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Application and Professional Skills

Taxation of Larger Companies and Groups

SUGGESTED SOLUTION

Draft report to Chief Financial Officer of Big Brands Europe plc

New Business Proposal

Introduction

This report is written for use by Big Brands Europe plc only and should not be relied on by any other party.

It is based on information provided in Jill Jones's letter of 1 May 2020, together with our understanding of the tax history of the group. Before acting upon the advice in this report, you should obtain further advice in respect of the non-corporate income tax position in Middleland and Commercia and confirmation that the corporate income tax position is as stated.

As you are seeking separate advice on local taxes in Middleland and Commercia we have not compared employment taxes, VAT (sales taxes) or customs duties in the territories.

Executive Summary

1. To enable us to advise and make recommendations on the three areas requested we have identified five tax issues:
   a) Relief for external interest will be restricted under Corporate Interest Restriction (CIR) rules if an equity investment is made in the new company ('TradeCo'). Loans to Middleland or Commercia TradeCos would obtain interest relief more quickly than a loan to a UK TradeCo. Relief for interest paid to Big Brands Europe plc will also be restricted if a loan is made to a UK TradeCo.
   b) Start-up losses are relievable in the UK by either trading in the UK or using a UK TradeCo operating an overseas permanent establishment (PE).
   c) The most Corporate Tax (CT) would be payable by UK TradeCo, with the least payable by a Commercia TradeCo.
   d) Transactions between the UK and overseas should be measured at arm's length. There is little risk of any tax liability under the Controlled Foreign Companies (CFC) legislation in respect of overseas entities.
   e) There would be a modest cost in repatriating profits from a Middleland TradeCo, with potentially higher costs from a Commercia TradeCo.

2. A debt (rather than equity) investment into TradeCo is recommended.

3. Subject to overseas advice to ensure start-up losses are protected, we recommend that trading starts in Commercia through a PE of a UK tax resident company (subject to profit repatriation issues - see below) that is later incorporated into a Commercia tax-resident entity at the start of year 2.

4. If profit repatriation after year 8 is not important, Commercia is the ideal location for TradeCo, with low rates of tax and maximum tax reliefs. If profit repatriation in the longer-term is an issue, Middleland should be considered as an alternative.

Overview

The three questions posed are connected and dependent on one another. To answer them, it is first necessary to consider a number of related issues that apply to each of those questions. A balanced consideration of those issues leads to an optimum solution which addresses the three questions.

Issues to be addressed

Debt, equity and interest

Big Brands Europe plc ('BBE') will borrow £50 million to fund investment in the trading company (TradeCo) either as a loan or as equity.

Loan

If the investment is made by way of loan, TradeCo should pay a market rate of interest on that loan or have one imposed for tax purposes under transfer pricing legislation in the UK (see below). TradeCo will then bear an interest expense and BBE will have an interest receipt on the internal loan and will bear the interest expense on the external loan. The treatment of the interest receipts and expenses depends on the tax-residence of TradeCo.

If it is UK tax-resident, it will be subject to the CIR regime. As the group is already subject to an interest restriction, the addition of more debt and interest expense will cause the additional interest to be restricted each year until substantial additional profits are made. Accordingly, that interest will not be tax-relieved immediately, but deferred and relieved only when there is sufficient future capacity.

If TradeCo is non-UK tax-resident, the interest expense in BBE is matched by interest receivable at least equal to that expense, so there is no increase in the net interest expense of the UK group and no interest restriction on that interest. Instead the deductibility of the interest expense in the non-UK tax-resident company needs to be considered within the rules of the overseas territory. If TradeCo were either Middleland or Commercia tax-resident, interest up to 30% of accounting profits would be relievable in any year, with surpluses carried forward.

Equity

If the investment is made into TradeCo by way of equity, there will be no payment of interest by TradeCo and no interest receivable by BBE, with the only interest expense being that payable on the external borrowings by BBE. That interest would be subject to carry forward under the UK CIR rules, as referred to above.

Legal form of the trading entity: Use of start-up losses

If TradeCo were UK tax-resident, its tax losses could be group relieved in the year they are incurred against profits of other UK companies, saving tax at the prevailing rate of Corporation Tax, currently 19%.

If trading losses are realised in a Middleland or Commercia TradeCo, they cannot be group relieved in the UK. Instead they are carried forward and relieved against future profits of TradeCo, subject to local tax restrictions. Trading losses can only be carried forward for three years in Commercia. Those losses would be relieved at 15% (rate of tax on profits) in Middleland and 10% in Commercia, compared to 19% in the UK.

It is possible to trade overseas through a PE of a UK tax-resident company, so that start-up losses, computed under the UK tax rules, can be group relieved in the UK. Once the business becomes profitable, the PE can be incorporated into a company that is tax-resident in the overseas territory, which would then tax the profits under its regime, and might also give relief for previously incurred losses, thus effectively getting relief for the losses twice. The incorporation of the PE can generally be undertaken without incurring exit tax charges in respect of capital assets and intangibles in the UK. However, as Middleland requires local businesses to operate through locally incorporated companies, this option would not be available there.

Corporate Tax payable

Table 1 in the Appendix shows the estimated annual tax profits/losses in each country on the basis that the interest deduction is taken in that country by virtue of TradeCo being funded by loan finance. For Middleland and Commercia, this gives relief more quickly than equity investment, whereas in the UK interest relief is wholly deferred.

The proposed capital expenditure, if incurred by a UK TradeCo, will attract allowances as follows:

a) Building (excluding cost of land) - 2% per annum fixed rate over a 50-year period;
b) Plant and machinery - 18% per annum on a writing-down basis (assuming the 100% annual investment allowance has been used elsewhere by the group).

Both Middleland and Commercia give faster rates of relief on buildings and on plant and machinery (being 10 years and 4 years respectively), and additionally, Commercia gives 10% per annum relief per annum for 10 years on the cost of land.

Therefore, in the early years, taxable profits in Middleland and Commercia would be lower than in the UK because of higher reliefs on the building and on plant and machinery, although those differences would reverse in later years as the expenditure would be relieved in the UK over a longer period. The relief given in Commercia on the cost of land is an absolute difference that will permanently reduce taxable profits in Commercia compared to either the UK or Middleland, subject to how any profit or gain might be taxed on any future sale of the land.

International tax issues - Transfer Pricing and Controlled Foreign Companies ('CFCs')

Under UK transfer pricing rules, transactions between large companies (such as those of the BBE Group) under common control (within the UK or otherwise) are recognised for tax purposes as if the two companies are acting at arm's length, i.e. at market value. If the transactions are not so conducted, market value is substituted.

If two companies are both UK tax-resident and their profits/losses are fully taxed or relievable within the current year, the overall effect of any transfer pricing adjustment between them is neutral.

However, if TradeCo is not UK tax-resident, transfer pricing adjustments can result in additional taxable profits arising in the UK, although corresponding adjustments in the other territory can sometimes be claimed. UK transfer pricing legislation can apply to transactions such as:

- Goods;
- Management services provided from the UK;
- Interest charged on any inter-company loan (both the rate and the amount of loan);
- Royalties paid to UK.

You should keep documentation to demonstrate that arm's length prices are charged in all these areas.

Under UK tax law, the profits of CFCs can be subject to UK Corporation Tax. A wholly-owned company tax resident in either Middleland or Commercia would be a CFC. However, CFC legislation only applies where the tax payable in the overseas territory is less than 75% of the UK corresponding tax. Similar rules apply to foreign PEs of UK companies.

The legislation can also only apply if the overseas activity has been set up for tax avoidance motives and the assets or risks of the CFC/PE are managed by connected UK parties. While the 'tax avoidance' test might be triggered if you decide to operate in Commercia due to its low tax rate, it should be possible to run the business there on commercially independent lines so that this test is not satisfied. In those circumstances, a Commercia company should not be caught by the CFC legislation.

Profit repatriation

Profits earned by the new business (if established abroad) might need to be brought into the UK to fund dividends payable by BBE, to repay its external borrowings or to undertake further investments by it in the UK or elsewhere.

Profits can be transferred in several ways:

a) Repaying debt insofar as the investment into TradeCo is by way of debt.
b) Paying interest on loans. That interest may or may not be deductible in computing taxable profits (see above), and will be taxable in the receiving company.
c) Paying royalties for the use of intellectual property (for example, a brand name or some patented industrial process). Royalties will generally be deductible in computing profits in the paying company, subject to local transfer pricing considerations, and will be taxable in the UK.
d) Dividends can be paid, normally only out of accumulated profits, after start-up losses have been eliminated by subsequent profits. Dividends are not deductible in computing profits of the paying company, and dividends received are not liable to UK CT, except where there is a tax avoidance motive.

There are no withholding taxes on any of these payments between UK tax-resident companies, nor are they generally levied on debt repayments from overseas although you should confirm this from your Middleland and Commercia advisers.

Both Middleland (within the terms of Middleland/UK Double Tax Treaty) and Commercia (under its domestic law) charge withholding taxes. They are creditable against CT chargeable on the amounts receivable in the UK. Therefore, insofar as the withholding tax is not greater than the UK CT payable on those amounts, it is fully recovered (although there is a timing delay if the withholding tax is paid before it is relieved against UK CT). However, if the withholding tax is more than the CT on the amount receivable, the excess cannot be relieved against UK CT on other income and is therefore an expense of the transaction.

Middleland withholds tax at 10% on interest and 5% on dividends. Royalties attract no withholding taxes. As interest would be subject to UK CT at 19%, the withholding tax would be fully recovered. However, as dividends are not taxable in the UK, the 5% withholding would become an actual cost.

Commercia withholds tax at 20% on all payments of interest, royalties and dividends. As the UK rate of CT on interest and royalties is 19%, and nil on dividends, 1% of the withholding taxes on interest and royalties, and 20% on dividends, would not be relievable in the UK and would become actual costs.

In summary:

a) there are no tax costs in transferring profits between UK companies;

b) there are unlikely to be tax costs in repaying debt between TradeCo and BBE;
c) the only cost of transferring profits from Middleland to the UK would be in respect of dividends, at 5% (subject to timing costs on withholding taxes/ later CT relief); and
d) in respect of Commercia, there would be additional costs in paying interest (1%), royalties (1%) and dividends (20%).

Advice and recommendations

You have asked for advice in three areas:

1. <u>Should the initial investment be by way of equity or loan?</u>

The group is incurring an additional interest expense on its new external borrowings.

As indicated under Issue 1 above, if the investment is made into TradeCo by way of equity, the question of whether that interest is tax relievable falls within UK rules. Because the group is currently subject to the CIR rules, any additional interest will also be restricted until the overall profitability of the group improves significantly. At current levels of profitability, depreciation and interest, the maximum interest deduction is £48 million. Adding £2.5 million to the current interest cost of £60 million will require pre-depreciation profits to rise to £208 million (£62.5 million interest / 0.3 being the maximum rate of deduction) i.e. by £48 million over current levels. Until group profits increase to that level, full relief for the additional interest will not be available in the UK.

Alternatively, if the investment into TradeCo is made by way of loan, the interest deduction falls within the tax rules of the country in which it is tax-resident. A UK TradeCo would be subject to CIR rules as described above. However, relief would be available in a Middleland or Commercia TradeCo from the start at 30% of accounting profits. As Table 1 shows, by Year 4, all but £2.5 million of interest will have been relieved. If future profits are at least £15 million per annum, that surplus will have been relieved by Year 6.

In summary, a loan investment into a Middleland or Commercia TradeCo will relieve the interest more quickly than in the UK, albeit at lower rates of tax. However, future rates and regimes cannot be predicted accurately, so it seems sensible to take the relief as quickly as possible under the current regimes.

Therefore, we recommend a loan investment into either Middleland or Commercia, subject to other factors discussed below.

2. <u>What legal form should TradeCo take?</u>

As discussed above, a UK TradeCo will be exposed to UK CT. In consequence, start-up losses will be group-relieved, but interest relief will be deferred and capital expenditure relieved more slowly than elsewhere.

On the other hand, losses of a Middleland or Commercia TradeCo cannot be group relieved in the UK and, in Commercia, are eliminated if not used within three years of their being realised.

If you operate in Commercia, you should consider beginning operations through a UK TradeCo operating a PE in Commercia. As a UK tax-resident company, TradeCo's start-up losses amounting to £4.9 million (see Table 1) could be group relieved immediately, effecting a saving of £931,000 of UK CT. Once UK taxable profits arise (beginning of Year 2), you could incorporate the business into a Commercia tax-resident company without incurring UK tax charges on assets leaving the UK company (though deferred gains become realised if the company is later sold). The Commercia company's profits would then be subject to Commercia's low rate of CT and would not fall within the UK jurisdiction.

You would need to check that start-up losses, computed under Commercia tax laws, would be recognised in Commercia.

As PE trading is not permitted in Middleland, you would need to trade through a Middleland TradeCo from the outset of operating in that country.

3. <u>In which country should the business be carried on?</u>

The following factors should be considered in respect of each country:

- Amounts of tax payable
- How much tax relief is given and when?
- Ability to repatriate profits to UK

Taking the first two points together, it is clear from Table 1 that, based on current projections, you will pay the highest amounts of tax in the first four years if the business is carried on in the UK, where taxable profits (net of Year 1 loss relief) are about £24 million compared to £2.5 million in Middleland and nil in Commercia, although relief for deferred interest and capital allowance will be higher in the UK in later years. It should be noted that Commercia also gives relief for the cost of land, £14 million, that is not available in the UK or Middleland. Our projections suggest that losses of £1.3 million will be lost in Commercia under its 3-year carry forward restriction, thus reducing the overall advantage to about £12.7 million.

Once the business is profitable and all brought forward reliefs have been utilised, the rate of tax payable in Commercia at 10% will be lower than in either Middleland (15%) or the UK (19%).

In deciding between Middleland and Commercia, consideration should be given to the third point above. Middleland's OECD-model Double Tax Agreement with the UK will facilitate the repatriation of profits to the UK, whereby the only tax cost on payments to the UK would be withholding tax of 5% in respect of dividends. In contrast, withholding taxes in Commercia would generate tax costs of 1% on interest and royalties (net of UK tax at 19%) and 20% on dividends, thus making Commercia relatively less attractive than Middleland.

However, it should be possible to repatriate profits to the UK by way of loan repayments insofar as the initial investment has been made by way of a loan into the overseas TradeCo. The first £50 million of distributable after-tax profits could be returned to the UK, free of withholding taxes. Distributable profits up to and including Year 4 are £10 million (£20 million profits less £2.5 million x 4 of interest) and future after-tax profits will be about £10 or £11 million per annum (assuming profitability of £15 million in Year 4 is maintained, less £2.5 million interest, less Corporate Tax at 10% or15%) . Therefore, accumulated profits including Year 8 might be about £50 million. All of this could be used to repay debt before profits would need to be returned as dividends.

In conclusion, the flexible employment laws and low tax rates of CT suggest that the favoured location would be Commercia, subject to consideration of whether and when it would be desired to repatriate profits (rather than loan repayments) to the UK. If that is an important issue, Middleland should be considered instead.

Appendix

Table 1

	UK £'000s	**Middleland** £'000s	**Commercia** £'000s
Year 1			
Accounting profits	(5,000)	(5,000)	(5,000)
Add depreciation	4,000	4,000	4,000
Deduct interest relief	0	[Note 1] 0	[Note 1] 0
Deduct allowances on factory/land	(300)	(1,500)	[Note 2] (2,900)
Deduct allowances on P&M	(3,600)	(5,000)	(5,000)
Profit/(loss)	[Note 3] **(4,900)**	**(7,500)**	**(8,900)**
Tax payable	**0**	**0**	**0**
(loss c/f)	***0***	***(7,500)***	***(8,900)***
Year 2			
Accounting profits	3,000	3,000	3,000
Add depreciation	4,000	4,000	4,000
Deduct interest relief	0	[Note 1] (900)	[Note 1] (900)
Deduct allowances on factory/land	(300)	(1,500)	[Note 2] (2,900)
Deduct allowances on P&M	(2,952)	(5,000)	(5,000)
Profit/(loss)	**3,748**	**(400)**	**(1,800)**
(loss b/f)	***0***	***(7,500)***	***(8,900)***
Taxable	**3,748**	**0**	**0**
Tax payable	**712**	**0**	**0**
(loss c/f)	***0***	***(7,900)***	***(10,700)***
Year 3			
Accounting profits	7,000	7,000	7,000
Add depreciation	4,000	4,000	4,000
Deduct interest relief	0	[Note 1] (2,100)	[Note 1] (2,100)
Deduct allowances on factory/land	(300)	(1,500)	[Note 2] (2,900)
Deduct allowances on P&M	(2,420)	(5,000)	(5,000)
Profit/(loss)	**8,280**	**2,400**	**1,000**
(loss b/f)	***0***	***(2,400)***	***(1,000)***
Taxable	**8,280**	**0**	**0**
Tax payable	**1,573**	**0**	**0**
(loss c/f)	***0***	***(5,500)***	***(9,700)***

Year 4			
Accounting profits	15,000	15,000	15,000
Add depreciation	4,000	4,000	4,000
Deduct interest relief	0	[Note 1] (4,500)	[Note 1] (4,500)
Deduct allowances on factory/land	(300)	(1,500)	(2,900)
Deduct allowances on P&M	(1,985)	(5,000)	(5,000)
Profit/(loss)	**16,715**	**8,000**	**6,600**
(loss b/f)	***0***	***(5,500)***	***(6,600)***
Taxable	**16,715**	**2,500**	**0**
Tax payable	**3.176**	**375**	**0**
(loss c/f)	***0***	***0***	[Note 4] ***(1,800)***
Future relief:			
Unused interest	**10,000**	**2,500**	**2,500**
Factory/land	**13,800**	**9,000**	**17,400**
P&M	**9,043**	**0**	**0**
Losses	**0**	**0**	**1,800**

Note 1

Annual interest on £50 million at 5% = £2,500,000. Relief restricted to 30% of accounting profits in Middleland and Commercia.

Year 1 - profits £nil; interest relief nil; carry forward £2.5 million

Year 2 - profits £3 million at 30% = £0.9 million. Carry forward £2.5 million b/f + £2.5 million - £0.9 million = £4.1 million

Year 3 - profits £7 million at 30% = £2.1 million. Carry forward £4.1 million b/f + £2.5 million - £2.1 million = £4.5 million

Year 4 - profits £15 million at 30% = £4.5 million. Carry forward £4.5 million b/f + £2.5 million - £4.5 million = £2.5 million

Note 2

10% of cost of land plus factory.

Note 3

All group-relieved, no carry forward.

Note 4

Year 1 losses £8.9 million less utilised years 3 and 4, £7.6 million = £ 1.3 million, not available to carry forward beyond Year 4. Therefore losses to carry forward are £1.8 million.