



**AF2**

**THE CHARTERED INSURANCE INSTITUTE**

**TUESDAY 20 OCTOBER 2009**

**ADVANCED DIPLOMA IN FINANCIAL PLANNING  
AF2—BUSINESS FINANCIAL PLANNING**

**SPECIAL NOTICES**

- **All questions in this paper are based on English law and practice applicable in the tax year 2009/2010, unless stated otherwise and should be answered accordingly.**
- **Assume all individuals are domiciled, resident and ordinarily resident in the UK unless stated otherwise.**

**INSTRUCTIONS**

- **Three hours are allowed for this paper.**
- **Read the instructions overleaf carefully before answering any questions.**
- Fill in the information requested on the answer book and form B.
- If you bring a calculator into the examination room, it must be a silent battery or solar-powered non-programmable calculator. The use of electronic equipment capable of being programmed to hold alphabetic or numerical data and/or formulae is prohibited. You may use a financial or scientific calculator, provided it meets these requirements and you must enter the serial number, model and make on the form B.
- You are allowed to write on the inside pages of this question paper but you must **not** write your name, candidate number, PIN or any other identification **anywhere** on this question paper.
- The answer book and this question paper **must both be handed in personally by you** to the invigilator before you leave the examination room. **Failure to comply with this regulation will result in your paper not being marked and you may be prevented from entering this examination in the future.**

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**THE CHARTERED INSURANCE INSTITUTE**

**AF2—Business financial planning**

**CANDIDATE INSTRUCTIONS**

**READ THE INSTRUCTIONS BELOW BEFORE ANSWERING ANY QUESTIONS**

Three hours are allowed for this paper. You should answer **all** questions in Sections A and B.

The paper carries a total of 160 marks, as follows:

Section A: 80 marks

Section B: 80 marks

You are advised to spend approximately 90 minutes on Section A, and 90 minutes on Section B. You are strongly advised to attempt **all** the required questions to gain maximum possible marks.

The number of marks allocated to each question part is given next to the question and you should spend your time in accordance with that allocation.

Any rough notes made in your answer book must be crossed through before you hand it in.

**Tax tables are provided at the back of this paper.**

Answer each question on a new page and leave six lines blank after each question part.

**It is important to show all steps in a calculation, even if you have used a calculator.**

**Please ensure that you understand the Special Notices printed in the box on the front page.**

*Subject to providing sufficient detail, you are advised to be as brief and concise as possible, using note format and short sentences on separate lines wherever possible.*

## SECTION A

**This question is compulsory and carries 80 marks.**

### Question 1

Ken and Ellie Harris, aged 60 and 56 respectively, are preparing to retire having built up two successful businesses. They own and control two UK resident private limited companies but have never previously sold any business assets and are seeking your advice on various aspects of their planned disposals and subsequent retirement.

The first company is Staytite Fixings Ltd, a wholesale operation supplying ironmongery products to the building trades. They each own 50% of the company's issued and paid capital of 1,000 £1.00 shares, which they acquired at par value in March 1986. They are both directors whose salaries have been £120,000 per annum each for a number of years. To date in 2009/2010, they have each received remuneration totalling £45,000.

The company holds cash of £250,000 of which £75,000 is accounted for in a director's loan made by Ken. The company has retained profits of £100,000.

Ken and Ellie have agreed to sell their shares in the business on 1 November 2009 to a major plc for £750 each, of which £500 is due on the completion day and the balance 12 months later. Ken and Ellie will resign as directors on the completion day and the sale contract provides that the shares will be transferred with all cash having been removed from the company. Any associated costs of distributing the cash must be met from the cash distributed.

The second company is KEH Holdings Ltd, which runs a number of DIY stores. Ken and Ellie hold 52% of the shares with the balance held by their two sons, Gary and Steve, who are both directors and each receive salaries of £50,000 per annum. The company has surplus cash of £950,000.

KEH Holdings Ltd operates a small self-administered pension scheme (SSAS) of which Ken and Ellie are the only members. The scheme has a value of £2,800,000 which includes a warehouse leased to Staytite Fixings Ltd under a new 21 year lease. The property is valued at £1,750,000 and generates an annual rent of £110,000. Contributions paid up to 1 October 2009 for Ken and Ellie have been £15,000 each. This scheme holds the entirety of Ken and Ellie's pension rights and they hold benefits equally.

Ken and Ellie will make a gift of  $\frac{2}{3}$ <sup>rd</sup>s of their shares in KEH Holdings Ltd to their sons upon their retirement from the company and drawing maximum pension benefits.

In order to ensure as clean a break as possible is made, it is proposed that the property is sold by the SSAS and the scheme wound-up so that Ken and Ellie can secure their pensions through individual pension contracts. Their sons would like to purchase the property if they can. They each have a pension fund worth £250,000 and would be willing to utilise this. Additionally, they have between them £500,000 available which they can utilise. Their bank has indicated its willingness to advance up to 70% of the purchase price to either them or KEH Holdings Ltd or a new pension arrangement in order to purchase the property.

## Questions

- (a) (i) Calculate, **showing all your workings**, the Capital Gains Tax (CGT) that Ken will have to pay upon the sale of his Staytite Fixings Ltd shares. (12)
- (ii) State the date or dates on which the CGT will become due to be paid on the immediate and deferred payment. (2)
- (b) (i) Recommend, giving your reasons, a set of profit extraction steps for Staytite Fixings Ltd to pay £250,000 to Ken and Ellie with the least possible amount of tax being paid by them. *The money must be received directly from the company so any kind of pension arrangement is not a strategy that you can recommend.* (9)
- (ii) Calculate, **showing all your workings**, the net cash receipt to Ken and Ellie from the strategy you suggest in (b)(i) above. *Note – Ken and Ellie have identical tax status, therefore you may find it simpler to assume it is either one of them who will receive the whole of any taxable payments rather than performing your calculations twice.* (10)
- (c) Explain to Ken and Ellie what impact the sale of the business will have on its Corporation Tax affairs, if any, and those of KEH Holdings Ltd. (2)
- (d) Ken has asked you to advise him of the possible tax consequences of the proposed gift of the shares in KEH Holdings Ltd by Ken and Ellie to their sons, which will take place only after Staytite Fixings Ltd has been sold.
- (i) Explain the immediate and future Inheritance Tax (IHT) treatment of the gift and highlight the major IHT drawback of the proposed transaction. Explain an alternative course of action to overcome this drawback. (7)
- (ii) Explain the Capital Gains Tax (CGT) implications of the gift and describe the options available to the donors. (6)
- (iii) Explain why the share valuation for IHT purposes may differ from the share valuation for CGT purposes. (3)

- (e) It has been agreed that KEH Holdings Ltd will make an immediate contribution to the pension scheme in order to provide the maximum possible benefits to Ken and Ellie without incurring any pension scheme tax charges. The cost of this will be met from the company's surplus cash.
- (i) Explain and calculate, **showing all your workings**, the maximum contribution the company can now make to the scheme under current HM Revenue & Customs (HMRC) guidance. (8)
- (ii) State the vital enquiry you need to make to ensure that your answer to (e)(i) above actually applies in Ken and Ellie's case. (1)
- (f) Gary and Steve consult you about their intended acquisition of the property from their parents' pension scheme.
- (i) State **seven** advantages and **three** disadvantages, which demonstrate why they should purchase the property personally rather than through KEH Holdings Ltd. *Ignore the possibility of a purchase through a pension arrangement.* (10)
- (ii) Calculate, **showing all your workings**, the maximum purchase price that Gary and Steve can reach through a new pension scheme established with their existing funds and making maximum **personal** contributions for a single year. (6)
- (iii) Calculate, **showing all your workings**, the total additional amount that could be made available for a pension scheme property purchase as a result of a **company** contribution from KEH Holdings Ltd. (4)

**Total marks available for this question: 80**

**Section B questions can be found on pages 8 – 11**

## SECTION B

**Both questions in this section are compulsory  
and carry an overall total of 80 marks.**

### Question 2

The Chambers partnership is a family run firm providing business advice and accountancy services to small businesses. The partnership has been expanding rapidly, with their gross profit nearly doubling from 2003.

The expansion of the business resulted from the employment of Jack in April 2003 as their business development manager, due to his wide ranging local business contacts.

Jack's wife, Diane, joined the firm 11 months ago as an accountant in the practice. Jack and Diane are now expecting the imminent arrival of their first child and it is Diane's intention to take up to 26 weeks maternity leave once the child is born. Jack is also keen to take time off to spend with his wife and newborn child. Furthermore, it is Diane's wish that once she returns to work, she either returns part-time or adopts flexible working hours. Jack and Diane told their employer in good time of the pending birth and their plans with regards to taking leave.

The prospect of losing Diane for a period of up to 26 weeks has made the practice partners consider their vulnerability to the loss of their employees' services. In particular they have reviewed how important Jack is to the firm and they have decided to put in place key person assurance payable in the event of his serious illness or death. Jack is in receipt of a salary of £50,000 along with a company car and pension contributions based on 5% of his salary.

In order to provide cover for Diane whilst she is off work, the partners have also decided to take on a temporary worker, Michael, a qualified accountant, as an agency worker through a local employment agency.

### Questions

- (a) In relation to the imminent birth of Jack and Diane's child:
- (i) explain to the firm's partners, Diane's relevant maternity rights and their obligations as a result of her wish to take up to 26 weeks maternity leave and then possible return on a part-time basis; (6)
  - (ii) explain to Diane her position with regards to pay whilst she is on maternity leave and how her intended maternity leave will affect her conditions of employment; (6)
  - (iii) explain Diane's rights to the firm's partners and their obligations should she decide to return to work and request flexible working hours. (4)

- (b) In relation to Jack's intention to seek paid paternity leave:
- (i) state, giving your reasons, whether Jack fulfils the criteria in order to qualify for paternity leave; (4)
  - (ii) state the maximum period of paternity leave that Jack can take and what restrictions apply to how this is taken. (3)
- (c) After an initially promising start, Michael has proven to be a poor stand-in for Diane, as his work was not of the required standard. The firm's partners have therefore decided to dismiss Michael, but are concerned that he may claim unfair dismissal.
- Explain to the partners, giving your reasons, whether Michael could claim unfair dismissal. (4)
- (d) In relation to protecting the business in a critical illness event of Jack's long-term serious illness, the partners have recommended using a critical illness policy with the sum assured calculated using the proportion of profits formula based on the business' net profit.
- (i) Explain briefly to the partners how the policies for key person assurance should be written. (3)
  - (ii) State the drawbacks of the partners using the proportion of profits formula based on the business' net profit in order to calculate the sum assured. (3)
  - (iii) Explain why the partners may decide to select a lower level of cover to protect the business against Jack's ill-health, rather than protection against his death. (3)
  - (iv) State **two** advantages and **two** disadvantages of combining death and critical illness cover in a single unit-linked contract. (4)

**Total marks available for this question: 40**

### Question 3

Paradigm Ltd is a company that supplies computer networking components. The company has grown quickly over the five years since its inception.

The managing director and majority shareholder is John Sharp, a charismatic individual who has been the driving force behind the company's rapid growth. Frank Thompson, the company's research and development director, is the other shareholder in the company. John has always sought to increase market share even where the business transacted was not necessarily initially profitable and against Frank's wishes has taken on a growing number of contracts that are currently not profitable. In order to finance the business's future expansion, the company took out a loan from a bank which John agreed to guarantee and secure on his private residence.

John never showed a great deal of interest in the company's finances and has never employed a financial controller. The day-to-day bookkeeping is the responsibility of Jane, the accounts clerk. John has been accustomed to simply reviewing the year end profit and loss account and balance sheet.

Jane has repeatedly been off sick which has led to the bank and a number of key suppliers not being paid on time or indeed at all and a number of Jane's responsibilities have been neglected.

Following the production of accounts to March 2009, which are reproduced overleaf, Frank has insisted on the appointment of a financial controller who has contacted you to assist with a review of the financial state of the company based on the year end accounts to 31 March 2009.

**Table 1**

<b>PROFIT &amp; LOSS</b>	<b>Year end 31 March 2009 £</b>	<b>Year end 31 March 2008 £</b>
Sales	872,000	650,000
Cost	<u>211,000</u>	<u>129,000</u>
<b>Gross Profit</b>	<b>661,000</b>	<b>521,000</b>
Overheads	673,500	451,000
Interest	<u>10,900</u>	<u>9,700</u>
<b>Net Profit</b>	<b>(23,400)</b>	<b>60,300</b>
Tax	(4,000)	12,100
Dividends	<u>40,000</u>	<u>25,000</u>
<b>Retained Profit</b>	<b>(59,400)</b>	<b>23,200</b>
<b>BALANCE SHEET</b>	<b>Year end 31 March 2009 £</b>	<b>Year end 31 March 2008 £</b>
<b>Fixed Assets</b>	<b>76,900</b>	<b>90,100</b>
<b>Current Assets</b>		
Stock	56,000	29,000
Debtors	85,000	31,000
Cash	<u>29,000</u>	<u>54,000</u>
	<b>170,000</b>	<b>114,000</b>
<b>Current Liabilities</b>		
Tax	16,100	12,100
Creditors	119,000	32,000
Accruals	15,000	8,000
Dividends due	<u>20,000</u>	<u>12,500</u>
	<b>170,100</b>	<b>64,600</b>
<b>Long Term Liabilities</b>	<b><u>67,100</u></b>	<b><u>70,400</u></b>
<b>Net Assets</b>	<b>9,700</b>	<b>69,100</b>
<b>Comprising</b>		
Shareholder Funds	69,100	45,900
Profit	<u>(59,400)</u>	<u>23,200</u>
	<b>9,700</b>	<b>69,100</b>

**Questions (a), (b), (c), and (d) can be found on page 13**

## Questions

*To gain maximum marks you MUST show ALL your workings and express your answers to two decimal places.*

- (a) (i) Identify the **two** key internal financial management reports that you should ask to see in advance of your meeting with the new financial controller. (2)
- (ii) Explain the reasons why the two reports identified in (a)(i) are essential in order to assess the ongoing viability of the business and how they interact with each other. (6)
- (b) (i) Identify and provide the formula for the key ratio you can use to give John the best indication of the company's current liquidity position. (3)
- (ii) Calculate, **showing all your workings**, this ratio for the previous two years and comment on the change. (4)
- (iii) State the formula for the debtor's ratio. (2)
- (iv) Calculate, **showing all your workings**, the debtor's ratio for the previous two years and comment on the change. (4)
- (c) During the meeting, you warn John that if he insists on the business trading its way out of its current difficulties that a liquidator could subsequently apply to the Court to have John declared as being guilty of wrongful trading.
- (i) Explain to John why he may be at risk of a charge of wrongful trading. (4)
- (ii) Explain the implications for John and Frank of wrongful trading. (6)
- (d) You have just learned that one of the company's main creditors has petitioned the Court for a winding up order after a statutory demand for payment has gone unanswered.
- (i) Solely in relation to his role as a shareholder, advise Frank as to the extent of his liability for the company's debts. Give your reasons for the extent of this liability. (3)
- (ii) Explain why John's liability will be greater than Frank's liability for the company's debts. (3)
- (iii) Explain to Frank the **three** possible alternatives to a compulsory liquidation. (3)

**Total marks available for this question: 40**

# TAX TABLES

## INCOME TAX RATES

2009/2010		2008/2009	
Rate	Band	Rate	Band
%	£	%	£
10	1 - 2,440*	10	1 - 2,320*
20	1 - 37,400	20	1 - 34,800
40	Over 37,400	40	Over 34,800

\* A new 10% starting rate is applied for savings income only from 06.04.2008. Only applicable where non-savings income after allowances is under £2,440 for 2009/2010.

## NATIONAL INSURANCE CONTRIBUTIONS

### 2009/2010 Rates

Class 1 Employee	Weekly	Monthly	Yearly
	£	£	£
Lower Earnings Limit (LEL)	95	412	4,940
Upper Earnings Limit (UEL)	844	3,656	43,875
Upper Accruals Point	770	3,337	40,040

### Class 1 Employee contributions 2009/2010

Total earnings £ per week	Contracted-in rate		Contracted-out rate	
	%	%	%	%
Up to 110.00*	Nil	Nil	Nil	Nil
110.01 - 770.00	11	11	9.4	9.4
770.01 - 844.00	11	11	11	11
Above 844.00	1	1	1	1

### Class 1 Employer contributions 2009/2010

Total earnings £ per week	Contracted-in rate		Contracted-out rate	
	%	%	Final salary	Money purchase
	%	%	%	£
Below 110.00**	Nil	Nil	Nil	Nil
110.01 - 770.00	12.8	12.8	9.1	11.4
770.01 - 844.00	12.8	12.8	12.8	12.8
Excess over 844.00	12.8	12.8	12.8	12.8

\* This is the primary threshold below which no NI contributions are payable. However, the lower earnings limit is £95 per week. This £95 to £110 band is a zero rate band introduced in order to protect lower earners' rights to contributory State benefits e.g. Basic State Pension.

\*\* Secondary earnings threshold.

**Class 2 (self-employed)** Flat rate per week £2.40 where earnings exceed £5,075 per annum.

**Class 3 (voluntary)** Flat rate per week £12.05

**Class 4 (self-employed)** 8% on profits between £5,715 - £43,875 plus 1% on profits above £43,875

## INCOME TAX RELIEFS

	2009/2010	2008/2009
	£	£
Personal (basic)	6,475	6,035
Personal (age 65-74)	9,490	9,030
Personal (aged 75 and over)	9,640	9,180
Married/civil partners (minimum) at 10% †	2,670	2,540
Married/civil partners (age under 75) at 10% †	N/A	6,535
Married/civil partners (age 75 and over) at 10%	6,965	6,625
Age-related relief reduced by 50% of income over	22,900	21,800
Child Tax Credit (CTC)		
family element	545	545
family element baby addition	545	545
CTC usually reduced by 6.67% of joint income over	50,000	50,000
Blind person's allowance	1,890	1,800
Enterprise Investment Scheme relief limit @ 20%	500,000	500,000
Venture Capital Trust relief limit @ 30%	200,000	200,000

† where at least one spouse/civil partner was born before 6 April 1935

## PENSIONS

Lifetime Allowance		Annual Allowance	
2006/2007	£1.5 million	2006/2007	£215,000
2007/2008	£1.6 million	2007/2008	£225,000
2008/2009	£1.65 million	2008/2009	£235,000
2009/2010	£1.75 million	2009/2010	£245,000
2010/2011	£1.8 million	2010/2011	£255,000

### Notional Earnings Cap

£123,600 – (For schemes that require post 1989 benefits to be still subject to a cap)

### Annual allowance charge

40% member's tax charge on the amount of total pension input in excess of the annual allowance.

### Lifetime allowance charge

55% of excess over lifetime allowance if taken as a lump sum.

25% of excess over lifetime allowance if taken in the form of income, which is subsequently taxed under PAYE.



## INHERITANCE TAX

	<b>2009/2010</b>	<b>2008/2009</b>
Nil-rate band*	£325,000	£312,000
Rate of tax on excess	40%	40%
Lifetime transfers to and from certain trusts	20%	20%
Overseas domiciled spouse/civil partner exemption	£55,000	£55,000

100% relief: businesses, unlisted/AIM companies, certain farmland/building

50% relief: certain other business assets

### Reduced tax charge on gifts within 7 years of death

	0-3	3-4	4-5	5-6	6-7
Years before death					
% of death charge	100	80	60	40	20
Annual exempt gifts	£3,000 per donor			£250 per donee	

\* From 8 October 2007 up to 100% of the unused proportion of a deceased spouse's/civil partner's nil-rate band can be claimed on the surviving spouse's/civil partner's death.

## MAIN SOCIAL SECURITY BENEFITS

		<b>From 06.04.09</b>	<b>From 06.04.08</b>
		<b>£</b>	<b>£</b>
Child Benefit	first child	20.00	20.00*
	subsequent children	13.20	13.20*
Incapacity Benefit	short-term lower rate**	67.75	63.75
	short-term higher rate**	80.15	75.40
	long-term rate	89.80	84.50
Attendance Allowance	lower rate	47.10	44.85
	higher rate	70.35	67.00
Retirement Pension	single	95.25	90.70
	married	152.30	145.05
Pension Credit	single person standard minimum guarantee	130.00	124.05
	married couple standard minimum guarantee	198.45	189.35
	maximum savings ignored in calculating income	6,000	
	increased from November 2009	10,000	
Bereavement Benefit (lump sum)		2,000.00	2,000.00
Widowed Parent's allowance		95.25	90.70
Jobseekers Allowance		64.30	60.50

\* From 5 January 2009

\*\* Under State Pension Age

## VALUE ADDED TAX

Standard rate	15%*/17.5%**
Annual registration limit - from 1 May 2009	£68,000

\* Effective from 1 December 2008

\*\* Effective from 1 January 2010

## CORPORATION TAX

Financial Year	2009 to 31/3/10	2008 to 31/3/09
Full rate	28%	28%
Small companies rate	21%	21%
Small companies limit	£300,000	£300,000
Effective marginal rate	29.75%	29.75%
Upper marginal limit	£1,500,000	£1,500,000

## CAPITAL ALLOWANCES

Plant & machinery 100% annual investment allowance (first year)	£50,000
Plant & machinery in excess of annual investment allowance (first year)	40%
Plant & machinery, patent rights, know-how (reducing balance) per annum	20%
Certain long-life assets, integral features of buildings (reducing balance) per annum	10%
Industrial & agricultural buildings (straight line)	2%
Energy & water-efficient investments	100%
Qualifying flat conversions & business premises renovations	100%
Motor cars: with emissions in excess of 160g/km	10%
generally	20%*
with CO2 emissions of 110g/km or less	100%
Research & Capital expenditure	100%
Development: Revenue expenditure - small/medium-size firms	175%
- large firms	130%

\* Maximum £3,000

## CAPITAL GAINS TAX

Exemptions	2009/2010	2008/2009
Individuals, estates etc	£10,100	£9,600
Trusts generally	£5,050	£4,800
Chattels proceeds (5/3 excess gain is taxable)	£6,000	£6,000
<b>Rates</b>		
Individuals	18%	18%
Trusts and estates	18%	18%

## ENTREPRENEURS' RELIEF

### Entrepreneurs' Relief 2009/2010

4/9<sup>ths</sup> of gain tax free. Lifetime limit eligible for relief: £1,000,000

For trading businesses and companies (minimum 5% employee shareholding) held for 1yr+

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