The Chartered Institute of Taxation

Application and Professional Skills

Taxation of Larger Companies and Groups

May 2024

Suggested answer

Report to the Board of Abertol plc

Project Rhine

Introduction

This report has been prepared for the Board of Abertol plc. It identifies the tax issues arising from Project Rhine and gives advice on how best to deal with these. Our advice and recommendations are included in the Executive Summary.

The report should not be relied on for any other purposes or by any other persons.

We have relied on information provided by Jack Henforth, Chief Financial Officer of Abertol plc, to Jacob Stanhope of Browne & Green LLP at a meeting between them on 23 April 2024. Mr Stanhope's notes of that meeting are separately provided as a record of the discussions. Please let us know if any of that information is incorrect or incomplete.

This report is based on our current understanding of the Corporate Tax regimes in the UK and Farland.

Before you implement our advice, we recommend that you take tax advice in Farland and that we are asked to advise on changes to UK tax legislation that could impact on our advice.

J Needler
Browne & Greene LLP
May 2024

Executive summary

The following issues are considered separately within the body of the report:

- Corporation Tax:
    - Tax relief on purchase price;
    - Tax status of Abertol Farland Ltd;
    - Potential new losses in Abertol Manufacturing Ltd; and
    - Availability and use of losses.

- Indirect Taxes
    - Stamp Duties; and
    - Value Added Tax.

The Abertol group may either buy the shares of e-Boxes Ltd or its assets.

Under either option, the Abertol group would inherit the same tax assets in respect of the balance of structures and building allowances (SBA) and remaining unrelieved capital expenditure on other tangible fixed assets.

Under an asset purchase, there would be £75 million of relievable intellectual property (IP) expenditure, compared to only £15 million on a share purchase. Furthermore, a potentially valuable capital gains base cost would be available on the land and buildings of £100 million, as against only £30 million on a share purchase.

Under a share purchase, the stamp duty liability would be £4 million less than under an asset purchase. Furthermore, £95 million of trading losses (including those estimated to 30 June 2024) are potentially available, whereas an asset purchase would not enable any of e-Boxes Ltd losses to be acquired. However, the trade restructuring proposals would almost certainly lead to the losses being disallowed. This could be avoided only by not changing the nature of the trade, which would be contrary to the rationale for the acquisition, and adversely affect profitability. Even if the losses did survive, they could only be used against e-Boxes trade's profits, for 5 years, and then their utilisation, along with all other group losses, would be limited to £5 million plus 50% of profits per annum.

The recent court decision in USA could realise a £60 million tax deduction, and create a relievable loss, in Abertol Manufacturing Ltd. We recommend that the company enters into an agreement (with Abertol USA

Inc) to bear the costs of the fine and the legal costs as expenses wholly and exclusively to defend and to preserve its trading reputation. Any such Abertol Manufacturing Ltd losses will survive for carry forward purposes under any of the proposed scenarios, subject to the £5 million/50% profits restriction.

The proposed acquisition of the e-Boxes Ltd IP by Abertol Farland Ltd appears to have no tax advantages because:

- there is no tax relief for IP in Farland;
- its transfer would be treated as a market value transaction between connected persons giving rise to a £60 million (£75 million less £15 million) taxable credit in the UK (in e-Boxes Ltd) if transferred after a share purchase;
- royalties paid to Abertol Farland Ltd for the use of the e-Boxes IP would give rise to a Controlled Foreign Companies (CFC) charge at a similar level to any tax deduction in the UK for the royalties;
- there is a significant risk that Abertol Farland Ltd would become UK tax resident, and all its profits liable to UK tax; and
- Diverted Profits Tax at 31% could be charged on the diverted profits.

We therefore recommend that the IP should not be acquired by, nor transferred to, Abertol Farland Ltd so that no royalties would be paid overseas for the use of that IP.

Given the uncertainty whether Boxes Ltd’s losses will survive the proposed restructuring, and notwithstanding the additional stamp duty costs, we recommend that the assets of e-Boxes Ltd are bought separately in the UK, and thus relief obtained for £75 million expenditure on the IP, over the periods of account that it is written off, a benefit of £18.75 million at current tax rates.

The trades of Abertol Manufacturing and of e-Boxes Ltd can be integrated (legally and operationally) in a single company or kept in separate companies and merged operationally.

CORPORATION TAX

Tax relief on purchase price

Asset purchase option

If the assets of e-Boxes Ltd were purchased for £200 million, £100 million would be for land and buildings, £75 million would be for the IP, and £25 million would be for the other net assets.

The purchase of the land and buildings for £100 million would not affect the continuity of any existing Structures and Buildings allowance (SBA) whereby relief at 3% per annum would continue to be available on the cost incurred on construct ion i.e., £750k relief per annum (£25 million at 3%) until fully relieved. A £100 million base cost in the asset would be deductible in computing any capital gain on a future disposal of the asset. Plant and machinery allowances would be available in respect of the price paid for other qualifying assets.

The £75 million spent on the IP would be capitalised on the balance sheet of the acquiring entity (Abertol Farland Ltd) and would be required, under Farland accounting standards, to be written off over its anticipated useful life. However, no tax relief is given under Farland tax law for expenditure on intangible fixed assets

If the acquiring entity were within the charge to UK tax, UK tax relief would be available for the expenditure:

a) as the expenditure is written off to the income statement, and ~~or~~
b) by election at fixed 4% per annum (i.e. fully relieved over 25 years).

The relief would be a deduction in computing the taxable profits of a trading company. A loss created by the deduction would be available to be relieved against other income of the company or as group relief, without restriction. If a loss were carried forward, it would be subject to restrictions (discussed below).

Claiming the relief as the IP is written off in the accounts enables the tax relief to reflect the commercial value of the asset rather than at the fixed 4% tax rate. If the IP is written off over a period that is less than 25 years, it would enable the tax relief to be obtained more quickly.

Share purchase option

The shares in e-Boxes Ltd would have a base cost of £200 million for Abertol plc. While that would be deductible in computing a chargeable gain on a future disposal of the shares, under current law any such gain would be exempt if the company were still trading at the time of disposal.

The subsequent transfer of the trade and non-IP assets of e-Boxes Ltd to Abertol Manufacturing Ltd would be a transfer between group members with no chargeable gains implications. Plant and machinery would transfer at its tax written down value (either under the connected party rules or succession rules – see below) and writing down allowances would continue to be claimed.

The land and buildings would continue to attract SBA at 3% per annum of the £25 million construction costs i.e., £750,000 relief per annum. The base cost of the land and buildings to Abertol Manufacturing Ltd would remain at £30 million, being the original cost to e-Boxes Ltd.

The current method of relief for the IP would continue as follows:

- The remaining tax written down value, £15 million, would qualify for tax relief as it is written off in future years.
- No further tax relief would be available for the additional amounts expended in recent years that have been charged to the income statement and have contributed to the unrelieved trading losses of £85 million at 31 December 2023. (The availability of the losses is considered below.)

Summary

Buying the assets of e-Boxes Ltd could enable £75 million of tax deductions to be claimed for expenditure on the IP over not more than 15 years, if it is retained in the UK, whereas a share acquisition attracts only £15 million of relief for IP.

Furthermore, by buying the assets, there would be a chargeable gains deductible base cost of £100 million in the land and buildings, compared to £30 million under a share acquisition. However, SBA at £750,000 per annum arises under either an asset or share purchase.

Tax status of Abertol Farland Ltd

Controlled Foreign Companies legislation.

A company is a controlled foreign company (CFC) if it is a non-UK resident company that is controlled by a UK resident person. Abertol Farland Ltd is controlled, through a 100% shareholding, by Abertol plc, and is therefore a CFC. This means that its chargeable profits are attributed to and chargeable to UK Corporation Tax on Abertol plc.

The “chargeable profits” are profits of a CFC that arise from assets it owns or risks it bears where the management functions in relation to those assets or risks are undertaken by UK connected persons, and those profits would not arise if those management functions were undertaken by third parties.

Abertol Farland Ltd owns the original IP that it developed before being acquired by Abertol plc. Profits arising from receipts of royalties for the use of that IP would arise if managed by a third party, so they do not represent chargeable profits which could be attributed to Abertol plc.

However, if the IP of e-Boxes Ltd were held by Abertol Farland Ltd, and royalties were received in respect of that IP, the profits on those royalties would be likely to fall within the definition of “chargeable profits” because they would not arise if the IP were managed by a third party.

Those chargeable profits would be attributed to Abertol plc and charged to UK tax. However, the deduction for royalties incurred in Abertol Manufacturing Ltd would be matched (subject to any allowable deductions in Abertol Farland Ltd which are likely to be modest) by taxable profits attributed to Abertol plc, thus leaving no material UK tax advantage overall. Thus, Abertol Farland Ltd’s proposed holding of the e-Boxes Ltd’s IP would, from a group perspective, be of no tax benefit.

Diverted profits tax (DPT).

Contrived arrangements to divert profits out of the scope of UK taxation are also at risk of being taxed at 31%. Should HMRC establish that DPT were payable by Abertol Manufacturing Ltd in respect of arrangements made between it and Abertol Farland Ltd for the use of the latter's IP, this would add to the disadvantage of these arrangements. However, this is only likely to be the case where the arrangements lack economic substance and result in a 'tax mismatch' between the two parties.

Taxable gain in e-Boxes Ltd under share purchase option

If e-Boxes Ltd sold its IP to Abertol Farland Ltd, the disposal would be at market value, at £75 million. This would realise an accounting profit of £60 million (£75 million less the £15 million current book value) that would be immediately taxable in e-Boxes Ltd as an intangible fixed asset credit. However, losses brought forward might be available to offset this, subject to restrictions discussed below.

Tax residence of Abertol Farland Ltd

Abertol Farland Ltd is currently considered to be tax resident in Farland. However, the proposal that Abertol plc would fund the acquisition of the intellectual property of e-Boxes Ltd by Abertol Farland Ltd by a further share subscription in the latter company could suggest that the company has become centrally managed and controlled in the UK. If so, the company would be UK tax resident.

If, under Farland tax law, Abertol Farland Ltd were also regarded as resident in Farland, the tax authorities in the two countries would negotiate, under the terms of the Double Tax Convention, and reach an agreement on the residence of the company. This would be by reference to various factors including the place of effective management and the place of incorporation. The tax authorities might also review the residence status of the company in prior periods.

If the company became UK tax resident, all its profits, including those arising on royalties received for its original IP as well as for the newly acquired e-Boxes IP, would be liable to UK Corporation Tax.

As a UK tax resident company, however, Abertol Farland Ltd would be entitled to tax relief on the acquired IP (see above) whereas if it were non-UK resident no relief would be so available under Farland tax law.

Potential new losses in Abertol Manufacturing Ltd

It is not clear whether Abertol Manufacturing Ltd is bound, under the terms of its contract with the US company for the supply of manufactured products, to bear costs arising on the sale of those products.

If it were, the costs related to the US court case (£60 million in total) are likely to be an allowable tax deduction in the UK as an expense wholly and exclusively incurred for the purposes of its trade, thus generating a tax loss of approximately £55 million in the year ended 31 December 2024. Although costs in respect of fines incurred for breaking the law are not allowable under UK tax law, the amount charged to and borne in the UK would not be a payment of the fine itself but would arise under a contractual indemnity and thus tax deductible. The associated legal costs would similarly be allowable. Contractual product remediation and recall costs would also be tax deductible.

If, however, there is no contractual obligation for Abertol Manufacturing Ltd to bear these costs, they would still be allowable if they were incurred wholly and exclusively for the purposes of the company's trade and are not of a capital nature. The wholly and exclusively test would be failed if the costs were borne for the purposes of Abertol USA Inc's trade. The capital test would be failed for costs incurred to create or alter the profit-earning capacity of Abertol Manufacturing Ltd.

The costs would most likely be allowable if they were incurred to preserve and maintain Abertol Manufacturing Ltd's reputation as a manufacturer. A legal agreement between Abertol USA Inc and Abertol Manufacturing Ltd stating that this is the reason for the recharge of the costs would be helpful, although not a guarantee that a UK tax deduction would be available.

If there were a UK tax loss of £55 million, £10 million could be carried back to relieve the Corporation Tax profits of Abertol Manufacturing Ltd for the year ended 31 December 2023. The remaining £45 million would then be available to carry forward by Abertol Manufacturing Ltd (as explained below).

Availability and use of losses

Asset purchase option

Upon the disposal of its assets, e-Boxes Ltd would be regarded as having ceased to trade, and the acquiring company would be treated either as commencing a new trade or expanding its existing trade. The brought forward losses of e-Boxes Ltd would not be available to the acquiring company as there is no provision under which the losses can be transferred.

The losses of Abertol Manufacturing Ltd (arising in the year ended 31 December 2024) as a result of the contractual indemnity payment (described above) may be carried forward against profits of is expanded trade subject to the £5 million / 50% restriction referred to below.

Share purchase option

After the acquisition of all the shares of e-Boxes Ltd by the Abertol group, e-Boxes Ltd would continue its trade until it is transferred to Abertol Manufacturing Ltd. Therefore, its trading losses (after relief for the gain arising on the transfer of the IP to Abertol Farland Ltd) would be preserved. Furthermore, these losses would be preserved upon the subsequent transfer of that trade to Abertol Manufacturing Ltd since this would be an intra-group transfer between connected persons under the succession rules.

Upon the transfer of its non-IP assets and trade, e-Boxes Ltd would cease trading and its trade would then be carried on by the successor company, Abertol Manufacturing Ltd. It is likely that Abertol Manufacturing Ltd would be regarded as continuing its original trade, expanded by the addition of the e-Boxes trade. Subject to loss restrictions (discussed below), the losses incurred by Abertol Manufacturing Ltd before the transfer and the losses of both trades incurred after the transfer would be available to carry forward against future profits of the merged trade. However, losses incurred by e Boxes Ltd prior to transfer are streamed and set against future profits of the trade formerly carried on by e-Boxes Ltd (subject to the loss restriction rules below).

The two trades, once merged into Abertol Manufacturing Ltd, might be considered to lose their identities and a completely new trade would begin to be carried on. The carry forward of losses of both predecessor trades would then be denied. However, as both trading activities would continue, it is unlikely that this will be the case so that the carry forward losses would be lost.

Loss restrictions:

Following its transfer to Abertol Manufacturing Ltd, it is proposed that the e-Boxes trade will start selling to the existing retail companies within the Abertol group. A change in the customers, outlets or markets of the trade constitutes a major alteration in the nature or conduct of the trade. Such a change, when accompanied by a change in ownership of a company (e-Boxes Ltd in this case) causes the carry forward of unrelieved trading losses to be denied. The “major alteration” test is one of fact and degree and HMRC’s view will be influenced by the extent to which the client base of the e-Boxes trade changes, and by other alterations in the trade. If the IP were separated out of the trade, that would further suggest that there has been a major alteration. The denial of the losses from the major alteration of the e-Boxes trade would occur whether or not the trade is transferred to Abertol Manufacturing Ltd.

Any brought forward loss in Abertol Manufacturing Ltd would not be affected by the major alteration test even though it will also begin selling to new customers because there will not also be a change of ownership of that company.

If the major alteration test is not triggered, e-Boxes Ltd’s brought forward losses arising before the change of ownership are not blocked in their entirely but cannot be relieved against other taxable profits or gains within the company or group relieved for a period of five years after the end of the accounting period when e-Boxes Ltd is acquired. They can be relieved during that time only against future trading profits of the e-Boxes Ltd trade. Should that trade be transferred to Abertol Manufacturing Ltd, it would be necessary to measure separately profits arising in the two original trades, so that brought forward losses of the e-Boxes Ltd trade are relieved only against the profits of the e-Boxes trade.

Any losses brought forward that are not restricted as described above are then subject to a maximum offset of brought forward losses in any year within a group of £5 million plus 50% of profits above £5 million .

In summary, the losses of e-Boxes Ltd can only be preserved under a share acquisition. Should the trade then be transferred to Abertol Manufacturing Ltd, that company will succeed to that trade and to its trading losses. Abertol Manufacturing Ltd is likely to be regarded as then carrying on a single merged trade, and both its losses and those of e-Boxes Ltd should be available to carry forward (as described above).

However, the carry forward losses of e-Boxes Ltd would be denied if there is a major alteration of the trade following a change of ownership. Even if that were not the case, those losses could only be relieved against the profits of the original trade, measured by streaming if the trade is transferred to Abertol Manufacturing Ltd, for five-years after the accounting period in which the acquisition is made.

All losses carried forward that have not been restricted are subject to the £5 million / 50% restriction referred to above.

INDIRECT TAXES

Stamp Duties

A purchase of e-Boxes Ltd shares for £200 million would incur a Stamp Duty liability for the acquiring company of ½% of the purchase price, i.e., £1 million.

Alternatively, on an asset purchase, Stamp Duty Land Tax (SDLT) will arise in respect of the acquisition of the land and buildings only, as follows:

Amount of consideration	**Rate**	**SDLT payable** **£**
First £150,000	0%	0
Next £100,000	2%	2,000
Remaining £99.75 million	5%	4,987,500
Total		**4,989,500**

Therefore, an asset purchase incurs stamp duties that are almost £4 million higher than on a share purchase.

Value Added Tax (VAT)

A purchase of shares is outside the scope of VAT, so no VAT would be payable.

On an asset purchase, the purchase of the whole business would be a transfer of a going concern (TOGC), which again is outside the scope of VAT, provided the acquiring company carries on the same kind of business as that previously undertaken by e-Boxes Ltd. A check should be made as to whether an option to tax has been exercised over the property in which case the group will also need to opt to tax it to satisfy the TOGC conditions. A check should also be made as to whether any assets fall within the Capital Goods Scheme though this is unlikely to create issues given the fully taxable status of the parties.

However, if the intellectual property were purchased separately by Abertol Farland Ltd, the purchase of the other assets is unlikely to be a TOGC, and as Abertol Farland Ltd is not established or have a fixed establishment in the UK it is not eligible to be a member of the Abertol VAT group. Consequently, VAT at 20% of the purchase price allocated to the other taxable assets would have to be paid. These would consist of the tangible assets, including possibly the building if the vendor has opted to tax it. As the Abertol VAT group is wholly taxable, the VAT would be wholly recoverable, with no net cost to the group.

A purchase of the intellectual property by Abertol Farland Ltd would also not attract any VAT liability, as it would be outside the scope of UK VAT, the supply being one of services and place of supply being in Farland. Therefore, there are no VAT cost consequences of either method of acquisition.