated businesses, then handle the differences for incorporated businesses. The only difference, really, is the handling of the private usage. This area was assessed in Task 2.1 in the December 2005 exam, and badly answered by the majority of students who adjusted for the private usage of 20% on the Managing Director's car. By adjusting for this, students would have total allowances of £9,200 instead of the correct answer of £11,000.

Industrial buildings allowance (IBA)

Each time this area has been assessed, students have struggled. It is very clear in the guidance notes to the Standards that only buildings that have been in continuous industrial usage will be assessed. However, both new buildings and second hand buildings are assessable, and it is the latter that causes students so many problems.

Students need to understand that the only time when the written down allowance is time apportioned is when the accounting period is not for 12 months – the length of ownership of the actual building during a 12-month accounting period does not affect a full 4% allowance.

For instance, in Section 1 of the December 2003 exam, the industrial building was bought in April 2001, and the first accounting period lasted from January 2001 to September 2001. This meant a variety of options existed:

- a) A full 12 months, ignoring all dates
- b) Take 9/12 of the allowance being the length of the accounting period
- c) Take 6/9 of the allowance being from April 2001 to September 2001.

The correct answer is b) as this is the length of the accounting period.

In the June 2004 exam, the accounting period was a full 12 months ended January, but an industrial building was bought in the August. A common error made by students was to take 6/12 of the 4% WDA.

The first time a second-hand building was assessed was in Section 2 of the June 2005 exam. It was quite appallingly answered, with the majority of students failing to appreciate that second-hand buildings cannot have a 4% allowance. Whilst most text books will provide all the information on how to compute residues before and after sale, this is really quite unnecessary. The significance of these figures only applies to the situation when there are periods of non-industrial use. As this will not be assessed, it is not necessary to burden students with this level of detail. Many students in the June 2005 exam spent a lot of time on trying complicated computations to find the residue before and after sale. It can be a complicated concept, and only confused the students so that they could not complete the task. Students only need to know that the cost used in the IBA computation can never exceed the original cost. Therefore, when a building is sold for an amount higher than the original cost, it is the original cost that is used in the IBA computation for the new owner. When it is sold for an amount lower than the original cost, it is the amount paid by the purchaser that is used.

Another area of confusion with second-hand buildings is the length of time left the building has once sold. Take a situation where the building is brought into use, as a new building, on 1 January 2001. The owner has a year end of 31 August. The building is sold on 1 November 2003, and the new owner has a year end of 30 April. If we assume that both owners have traded for many years and therefore all relevant accounting periods are for 12 months, the dates, and therefore the related allowances, should be straightforward. The basic rule for being able to claim IBAs is: is the industrial building in use at the end of the accounting period? If yes, IBAs are claimed for the full year (when the accounting period is for 12 months), if not, no IBAs can be claimed.

Therefore with this example, the first owner can claim the IBA at 4% for the years ended 31 August 2001, 2002 and 2003. Although the owner had the building for the period 1 September 2003 to 31 October 2003, no IBAs can be claimed. For the new owner, IBAs can be claimed for the years ended 30 April 2004 on. In the year of purchase, a full year's worth of allowances can be claimed as the accounting period is for a full year. The trick with the dates is to start with the first day of the life of the building, then add on 25 years to arrive at the end of the life of the building. The time period over which the new owner can claim allowances is the time from the date of purchase to the date at the end of the life of the building. With the above example, the building's end of life date would be 31 December 2025. As the date of purchase is 1 November 2003, the remaining life of the building would

be 22 years and 2 months, or 266 months. Therefore the IBAs for the new owner would be $\text{£Value} \times \frac{12}{266}$.

In summary, when a second hand building is sold, all students need to know is two simple figures:

- a) Which is the lower – the original cost or the proceeds?
- b) How many months are there left from the date of purchase to the end of the life of the building?

Then a) is divided by b), and that gives the annual IBAs for the new owner.

SECTION 5

Capital transactions

The extent to which this area is covered in the business tax exam is much less than the equivalent in the personal tax exam.

Generally, there will be, at the most, only one computation in each section, although it is more likely that there will be only one task in the whole exam that covers this topic. In the five exams that have been sat, four of them have assessed shares. This is not indicative that this will also be the case, although share disposals tend to fit company scenarios well.

What has been a surprise over the previous exams is the lack of confusion by students over the rules that apply for individuals and for companies. Many students sit both papers at the same time, and therefore need to clearly distinguish between the two sets of rules, especially for share disposals. It was anticipated that evidence of confusion would be apparent, but this is simply not the case.

Where students go wrong in share disposals is in two areas:

- a) not using an appropriate layout. This goes back to the 'Balance Sheet of Taxation' issue that was discussed early – this is another example of students needing to learn the appropriate narrative and structure of a layout in order for them to compute the figures accurately. It is recommended that students use the standard three columns for the share pool of: number of shares, original cost and indexed cost.
- b) handling rights issues and bonus issues. In both tax units this area causes students problems. This will be covered in detail later in the PTC section of this guide, but the simple way to explain the difference between the two is that bonus shares are free, and therefore have no monetary implications at all. This means that there can be no indexation allowance when a bonus issue event takes place. Indeed, these two events are easier with companies as the pool does not close in April 1998.

The other aspect of capital transactions that students need to cover for this unit, is the handling of reliefs. There are only two reliefs that are assessable in this unit: rollover and gift.

ROLLOVER RELIEF

Only the basics of this topic are expected to be covered. Take an example:

In February 2000, Andy bought a building for £150,000. He sold the building in October 2005 for £200,000. The same month, he bought another building for £220,000.

On the first building, there is a simple gain of £50,000 (£200,000 - £150,000). There is an indexation allowance implications as the owner is an individual and all transactions happen after 6 April 1998. As the full amount of the proceeds on this first building is reinvested in the second, the whole amount of the gain of £50,000 can be rolled over and set against the second building. The second building is therefore deemed to have a cost of £220,000 - £50,000 = £170,000. When the second building is sold, there will be an increase in the tax payable.

However, if the second building had only cost £180,000, the situation would be slightly different. £20,000 of the proceeds on the first building have not been reinvested. This £20,000 will attract taper relief and becomes liable to capital gains tax (CGT). The amount of rollover relief is therefore £30,000, (£50,000 - £20,000). This means that the deemed cost of the new building is £150,000 (£180,000 - £30,000).

This is the extent of the complexities of rollover relief that is needed for this unit.

GIFT RELIEF

This works in virtually the same way as rollover relief, the main difference being that there are, of course, no proceeds (otherwise it won't be a gift). Therefore, in place of proceeds, the market value of the asset is used at the time of the transfer.

Preparing Personal Taxation Computations (PTC)

SECTION 6

Employment Income

This forms the basis of Section 1 in the personal tax exam. The main area of this tax that students must be able to show competence in is benefits in kind. The benefits that are examinable are:

- Company cars
- Fuel provided for private usage
- Assets provided for private usage
- Beneficial loans
- Provision of accommodation, including expensive accommodation
- Expenses connected with living accommodation
- Reimbursed expenses
- Some exempt assets

Most of these are quite self explanatory, but areas that need expanding on are:

Company cars: the base level for the car's CO₂ emission will always be given in the exam tax tables, but no formula will be provided. Therefore, in the exam, students need to compute two figures:

- the cost of the car chargeable
- the percentage charge based on the CO₂ emissions

The first time that a capital contribution was assessed was in the December 2005 exam, and it was generally handled inaccurately. It was treated as an annual contribution, instead of a capital contribution. It must also be remembered that when an employer pays a second hand car, it is the price of the car when new that is taxable, not the price paid by the employer.

When the percentage charge is being computed, it is vital that the CO₂ emission rating of the car is taken DOWN to the next 5. So a car with a rating of 164 will be taken down to 160. This figure is then compared to the base level, currently 140. The difference is divided by 5, added to 15%, to arrive at the final chargeable percentage.

A formula could look like:

$$\frac{\text{Car's CO}_2 \text{ emission taken down to nearest 5} - 140}{5} + 15\% = \text{chargeable \%}$$

For diesel cars, an additional 3% is added, but the total percentage is capped at 35%.

Assets used for private usage: when employees are given the use of an asset for private purposes, there is an annual benefit equal to 20% of the asset's market value when first provided. There are several details that need to be explored here. First, if the asset has no private usage at all, there is no benefit. Secondly, if the asset is given to the employee then the full amount of the market value is assessable, with complexities when the asset is first given for use only, then gifted in full. Lastly, exemptions from these rules generally apply to the provision of mobile phones.

Beneficial loans: as with all computations of this nature, students will be expected to only use round months, and never days. Therefore only the average method will ever be assessable.

Expenses connected with living accommodation: students must be able to distinguish between running expenses and assets that are within the accommodation. Running expenses are taxable in full. Take the following example:

Evelyn is provided with the use of a house by her employer, who pays the following on her behalf:

	£
Electricity	600
Gas	200
Water	400
Furniture	800

She will be taxed on the full amount of the electricity, gas and water. The furniture, though, is an asset, so she will be taxed on £160, being 20% of £800. Had the employer given the furniture to her, rather than just allow her to use it, then the full £800 would have been taxable.

With many aspects of the tax exams, students lose marks by following a totally inappropriate layout, meaning that what they are doing cannot be followed. A recommended layout is to give headings for each of the benefits taxable, clearly showing which benefit is being calculated. Also, a total must be provided, which is normally a requirement of the task.

SECTION 7

Property Income

This is really quite straightforward, and in previous exams students have performed well in this area. Examples of a typical question on this area can be seen in the December 2004 and 2005 exams.

Again, following a good layout is important, especially when there is more than one property in the scenario. An example of a simple layout is:

	Property 1		Property 2	
	£	£	£	£
Income		X		X
Expenses:				
Insurance	X		X	
Redecoration	X		-	
Interest	X		X	
Wear and tear	(X)	(X)	(X)	(X)
Profit/(Loss)		<u>X</u>		<u>(X)</u>

There are three things to note here:

- Cost of furniture is not a deductible expense, as it is capital expenditure. Instead, wear and tear of 10% can be claimed. This 10% is based on the rent due for the period in question. This is one of the reasons why it is best to keep properties separate – one may attract the 10% wear and tear, but the other may not.
- Watch out for periods that are not for 12 months.
- Any profits or losses are amalgamated in the same tax year. Therefore, it is best to do a separate computation for each property, net off all profits and losses. If there is a resulting profit, it is taxable in that year. If there is a resulting loss, it is carried forward to be set off against the next available profit in subsequent tax years.

SECTION 8

Capital gains tax (CGT)

This topic forms the basis for Section 2 in the PTC exam.

SHARES

Without a doubt, this is one of the areas where it is vital to adopt the 'Balance Sheet of Taxation' approach – students must be able to visualise all the narratives here, together with a potential order of events. An example would be:

	No of Shares	Original Cost £	Indexed Cost £
First purchase			
IA to next event			
Events that attract IA:			
Additions, disposals, rights issues			
Events that do not attract IA:			
Bonus issues			

By far the biggest errors made by students in the exams are surrounding rights issues. With both rights issues and bonus issues, they must be attached to the shares that generated the issue. Where the confusion tends to lie is when the originating shares are acquired before April 1998 and the issue is after. This confusion may arise because students are taught that in April 1998 the share pool is closed, and therefore believe that no other addition to the pool can be made. This is not the case, when rights or bonus issues are involved.

In the June 2005 exam, Task 2.1 was about such a scenario. The task is:

In December 2004, Danielle sold 5,000 of her shares in Knight Ltd for £35,000. These shares do not qualify as business assets. Her transactions in the shares of Knight Ltd were as follows:

Date	Transaction	No of Shares	£
May 1993	Purchased	1,000	2,500
June 1995	Purchased	4,000	14,600
January 1998	Sold	500	2,000
July 2002	Rights issue	1 for 5	£2 per share.

The indexation factors were:

May 1993 to June 1995	0.062
June 1995 to January 1998	0.065
January 1998 to April 1998	0.019

Students tended to compute the share pool for the first two transactions fine. So a student would have:

	No of Shares	Cost £	Indexed Cost £
May 1993	1,000	2,500	2,500
IA to June 1995 – 0.062			<u>155</u>
			2,655
June 1995 – purchase	<u>4,000</u>	<u>14,600</u>	<u>14,600</u>
	5,000	17,100	17,255
IA to January 1998 – 0.065			<u>1,122</u>
			18,377

However, at this stage some students would make the error of deducting the proceeds of the sale from the pool, and not the share number apportioned cost. It is not uncommon to also find that students feel that they need to do something with the proceeds from the January 1998 sale – but this piece of information is actually not relevant and needs to be ignored. The correct deductions from the pool for the disposal are:

January 1998 – sold	<u>(500)</u>	<u>(1,710)</u>	<u>(1,838)</u>
	4,500	15,390	16,539

The cost figures have been arrived at by:

Original cost: $500/5000 \times £17,100 = £1,710$

Indexed cost: $500/5,000 \times £18,377 = £1,838$

It is worth mentioning at this stage that no pence should be used in the share pool – only rounded figures. It does not really matter if the figures are rounded up or down.

The pool now needs to be complete up to April 1998, and in theory then frozen. There are only three events that can bring adjustments to the pool:

- Disposals
- Rights issues
- Bonus issues

In the question above, we have two of these events – a disposal and a rights issue. The majority of students are comfortable with the adjustment of the disposal, but the rights issue is a problem. Assuming that the student has the answer as above, a typically wrong answer would look like:

Rights issue:		£	
Proceeds: $900/5,000 \times £35,000$		6,300	
Cost $900 \times £2$		<u>1,800</u>	
Gain		<u>4,500</u>	
Share pool – b/fwd from above	4,500	15,390	16,539
IA to April 1998 – 0.019			<u>314</u>
			16,853
December 2004 – disposal	<u>4,100</u>	<u>14,022</u>	<u>15,355</u>
Pool to carry forward	<u>400</u>	<u>1,368</u>	<u>1,498</u>
		£	
Proceeds: $4,100/5000 \times £35,000$		28,700	
Cost		<u>15,355</u>	
Gain		<u>13,345</u>	

Total Gain = $£13,345 + £4,500 = £17,845$.

It is fundamental to understand why the above answer is wrong. The shares that have given rise to the rights issue must have that issue attached. Therefore the correct answer is:

Share pool – b/fwd from above	4,500	15,390	16,539
IA to April 1998 – 0.019			<u>314</u>
			16,853
July 2002 – Rights issue	<u>900</u>	<u>1,800</u>	<u>1,800</u>
	5,400	17,190	18,653
December 2004 – disposal	<u>5,000</u>	<u>15,917</u>	<u>17,271</u>
Pool to carry forward	<u>400</u>	<u>1,273</u>	<u>1,382</u>
		£	
Proceeds		35,000	
Cost		<u>15,917</u>	
		19,083	
IA (17,271 – 15,917)		<u>1,354</u>	
Gain		<u>17,729</u>	

This principle applies to bonus issues as well, although with no monetary value attached to the bonus issue shares themselves, it is impossible for them to have their own calculations.

PRINCIPLE PRIVATE RESIDENCE

This area of CGT can look daunting for a student. Any reasonably sized task on this topic will look like just a jumble of dates that the student needs to pick their way through. Students need to understand that even when the owner of the property has not physically occupied the house, certain periods may be classified as occupation. First, they must learn the rules of what is classified as occupation:

- actual physical occupation
- the last 36 months of ownership
- any period during which the owner has worked overseas
- a maximum of four years during which the owner has worked in the UK
- a maximum of three years for any other reason

For the last three periods to be classified as occupation, actual physical occupation must have taken place at some time both before and after the deemed occupation. The June 2004 paper has a question on this topic:

Adam bought a house on 1 October 1985 for £65,000. He lived in the house until 31 January 1988. He then worked abroad for exactly two years before returning to the UK to live in the house again. He took early retirement on 1 April 1994, moving to Portugal to live until 1 April 2003. He moved back into the house until 30 November 2003, when he sold it for £187,500.

There is a variety of ways on tackling a question like this. First, the total period of ownership, in months, should be worked out. In this question, it is 18 years and 2 months, or 218 months. Then adopt a layout like:

Dates	Occupation	Non-occupation
1 Oct 1985 – 31 Jan 1988		
1 Feb 1988 – 31 Jan 1990		
1 Feb 1990 – 31 Mar 1994		
1 Apr 1994 – 31 Mar 2003		
1 Apr 2003 – 30 Nov 2003		

Once the dates have been broken down into events, then it is easier to see what is occupation and what is not.

1 Oct 1985 – 31 Jan 1988	Actual occupation
1 Feb 1988 – 31 Jan 1990	Worked abroad, before and after actual occupation
1 Feb 1990 – 31 Mar 1994	Actual occupation
1 Apr 1994 – 31 Mar 2003	Not working, but 8 months used of the allowed last 36 months in the next period, leaving 28 months allowed here. Also, 3 years allowed for any reason. So of the 9 years here, or 108 months, 64 are deemed occupation, leaving 44 chargeable.
1 Apr 2003 – 30 Nov 2003	Last 36 months always deemed occupation

The CGT computation to work out the gain on the house is exactly the same as for all assets. The difference is when the gain has been worked out, it is reduced by the fraction of occupation, leaving only the fraction of non-occupation actually chargeable to CGT. In the above example, 44/218 would be the chargeable fraction.

A very simple way to alter this question is to simply alter one or two dates. Practice makes perfect, and if students can start with the right answer, then make alterations to it based on variations to the question, they should find it easier to understand and apply the principles.

OTHER ASSETS

Part disposals and chattels most also be covered in detail.

Part disposals should be straightforward. In the December 2005 exam, a part disposal of land was assessed. The data stated: 'Andrew bought 100 acres of land as an investment in December 1987 for £10,000. In August 2004 he sold 70 acres of the land of £40,000. The remaining 30 acres were valued at £20,000 on the date of sale.'

A typical wrong answer saw the student apportion the cost of £10,000 based on the acreage, not on value. Therefore, a typical cost used was £10,000 x 70/100. Whilst this is actually quite understandable, it is not right, and the correct formula must be learnt by students.

Chattels are reasonably straightforward, and it will always be clear in the exam that the asset should be classified as a chattel. When assessed in previous papers, there is a variety of interesting things that students do with £6,000! The following table may help:

Proceeds/Cost	CGT impact
Both less than £6,000	Ignore for CGT purposes
Proceeds more than £6,000, cost less	Gain cannot exceed 5/3 of excess of proceeds over £6,000
Proceeds less than £6,000, cost more	Proceeds used in CGT computation is £6,000, not actual proceeds
Both more than £6,000	Normal CGT computation takes place

TAPER RELIEF

There will always be a separate task in the exam that handles the taper relief. It is recommended that students use the 'Balance Sheet of Taxation' approach here, with the following being a recommended layout:

	TOTAL	Asset 1	Asset 2	Asset 3
	£	£	£	£
<i>Taper relief here</i>		(%)	(%)	(%)
Gains from previous tasks	X	X	X	X
Less Loss to highest TR	(X)	(X)		
	<u>X</u>	<u>X</u>	<u>X</u>	<u>X</u>
Chargeable after TR	X	<u>X</u>	X	X
Less Annual Exemption	(X)			
Taxable Gains	<u>X</u>			

Some suggested layouts show the above in a vertical format – this is not viewed as the easiest for students to use, especially when losses need to be handled. The horizontal format as above makes it easier to see which asset has the highest taper relief. Also, if the one with the highest taper relief is not enough to fully absorb the loss, then the loss can be easily allocated to the asset with the next highest taper relief.

Also, in relation to taper relief, it is vital to understand that the percentage given is the CHARGEABLE percentage. The use of the word relief can be misleading as it implies that the percentage is the relief and therefore should be deducted from the gain.

SECTION 9

Miscellaneous personal income and allowances

These areas can be examined in either section of the PTC exam, and frequently in both. Confusion can arise on which income attracts which rates, and the order in which they need to be handled in the tax liability task. The following table may help:

	Order in tax liability computation	Tax rates
Salaries, trading profits and property income	First	10%, 22% 40%
Bank and building society interest	Second	10%, 20% 40%
Dividends	Third	10%, 32.5%
Interest from ISAs	Exempt	Exempt

The complexities that surround income in different tax bands is acknowledged. However, this is vital to the PTC exam, and must be thoroughly taught. One question with different alternatives can easily assess a student's understanding of this topic. An example would be:

Assume rate bands of £2,090 and £32,400, and personal allowances have already been adjusted for. George receives gross interest of £2,000 and gross dividends of £3,000. What is the tax liability if his salary is:

- a) £20,000 [This has all income in the basic bands only]
- b) £35,000 [This has the salary in the 40% band, the other two in the higher rates]
- c) £31,000 [This has the salary in the basic rate, the interest is split across the rates and the dividends are higher rate only]
- d) £30,000 [This has the salary and interest at basic rate, the dividend is split across the rates]

It is only the basic personal allowance that is assessable in the exam, so there should be no problems here.

PENSIONS

This can be a highly complex area. Students will not need to know all the complexities that surround the computation of pensions, such as permitted contributions or carry back provisions. The data will contain information on either occupational pension schemes, or private pension schemes.

Occupational pension schemes: students need to understand how to handle the contribution made by the employee, and that made by the employer. The contribution by the employee will normally be expressed as a percentage of the salary. This is, therefore, simply deducted from the salary before the taxation is calculated. The contribution made by the employer is ignored. When assessed in previous exam papers, a very common mistake made by students is to treat the employer contribution as a benefit in kind. Whilst there is a kind of logic to this, it is not correct and students will be penalised in the exam for its inclusion. There are no other aspects to this form of pension scheme that students need to understand.

Private pension scheme: this is a totally different type of scheme. Students will simply be told what the contribution made by the taxpayer is – there will be no need to compute this. Therefore all the information on permitted contributions based on age is not needed. Students need to carefully read the information to determine if the payments are net or gross – obviously, if the former, the contributions need to be grossed up at 22%. The reason for this is that payments into this type of scheme are made net of basic rate of tax at 22%. If the taxpayer is a basic or lower rate taxpayer, they are only entitled to 22% tax relief on the gross payments, and as this has already been given at source, no further adjustments are necessary in relation to the tax computation.

However, where the taxpayer is a higher rate taxpayer, they can obtain relief at 40% on the gross contributions. As they have already been given 22% relief at source, they are entitled to additional tax relief of the 40%. The way in this is done is by expanding the basic rate for the pension amount.

The December 2005 exam had such a question:
The total income from task 1.2 showed the following:

	Total	Non Saving	Saving	Dividends
	£	£	£	£
TOTAL	<u>42,035</u>	<u>39,815</u>	<u>1,320</u>	<u>900</u>

The taxpayer paid £234 per month, net, into a private pension scheme.

This task handles all the issues in this section of the guide, so read carefully:

The tax payable would therefore be:

	£	
2,020 x 10%	202.00	This is straightforward
29,380 x 22%	6463.60	This, too, is straightforward. As the salary is way above the 40% tax band, all the basic rate will be used for the salary
3,600 x 22%	792.00	This is the pension. The calculation to get to the £3,600 is: £234 x 12 x 100/78.
4,815 x 40%	1,926.00	This is the remainder of the salary at 40%, being £39,815 – 2,020 – 29,380 – 3,600
1,320 x 40%	528.00	As the salary is in the 40% band, all of the non savings income must be in this band as well.
900 x 32.5%	292.50	The higher tax band for dividends is at 32.5%, not 40%

This is the level of complexity that private pension schemes will be taken to in a computational question. However, care must be taken when the salary is not in the higher tax band.

To continue the above example, assume all figures are the same, but the salary is £33,000, in which case the higher rate still does not take effect until £35,000 has been reached. So, the tax payable would have been:

	£	
2,020 x 10%	202.00	Same as above
29,380 x 22%	6463.60	The salary is £1,600 above the normal 40% band of £31,400, all the 22% band is allocated to the salary.
1,600 x 22%	352.00	This is the balance left of the salary in the basic rate
1,320 x 20%	400.00	This is the savings income that will be at the basic rate, but the basic rate for savings is at 20%, not 22%.
680 x 10%	68.00	The last bit of the pension is in the basic rate for the dividends, which is 10%.
220 x 32.5%	71.50	This is the remainder of the dividends, which is taxed at the higher rate of 32.5%

This may appear very complicated, but students need to simply follow the procedure as above to work out what is taxable at what rate.

SECTION 10

Dates, interest, penalties and tax returns

INCOME TAX

There are several key dates that students simply need to learn. Firstly for income tax, it is common for students to confuse the dates that the tax returns are due and the dates that the tax payable is due. This confusion is not helped by the fact that 31 January is common to both. Also, the dates are changing from 2007/08. Prior to that, the dates were:

	Tax return	Tax payable
First date	30 Sept – if you want HMRC to compute the tax liability	31 Jan – first payment due for the tax year that 31 Jan falls into
Second date	31 Jan – if you want to compute the tax liability yourself	31 July – second payment due for the tax year just ended

From 2007/08, the dates for the tax payable remain the same, but the dates to complete the tax return are 31 October for paper based returns, and 31 January for filing online returns.

Another common mistake made by students is to assume that if the tax return is given to HMRC by 30 September, that HMRC will actually complete the tax return. This is a definite 'No', and although the student may quote the right date, no marks will be given as the context used for the date will be wrong.

With interest and penalties, the main penalty that students need to know is in relation to the late submission of a tax return. The penalties are:

Up to 6 months late	£100
Between 6 and 12 months late	Another £100
Over 12 months late	Another penalty of up to 100% of the tax unpaid

For late payments of tax, the interest applicable is:

Up to 28 days late	Interest, currently at 6.5%
Between 28 days and 6 months late	Surcharge of 5%
Over 6 months late	Another surcharge of 5%

CORPORATION TAX

Companies are required to notify HMRC within three months that they have commenced trading. The penalty for failing to notify them is £300 for the initial failure, and £60 per day for continued failure, after an initial penalty has been imposed.

The relevant date for the tax return is basically 12 months after the end of the period covered by the return. Failure to submit the return incurs the following penalties:

	First return	Third return	Also
Up to 3 months late	£100	£500	
More than 3 months late	£200	£1,000	
Between 6 and 12 months late			10% of tax outstanding
More than 12 months late			20% of tax outstanding

The payment of corporate tax is slightly more complex, as this depends on the size of the company. The normal date of payment is 9 months and 1 day after the end of the accounting period. However, when a company pays tax at the full rate, without marginal relief, the tax is paid in instalments. This can be quite a complicated, as the instalments are based on the company's estimate of the tax liability. Therefore, any question on this in the exam will be very clear, and relatively simple.

TAX RETURNS

The tax returns that are assessable in the exam are:

	BTC	PTC
Section 1	Trading profits	Employment income Property income
Section 2	Corporation tax, short version	Property income

These are really very straightforward to complete, requiring only a little practice and lots of reading. Students must be able to link the specifics of the data to the above tax returns. One way to do this is to ask students to complete a return each time they do a computation on the relevant area. This way, they become used to the structure of each return and find it quite natural to complete one using the data from a variety of different questions. It is not advisable to teach the completion of the tax returns as a separate topic. If it is done in this way, students will not be able to directly link the details of a question to a return – the return will be viewed in isolation to the data, and that makes it more difficult for students to see the direct link.

SECTION 11

Further reading

Unit 18 (BTC)	Study text and revision kit	BPP
	Combined course and revision companion	
	Combined study text and workbook	Kaplan Publishing Foulks Lynch
	BTC textbook	Osbourne
Unit 19 (PTC)	Study text and revision kit Combined course and revision companion	BPP
	Combined study text and workbook	Kaplan Publishing Foulks Lynch
	PTC textbook	Osbourne

Websites

H M Revenue & Customs:
www.hmrc.gov.uk

HM Treasury:
www.hm-treasury.gov.uk

AAT contact

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