

AF4

Advanced Diploma in Financial Planning

Unit AF4 – Investment planning

October 2016 examination

SPECIAL NOTICES

All questions in this paper are based on English law and practice applicable in the tax year 2016/2017, 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.

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 AF4 – Investment 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

Read carefully all information provided in the case study before attempting the questions. Your answers should take into account the clients circumstances as set out in the case study. Please carry out ALL of the tasks (a), (b), (c), (d), (e) and (f) which follow.

Geoff has recently retired. He is a higher-rate tax payer and has accumulated over his working life a portfolio of 10 UK shares. One of these shares is Black Gold plc, an oil exploration and production company. Sample accounts figures and ratios for Black Gold plc are shown in Table 1 below.

Table 1

| Company | 2015 Working capital (current) ratio | 2015 Liquidity ratio | 2016 Stock (£m) | 2016 Current assets (£m) | 2016 Current liabilities (£m) |
|----------------|---------------------------------------------|-----------------------------|------------------------|---------------------------------|--------------------------------------|
| Black Gold plc | 1.25 | 1.05 | 31 | 87 | 63 |

Geoff also owns shares in Z&M Haulage plc, a transport and logistics company. He is aware that the oil price has fallen from historic highs and is currently trading at a low level. He would like to know how this may impact upon Black Gold plc and Z&M Haulage plc.

Another of Geoff's shares is in Luxury Motors plc who sell the majority of their cars to the Chinese market. Geoff is interested in understanding how Luxury Motors plc has been affected by sterling's recent fall against the Yuan (RMB). He has also read that China had been seeking to move from a fixed to a floating exchange rate but is unsure what this means.

Finally, Geoff is interested in how his share portfolio has performed relative to the FTSE 100. Over the last year, Geoff's portfolio has fallen from £355,440 to £343,000 but his shares have paid gross dividends of £8,800 all of which have been paid in the tax year 2016/2017 and not reinvested. The FTSE 100 has dropped by 4.7% over the same period.

Geoff has been concerned about his portfolio losses over the last year and is considering selling them all and investing into a FTSE 100 index tracker.

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 2016 working capital (current) and liquidity ratios for Black Gold plc. (6)
- (ii) Comment on the direction of change in Black Gold plc's working capital (current) and liquidity ratio from 2015 to 2016 and give likely reasons for the changes. (7)
- (b) Explain briefly what is meant by the following terms and how they relate to the solvency of a company:
- (i) negative operating cash flow; (3)
- (ii) negative working capital. (3)
- (c) (i) State the impact the low oil price will have on Z&M Haulage plc and how it could seek to benefit over the medium term. (3)
- (ii) Explain briefly what actions the management of Black Gold plc might take to minimise the impact of a lower oil price on its financial position. (3)
- (d) (i) Explain briefly what is meant by a fixed and floating exchange rate. (4)
- (ii) Identify **four** key economic factors which could result in the depreciation of sterling. (4)
- (iii) Explain the likely impact the fall of sterling against the Yuan (RMB) would have on Luxury Motors plc. (5)
- (iv) Explain, giving your reasons, the likely impact a depreciation in the value of sterling would have on the rate of inflation in the UK. (3)

QUESTIONS CONTINUE OVER THE PAGE

- (e) (i) Explain how the FTSE 100 is composed. (5)
- (ii) Calculate, **showing all your workings**, the percentage holding period return on Geoff's portfolio net of tax over the last year. (7)
- (iii) Assess, giving reasons, how Geoff's portfolio has performed in comparison to the FTSE 100 over the last year. (4)
- (iv) Explain briefly the limitations of using the FTSE 100 as a benchmark for Geoff's portfolio. (3)
- (f) (i) Explain to Geoff **four** different methods a FTSE 100 tracker could use to mirror the index performance. (10)
- (ii) Explain **five** advantages and **five** disadvantages of Geoff selling his portfolio of shares to invest into a FTSE 100 tracker. (10)

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

Read carefully all information provided in the case study before attempting the questions. Your answers should take into account the clients circumstances as set out in the case study. Please carry out ALL of the tasks (a), (b), (c), (d), (e) and (f) which follow.

Tommy, aged 23, has recently inherited a portfolio of shares and cash from his grandfather. He has some understanding of, and a keen interest in, investment processes. Tommy has approached you for advice and has read your brochure within which it states you utilise a Centralised Investment Proposition offering both advisory and discretionary management.

Tommy has been notified of a capital reorganisation of two of the shares he has inherited and has asked for clarification. Hornbeam plc has offered a five for twelve rights issue. Aspen plc has announced a scrip/bonus issue of two shares for every five held.

See Table 1 for details of these shares.

Table 1

| Company | Shares held | Pre-reorganisation share price £ | Rights issue price £ |
|----------------|--------------------|---------------------------------------------|---------------------------------|
| Hornbeam plc | 11,700 | 3.45 | 1.80 |
| Aspen plc | 2,000 | 15.00 | Not applicable |

Questions

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

- (a) For Hornbeam plc:
- (i) Calculate, **showing all your workings**, how many shares Tommy will own if he takes up the rights offer in full. (5)
 - (ii) Calculate, **showing all your workings**, the theoretical ex-rights price of Tommy's shares. (5)
 - (iii) List **three** reasons why Hornbeam plc might have a rights issue. (3)
- (b) Explain briefly **two** methods other than a rights issue Hornbeam plc could use to raise additional share capital via the stock market. (4)
- (c) State **two** options Tommy has with his 'rights' if he decides not to take up the rights issue offer from Hornbeam plc. (2)
- (d) (i) Calculate, **showing all your workings**, the value of one Aspen plc share after the bonus issue. (4)
- (ii) Explain briefly why a company would have a scrip/bonus issue. (2)
- (e) (i) Explain briefly to Tommy what is meant by a Centralised Investment Proposition and how it works. (5)
- (ii) Explain briefly **three** advantages and **three** disadvantages of a Centralised Investment Proposition for Tommy. (6)
- (f) Explain to Tommy the differences between advisory and discretionary management. (4)

Total marks available for this question: 40

QUESTIONS CONTINUE OVER THE PAGE

Question 3

Read carefully all information provided in the case study before attempting the questions. Your answers should take into account the clients circumstances as set out in the case study. Please carry out ALL of the tasks (a), (b), (c), (d) and (e) which follow.

Dawn is a higher-rate taxpayer who owns a buy-to-let property she bought some years ago for £140,000. The property is now worth £163,000 and has an outstanding interest only mortgage of £119,000. She has not realised any capital gains or losses for the tax year 2016/2017 and is considering selling the property and investing elsewhere.

Dawn holds shares in the following open-ended investment company (OEIC):

| Fund | Share price p | Dividend p | Cash |
|---------------------|---------------|------------|-------|
| ABC Direct Property | 1,400 | 45 | 18.3% |

Dawn also has the following Real Estate Investment Trust (REIT):

| Fund | Value of properties £million | Debt £million | Share price p | Net asset value per share p | Dividend p |
|---------------|------------------------------|---------------|---------------|-----------------------------|------------|
| Regional Land | 620 | 186 | 70 | 75 | 3.8 |

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 amount Dawn would receive, after Capital Gains Tax and redemption of the existing mortgage, should she decide to sell her buy-to-let property. (6)
- (ii) Identify **three** other costs that Dawn needs to consider before sale. (3)
- (b) Explain **four** risks, other than legislation and taxation changes, that Dawn faces as a buy-to-let investor. (8)
- (c) Identify **six** reasons why the ABC Direct Property OEIC may be holding a large cash balance and explain the implications of this for investment performance. (6)
- (d) Identify **five** advantages of investing in property via the ABC Direct Property OEIC fund rather than a buy-to-let property. (5)
- (e) (i) Calculate, **showing all your workings**, the income (dividend) yield on the ABC Direct Property OEIC and the Region Land REIT. (4)
- (ii) Explain briefly why the REIT structure may lead to a different income yield in comparison to the OEIC. (2)
- (iii) Explain briefly why an investment manager may select a property investment with a lower yield. (3)
- (iv) Explain briefly to Dawn the rules a REIT must follow when distributing income and the taxation consequences. (3)

Total marks available for this question: 40

The tax tables can be found on pages 13 – 19

INCOME TAX

| RATES OF TAX | 2015/2016 | 2016/2017 |
|------------------------------------------------------------------------------------------|-----------|-----------|
| Starting rate for savings* | 0% | 0% |
| Basic rate | 20% | 20% |
| Higher rate | 40% | 40% |
| Additional rate | 45% | 45% |
| Starting-rate limit | £5,000* | £5,000* |
| Threshold of taxable income above which higher rate applies | £31,785 | £32,000 |
| 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) § | £10,600 | £11,000 |
| Personal Allowance (if born between 6 April 1938 and 5 April 1948) § | £10,600 | £11,000 |
| Personal Allowance (if born before 6 April 1938) § | £10,660 | £11,000 |
| Married/civil partners (minimum) at 10% † | £3,220 | £3,220 |
| Married/civil partners at 10% † | £8,355 | £8,355 |
| Transferable tax allowance for married couples/civil partners | £1,060 | £1,100 |
| Income limit for age-related allowances § | £27,700 | £27,700 |
| Blind Person's Allowance | £2,290 | £2,290 |
| Enterprise Investment Scheme relief limit on £1,000,000 max | 30% | 30% |
| Seed Enterprise Investment relief limit on £100,000 max | 50% | 50% |
| Venture Capital Trust relief limit on £200,000 max | 30% | 30% |
| <i>§ the Personal Allowance reduces by £1 for every £2 of income above the income limit irrespective of age (under the income threshold).</i> | | |
| <i>† where at least one spouse/civil partner was born before 6 April 1935.</i> | | |
| Child Tax Credit (CTC) | | |
| - Child element per child (maximum) | £2,780 | £2,780 |
| - family element | £545 | £545 |
| Threshold for tapered withdrawal of CTC | £16,105 | £16,105 |

NATIONAL INSURANCE CONTRIBUTIONS

| Class 1 Employee | Weekly | Monthly | Yearly |
|----------------------------|--------|---------|---------|
| Lower Earnings Limit (LEL) | £112 | £486 | £5,824 |
| Primary threshold | £155 | £672 | £8,060 |
| Upper Earnings Limit (UEL) | £827 | £3,583 | £43,000 |

| Total earnings £ per week | CLASS 1 EMPLOYEE CONTRIBUTIONS |
|---------------------------|--------------------------------|
|---------------------------|--------------------------------|

| | |
|-----------------|-----|
| Up to 155.00* | Nil |
| 155.01 – 827.00 | 12% |
| Above 827.00 | 2% |

**This is the primary threshold below which no NI contributions are payable. However, the lower earnings limit is £112 per week. This £112 to £155 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 |
|---------------------------|--------------------------------|
|---------------------------|--------------------------------|

| | |
|--------------------|-------|
| Below 156.00** | Nil |
| 156.01 – 827.00 | 13.8% |
| Excess over 827.00 | 13.8% |

*** Secondary earnings threshold.*

| | |
|--------------------------------|-------------------------------------------------------------------------|
| Class 2 (self-employed) | Flat rate per week £2.80 where profits exceed £5,965 per annum. |
| Class 3 (voluntary) | Flat rate per week £14.10. |
| Class 4 (self-employed) | 9% on profits between £8,060 - £43,000. 2% on profits above £43,000. |

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 |
| 2014/2015 | £1,250,000 | £40,000 |
| 2015/2016 | £1,250,000 | £40,000 § |
| 2016/2017 | £1,000,000 | £40,000 |

ANNUAL ALLOWANCE CHARGE

20% - 45% member's tax charge on the amount of total pension input in excess of the annual allowance.

MONEY PURCHASE ANNUAL ALLOWANCE

| 2015/2016 | 2016/2017 |
|-----------|-----------|
| £10,000* | £10,000* |

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.

§ increased to £80,000 from 6 April - 8 July 2015. If not used, can be carried forward to 9 July 2015 - 5 April 2016, subject to a maximum of £40,000.

* transitional rules apply to the calculation for pre/post 8 July 2015 position.

CAPITAL GAINS TAX

| EXEMPTIONS | 2015/2016 | 2016/2017 |
|---------------------------------------------------------------------------|-----------|-----------|
| Individuals, estates etc | £11,100 | £11,100 |
| Trusts generally | £5,550 | £5,550 |
| Chattels proceeds (restricted to five thirds of proceeds exceeding limit) | £6,000 | £6,000 |

TAX RATES

Individuals:

| | | |
|---------------------------------------------------------|-----|-----|
| Up to basic rate limit | 18% | 10% |
| Above basic rate limit | 28% | 20% |
| Surcharge for residential property and carried interest | 0% | 8% |

| | | |
|---------------------------------------|-----|-----|
| Trustees and Personal Representatives | 28% | 20% |
|---------------------------------------|-----|-----|

| | | |
|------------------------------------------|-------------|-------------|
| 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 TRANSFERS

| | 2015/2016 | 2016/2017 |
|-------------------------------------------------|-----------|-----------|
| Transfers made on death after 5 April 2015 | | |
| - Up to £325,000 | Nil | Nil |
| - Excess over £325,000 | 40% | 40% |
| Transfers made after 5 April 2015 | | |
| - Lifetime transfers to and from certain trusts | 20% | 20% |

A lower rate of 36% applies where at least 10% of deceased's net estate is left to a registered charity.

MAIN EXEMPTIONS

| | | |
|--------------------------------------------------------------------|----------|----------|
| Transfers to | | |
| - UK-domiciled spouse/civil partner | No limit | No limit |
| - non-UK-domiciled spouse/civil partner (from UK-domiciled spouse) | £325,000 | £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 (CO₂) emissions. There is no reduction for high business mileage users.

For 2016/2017:

- The percentage charge is 7% of the car's list price for CO₂ emissions of 50g/km or less.
- For cars with CO₂ emissions of 51g/km to 75g/km the percentage is 11%.
- For cars with CO₂ emissions of 76g/km to 94g/km the percentage is 15%.
- Cars with CO₂ emissions of 95g/km have a percentage charge of 16% and thereafter the charge increases by 1% for every complete 5g/km to a maximum of 37% (emissions of 200g/km and above).

There is an additional 3% supplement for diesel cars not meeting Euro IV emission standards. However, the maximum charge remains 37% of the car's list price.

Car fuel The benefit is calculated as the CO₂ emissions % relevant to the car and that % applied to a set figure (£22,200 for 2016/2017) e.g. car emission 100g/km = 17% on car benefit scale. 17% of £22,200 = £3,774.

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 contribution's (Class 1A) of 13.8%.

PRIVATE VEHICLES USED FOR WORK

| | 2015/2016 Rates | 2016/2017 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

| | 2015/2016 | 2016/2017 |
|----------------------------------------------------------------------------------------------------------|-------------|------------------|
| Plant & machinery (excluding cars) 100% annual investment allowance (first year) | £500,000 | £200,000 |
| 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 2016 (Corporation Tax) or 06 April 2016 (Income Tax) | | |
| CO ₂ emissions of g/km: | 75 or less* | 76-130 |
| Capital allowance: | 100% | 18% |
| | first year | reducing balance |
| | | 131 or more |
| | | 8% |
| | | reducing balance |

*If new

CORPORATION TAX

| | 2015/2016 | 2016/2017 |
|-------------------------|------------|-----------|
| Standard rate | 20% | 20% |
| Small companies rate | 20% | N/A |
| Small companies limit | £300,000 | N/A |
| Effective marginal rate | 20% | N/A |
| Upper marginal limit | £1,500,000 | N/A |

VALUE ADDED TAX

| | 2015/2016 | 2016/2017 |
|-------------------------------|-----------|-----------|
| Standard rate | 20% | 20% |
| Annual registration threshold | £82,000 | £83,000 |
| Deregistration threshold | £80,000 | £81,000 |

MAIN SOCIAL SECURITY BENEFITS

| | | 2015/2016 | 2016/2017 |
|-------------------------------------------------|-----------------------------------------------|--------------|--------------|
| | | £ | £ |
| Child Benefit | First child | 20.70 | 20.70 |
| | Subsequent children | 13.70 | 13.70 |
| | Guardian's allowance | 16.55 | 16.55 |
| Employment and Support Allowance | Assessment Phase | | |
| | Age 16 – 24 | Up to 57.90 | Up to 57.90 |
| | Aged 25 or over | Up to 73.10 | Up to 73.10 |
| | Main Phase | | |
| | Work Related Activity Group | Up to 102.15 | Up to 102.15 |
| | Support Group | Up to 109.30 | Up to 109.30 |
| Attendance Allowance | Lower rate | 55.10 | 55.10 |
| | Higher rate | 82.30 | 82.30 |
| Retirement Pension | Single | 115.95 | 119.30 |
| | Married | 185.45 | 190.80 |
| Single Tier State Pension | Single | N/A | £155.65 |
| Pension Credit | Single person standard minimum guarantee | 151.20 | 155.60 |
| | Married couple standard minimum guarantee | 230.85 | 237.55 |
| | 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 | | 112.55 | 112.55 |
| Jobseekers Allowance | Age 18 - 24 | 57.90 | 57.90 |
| | Age 25 or over | 73.10 | 73.10 |
| Statutory Maternity, Paternity and Adoption Pay | | 139.58 | 139.58 |

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