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Application and Professional Skills

Taxation of Larger Companies and Groups

Suggested solution

DRAFT REPORT TO BOARD OF ORMPORT GROUP PLC

Proposed acquisition of development at Stockerton by Ormport Group plc

The report is based on information made available to Little & Smith LLP in the course of undertaking financial due diligence on Factory 19 Ltd and in a letter dated 29 April 2019 from Mr Andy Brown, Chief Financial Officer, to Ms Eleanor Street, and information made available to us on the commercial and tax history of existing group companies up to and including the year ended 31 December 2018.

This report is provided for the use of Ormport Group plc only and should not be relied on by any other party.

Scope

We have considered:

A. Whether to acquire the part-completed development directly or the shares in Factory 19 Ltd;
B. Which of the three development options you should pursue based on the after-tax outturn; and
C. The company that should acquire the development.

Executive Summary

1. The Ormport Group should acquire the development itself, rather than the shares in Factory 19 Ltd because that is less costly, is legally less complex and does not involve subsequent negotiations with HMRC on various matters (see below).

2. If, however, the seller is not willing to dispose of the development itself and you instead acquire Factory 19 Ltd:
    a. an indemnity should be obtained against any possible undisclosed PAYE and subcontractor tax costs;
    b. it may be possible to negotiate a reduced price to take account of the absence of tax relief on the price paid for the shares;
    c. the development should be transferred as soon as possible to the appropriate entity (indicated below) in order to access available tax losses against future profits; and
    d. Factory 19 Ltd should be brought within the Ormport VAT group before the transfer of the development to another Ormport company.

3. Completing the development for sale (option 1) gives a better after-tax return than selling on the development (option 2). Whether option 3 is better than option 1 depends on future commercial factors.

4. If Factory 19 Ltd is acquired, the development should be acquired by, or transferred to, the following company:
    a. if the intention is to develop and sell the completed development (option 1) - Ormport Developments (No 2) Ltd; or
    b. if the intention is to develop then rent out the completed development (option 3) - Ormport Property Holding (South) Ltd.

5. If the development is to be retained as an investment property, you should opt to tax the land so that VAT inputs can be recovered.

A. Should the Ormport Group acquire the partly completed development or the shares in Factory 19 Ltd?

Purchase of the factory development

The supply of a partly completed commercial building by Factory 19 Ltd would be liable to VAT at 20%, adding £1.86 million to the consideration of £9.3 million, which becomes £11.16 million.

Stamp Duty Land Tax (SDLT) would be a payable as follows:

First £150,000 of consideration 0%	0
Next £100,000 of consideration 2%	£2,000
Remainder £10,091,000 at 5%	£545,500
Total	£547,500

All the VAT would be recoverable as allowable input tax, as discussed at section B below. Therefore, the total purchase price of the development at its current market value is £9.3 million plus SDLT of £547,500 i.e. £9,847,500, all of which would be deductible in computing either trading profits or a capital gain on a future sale, as discussed below in sections B and C.

Purchase of the shares of Factory 19 Ltd

The Ormport Group would take on the commercial history and liabilities of Factory 19 Ltd, including the:

- unpaid subcontractor bills of £800,000 (£600,000 per the statutory accounts plus a further £200,000 referred to in the due diligence report), plus applicable VAT thereon,
- parent company loan (which the vendor would require to be repaid on completion, or at some future point), and
- tax bills arising from the possible non-compliance with the PAYE and subcontractor deduction schemes.

A full indemnity should be obtained from the vendor in respect of any understated PAYE (income tax and NIC), income tax deductible from payments to subcontractor, and associated interest and penalties.

Assuming an indemnity is obtained, the value of the shares in Factory 19 Ltd is approximately £3.3 million, being the £9.3 million current market value of the development less approximately £6 million of liabilities (or put another way, the value of the net assets of the company in excess of the balance sheet value at 31 March 2019).

Stamp Duty at 0.5%, of approximately £16,500, would be payable on the share purchase.

No VAT arises on buying shares because the sale of existing shares is an exempt supply for VAT.

Once the shares of Factory 19 Ltd are acquired, the development can be transferred to another group company to access tax losses, as discussed below. Given the development is a capital asset of Factory 19 Ltd, the transfer to another group company will be a no gain/no loss transfer at £6 million.

In the event that the acquiring company then appropriates the asset to trading stock (of a trade either of property development or property dealing) it would be deemed to make a disposal of the development from capital to trading stock at market value at the point it is decided to develop for sale. A capital gain of would arise (being the value of the development at the point of appropriation in excess of cost of £6 million. However, an election can be made to treat the deemed disposal at cost so that the development transfers to trading stock at cost of £6 million.

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A transfer of the development between companies in the Ormport Group will not give rise to any SDLT liability because transfers between group companies are exempt, although the exemption is lost if the company receiving the development is sold outside the group within three years of such an intra-group transfer.

To avoid VAT being payable on the transfer, Factory 19 Ltd should be brought within the Ormport VAT group before the transfer is made.

Conclusion

Comparing tax costs of buying shares or assets

- the £3.3 million price paid for the shares would not be tax relieved on a future sale of the development, being a loss of tax relief at 17% of £561,000
- SDLT on an asset purchase (after tax relief at 17%) is £440,000 more than on a share purchase.

Overall, a purchase of the development itself is therefore less costly.

Although future relief for a capital loss in respect of the price paid for the shares might arise on a future winding up of Factory 19 Ltd or by way of a negligible value claim, the uncertainty of the future tax regime (for example, value-shifting anti-avoidance legislation) does not make this an attractive proposition.

Furthermore, a purchase of the development avoids the need to take on the risks associated with the possible PAYE/subcontractor issues.

For these reasons, a purchase of the development is recommended.

Should the vendor insist on a share sale, a reduction in the purchase price should be negotiated to take account of the loss of tax relief compared to buying the development.

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B. Which of the three development options should you pursue?

We have addressed this question by considering the tax consequences of each option, including consideration of which group company should acquire and exploit the development (under section C below).

1) Proposed future sale of completed development

If the development is further developed with a view to sale, the profits realised will be treated as trading profits from a trade of property development.

VAT will be chargeable on the sale (if it takes place within three years of completion) and all input VAT will be recoverable.

2) Proposed future sale of uncompleted development

Holding the development with a view to an onward sale at a profit may be regarded as a trade of property dealing, distinct from property development. As it was acquired with the intention of turning it to account within a short period of time, that may be used to support an argument that the holding and sale of the development was a venture in the nature of trade.

Even if the activity does not amount to a trade, HMRC could invoke anti-avoidance legislation (i.e. the Transactions in Land rules) that taxes profits or gains realised, either directly or indirectly, from the sale of land as trading profits. This legislation applies where land is held as trading stock, or where one of main purposes of acquiring or developing the land (or property deriving its value from the land) was to realise a profit or gain from its disposal.

Losses brought forward from property development or property-dealing activities would not be available against profits on such a deemed trade.

VAT will be chargeable on the sale and all input VAT will be recoverable.

3) Proposed completion and letting of development

If the development is completed for rental purposes, its exploitation will be regarded as a property business, or part of such a business. Profits will arise from rentals less the costs of generating those rentals, but the capital cost of the development will not be deductible in computing those profits.

On a subsequent sale of the development, the capital cost will be deductible in computing a capital gain or loss.

If the Group did not opt to tax the land, input VAT on development and other costs would not be recoverable. Opting to tax would enable input VAT to be recovered. However, VAT would then be chargeable on rents charged to tenants. As the tenants will be industrial businesses and therefore likely to be making taxable supplies for VAT purposes, they should be able to recover that VAT. Therefore, charging VAT on rentals should not disadvantage them. You should therefore opt to tax the land in these circumstances.

C. Which company should acquire the development and undertake the activity?

We have recommended above that you should, if possible, buy the development directly. If, however, you buy Factory 19 Ltd itself, the development will be transferred to an existing Ormport Group company. This will enable the transferee company to access the available tax losses within the group that could be utilised against profits/gains arising on the development to reduce Corporation Tax liabilities.

We have considered and made recommendations on the Corporation Tax position by reference to each of the three options.

Our calculations of the after-tax effect of the three options are set out in the Appendix.

Option 1: Complete the development for sale

Both Ormport Developments (No 1) Ltd and Ormport Developments (No 2) Ltd have losses brought forward from trading as property developers, so the development of the Stockerton site by either company could be seen as a continuance of the same trade. This would enable their losses to be relieved against profits on the development.

Ormport Developments (No 1) Ltd prima facie has sufficient losses of £16 million to fully cover the projected profit, albeit perhaps over more than one accounting period given that the new loss carry forward rules would restrict the use of the losses should group taxable profits exceed £5 million in an accounting period.

Ormport Developments (No 2) Ltd has losses brought forward of £1 million, so that more of the profit would remain taxable. The losses of both companies arose in 2016, prior to the introduction of new loss relief rules that would allow carried forward losses to be group relieved.

Ormport Developments (No 1) Ltd last undertook a property development in 2016, since when its trade has consisted only of property maintenance. Furthermore, it has always undertaken office developments whereas Stockerton is an industrial development. These factors could lead HMRC to argue that Ormport Developments (No 1) Ltd's old trade of property development and maintenance has ceased, that it now carries on a property maintenance trade, and that a new activity of factory development represents a new trade. In that case, the losses of the old trade would not be available to be relieved against the profits of the new trade.

Ormport Developments (No 2) Ltd has continued to trade as property developers throughout, undertaking a variety of development types. Undertaking a factory development at Stockerton should be regarded as a continuation of the same trade. Ormport Developments (No 2) Ltd joined the group on 30 June 2018. Therefore it also has to satisfy the test that there has not been a major alteration in the nature or conduct of the trade in the period beginning three years before and up to five years after it was acquired, as that would prevent the carry forward of losses. As it continues actively to develop properties in different sectors, it is unlikely that it would fail that test.

In summary, we recommend that Ormport Developments (No 2) Ltd should undertake the Stockerton development and shelter part of the profits with the £1 million brought forward losses. Even though the losses in Ormport Developments (No 1) Ltd are greater, the risk of losses forward being denied in Ormport Developments (No 1) Ltd is much higher than in Ormport Developments (No 2) Ltd.

As calculated in Tables 1 and 2 of the Appendix, the after-tax surpluses would be:

a) if the development is purchased direct from Factory 19 Ltd, £3,035,575; or
b) if Factory 19 Ltd is purchased and the development subsequently transferred to Ormport Developments (No 2) Ltd, £2,912,500.

Option 2: Hold the development for onward sale (dealing profit)

This activity is similar to the trade undertaken by Ormport (Land Holdings) Ltd, as a dealer in undeveloped land, but dissimilar to the property development trades carried on by Ormport Developments (No 1) Ltd and Ormport Developments (No 2) Ltd. Therefore, losses of those two companies would be unlikely to be available to shelter a dealing profit. Turning a part-completed development to profit in this way is not identical to the trade of Ormport (Land Holdings) Ltd, so a risk also exists that its losses brought forward could be denied, but that risk is relatively modest compared to the risk of the losses of either of the development companies being blocked.

We therefore recommend that this activity, if carried on, be undertaken by Ormport (Land Holdings) Ltd.

As calculated in Tables 1 and 2 of the Appendix, the after-tax surplus would be:

a) if the development is purchased direct from Factory 19 Ltd, £2,652,500; or
b) if Factory 19 Ltd is purchased and the development subsequently transferred to Ormport (Land Holdings) Ltd, £2,588,500.

Should the activity not amount to a trade, HMRC could invoke anti-avoidance legislation to deem a separate trade from that carried on by Ormport (Land Holdings) Ltd, so that losses brought forward would not be relievable against the deemed trade profits.

To minimise this risk, the development should be acquired by or transferred to Ormport (Land Holdings) Ltd at the outset and a Board minute passed stating that the development is being acquired as part of its land bank, with a view to a future profit on sale. In that way, it is being integrated into the existing trade, and the chance of profits on the onward sale being treated as part of the profits of that company's trade is maximised.

Option 3: Complete the development for rental

£1 million of the construction costs, on building fixtures, will qualify for capital allowances at 8% per annum on a reducing balance basis, i.e. £80,000 deduction in the first year.

Rental income at £900,000 per annum, reduced by capital allowance and any other allowable costs, would be taxable as profits of a property business.

All of the losses of Ormport Investments (North) Ltd are property business losses that arose before it joined the Ormport Group. Such losses cannot be carried forward and relieved against profits arising after a change of ownership where there has been a major change in the nature or conduct of the property

business. The recent change from industrial to office commercial lettings might well be regarded by HMRC as such a change.

Ormport Investments (South) Ltd has been a member of the group for many years so its losses can be carried forward against future property business profits. Its losses arose in the accounting period to 31 December 2017. The proportion that arose after 1 April 2017 can be carried forward and group relieved against any other income of group companies in 2019 and later years. However, the losses that arose before 1 April 2017 can be relieved only by carry forward against its future property business profits. In the absence of any other group profits in 2019, the most effective way of relieving its losses is for Ormport Investments (South) Ltd to undertake the Stockerton development and carry forward its losses against future rental profits.

We recommend, therefore, that if Stockerton is developed for rental, the development should be owned and developed by Ormport Investments (South) Ltd.

Long-term projections are dependent on future tax rates. However, assuming the Corporation Tax rate remains at 17%, and there are no other significant future costs, approximate tax liabilities would be £nil in the four years up to and including 2022, so aggregate net profits would be £2,250,000 and thereafter profits would be about £750,000 per annum after tax (see Table 3 of the Appendix).

In contrast to options 1 and 2, where all the Corporation Tax will crystallise not later than the point of sale, under option 3 there is a deferred tax liability that would arise on a capital gain on a future disposal of the building at say its current market value of £18 million, less costs of £14 million (development purchased) or £10.3 million (shares in Factory 19 originally purchased.

Conclusion

Option 1 will give a better after-tax return than option 2 and acquiring the development rather than the shares of Factory 19 Ltd (followed by a transfer of the development to an Ormport group company) would be more beneficial.

It is more difficult to decide between options 1 and 3. Under option 3, the future tax regime and tax rates, and the attractiveness of the rental market are unknown elements that will impact on the financial performance of a property investment.

If the tax regime does not change and you have continuity of rental income, by 2023 your surplus on option 3 will be about £3 million, similar to the best projection for option 1.

Whether continuing to generate £750,000 per annum under option 3 is a better choice than having available cash under option 1 next year to invest in new property or other ventures is a commercial decision for you to make.

Appendix

Table 1 – Comparison of options 1 and 2: Corporation Tax payable

	Sale proceeds £	Deductible costs £	Net profit £	Losses brought forward £	Taxable profit £	Corporation Tax at 17% £
Option 1 - develop and sell						
Development purchased	18,000,000	(14,547,500) Note 1	3,452,500	(1,000,000)	2,452,500	416,925
Shares purchased and development transferred	18,000,000	(10,700,000) Note 2	7,300,000	(1,000,000)	6,300,000	1,071,000
Option 2 - sell with no further development						
Development purchased	12,500,000	(9,847,500) Note 3	2, 652,500	(2, 652,500) Note 4	nil	nil
Shares purchased and development transferred	12,500,000	(6,000,000)	6,500,000	(3,000,000)	3,500,000	595,000

Notes:

1. Cost £9.3 million plus additional development costs £4.7 million plus SDLT £547,500

2. Cost £6 million plus additional development costs £4.7 million

3. Cost £9.3 million plus SDLT £547,500

4. From losses brought forward £3 million, leaving £255,000 to carry forward

Table 2 - Comparison of options 1 and 2: Net surpluses after tax

	Sale proceeds £	Costs £	Corporation Tax £	Net surplus £
Option 1 - develop and sell				
Development purchased	18,000,000	(14,547,500)	(416,925)	3,035,575
Shares purchased and development transferred	18,000,000	(14,016,500) Note 1	(1,071,000)	2,912,500
Option 2 - sell with no further development				
Development purchased	12,500,000	(9,847,500)	nil	2,652,500
Shares purchased and development transferred	12,500,000	(9,316,500) Note 2	(595,000)	2,588,500

Notes:

1. £3.3 million for shares plus repayment of net liabilities £6 million plus additional development costs £4.7 million plus SDLT £16,500

2. £3.3 million plus repayment of net liabilities £6 million for shares plus SDLT £16,500

Table 3: Option 3: Corporation Tax payable

Y/e 31 December	Rental £	Capital allowances (8% pa reducing balance) £	Net profit £	Losses relieved brought forward £	Taxable profits £	Corporation Tax at 17% £	Net surplus after tax £
2019	0 Note 1	(80,000)	(80,000)		Nil	Nil	0
2020	450,000 Note 2	(73,600)	376,400	(376,400)	Nil	Nil	450,000
2021	900,000	(67,712)	832,288	(832,288)	Nil	Nil	900,000
2022	900,000	(62,295)	837,705	(837,705)	Nil	Nil	900,000
2023	900,000	(57,311)	842,689	(33,607) Note 3	809,082	137,544	762,456
2024 and future years	900,000	(40,000) Note 4	860,000		860,000	146,200	753,800

Notes:

1. Assuming development takes 12 months.
2. Assuming the property is tenanted from 1 July 2020.
3. £2 million losses at outset plus £80,000 loss in 2019 accounting period, less losses utilised in 2020, 2021 and 2022.
4. Estimated capital allowances at 8% on average over future years.

ASSESSMENT NARRATIVE

Structure

A simple pass or fail will be awarded.

Identification and Application

The following are the relevant topics for assessment with their weightings:

1	20%	Purchase of development. Identify VAT and SDLT issues
2	25%	Purchase of company. Identify cost issues, ability to transfer asset, elections needed on appropriation, chargeable gains no gain/no loss transfer. Refer to lower cost base of development, indemnity and price negotiations. SDLT and VAT issues.
3	20%	Discuss property development - option 1 including which company to carry on activity.
4	10%	Discuss property dealing - option 2 including which company to carry on activity.
5	25%	Discuss development for rental - option 3 including which company to carry on activity.

A grade of 0,1,2,3, or 4 is awarded for each topic. The weighting is applied to that grade to produce a weighted average grade. This is then converted to a final absolute grade by rounding up or down to the nearest grade. Thus, scores in the range 2.5 to 3.49 will be a grade 3. In this example, the candidate will score a grade 3 overall and secure a pass for this skill.

Relevant Advice and Substantiated Recommendations

The following are the topics for assessment with their weightings:

25%	Advice and recommendation on whether to buy the development or company.
20%	Advice and recommendation on whether to use No 1 or No 2 if property dealing.
5%	Advice and recommendation to use Land Holdings Ltd if property dealing and advice on how to minimise risk of anti-avoidance.
20%	Advice and recommendation to use North or South if property business, and exercise option to tax for VAT.
30%	Overall advice and recommendations.

The final grade will be determined for this skill in the same way as for Identification and Application.