Institution **CIOT - CTA**
Course **APS VAT and Other Indirect Tax**

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Count(s)	Word(s)	Char(s)	Char(s) (WS)
Section 1	**3222**	**15551**	**18908**
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Answer-to-Question-_1_

Draft Report for Board of Coua Ltd:
RE: Disposal of Eggton Ltd and Proposals for Reinvestment of Proceeds

1 Scope of The Report:

1.1 This report will underline the tax implications of the share sale of Eggton Ltd. The report will also review the two potential options for reinvestment of the proceeds from the share sale.

Option 1 - Norrisco Ltd
Option 2 - Unumiota Ltd

1.2 This report is based on the information which has been provided to BFR Tax LLP. Please note, the contents of this report are to be viewed by the Board of Coua Ltd only, any disclosures to third parties should not be done without our prior consent.

1.3 The report will be broken into three main sections:

1 - Disposal of Eggton Ltd
2 - Analysis of Option 1 (Norrisco Ltd)
3 - Analysis of Option 2 (Unumiota Ltd)
4 - Proposed losses

2 Executive Summary:

2.1 Based on all of the information i was provided with and my summaries below, it is my recommendation that you proceed with Option 1 for the reinvestment of proceeds from the sale of Eggton Ltd. Although Option 2 has an overall greater earning potential, with projected sales being over £700million in comparison to £213million, i have estimated that option 1 will provide a return on investment at 77.39% (see 4.18) compared to 26.02% (see 5.5) for option 2. Option 1, also has significantly lower proposed outlay.

2.2 The main reason for the increased return % is based on the variety of reliefs that are available regarding Option 1. You can claim Structured Buildings Alloances (see 4.4), Capital Allowances (see 4.7) and Research and Development relief (see 4.9). All of these allowances reduce the outlay cost of the Option by £22,770,000(see Appendix D).

2.3 Option 1 also has the added security of being in a trade which you are comftable in and have experience in. Although it appears that the market for Option 2 is a better one, this is an unknown market. Both options will no doubt incur challenges in the future and i believe your experience in the same markets means that it makes Option 1 a more attractive proposition. Option 2 also has a much higher proposed outlay, i believe this increases its risk in comparison to option 1.

2.4 The fact that Option 1 also maintains the group structure is also another positive. Again, Coua has built great success on this structure and i believe mirroring it going forward can result in great security and continuity. The group structure also gives the added incentive of Group Reliefs. Such as loss relief (see 6.2) which means Coua can utilise the proposed losses in years 1, 2 and 3 in Option 1, to reduce their Corporation Tax liability. Option 2, did not offer this (see 6.3).

2.5 Option 1 does not come without challenges, as stated in the report seen by myself, the market has experienced less than expected growth in the last 12 months. However, the anticipation is that this growth will begin to increase as the demand for electrical cars increases and the phasing out of traditional car batteries.

2.6 Option 1 will require a registration with the Customs Declaration Service and HMRC for accounting for duties which will be associated with the imports from Sayonara (see 4.15). I have given an estimate of what potential duty costs may be incurred (4.16) but could give a more robust calculation if more details are provided. I recommend appointing a customs agent to assist with the importing (see 4.15).

2.7 I have also been able to review tax implications surrounding the proposed sales of Eggton (see 3). The majority of the costs associated with the sale can be reclaimed in terms of VAT, except cost 2 (see 3.1).

2.8 Positively, the share sale of Eggton would appear to qualify for the substantial shareholding exemption, which would make the share sale exempt, resulting in huge tax savings and the proposed sale price of £35 million being classed as exempt. (see 3.9). The net proceeds of the sale will be £34,115,000 (see 3.11).

2.9 Finally, please do let me know if you receive any additional relevant information, or if there are any points you would like further clarity on.

<u>3 Disposal of Eggton Ltd:</u>

3.1 Regarding the disposal of Eggton Ltd, i will discuss the bills which are due to be paid and the Corporation Tax treatment of the overall share sale.

Bills:

3.2 The bills associated with the share sale, have been broken down into four main areas.

3.3 Coua are a fully taxable entity and therefore, generally can fully recover 20% associated VAT costs.

3.4 1) Commission to Melanie Honeyford, this is a standard business to business UK service, and all of the VAT will be fully recoverable. Therefore, the cost of this will work out at the advised, £350,000.
2) Although this is another commission payment. I believe the VAT treatment of this may be different. As this is for an investment fund based in Hong Kong, i believe the service received will be subject to reverse charge procedures, as it is B2B outside the UK. Which will mean Coua, will need to account for the cost of the associated VAT. This will bring this cost to £175,000 plus VAT @ 20% totalling = £210,000
3) The legal fees will be fully recoverable, this will have a net cost of £200,000.
4) Accountancy fees will also again, be fully recoverable, leaving a net cost of £125,000.

3.5 These bills, will end up with a net cost to Coua of £885,000 based on the above. This is a slight increase of £35,000 from the initial projections provided.

3.6 Base Cost of Shares:

3.7 Normally, when you dispose of assets or shares, this can result in a gain. Gains are then taxed accordinglly.
3.8 This would normally be a significant outlay for the group, based on the £35million share sale. However, i conclude that the share sale, can benefit from the substantial

shareholding exemption. This would allow 100% relief on what would have been the corporation tax payable on the proceeds (estimated @ £8,750,000, i.e. 25% of the proceeds).

3.9 Eggton meet the conditions to qualify for the exemption in that they are disposing of a substantial shareholding amount (the requirement is for disposals of 10%+) and Coua have also held the shares in Eggton for the required timeframe (the shares have been held for nearly 20 years). The shares need to be in a qualifying trading co, again this appears to be met through Eggton's operations.

Therefore, i am pleased to inform you, that the entire £35,000,000 share sale will qualify for the 100% exemption, meaning that there will be no Corporation Tax payable. I trust you will be delighted with this.

3.10 Normally, where there is a group selling shares of one of their companies, there are potential for a de-grouping charges. This will be if Eggton or Coua have transferred any assets between themselves for no gain no loss within the last 3 years. However, any de-grouping charges which do arise can be added to the proceeds and also qualify for the substantial shareholding exemption.

<u>Net Proceeds:</u>

3.11 The net proceeds from the sale will therefore be:

£35,000,000 less £885,000 = £34,115,000.

<u>4 Analysis of Option 1 (Norrisco Ltd):</u>

4.1 Firstly, the vendor has opted to tax the land. This means, that the £8,000,000 price for the land, does not include VAT which will be an additional cost of £1,600,000. One option that you have, you could discuss with the vendor whether they would be willing to revoke the option to tax, prior to the sale. This would mean that the additional £1,600,000 would not be chargeable. Options to Tax are useful if you plan to rent out part of the building in the future, this would mean that a normally exempt output, such as rental income, could be charged with VAT and therefore associated costs would be recoverable. However, as the building is to be used entirely by Norrisco and there are no indications of it being rented out, i would advise on contacting the vendor to determine whether the OTT could be revoked prior to sale.

4.2 The costs for Option 1, can be broken down into 3 areas.
- Construction
- R&D expenditure
- Overall costings

<u>Construction Costs:</u>

4.3 Regarding the construction, the associated VAT costs will all be recoverable as Norrisco are part of a fully taxable VAT group. None of the costs of construction unfortunately are eligible for any of the reduced or zero-rate exemptions. This means, the VAT will be payable, however it will be recoverable.
There will be some reliefs available which will be able to redcue the overall cost of Option 1.
4.4 Firslty, regarding the construction costs of £23,000,000. Part or potentially all of these will qualify for structured buildings allowances (SBAs). These amount to a 3% saving per year on qualfying construction costs. Land costs are sepcifically excluded from SBAs and do not qualify. Without a breakdown of the full costs, i am unable to

determine the exact figure, but general construction costs are included so i will proceed on the basis that 100% of the £23,000,000 will be elibigle for SBAs.
4.5 The SBAs result in a relief of £3,450,000 over 5 years (full calculation found in **Appendix A**).

4.6 Regarding the equipment fit-out, i believe you will be able to claim Capital Allowances relief for some of these cost. Again, without a full breakdown of costs, i cannot fully determine the capital allowances, however, i will provide an estimate.
4.7 Capital Allowances give relief on expediture on capital items, for Norrisco, this will mainly concern new plant and machinery. A new factory and R&D department will no doubt be equipped with a high amount of new plant and machinery. Every incorporated company is entitled to an Annual Investment Allowance of £1,000,000 which will give relief to qualifying investments, and also once this has been used up, new plant and machinery will qualify for 100% first-year allowances. If we assume that the equipment fit out, is 75% qualifying new plant and machinary. This will result in an initial capital allowance relief of £10,500,000 (a breakdown can be found in **Appendix B**).

4.8 Overall, with the above reliefs, the construction costs will reduce from £45,500,000 to £31,550,000.

<u>4.9 Research and Development:</u>
Businesses can qualify for a relief based on their research and development expenditure. As Norrisco will be undertaking R&D on 'new and unproven' technology, they will qualify for R&D relief. R&D relief reduces your corporation tax liability through a 20% refund of qualifying expenditure.
This relief is available on costs fully associated with the R&D expenditure and includes employee costs (salarys and NICs), as well as costs on consumables and utilities.
4.10 The R&D has been expensed at £28,000,000 over 5 years, once you have claimed

the credit, this will result in a relief of £5,600,000 over the 5 years.
Buildings which are used for R&D also qualify for 100% capital repayments. As, this building will be partly used for R&D, i will give an apportioned estimate about how much of the construction cost will qualify as a capital allowance repayment.
4.11 I estimate that the building will be used for 14% R&D purposes. See **Appendix C.** This would mean that an additional 14% of the construction costs for the new factory and R&D centre, can also be reclaimed as a capital repayment. This would amount to £3,220,000 (14% of the total construction costs).

4.12 Based on all of the above, the projected net cash return on investment of £15,475,000 would actually be increased by £19,872,000 to a total of £35,347,000 (**Appendix D).** This would increase the projected return on investment compared to initial investment from 34.01% to 77.68% over five years.

4.13 The above has obviously been extremely positive in terms of Option 1 and the increased net return on investment; however, there are some additional points to raise.

4.14 The project has been described as a 'gamble', with the proposed new market having disappointing growth over the last year. This needs to be considered because there is a hugely significant outlay being proposed, and this is not an amount of money you can afford to gamble with. Although, the suggestion is that the market is predicted to grow as combustion engines are phased out.

4.15 Finally, with the equipment being specially sourced from Sayonara, you will be subject top import duties, as the region does not have a free trade agreement with the UK. This will mean, for what appears to be the first time, you will need to register for Customs and Duties with HMRC. I will give an estimation of the duty costs below. However, i will first detial the admin that will be invovled. You will need to register with

the Customs Declaration Service as you will be importing goods into the UK. You will also need to apply for a GB EORI number for your imports. Duties, will be payable on the equipment imports, and duty is normally payable at the time of import. However, you can operate Postponed Invoice Accounting and instead of having to pay for the duties immediately, you can postpone the amount and account for it as output tax on your VAT return. I would advise doing this as it delays the payment and can result in cash flow benefits. I would also advise perhaps engaging in a customs agent. They would complete the importing formalities and admin on your behalf, as you have (from what i can see) never been an importer previously, this will decrease the potential burden of importing for the first time. The agent would be a direct representative, this means you would still be responsible for the duties payable and any potential penalties that may be incurred.
4.16 Regarding the duties which will be payable. Without a confirmed duty rate, i cannot give you the exact figure, however, i can provide an estimate. Duty rate is based upon the value of the consigment, it also needs to have insurance and freight costs added. See **Appendix E** for a full break down, however, i estimate duty costs to potentially be around £588,000 for the importing of the specialised equipment from Sayonara.

4.17 If this was then included in the overall net cash return on investment, the final figures for option 1 would be:

4.18 Return on Investment - £34,759,000
77.39% return over 5 years based on initial investment of £45,500,000

<u>5 Analysis of Option 2 (Unumiota Ltd):</u>

5.1 The costs for Option 2, can be broken down into 3 areas.

- Shares
- Rag Trade
- Other

5.2 Shares:

Regarding the shares, when purchasing the shares of another company, alongside the cost of the shares you will also need to pay stamp duty @ 0.5%. The stamp duty is payable on the full price including VAT. This means the cost of the shares would total £51,660,000 (including SD of £2,460,000). See **Appendix F.** You will also take on the liabilities and history of this company. And although, they appear to be a very strong and well performing company, stringent due diligence would be required to ensure there are no hidden liabilites/negative history. This would obviously be at a cost.

5.3 Rag Trade:

Although it is an additional cost, and the professional fees will be passed to yourselves, i would still proceed with using the Rag Trade lender. They specialise in this area, which is a totally new area for yourself and i believe the additional cost is ultimately worth it for the security it will provide. I would also agree with the board on building up the £1million reserve for the end of the 5 year period, this is a sensible option and will be included in the overall costing.

5.4 Other Costs:

The professional costs are unavoidable and will be standard rated and fully recoverable.

5.5 The full return on investment for Option 2 is revised to:

Net cash return on investment of - £1,390,000

Amounts to a return of 26.02% return on initial investment over 5 years.

(Breakdown found in **Appendix G**).

5.6 A final point regarding Option 2. Although, it appears to be the safer option and you are proposing the purchase of an establihsment entity in an established field, it does not come without it's risks. The clothing industry is a completely different industry to thge one you have experienced and been successful in, and the potential challenges/obstacles that may present (like in any business) could need a completely different solutiuon to ones which you are used to.

5.7 Finally, rgearding the price increase to £41 million. The balance sheet assets of the company are £33 million, and to have the price increased by £8 million seems high and must be noted that there does not appear to be much reasoning for this increase, which does provide a risk.

6 Proposed losses:

6.1 Both options propose that there will be some loss making involved. Option 1 states that it will be loss making for the first three years. And option 2 states, it will be loss making for the first year.

6.2 Option 1 - Losses:

Because option 1 still entails the entity to be within the group. You can use group loss relief for the losses incurred. This means, that the projected losses for years 1,2, and 3 can be relieved against the profits of Coua. This can provide a benefit as it will reduce Coua's profits and therefore reduce their Corporation Tax liability and charge.

6.3 Option 2 - Losses:

As option 2 is not being proposed to be part of the existing group. Group loss relief is not available. This means that the losses incurred by Option 2 in year 1 can only be offset against their own future profits. Although, unlikely to be an issue, carrying forward losses does always come with a gamble that you are carrying them forward against something that is presumed (future profits) and not guaranteed.

7 Appendices

7.1 Appendix A:

SBAs - Construction costs = 23,000,000 x 3% per annum = £690,000

Projections over 5 years = 690,000 x 5 = £3,450,000

7.2 Appendix B:

75% assumed qualfying purchases of £14,000,000 = £10,500,000

7.3 Appendix C:

Total estimated outlay for project = £197,525,000

Total R&D expenditure = £28,000,000

28,000,000/197,525,000 = 14.1% (round down to 14%).

7.4 Appendix D:

Projected sales	- 213,000,000
Less outlays	- (197,525,000)
Net Return on investment	- 15,475,000
Deduct from outlays:	
SBAs	- 3,450,000
Capital Allowances	- 10,500,000
R&D relief	- 5,600,000
R&D Capital Repayment	- 3,220,000
Total	- 22,770,000
Adjusted Return on Investment	- 35,347,000

7.5 Appendix E:

Value of equipment = 14,000,000

Insurance and freight @ 5%(estimate) = 700,000

Total value for duty purposes = £14,700,000

Duty rate @ 4% (estimate) = £588,000

7.6 Appendix F:

Cost of shares including VAT = £49,200,000

SD @ 0.5% = £2,460,000

Total cost = £51,660,000.

7.7 Appendix G:

Initial investment:

Shares - 51,660,000

Prof Costs - 750,000

Rag Trade - 1,000,000

Total - 53,410,000

Difference from projected = £10,660,000

New outlay = £699,810,000

New net return on investment = 701,200,000 - 699,810,000 = £1,390,000

% return compared to initial outlay = £1,390,000/53,410,000 = 26.02%