

AF2

Advanced Diploma in Financial Planning

Unit AF2 – Business financial planning

April 2017 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.

Candidates should answer based on the legislative position immediately BEFORE the 2017 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

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.

Tanya, aged 57, Ray, aged 55, and Michael, aged 58, are shareholding directors in Golrock Ltd. They bought their current business in 2012 via a Management Buyout (MBO). The business has 15 employees.

Tanya owns her main residence as tenants in common with her husband Peter. She raised the capital required for her contribution to the MBO as a loan secured against her main residence.

Shareholdings are as follows:

- Tanya 55%
- Michael 25%
- Ray 20%

In 2016, Michael was diagnosed with a serious illness which is likely to be terminal and he has not been effective in the business since his diagnosis. As a result, the company has not been performing well and the company overdraft with the bank has increased. Tanya wishes to renegotiate the overdraft arrangement with the bank.

The directors set up a small self-administered scheme (SSAS) when they completed the MBO. In 2015, the directors of Golrock Ltd made a sizeable contribution to the SSAS.

Recently, a rival business has been looking to take over Golrock Ltd.

The Profit and Loss Accounts and the Balance Sheet for Golrock Ltd are shown below:

Profit and Loss Accounts for the years ending 31 March

	2017	2016
	£'000	£'000
Sales	740	720
Cost of sales	(630)	(611)
Gross profit	110	109
Expenses*	(96)	(88)
Operating profit	14	21
Taxation	(3)	(4)
Profit after tax	11	17

*Depreciation is included in expenses for each year.

Balance Sheet as at 31 March				
	2017		2016	
	£'000	£'000	£'000	£'000
Fixed assets		668		682
Current assets				
Stock	106		112	
Debtors	34		23	
Cash at bank	1		8	
	<u>141</u>		<u>143</u>	
Current liabilities				
Creditors	112		88	
Taxation	3		4	
Bank overdraft	24		–	
	<u>139</u>		<u>92</u>	
Net current assets		2		51
Long-term liabilities				
Asset finance loans		(272)		(275)
		<u>398</u>		<u>458</u>
Ordinary share capital		250		250
Reserves		148		208
		<u>398</u>		<u>458</u>

QUESTIONS CONTINUE OVER THE PAGE

Questions continue on pages 7 – 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 following ratios for the tax years 2016 and 2017, in respect of the accounts provided:
- Operating profit margin. (3)
 - Current ratio. (3)
 - Quick ratio. (3)
- (ii) Explain briefly the implications of the change in each of the ratios in **part (a)(i)** above from 2016 to 2017. (3)
- (iii) Golrock Ltd's gearing ratio has risen from 60% in 2016 to 68% by March 2017. Describe **three** implications of this change for the company and state **three** actions that the company may take to address the situation. (6)
- (b) Explain to the directors the conditions that need to be satisfied for a small self-administered scheme (SSAS) to help finance Golrock Ltd to prevent an unauthorised payment charge. (10)
- (c) The bank has refused to increase the amount of the company's overdraft facility. With full knowledge of the company's financial position, the directors wish to continue trading.
- (i) Explain the implications for the directors if they continue trading. (8)
- (ii) Describe briefly the main possible defence to any charges stated in **part (c)(i)** above, that the directors could advance for their actions if they continue trading. (2)
- (iii) Should the situation worsen, the directors are considering implementing a members' voluntary liquidation. Describe the steps they will have to take for implementing a members' voluntary liquidation and explain why this may not be an option for them. (6)
- (iv) Describe how the process of administration could help the company to avoid compulsory liquidation. (7)

QUESTIONS CONTINUE OVER THE PAGE

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- (d) (i) Explain briefly the potential implications for Tanya should the company fail and she is unable to service her loan. (4)
- (ii) Explain the legal protection for Tanya's pension should she be made bankrupt. (5)
- (e) Silrock Ltd has made an offer to buy all the shares of Golrock Ltd from the directors. Golrock Ltd will cease to exist and the business will be transferred into Silrock Ltd.
- (i) Explain the tax benefits for the directors of selling their shares in the business to Silrock Ltd. *Assume the directors will have no association with Silrock Ltd.* (6)
- (ii) Identify and outline the legal protection the employees will receive when Golrock Ltd is purchased by Silrock Ltd. (5)
- (iii) Explain the responsibilities and liabilities the regulations you have identified in **part (e)(ii)** above will place on the directors on the transfer to Silrock Ltd. (5)
- (iv) Two of Golrock Ltd's employees are unlikely to agree to a transfer.
- Describe briefly how these employees will be treated under the regulations identified above. (4)
- Total marks available for this question: 80**

Section B questions can be found on pages 10 – 13

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) and (d) which follow.

Andy and Bella are the directors and shareholders of a private limited company called PQ Testing Ltd (PQT). They operate in the electrical engineering sector and build and sell test equipment for manufacturers of consumer electrical goods. They each hold 50% of the company's issued shares. The company makes a net profit of £280,000 per year, out of which Andy and Bella draw modest salaries and the rest as dividends.

Both Andy and Bella believe they could run the business without the other if either of them died. However, profits would be halved until they could find a new collaborator with whom to run the business. They think that it could take up to one year to find the right person.

Should Andy die, Bella would take control of the business. There is no life or critical illness cover in place.

Andy is unmarried and lives with his girlfriend Alison who is the sole beneficiary of his Will. Alison works in social services and has no knowledge of, or interest in, the business.

Charlie is a highly skilled software engineer who is the technical brains behind PQT's product. Charlie is paid a salary of £140,000, out of a total payroll of £250,000. The company employs six assemblers and installers but Andy, Bella and Charlie are the key people in the business. Both Andy and Bella believe it could take up to two years to replace Charlie.

PQT is constituted upon the unmodified Companies (Model Articles) Regulations 2008, which means there is no specific shareholder agreement in place.

You are in a meeting with Andy and Bella who are consulting you on their needs for shareholder and key-person insurance arrangements.

Questions

- (a) (i) Describe briefly the consequence of Andy's death in respect of his shares in PQT. (2)
- (ii) Identify the problems arising for Alison from the consequences identified in part (a)(i) above. (4)
- (iii) Identify the problems arising for Bella from the consequences identified in part (a)(i) above. (4)
- (b) Andy and Bella have agreed that they want the surviving director to take on the business and for the deceased director's estate to be fairly compensated for their share of the business.
- (i) State the **three** components of a well-founded shareholder protection arrangement. (3)
- (ii) Recommend, with explanations, the type of agreement Andy and Bella should enter into in order to address their needs and objectives. (8)
- (c) (i) Identify the financial implications that should be considered when assessing the level of key-person cover for Andy, Bella and Charlie. (4)
- (ii) It has been agreed that key-person cover should be for a period of five years.
- Recommend, with explanations, an appropriate method to calculate key-person cover for:
- Andy and Bella. (3)
 - Charlie. (2)
- No calculations are required.*
- (iii) State, giving your reasons, which if any of the key-person policies would qualify for Corporation Tax relief on the premiums. (5)
- (d) Describe how a stand alone critical illness arrangement should be set up by Andy and Bella to protect their business shareholdings. (5)

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.

Jason, aged 28, is a commercial heating engineer, and Martin, also aged 28, is an electrician. Both are employees of small companies.

Jason and Martin have decided to start a new business together offering installation, commissioning and servicing of heating and electrical systems to commercial customers.

They have decided to start their new business on 1 September 2017. In starting their new business, they will incur significant expenditure in the first year as they will need to buy vans, tools and safety equipment, as well as incurring costs on marketing their new business. They expect the financial performance of the business to be as follows:

- Year 1: loss of £60,000 to 31 March 2018 or a loss of £50,000 to 30 April 2018.
- Year 2: profit of £120,000.
- Year 3: profit of £180,000.

In order to fund the new business, Jason and Martin will use up all their savings and investments. They will initially rely solely on their drawings from their new business. They would like to pay as little tax as possible.

Jason is married with a young family and lives in a house that is mortgaged and he does not want to put this at risk.

Martin would like to keep the business structure as simple as possible and avoid too many legal responsibilities. Jason has agreed with him to rule out trading as a limited company.

Questions

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

- (a) Jason and Martin need advice as to whether it is best to have a 30 April year end or a 31 March year end.
- (i) Calculate, **showing your workings**, Jason's share of the taxable profit/loss for the tax year 2017/2018 if they were to choose a 30 April year end. (4)
- (ii) Calculate, **showing your workings**, the difference in Jason's share of the taxable profit/loss if they were to choose a 31 March year end instead of a 30 April year end. (2)
- (b) State, giving your reasons, whether a 30 April or 31 March year end would be best for Jason and Martin. (4)
- (c) (i) Identify **two** business structures under which Jason and Martin could trade. (2)
- (ii) Recommend, with reasons, the most appropriate business structure for Jason and Martin to trade under to accommodate Jason's requirements. (8)
- (iii) Explain to Martin the disadvantages for him of trading under the structure identified in **part (c)(ii)** above. (8)
- (d) If Martin were to enter into a lease agreement for the new vans, state, giving your reasons, whether Jason would also be bound by the terms of the contract. (5)
- (e) With regards to ongoing service contracts with their potential customers:
- (i) explain to Jason and Martin the difficulties the business could face in meeting its obligations if one of them were unable to work due to illness; (4)
- (ii) state the actions Jason and Martin could take to minimise the business risk of not meeting these obligations due to illness. (3)

Total marks available for this question: 40

The tax tables can be found on pages 15 – 21

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
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**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%

§ 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)	£2,780	£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	131 or more
Capital allowance:	100%	18%	8%
	first year	reducing balance	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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