THE CHARTERED INSURANCE INSTITUTE

CII

AF2

Advanced Diploma in Financial Planning

Unit AF2 – Business financial planning

April 2013 examination

SPECIAL NOTICES

All questions in this paper are based on English law and practice applicable in the tax year 2012/2013, unless stated otherwise in the question, and should be answered accordingly.

Assume all individuals are domiciled, resident and ordinarily resident in the UK unless stated otherwise.

Candidates should answer based on the legislative position immediately BEFORE the 2013 budget.

Instructions

- Three hours are allowed for this paper.
- **Do not begin writing until the invigilator instructs you to.**
- **Read the instructions on page 3 carefully before answering any questions.**
- Provide the information requested on the answer book and 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.**

Unit AF2 – Business financial planning

Instructions to candidates

Read the instructions below before answering any questions

- **Three hours** are allowed for this paper which 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** 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.
- Read carefully all questions and information provided before starting to answer. Your answer will be marked strictly in accordance with the question set.
- You may find it helpful in some places to make rough notes in the answer booklet. If you do this, you should cross through these notes before you hand in the booklet.
- It is important to show all steps in a calculation, even if you have used a calculator.
- 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.
- Tax tables are provided at the back of this question paper.
- Answer each question on a new page and leave six lines blank after each question part.

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

Aaron, age 52 and Walter, age 57, are the two equal shareholding directors in Seatek Services Ltd, a company that maintains offshore wind farms. The value of the business is £1,200,000. They each own 500 £1.00 nominal ordinary shares, which is the entire issued share capital of the company. They are about to admit another shareholding director, Pieter, next week and he will invest £250,800 in the company by subscribing for £1.00 nominal ordinary shares. All parties have agreed Pieter's share entitlement will be based on the value of the current 1,000 shares.

There is an existing shareholder agreement which states that 'on the death of a shareholder the ownership of his shares shall pass entirely to the surviving shareholder'. There is no provision for compensating the deceased's family in the agreement and so, at the same time that the agreement was drawn up, Aaron and Walter each took out a £300,000 level term assurance policy written to their 65th birthday. Each policy was written in trust for the benefit of their respective spouses. These two policies are still in force and there are no other policies or agreements. Aaron, Walter and Pieter are all in good health and wish to discuss updating the shareholder agreement to ensure there is adequate compensation for their families and also that the arrangement is structured to take advantage of any Inheritance Tax reliefs that are available. They are also concerned that if any of them suffer from future ill health that their co-shareholders would be in a position to buy them out should they wish it.

They have seen a supply boat for sale, which will cost £500,000. In spite of having good accounts and a strong balance sheet, their bank will not provide them with a marine mortgage which is their usual method of financing this type of purchase. They are consequently seeking alternative options and recently asked you if they could use their pension funds to buy the supply boat.

In preparation for your next meeting with them, you have requested details of their current pension values and, in addition, a list of the land and buildings the company owns and their current values. You have been advised that there are no spare funds to make further pension contributions at this time. Your discussions indicated that £200,000 of the cash to be invested in the company by Pieter and £30,000 of the cash currently held by the company could be used towards the purchase of the supply boat. All three directors have advised you that they are prepared to use their personal pension funds to help with the funding shortfall, but whatever method is recommended to raise the capital, the balance sheet must be left in a strong position.

Schedule of cash, land and buildings:

Office Premises	£250,000 owned outright
Adjoining dockside land and buildings	£300,000 owned outright
Cash held by the company	£197,000

Schedule of personal pension funds (PP):

Aaron		Walter		Pieter	
Company	**Value**	**Company**	**Value**	**Company**	**Value**
Tartan Life PP	£223,000	Leeds Life PP	£240,000	Dover Life PP	£152,000

Questions

*To gain maximum marks for calculations you **must** show **all** your workings and express your answers to **two** decimal places.*

(a) **(i)** List **four** alternative funding options to purchase the boat. **(4)**

(ii) Explain, providing figures to support your explanation, if a self-invested personal pension scheme (SIPP) purchase of the office premises would provide sufficient funds for the company to purchase the boat. **(4)**

(iii) Explain why it would be inadvisable for their combined pension funds to purchase the boat directly, if HM Revenue & Customs consider it to be tangible moveable property. **(5)**

(iv) Explain, providing figures to support your explanation, how the establishment of a small self administered scheme (SSAS) and the use of a SSAS loanback could facilitate the purchase of a boat. **(6)**

(v) Explain, providing figures to support your explanation, any HM Revenue & Customs criteria that have to be met for the SSAS loanback to be approved. **(9)**

(b) **(i)** Calculate, **showing all your workings**, how many £1.00 nominal shares Pieter will receive for his £250,800 subscription. **(5)**

(ii) Explain the formalities that should be observed in issuing Pieter with his shares. **(6)**

(c) **(i)** Explain the inadequacies of the existing share agreement and compensation arrangements that need to be addressed prior to Pieter joining. **(10)**

(ii) Explain, giving your reasons to Pieter as a minority shareholder, the safeguards that can be put in place in a shareholder agreement to ensure his family receive fair value for the loss of his shares on his death. **(10)**

(d) **(i)** Explain to the clients the criteria required to obtain Inheritance Tax business property relief and the benefits of qualifying for it in relation to their circumstances. **(6)**

(ii) Recommend and justify a share protection arrangement which would best fulfil the needs of the **three** shareholders. **(5)**

(e) As directors, they have indicated that they require critical illness cover as part of their agreements.

(i) Explain to them how this arrangement would work in practise. **(5)**

(ii) Explain the potential problems of using a double option agreement and recommend an alternative that could be used. **(5)**

Total marks available for this question: 80

Questions continue over the page

SECTION B

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

Question 2

Graham and Peter have been running a successful electrical contracting business for a number of years. The business is an ordinary partnership with Graham and Peter each owning a 50% share.

Over the last couple of years they have experienced a general downturn in business and an increasing number of late paying customers has caused them to have difficulties with their cash flow.

They are concerned about what would happen to them personally as a result of either a claim for negligence or if the business deteriorates further and needs to be wound up.

Their accountant recommends that they convert from an ordinary partnership to a limited liability partnership (LLP); secondly that having converted to an LLP they should both introduce additional capital of £20,000 from their existing personal assets to help keep the business afloat; and finally that their business relationship be formally documented in an LLP agreement.

Graham and Peter have indicated that they are agreeable to the accountant's recommendations, provided they can receive interest from the LLP on their capital introduced. Graham believes the proposed arrangement will allow them to be paid tax efficiently by taking a low salary with the balance of their income as dividends.

Questions

(a) Explain to Graham and Peter how their administrative responsibilities in the business would increase if the partnership is converted to an LLP. **(6)**

(b) Explain to Graham and Peter their financial obligations to their creditors and each other should the business become insolvent, trading as an:

(i) ordinary partnership; **(6)**

(ii) LLP. **(6)**

(c) Explain how the conversion to an LLP would change the way the partnership might be sued for **any** negligence acts committed, before and after the conversion. **(6)**

(d) **(i)** Comment on the accuracy of Graham's understanding of how remuneration might be taken and any other factors that will influence the style of partners' remuneration if the accountant's recommendations are implemented. **(7)**

(ii) Describe the basis of assessment to tax that will apply to Graham and Peter once the business is converted to an LLP. *In your answer, do not make any reference to either allowable deductions or specific dates of submission/payment.* **(9)**

Total marks available for this question: 40

Questions continue over the page

Question 3

Patricia Baker-Williams is the Managing Director and 85% shareholder of BW Collection Ltd, a small company which manufactures exclusive home furnishings. The other company directors, her husband and two mature children, each own 5% of the company shares. BW Collection Ltd makes branded goods for their main customer, a national department store. However, they also supply furnishings under their own brand to a number of high end furniture stores.

The company has seen its sales decline, which has begun to worry Patricia and she has provided you with the following information from the company's accounts:

Profit and Loss:

	2012 **£**	**2011** **£**
Turnover	3,100,000	3,500,000
Cost of sales	1,700,000	1,800,000
Other operating expenses	1,300,000	1,500,000
Interest	55,000	45,000

Balance Sheet:

	2012 **£**	**2011** **£**
Fixed Assets	500,000	550,000
Stocks	600,000	750,000
Debtors	650,000	700,000
Cash at bank	25,000	75,000
Creditors: amounts falling due within one year	725,000	600,000
Creditors: amounts falling due after more than one year	200,000	100,000

In order to improve the company's sales, Patricia employed Carlotta Delato, a young designer, six months ago. Carlotta has just informed Patricia that she is three months pregnant and has not yet decided whether she would like to continue working or stay at home once the baby is born. Patricia would like Carlotta to continue to be involved in the company in the future.

Questions

*To gain maximum marks for calculations you **must** show **all** your workings and express your answers to **two** decimal places.*

(a) Calculate, **showing all your workings,** each of the following ratios, for the performance of the company in 2011 and 2012, state the purpose of the ratio and comment on the significance of your results.

(i) Operating profit (turnover less cost of sales and operating expenses). **(5)**

(ii) Quick ratio (current assets – stock / current liabilities). **(5)**

(iii) Debtor days ((debtors/sales) x 365). **(5)**

(iv) Finished goods stock ratio ((stocks/costs of sales) x 365). **(5)**

(b) For each of the **four** ratios identified in (**a**) above, recommend **one** action that the company could take to improve the result, giving **one** reason for each recommendation. **(8)**

(c) **(i)** State, giving your reasons, whether or not Carlotta will qualify for statutory maternity pay. **(3)**

(ii) Explain to Patricia the statutory maternity benefits available to Carlotta in respect of leave and pay. **(7)**

(iii) Provide examples of two incentives Patricia could provide to Carlotta to encourage her to return to work. **(2)**

Total marks available for this question: 40

The tax tables can be found on pages 11 – 15

INCOME TAX

RATES OF TAX	2011/2012	2012/2013
Starting rate for savings*	10%	10%
Basic rate	20%	20%
Higher rate	40%	40%
Additional rate	50%	50%
Starting-rate limit	£2,560*	£2,710*
Threshold of taxable income above which higher rate applies	£35,000	£34,370
Threshold of taxable income above which additional rate applies	£150,000	£150,000
Child benefit charge from 7 January 2013: 1% of benefit for every £100 of income over	N/A	£50,000

**restricted to savings income only and not available if taxable non-savings income exceeds starting rate band.*

MAIN PERSONAL ALLOWANCES AND RELIEFS

Income limit for Personal Allowance §	£100,000	£100,000
Personal Allowance (basic) §	£7,475	£8,105
Personal Allowance (age 65-74) §	£9,940	£10,500
Personal Allowance (aged 75 and over) §	£10,090	£10,660
Married/civil partners (minimum) at 10% †	£2,800	£2,960
Married/civil partners (age 75 and over) at 10%	£7,295	£7,705
Income limit for age-related allowances	£24,000	£25,400
Blind Person’s Allowance	£1,980	£2,100
Enterprise Investment Scheme relief limit on £1,000,000 max (£500,000 in 2011/2012)	30%	30%
Seed Enterprise Investment relief limit on £100,000	N/A	50%
Venture Capital Trust relief limit on £200,000 max	30%	30%

§ *the Personal Allowance reduces by £1 for every £2 of income above the income limit irrespective of age.*
† *where at least one spouse/civil partner was born before 6 April 1935.*

Child Tax Credit (CTC)		
- Child element per child (maximum)	N/A	£2,690
- family element	£545	£545
Threshold for tapered withdrawal of CTC	N/A	£15,860

NATIONAL INSURANCE CONTRIBUTIONS

Class 1 Employee	Weekly	Monthly	Yearly
Lower Earnings Limit (LEL)	£107	£464	£5,564
Primary threshold	£146	£634	£7,605
Upper Accrual Point	£770	£3,337	£40,040
Upper Earnings Limit (UEL)	£817	£3,540	£42,475

Total earnings £ per week	CLASS 1 EMPLOYEE CONTRIBUTIONS	
	Contracted-in rate/contracted-out (money purchase)	Contracted-out rate (final salary)
Up to 146.00*	Nil	Nil
146.01 – 770.00	12%	10.6%
770.01 – 817.00	12%	12%
Above 817.00	2%	2%

**This is the primary threshold below which no NI contributions are payable. However, the lower earnings limit is £107 per week. This £107 to £146 band is a zero rate band introduced in order to protect lower earners' rights to contributory State benefits e.g. Basic State Pension.*

Total earnings £ per week	CLASS 1 EMPLOYER CONTRIBUTIONS		
	Contracted-in rate	Contracted-out rate	
		Final salary	*Money purchase*
Below 144.00**	Nil	Nil	Nil
144.01 – 770.00	13.8%	10.4%	13.8%
770.01 – 817.00	13.8%	13.8%	13.8%
Excess over 817.00	13.8%	13.8%	13.8%

*** Secondary earnings threshold.*

Class 2 (self-employed)	Flat rate per week £2.65 where earnings exceed £5,595 per annum.
Class 3 (voluntary)	Flat rate per week £13.25.
Class 4 (self-employed)	9% on profits between £7,605 - £42,475 2% on profits above £42,475.

PENSIONS

TAX YEAR	LIFETIME ALLOWANCE	ANNUAL ALLOWANCE
2006/2007	£1,500,000	£215,000
2007/2008	£1,600,000	£225,000
2008/2009	£1,650,000	£235,000
2009/2010	£1,750,000	£245,000
2010/2011	£1,800,000	£255,000
2011/2012	£1,800,000	£50,000
2012/2013	£1,500,000	£50,000

ANNUAL ALLOWANCE CHARGE
20% - 50% 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

RATES OF TAX ON DEATH TRANSFERS	2011/2012	2012/2013
Transfers made after 5 April 2012		
- Up to £325,000	Nil	Nil
- Excess over £325,000	40%	40%
- Lifetime transfers to and from certain trusts	20%	20%

**For deaths after 5 April 2012, a lower rate of 36% applies where at least 10% of deceased's net estate is left to charity.*

MAIN EXEMPTIONS

Transfers to		
- UK-domiciled spouse/civil partner	No limit	No limit
- non-UK-domiciled spouse/civil partner (from UK-domiciled spouse)	£55,000	£55,000
- UK-registered charities	No limit	No limit
Lifetime transfers		
- Annual exemption per donor	£3,000	£3,000
- Small gifts exemption	£250	£250
Wedding/civil partnership gifts by		
- parent	£5,000	£5,000
- grandparent	£2,500	£2,500
- other person	£1,000	£1,000

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:

- Years before death	0-3	3-4	4-5	5-6	6-7
- Inheritance Tax payable	100%	80%	60%	40%	20%

CAR BENEFIT FOR EMPLOYEES

The charge for company car benefits is based on the carbon dioxide (CO_2) emissions. There is no reduction for high business mileage users.

For 2012/2013:

- Cars that cannot emit CO_2 have a 0% charge.
- The percentage charge is 5% of the car's list price for CO2 emissions of 75g/km or less.
- For cars with CO_2 emissions of 76g/km to 99g/km the percentage is 10%.
- Cars with CO_2 emissions of 100g/km have a percentage charge of 11% and thereafter the charge increases by 1% for every complete 5g/km to a maximum of 35% (emissions of 220g/km and above).

There is an additional 3% supplement for diesel cars not meeting Euro IV emission standards. However, the maximum charge remains 35% of the car's list price.

Car fuel The benefit is calculated as the CO_2 emissions % relevant to the car and that % applied to a set figure (£20,200 for 2012/2013) e.g. car emission 100g/km = 11% on car benefit scale. 11% of £20,200 = £2,222.

1. **Accessories** are, in most cases, included in the list price on which the benefit is calculated.
2. **List price** is reduced for capital contributions made by the employee up to £5,000.
3. **Car benefit** is reduced by the amount of employee's contributions towards running costs.
4. **Fuel scale** is reduced only if the employee makes good **all** the fuel used for private journeys.
5. **All car and fuel benefits** are subject to employers National Insurance Contributions (Class 1A) of 13.8%.

PRIVATE VEHICLES USED FOR WORK

	2011/2012 Rates	2012/2013 Rates
Cars		
On the first 10,000 business miles in tax year	45p per mile	45p per mile
Each business mile above 10,000 business miles	25p per mile	25p per mile
Motor Cycles	24p per mile	24p per mile
Bicycles	20p per mile	20p per mile

MAIN CAPITAL AND OTHER ALLOWANCES

	2011/2012	2012/2013
Plant & machinery (excluding cars) 100% annual investment allowance (first year)	£100,000	£25,000
Plant & machinery (reducing balance) per annum	20%	18%
Patent rights & know-how (reducing balance) per annum	25%	25%
Certain long-life assets, integral features of buildings (reducing balance) per annum	10%	8%
Energy & water-efficient equipment	100%	100%
Zero emission goods vehicles (new)	100%	100%
Qualifying flat conversions, business premises & renovations	100%	100%

Motor cars: Expenditure on or after 01/04/09 (Corporation Tax) or 06/04/09 (Income Tax)

CO_2 emissions of g/km:	110 or less*	111-160	161 or more
Capital allowance:	100% first year	18% reducing balance	8% reducing balance

*If new

Research & Development:	Capital expenditure	100%

MAIN SOCIAL SECURITY BENEFITS

		2011/2012 £	2012/2013 £
Child Benefit	First child	20.30	20.30
	Subsequent children	13.40	13.40
	Guardian's allowance		15.55
Employment and Support Allowance	Assessment Phase		
	Age 16 – 24	Up to 53.45	Up to 56.25
	Aged 25 or over	Up to 67.50	Up to 71.00
	Main Phase		
	Work Related Activity Group	Up to 94.25	Up to 99.15
	Support Group	Up to 99.85	Up to 105.05
Attendance Allowance	Lower rate	49.30	51.85
	Higher rate	73.60	77.45
Retirement Pension	Single	102.15	107.45
	Married	163.35	171.85
Pension Credit	Single person standard minimum guarantee	137.35	142.70
	Married couple standard minimum guarantee	209.70	217.90
	Maximum savings ignored in calculating income	10,000.00	10,000.00
Bereavement Payment (lump sum)		2,000.00	2,000.00
Widowed Parent's allowance		100.70	105.95
Jobseekers Allowance	Age 16 - 24	53.45	56.25
	Age 25 or over	67.50	71.00
Statutory Maternity, Paternity and Adoption Pay		128.73	135.45

CAPITAL GAINS TAX

EXEMPTIONS	2011/2012	2012/2013
Individuals, estates etc	£10,600	£10,600
Trusts generally	£5,300	£5,300
Chattels proceeds (restricted to five thirds of proceeds exceeding limit)	£6,000	£6,000

TAX RATES		
Individuals:		
Up to basic rate limit	18%	18%
Above basic rate limit	28%	28%
Trustees and Personal Representatives	28%	28%
Entrepreneurs' Relief* – Gains taxed at:	10%	10%
Lifetime limit	£10,000,000	£10,000,000

*For trading businesses and companies (minimum 5% employee or director shareholding) held for at least one year.

CORPORATION TAX

	2011/2012	2012/2013
Full rate	26%	24%
Small companies rate	20%	20%
Small companies limit	£300,000	£300,000
Effective marginal rate	27.5%	25.0%
Upper marginal limit	£1,500,000	£1,500,000

VALUE ADDED TAX

	2011/2012	2012/2013
Standard rate	20%	20%
Annual Registration limit	£73,000	£77,000

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