THE CHARTERED INSURANCE INSTITUTE

CII

AF2

Advanced Diploma in Financial Planning

Unit AF2 – Business financial planning

April 2014 examination

SPECIAL NOTICES

All questions in this paper are based on English law and practice applicable in the tax year 2013/2014, unless stated otherwise in the question, and should be answered accordingly.

It should be assumed that all individuals are domiciled and resident in the UK unless otherwise stated.

Candidates should answer based on the legislative position immediately BEFORE the 2014 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

Richard, aged 62, is the Managing Director holding the entire share capital of 500 shares in Design a Shed Ltd, with a Capital Gains Tax base cost of £500. He started the business in 1982. The business manufactures and installs bespoke garden sheds throughout the UK.

Richard's current salary is £120,000 per annum and he has typically taken dividends from the business each year depending on profits. The proposed dividend distribution for the current year is £85,000, although this has not been finalised.

Richard now wishes to retire and has negotiated the sale of his business via a Management Buyout (MBO) led by Jennifer, the current financial director who has been with the company for over 15 years. The purchase price has been agreed as £1,200,000. He has not previously sold any business assets. The proposal is to set up a new company which will purchase Richard's shares including the goodwill and assets of Design a Shed Ltd.

Along with Jennifer, Michael the Sales Manager and Stefan the Production Manager will also participate in the MBO. They have agreed that the shareholding of the new company will consist of ordinary shares in the following proportions:

- Jennifer 60%
- Michael 25%
- Stefan 15%

The proposition was presented to the bank and they agreed to lend the new company 45% of the purchase price. The loan offer included a number of conditions, firstly that the participants in the MBO each provide 20% of the value of their shareholding in the new company from their own resources. Secondly, that 35% of the purchase price is deferred and paid to Richard over a three year period in staged payments. The bank's borrowing will be secured as a fixed charge on the company's premises and warehousing. All parties being in agreement, the transaction for the full consideration was completed on 31 March 2014.

The staged payments to Richard are structured as loan notes issued by the new company and repayable in equal instalments, with redemption dates of 30 April 2015, 2016 and 2017 respectively. The loan holders will pay a cumulative coupon of 5% at the redemption dates and the debt will be secured as a floating charge on the assets of the new company.

In the new company, the management team is similar to the old set up but with Jennifer as managing director, Michael sales director and Stefan production director. Over the last few years Richard has let Jennifer and the rest of the team run the business on his behalf. The bank has attributed the recent success of the business to Jennifer's efficient management. Another important contributor to profit is Amy, the head of design. Amy's designs have won numerous awards over the years which have considerably improved sales and profitability.

Jennifer, Michael and Stefan are concerned about how the value of their shareholdings in the new company would be realised should they die or be permanently incapacitated. Jennifer is particularly concerned that either of her fellow directors' families would be able to participate in the running of the business if the families were to inherit or otherwise retain control of the shareholding.

Questions

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

(a) **(i)** Calculate, **showing all your workings**, the personal contribution required from each of the participants of the Management Buyout. **(3)**

(ii) Jennifer intends to raise the capital required to purchase her share as a loan against her main residence.

Explain the impact on her personal liabilities should the company fail in the future. **(4)**

(iii) Explain to Jennifer the Income Tax treatment of the interest paid on this loan. **(5)**

(b) **(i)** Calculate, **showing all your workings**, the Capital Gains Tax payable by Richard on the sale of his shares. **(4)**

(ii) Explain to Richard how he meets the criteria to qualify for entrepreneurs' relief. **(6)**

(c) **(i)** Define what is meant by a loan note, and explain briefly to Richard his entitlements under this agreement. **(4)**

(ii) Explain to Richard the drawbacks of the way the payment to him, for the sale of his shares, has been structured. **(6)**

(iii) The loans notes are secured with a floating charge. Explain how you might have suggested securing the loan notes in order to give Richard the best possible protection for the future sums due. **(8)**

(d) **(i)** Describe to Michael and Stefan their statutory duties as directors of the new company. **(7)**

(ii) List **four** situations where a director may be automatically disqualified. **(4)**

Questions continue over the page

(e) Outline, giving your reasons, the minimum key person protection you would recommend for the new company. Include details of the key person(s) to be covered and the basis for calculating the sum assured. *No calculations are required*. **(8)**

(f) **(i)** Jennifer has advised that they intend to adopt the unmodified model articles under the Companies Act 2006 for the new company.

Describe **three** amendments to the model articles as they apply to shareholders and the shares they hold you would recommend to meet the needs of the directors. **(6)**

(ii) Explain to Jennifer how a shareholder protection arrangement including a Cross-option agreement, could address her concerns regarding the situation on the death of one of the directors. **(7)**

(g) The new directors have asked you about the tax benefits under the Enterprise Investment Scheme in respect of any new shares it issues.

(i) Explain the tax benefits to the shareholders should they qualify. **(3)**

(ii) State, giving your reasons, whether or not the shareholders in this case would qualify. **(5)**

Total marks available for this question: 80

Section B questions can be found on pages 8 - 10

SECTION B

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

Question 2

DXT Ltd is a medical device manufacturing business based in the UK. It has an accounting period of 12 months, ending 31 May 2014.

The Board has decided to buy a number of automated injection moulding machines to modernise their manufacturing capability. Each machine will cost £55,000 with an estimated cost saving in the first year of £5,000 after installation and training costs, and an annual cost saving of £30,000 in years two and three. Each machine is expected to have a three-year lifespan with a residual value of £5,000.

In the current accounting period, the company has also incurred costs for a total internal refit costing, £150,000. 70% of which is classed as long-life assets.

The directors have provided you with the following information from their accounts:

	Year End 31/05/2013 (£)	**Year End 31/05/2014 (£)**
Turnover	4,500,000	7,250,000
Balance Sheet Value	2,500,000	4,350,000

The business has continued to grow over the last few years and now employs 65 staff in total. They have always considered themselves a small business and have to date submitted simplified accounts.

Ciaran is the sales director and his basic salary is £85,000 per annum plus a performance related bonus. He has a petrol company car with CO_2 emissions of 130g/km and the company pays for all the fuel costs including his private use. The car was purchased in March 2013 when the list price was £45,000. He currently participates in the company's private medical insurance scheme and pays £1,200 per annum. He is a member of the non-contributory pension scheme with employer contributions of 15% of salary. He does not currently pay any pension contributions personally into the scheme.

Questions

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

(a) The Board has asked for assistance in reviewing the financial viability of the proposed capital expenditure.

(i) Calculate, **showing all your workings**, the net present value of each new machine the company intends to purchase. Use a discount rate of 6% and assume revenues accrue at the end of each year. **(6)**

(ii) Explain briefly **two** alternative methods for assessing the financial viability of the proposed investment purchase, and provide **one** disadvantage of each compared with the net present value method**.** **(6)**

(b) The directors have decided to proceed with the purchase of four new machines before the end of May 2014, at a cost of £220,000. They have asked for advice relating to the tax reliefs and allowances available in respect of the capital expenditure.

Outline your recommendations to the directors for the most efficient use of capital allowances in respect of the capital expenditure for year ending 31 May 2014.
Use calculations where appropriate to support your advice. **(9)**

(c) Explain briefly to the directors the company's reporting requirements in relation to its accounts under the Companies Act 2006. **(5)**

(d) Ciaran's bonus of £25,000 gross was paid on 1 April 2014.

(i) Calculate, **showing all your workings**, the total Income Tax and National Insurance payable by Ciaran in the tax year 2013/2014. **(11)**

(ii) Explain briefly the potential immediate tax benefits to Ciaran had he taken the bonus as an employer pension contribution. **(3)**

Total marks available for this question: 40

Questions continue over the page

Question 3

Janet, Mark and Henry set up an ordinary partnership, HJM Engineering, under the Partnership Act 1890, two years ago. Janet contributed £10,000 to set up the business and Mark and Henry invested £5,000 each. The second year profit is £66,000. The partnership currently employs five full-time staff who have been with them since the partnership was set up.

The partners have always got on well and so did not feel the need, and have not had the time, to set up a Partnership Agreement.

Henry has recently given notice to leave the partnership and wants to withdraw the capital he invested as soon as possible. He intends to set up a similar engineering business as a sole trader in a nearby town but has yet to tell the other partners.

Before giving his notice, Henry agreed a contract on behalf of HJM Engineering to purchase a new machine, costing £8,000. He is concerned that the other partners may not agree to the purchase, especially in view of his imminent departure.

Questions

(a) Outline, with reasons, how the profit would be shared. **(4)**

(b) Explain to Henry how he can achieve his objective of leaving the partnership and obtain repayment of his capital. **(5)**

(c) Explain the extent to which each of the remaining partners is liable for the contract to purchase machinery if Henry leaves the partnership. **(9)**

(d) Janet and Mark have continued in business after Henry has left. They were unaware of the impact Henry's departure would have, and wish to ensure that a similar situation does not arise in the future.

(i) Describe, by reference to the Partnership Act 1890, the legal consequences of recent events. **(6)**

(ii) Based on recent events, explain why they should draw up a written partnership agreement. **(6)**

(e) Explain the legal position of the employees with regard to Henry leaving the partnership and to Janet and Mark continuing the business of that partnership. **(10)**

Total marks available for this question: 40

The tax tables can be found on pages 12 - 18

INCOME TAX

RATES OF TAX	2012/2013	2013/2014
Starting rate for savings*	10%	10%
Basic rate	20%	20%
Higher rate	40%	40%
Additional rate	50%	45%
Starting-rate limit	£2,710*	£2,790*
Threshold of taxable income above which higher rate applies	£34,370	£32,010
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	£50,000	£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 if born after 5 April 1948) §	£8,105	£9,440
Personal Allowance (if born between 6 April 1938 and 5 April 1948) §	£10,500	£10,500
Personal Allowance (if born before 6 April 1938) §	£10,660	£10,660
Married/civil partners (minimum) (if born before 6 April 1935) at 10% †	£2,960	£3,040
Married/civil partners (if born before 6 April 1935) at 10% †	£7,705	£7,915
Income limit for age-related allowances	£25,400	£26,100
Blind Person's Allowance	£2,100	£2,160
Enterprise Investment Scheme relief limit on £1,000,000 max	30%	30%
Seed Enterprise Investment relief limit on £100,000	50%	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 (under the income threshold).
† where at least one spouse/civil partner was born before 6 April 1935.

Child Tax Credit (CTC)		
- Child element per child (maximum)	£2,690	£2,720
- family element	£545	£545
Threshold for tapered withdrawal of CTC	£15,860	£15,910

NATIONAL INSURANCE CONTRIBUTIONS

Class 1 Employee	Weekly	Monthly	Yearly
Lower Earnings Limit (LEL)	£109	£473	£5,668
Primary threshold	£149	£646	£7,755
Upper Accrual Point	£770	£3,337	£40,040
Upper Earnings Limit (UEL)	£797	£3,454	£41,450

Total earnings £ per week	CLASS 1 EMPLOYEE CONTRIBUTIONS	
	Contracted-in rate/contracted-out (money purchase)	Contracted-out rate (final salary)
Up to 149.00*	Nil	Nil
149.01 – 770.00	12%	10.6%
770.01 – 797.00	12%	12%
Above 797.00	2%	2%

**This is the primary threshold below which no NI contributions are payable. However, the lower earnings limit is £109 per week. This £109 to £149 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 148.00**	Nil	Nil	Nil
148.01 – 770.00	13.8%	10.4%	13.8%
770.01 – 797.00	13.8%	13.8%	13.8%
Excess over 797.00	13.8%	13.8%	13.8%

*** Secondary earnings threshold.*

Class 2 (self-employed)	Flat rate per week £2.70 where earnings exceed £5,725 per annum.
Class 3 (voluntary)	Flat rate per week £13.55.
Class 4 (self-employed)	9% on profits between £7,755 - £41,450 2% on profits above £41,450.

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
2013/2014	£1,500,000	£50,000

ANNUAL ALLOWANCE CHARGE

20% - 45% 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.

CAPITAL GAINS TAX

EXEMPTIONS	2012/2013	2013/2014
Individuals, estates etc	£10,600	£10,900
Trusts generally	£5,300	£5,450
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.*

INHERITANCE TAX

RATES OF TAX ON DEATH TRANSFERS	2012/2013	2013/2014
Transfers made after 5 April 2013		
- 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 2013, a lower rate of 36% applies where at least 10% of deceased's net estate is left to charity.*

MAIN EXEMPTIONS

	2012/2013	2013/2014
Transfers to		
- UK-domiciled spouse/civil partner	No limit	No limit
- non-UK-domiciled spouse/civil partner (from UK-domiciled spouse)	£55,000	£325,000
- 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 2013/2014:

- Cars that cannot emit CO_2 have a 0% charge.
- The percentage charge is 5% of the car's list price for CO_2 emissions of 75g/km or less.
- For cars with CO_2 emissions of 76g/km to 94g/km the percentage is 10%.
- For cars with CO_2 emissions of 95g/km to 99g/km the percentage is 11%.
- Cars with CO_2 emissions of 100g/km have a percentage charge of 12% and thereafter the charge increases by 1% for every complete 5g/km to a maximum of 35% (emissions of 215g/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 (£21,100 for 2013/2014) e.g. car emission 100g/km = 12% on car benefit scale. 12% of £21,100 = £2,532.

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

	2012/2013 Rates	2013/2014 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

	2012/2013	2013/2014
Plant & machinery (excluding cars) 100% annual investment allowance (first year)	£25,000	£250,000
Plant & machinery (reducing balance) per annum	18%	18%
Patent rights & know-how (reducing balance) per annum	25%	25%
Certain long-life assets, integral features of buildings (reducing balance) per annum	8%	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 April 2013 (Corporation Tax) or 06 April 2013 (Income Tax)

CO_2 emissions of g/km:	95 or less*	96-130	131 or more
Capital allowance:	100% first year	18% reducing balance	8% reducing balance

*If new

Research & Development:	Capital expenditure	100%

CORPORATION TAX

	2012/2013	2013/2014
Full rate	24%	23%
Small companies rate	20%	20%
Small companies limit	£300,000	£300,000
Effective marginal rate	25%	23.75%
Upper marginal limit	£1,500,000	£1,500,000

VALUE ADDED TAX

	2012/2013	2013/2014
Standard rate	20%	20%
Annual registration threshold	£77,000	£79,000
Deregistration threshold	£75,000	£77,000

MAIN SOCIAL SECURITY BENEFITS

		2012/2013	2013/2014
		£	£
Child Benefit	First child	20.30	20.30
	Subsequent children	13.40	13.40
	Guardian's allowance	15.55	15.90
Employment and Support Allowance	Assessment Phase		
	Age 16 – 24	Up to 56.25	Up to 56.80
	Aged 25 or over	Up to 71.00	Up to 71.70
	Main Phase		
	Work Related Activity Group	Up to 99.15	Up to 100.15
	Support Group	Up to 105.05	Up to 106.50
Attendance Allowance	Lower rate	51.85	53.00
	Higher rate	77.45	79.15
Retirement Pension	Single	107.45	110.15
	Married	171.85	176.15
Pension Credit	Single person standard minimum guarantee	142.70	145.40
	Married couple standard minimum guarantee	217.90	222.05
	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		105.95	108.30
Jobseekers Allowance	Age 16 - 24	56.25	56.80
	Age 25 or over	71.00	71.70
Statutory Maternity, Paternity and Adoption Pay		135.45	136.78