Institution **CIOT - CTA**
Course **APS Taxation of Larger Companies**

Event **NA**

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Answer-to-Question-_1_

REPORT

To: Board of EastTeaCo plc
From: Lambert Maskell LLP
Subject: Collaboration with M20 Projects Ltd
Date: 2 November 2023

**INTRODUCTION**

This report has been prepared solely for the use of EastTeaCo plc and its subsidiaries in respect of the potential collobortion with M20 Projects Ltd.

This report is based on information provided by Anna Anderson in an emai dated 1 November 2023.

Lambert Maskell LLP does not accept any liabilities towards third parties who chose to rely on any information or advice included in this report.

All tax law is correct at the time of writing

**EXECUTIVE SUMMARY**

- EastTeaCo UK Ltd are currently considering undertaking a joint project with a third party, M20 Projects Ltd, regarding the use of caffine alternatives. The EastTeaCo Group, therefore, would like to understand what the best way to structure this joint project would be from a tax perspective.
- Royalty payments from third parties may be recieved net of WHT. Unilateral double tax relief should be available under UK domestic legislation for these payments.

COLLABORATION WITH M20 PROJECTS

- It is expected that ECT UK will be able to claim R&D relief for

the £70m incurred in relation to the development of the new manufacturing processes. Relief will be provided via the RDEC, such that 13% of the qualifying expenditure will be available as a tax credit against corporation tax relief.
- M20 Projects are expected to be able to claim R&D relief as an SME, therefore an enhanced deduction will be available at 230% on the total expenditure of £30m. The loss arising could then be surrendered to HMRC for a tax credit at 14.5%.
- The royalty income recieved by ECT UK will be taxable to UK corporation tax at 12%, on the basis that a patent box election has been made. The royalties payable to M20 will be deductible for corporation tax purposes as trading IFA debits.
- It is expected that the additional corporation tax arising as the result of the royalty income will be extinguised by the RDEC available in respect of the R&D expenditure.

INCORPORATION OF A NEW COMPANY
- It is expected that NewCO will be able to claim R&D relief for the £100m incurred in relation to the development of the new manufacturing process and the running of the clinical trials. R&D relief will be available under RDEC, as NewCo will be considered large for R&D purposes. Therefore, 13% of the qualifying expenditure will be treated as taxable tax credit and offset against the corporation tax liability.
- It is expected that in YE 2025 and YE 2026, some of the RDEC will be surrenderable to ECT UK. Cash repayments from HMRC could also be anticipated.
- The royalty income recieved by NewCo will be taxable to UK. corporation tax at 12%, on the basis that the patent box election.
- A corporation tax deduction will be available for the royalty payments to ECT UK. However, these payments must be made at arm's length.
- ECT UK and NewCo will be connected parties for transfer pricing purposes, therefore the loan must be made at arm's length. Interest should therefore be charged on the loan at arm's length.

It is not expected that the loans will be caught by any anti-abuse legislation.

EXIT BY M20 PROJECTS LTD
- If the rights over the patent are sold to ECT UK, a trading IFA gain will arise in M20. This will be chargeable to UK corporation tax at 25%. The payment will be reduced by the R&D relief M20 has been able to claim and the royalty income recieved.
- If the shares in NewCo are disposed of to ECT UK, a chargeable gain will arise in M20. However, this gain is expected to exempted from charge under the SSE provisions. The payment is not expected to be significantly reduced by R&D relief.

**RECOMMENDATION**

Based on the discussions in this report, it would be recommended that the collaborative project is run via joint venture, rather than by setting a a new joint venture company.

This is on the basis that ECT UK will be able to claim R&D relief itself and recieve royalty income directly from third parties.

If the collaboration is structured as a joint venture company, ECT UK will only be able to recieve some of the RDEC available to NewCo in YE 2025 and 2026. Lower royalty income will also be recieved by ECT UK under this option.

Furthermore, M20's exit from the joint venture collaboration is also expected to be more cost effective for ECT UK under the joint colloboration, as the payment would be reduced by the royalty income recieved and the R&D relief already claimed by M20.

Furthermore, transfer pricing will not need to be considered in regards to any transaction under this option, unlike under the NewCo. This will reduce the compliance burden on ECT UK and may also reduce external fees incurred.

Corporation tax relief is also expected to be available on the acquistion of the rights over the patent.

Under the joint venture company, the only significant cost saving on the disposal of the shares comes as the gain is expected to stem from the fact the gain will be exempt to charge to corporation tax.

Corporation tax relief will not be available for the cost of the shares or the stamp duty payable when the shares are acquired.

In order to claim R&D relief for the expenditure incurred in developing the new manufacturing process, a claim must be included in the corporation tax return for the YE 2025 and YE 2026 on the CT600L. The claim must be made within two years from the end of the accouting period in which it arose.

It would be recommended that supporting documentation is also submitted with this claim. Further support and advice can be provided in this respect.

It should be noted that the ultimate structure of the joint project will depend on negotiations with M20. M20, who should also seek seperate and legal advice, may consider that setting up under the joint venture company is more beneficial. Therefore, the ultimate structure may differ.

GENERAL
It is not expected that HMRC will raise any objections to any of the transaction proposed under this report. None of the transactions are expected to be caught by either general or targeted anti-avoidance provisions.

**JOINT VENTURE PROJECT**

EastTeaCo plc ('ECT') is considering setting up a joint venture project, which will see EastTeaCo UK Ltd ('ECT UK') work together with a third party, M20 Projects Ltd ('M20') via a collobrative approach.

R&D RELIEF
It is important to consider the research and development (R&D) relief available to ECT UK and M20 for the expenditure incurred on the R&D under this option.

R&D relief will be available as the companies are seeking to achieve a scientific advance, ie the use of a caffine alternative through the resolution of a scientific and technological uncertainity.

*EastTeaCo UK Ltd*
ECT UK will be considered large for R&D purposes because it is a member of a group with over 500 employees and a turnover in excess of (E)100m.

Therefore, R&D relief for any qualifying R&D expenditure (RDQE) will be given at 13% as a R&D tax credit.

This tax credit will be available to be off-set against the corporation tax liability of ECT UK.

However, it is important to note that the credit will also be treated as taxable income, so will be charged to corporation tax at 25%.

The expenditure incurred in respect of Project I by ECT UK will be considered to be in-house expenditure incurred for the benefit of ECT UK. Therefore, in order to be considered RDQE, two conditions will need to be met:
- Condition A: The expenditure must be incurred on staff costs, consumables, software, payments to participants in clinical

trials and externally-provided workers (EPWs).
- Condition B: The R&D activities must be directly attributable to the trade.

It is not clear what the £70m will be spent on exactly - beyond the development of the new industrial proces - however, for the purposes of this report it has been assumed that the full £70m has been spent on one of the qualifying types of expenditure.

It is expected that Condition B will be met as the project is directly related to the manufacturing of tea and coffee.

On this basis, in YE 2025 and YE 2026, ETC UK is expected to be able to claim an RDEC as follows:

| | | YE 2025 | YE 2026 |
|---|---|---|---|
| RDQE | | 30m | 40m |
| RDEC at 13% | | 3.9m | 5.2m |

It is important to note that any payments made to M20 in respect of any R&D work will not qualify for relief for ECT UK as the payments have not been made a large company for R&D purposes.

As noted above, these amounts will be available as a tax credit against the corporation tax liability of ECT UK arising in the current year. It would be expected that the full RDEC will be utilised in ECT UK.

*M20 Projects Ltd*
While M20 is not a client of Lambert Maskell LLP, it is important to understand how R&D relief will be provided to M20, particularly as this will play a role in payments recieved on their exit from the project.

Based on the information provided, M20 will be a small/medium sized (SME) company for R&D purposes. Therefore, they will be able to claim relief for RDQE via the enhanced expenditure regime.

This allows for an enhanced deduction at 230% for RDQE in calculating the trading profits for the current year. For SMEs, RDQE will also include payments to participants of relevent clinical trials.

Again, while it is not clear what the £30m relates to in detial, it can be assumed for the purposes of this report that the full £30m will meet the conditions to be treated as RDQE, an enhanced deduction will be available as follows:

| | | YE 2025 | YE 2026 |
|---|---|---|---|
| RDQE | | 13m | 17m |
| Enhanced deduction at 230% | | 29.9m | 39.1m |

Based on the figures provided for the year ended 30 June 2023, it is expected that, following the deduction of this expenditure, M20 will be loss-making for tax purposes.

The lower of the trade loss arising and the enhanced deduction will be available to be surrendered to HMRC for a tax credit at 14.5%. This will trigger a cash repayment to M20.

Alternatively, M20 can carry the loss back and set it against profits of an earlier trade.

PATENTS

*Royalties*

As a result of both project 1 and 2, ECT UK will begin to recieve new royalty income in respect of the new patent created under the projects.

The patent will be held as an Intangible Fixed Asset (IFA) on the balance sheet of ECT UK.

The royalties recievable will be treated as trading IFA credits in the hands of ECT UK and the interest payable to M20 will be treated as trading IFA debits. These amounts will, therefore, be taken into account when calculating the trading profits of ECT UK.

The net position of ECT UK in respect of the amounts recievable and payable is set in Appendix I.

It should be noted that while additional income is expected to arise in the hands of ECT UK, the RDEC arising (discussed above) will completely extinguish the additional tax expected to arise in YE 2026, as per the calculations in Appendix I.

These calculations have been prepared on the basis that a patent box election has been made, such that royalty income is taxed at 12%.

No withholding tax should be suffered on the payments of the royalties to M20, as M20 is a UK resident company.

As M20 and ECT UK are third parties, the transfer pricing rules (which are discussed below) will not been to be taken into account in respect of any royalty payments between the two unconnected companies.

If royalties are recieved by UK resident individuals or overseas companies, withholding tax (WHT) will be suffered on the royalties recievable. However, double tax relief (DTR) may be available under UK legislation such that the WHT suffered is treated as a tax credit against the corporation tax liability on the royalty income.

Further advice can be provided in this respect.

AMORTISATION
The new patent will be held as an IFA. Therefore, a corporation tax deduction will be available for any amortisation charged on the patent in the accounts when calculating the trading profits, or 4% per annum if more beneficial.

The amortisation will also be treated as an trading IFA debit.

**INCOPORATION OF A NEW COMPANY**
ECT are also considering incorporating a new company ('NewCo'). This company will be UK tax resident, so will be charged to UK corporation tax on its worldwide profits and gains.

CONSORTIUM RELIEF
A consortium company is defined as a company which is owned at least 75% by companies, who each own at least 5% of the shares, but is not 75% owned by one company.

On this basis, NewCo will be a consortium company. However, it has been stated that no relief will be claimed/surrendered under the consortium relief provisions. Therefore, no further analysis has been carried in respect of the availability of the corporation tax relief for any losses arising in NewCo for ECT UK and M20.

However, more information can be provided if required in this respect.

R&D RELIEF
NewCo will be considered large for R&D purposes. As it will be owned 70% by ECT UK, ECT UK are said to control the company so will be considered a link company.

Therefore, in determing NewCo's size for R&D purposes, the total figures for the ECT Group must be taken into account.

As such, as discussed in relation to the R&D relief available in ECT UK, relief for qualifying R&D expenditure will be given via the R&D expenditure credit (RDEC), meaning that a tax credit will be given at 13% on the qualifying expenditure. The credit will also be treated as taxable income.

It has been assumed that the development of the new process and the clinical trials will be run by NewCo. This will be considered in-house expenditure.

Therefore, both Condition A and B will need to be met in order to claim the R&D relief (discussed above). However, it should be noted that payments to participants of clinical trials will be considered a qualifying cost under Condition A.

It can be assumed for the purposes of this report, that both conditions will be met.

NewCo is taken to incur expenditure of £100m in YE 2025 and YE 2026 in respect of developing the new industrial process under Project 1 and running the clinical trials under Project 2.

As such, R&D relief will be available as follows:

| | | YE 2025 | YE 2026 |
|---|---|---|---|
| Project 1 | | 30m | 40m |
| Project 2 | | 13m | 17m |
| Total | | 43m | 57m |
| RDEC at 13% | | 5.59m | 7.41m |

*Utilising the R&D Relief*
In YE 2025, NewCo is not expected to recieve any income, and is therefore expected to be loss-making. As a result, no corporation tax liability will arise in the current period.

Therefore, in order to realise the R&D relief available via the

RDEC, the net amount of the credit (after tax) is surrendered first against a corporation tax liability of a prior period - in this case, relief will not available either.

The amount will then be surrendered to a group company such that they can set the credit against their own corporation tax liability. As such, ECT UK could benefit from this surrender.

Any amounts not used will then be available to surrender for a cash payment from HMRC.

The net amount of the RDEC in YE 2025 will be around £4.2m, ie 75% of £5.59m, assuming that the PAYE cap does not apply.

In YE 2026, NewCo will recieve income (as shown in Appendix II). Therefore, the RDEC will be available to offset against the corporation tax liability arising in the current year (estimated to be £3m).

The net amount of the remaining balance, taken to be around £3.3m, ie 75% of £4.41m, can then be relieved as above.

In order to determine the total amount surrenderable to ECT UK, further information would be required, particularly their estimated total taxable profits for the periods under question.

M20 will not be considered to be a member of the same group as NewCo because it will only hold 30% of its shares. Therefore, the R&D tax credit could not be surrendered to M20. Instead, M20 would only be able to enjoy an enhanced dividend if a cash payment is received from HMRC.

ROYALTIES
As discussed previously, the royalties will be recieved in the hands of NewCo as trading IFA credits. They will therefore be chargeable to corporation tax.

The royalty payments from ECT UK will also be treated as trading IFA credits, and will be deductible for corporation tax purposes.

The net income position of NewCo is shown in Appendix II.

However, it should be noted that ECT UK and NewCo will be connected for transfer pricing purposes, therefore all transactions between the two companies must be at arm's length.

No withholding tax (WHT) should be suffered on the payments between ECT UK, NewCo and M20 as the companies are all UK resident.

If the royalties are recieved by either UK individuals or overseas companies, the payments may be recieved net of WHT. However, double tax relief should be available via a tax credit for this tax under UK domestic legislation.

LOANS
Two interest-free loans will be made to NewCo from ECT UK and M20 in order to fund the intial R&D expenditure.

It should be noted taht no corporation tax deduction will be available in NewCo for the repayment of the loans to ECT UK or M20.

*Transfer Pricing*
As M20 is neither connected nor a large company for UK transfer pricing purposes, the £30m made by M20 to NewCo will not need to be at arm's length. However, it would be sensible for M20 to seek their own tax advice in this respect.

However, ECT UK and NewCo will be connected for UK transfer pricing purposes as ECT UK controls NewCo by way of a majority shareholding. ECT UK is also large for UK transfer pricing purposes. Therefore, this loan must be made at arm's length.

It is unlikely that given the current inflationary environment, an interest free loan will be considered to be arm's length. The arm's length interest rate must therefore be determined using one of the OECD's most appropriate methods (found in their Transfer Pricing Guidelines).

This will give rise to an interest deduction in NewCo and interest income in ECT UK. Subject the Corporate Interest Restriction (CIR) rules, a deduction may be available in NewCo for the interest payable.
The interest income will be taxable to corporation tax at 25% in ECT UK.

Where a transaction between connected parties does not take place at arm's length and a UK tax advantage arises - in this case, ECT UK will have lower total taxable profits because it has not received interest income - an adjustment must be made to the corporation tax return of the company with the advantage.

UK companies are also required to prepare documentation to support the arm's length nature of the transaction.

*Anti-Avoidance*
It is not expected that these loans will be caught by an specfic anti-avoidance, including the unallowable purpose rules or the hybrid mismatch arrangements.

**M20 PROJECT LTD'S EXIT**
M20 is seeking to exit both Project 1 and 2 by July 2028 at price that would enable £80m of post-tax profits to arise.

This £80m would, however, be reduced in a number of different ways, depending on the structure of the colloboration.

The tax implications of the tax have been set out below.

STRUCTURED AS A COLLABORATION
*Disposal of IFA*
If the collaboration was structured as joint project run by two seperate companies, in order to exit from the joint venture, M20 would have to dispose of its rights in the patent created.

As discussed previously, as the patent is treated as an IFA for tax and accounting purposes, in disposing of the rights over the patent, M20 would realise a trading IFA gain.

This trading IFA gain would be calculated as the sales proceeds less the tax-written down value of the IFA. The gain arising would be chargeable to UK corporation tax at 25%.

From the perspective of ECT UK, they would be treated as acquiring 30% of the rights in the patent, thereby gaining an additional IFA at the price paid. Tax relief would be available over the life of the patent via amortisation.

*R&D Tax Credit*
Under this structure, M20 will have recieved R&D credit at least 14.5% of £69m (see calculations above), which equal to around £10m, which will reduce the £80m.

*Royalty Income*
As shown in Appendix III, the total income recieved by M20 will be £12m, giving rise to a corporation tax liability of £1.44m. This will reduce the £80m by £10.56m

*Other Taxes*
No VAT will be chargeable on the purchase, nor will any stamp

duty or stamp duty land tax.

JOINT VENTURE

*Grant of Option*

It should be noted that the grant of the call option over the shares will give rise a chargeable gain in ECT UK. The gain will be equal to the price paid by M20 for the option.

*Disposal of Shares*

The disposal of the shares in NewCo will give rise to a chargeable gain in M20. This would ordinarily be charged to corporation tax at 25%.

However, it is expected thate the gain arising on the disposal of shares will qualify for the Substantial Shareholding Exemption (SSE), as NewCo will be trading company and the shares will have been owned for more than 12 months.

This means that the gain will be exempt from charge to corporation tax. This would reduce the sales proceeds recieveable by 25%.

From the perspective of ECT UK, they will be treated as acquiring 30% of the shares in NewCo, meaning that it becomes a wholly-owned subsidiary.

NewCo will thus become a member of the IFA group, with ECT as the principle company and its other wholly-owned UK subsidaries as members.

However, no immediate corporation tax relief will be available for the acquistion of the shares nor for the stamp duty payable (below).

*R&D Tax Credit and Dividend Income*

As discussed above, NewCo will not be able to surrender the RDEC arising to M20. Instead, M20 will only be able to enjoy the R&D relief via a potentially larger dividend payment.

As a result, the £80m is not expected to decrease signifcantly in this respect.

*Other Taxes*

No VAT is expected to be payable, nor is any stamp duty land tax.

Stamp duty would be payable by ECT UK on the purchase of the shares at 0.5% on the consideration.

APPENDIX I - NET ROYALTY INCOME IN ECT UK (JV)

| | | 2026 | 2027 | 2028 |
|---|---|---|---|---|
| | | £'000 | £'000 | £'000 |
| Royalty received (P1) | | 12,000 | 20,000 | 20,000 |
| Royalty recieved (P2) | | 6,000 | 12,000 | 12,000 |
| | | 18,000 | 22,000 | 22,000 |
| Royalty payable (P1 + P2) | | (5,400) | (6,600) | (6,600) |
| Royalty for use of know-how | | (3,000) | (4,500) | (4,500) |
| | | 9,600 | 10,900 | 10,900 |
| CT @ 12% | | 1,152 | 1,308 | 1,308 |
| | | | | |
| | | | | |
| | | | | |

APPENDIX II - ROYALTY INCOME IN NEWCO

| | | 2026 | 2027 | 2028 |
|---|---|---|---|---|
| Royalty recieved (above) | | 18,000 | 22,000 | 22,000 |
| Royalty from ECT UK | | 10,000 | 15,000 | 15,000 |
| | | 28,000 | 39,000 | 39,000 |
| CT @ 12% | | 3,000 | 4,140 | 4,140 |
| | | | | |

Note the above table is denominated in £thousand.

APPENDIX III - ROYALTY INCOME IN M20

| | | YE 2026 | YE 2027 | YE 2028 |
|---|---|---|---|---|
| Royalty reito M20 | | 3,000 | 4,500 | 4,500 |
| CT at 12% | | 360 | 540 | 540 |

Note the above table is denominated in £thousand.

APPENDIX II