Application and Professional Skills

Taxation of Larger Companies and Groups

November 2024

Suggested answer

REPORT TO NORWAL INC

ACQUISITION OF MACDUFF LIMITED AND SUBSEQUENT RESTRUCTURING

Introduction

This report considers and advises on the opportunities arising from the proposed purchase of Macduff Ltd (Macduff) for the expansion and restructuring plans.

It is based on information provided in the correspondence from Joanne Grey, global tax director of Norwal Inc (Norwal), dated 1 November 2024, is prepared for the sole use of Norwal and is based on current legislation. If there are any delays in proceeding, further advice should be sought to ensure that no changes to legislation impact on the advice given. In addition, advice should be sought on any tax implications arising in Ruritania or any other tax jurisdictions impacted by the proposed transactions.

Stephens LLP

November 2024

Executive Summary

On completion of the proposed acquisition of Macduff, Norwal will own a UK corporate entity, giving an opportunity to review the corporate structure.

The timing is important because, as identified, the planned Ruritanian tax rate increase from 20% to 35% over the next two years could result in a significant increase in Norwal's net tax cost.

If the current non-Ruritanian operations continue operating as branches of Norwal, the increased Ruritanian tax rate will result in additional tax in Ruritania beyond that arising overseas in its countries of operation. It would therefore reduce the overall tax cost if these operations were no longer liable to Ruritanian tax. Given the Ruritanian tax rules, this can only be achieved if legal ownership of these operations is in a country with a favourable tax treaty with Ruritania. Incorporating these operations in their countries of operation will not of itself be sufficient to eliminate the Ruritanian tax cost.

We therefore recommend that the profitable overseas operations be transferred to Macduff following its acquisition. Loss making operations, including operations in new jurisdictions which are not expected to be profitable in their early years, should remain as branches of Norwal to benefit from tax relief at the higher Ruritanian tax rate.

The profitable overseas operations could be branches of Macduff, which would elect to exempt those overseas branches from UK tax. The UK tax result would be the same as if the branches were transferred to the UK and then incorporated into local companies by transferring each business in exchange for shares issued to Macduff. In both cases, subject to any anti-avoidance rules, the profits would only be taxable in the overseas jurisdictions. No UK tax would arise on profit repatriated to the UK as dividends in the latter case so further tax would only arise on the ultimate repatriation of the profits to Norwal. Despite the 5% tax payable on dividends under the current UK/Ruritania treaty, the overall tax would be less than the planned 35% effective rate on profits taxable in Ruritania.

The choice between a subsidiary or the existing branch depends on several factors, including confirmation from local advisers of any distinctions between the tax treatment of branches and subsidiaries and advice as to the extent and costs of local compliance in non-tax areas. The requirement to allocate costs appropriate to the overseas operations will be the same in either situation. The use of a subsidiary gives clarity, potentially assisting with record keeping because there is no need to 'exclude' the branch records from the UK taxable profits. It may also benefit local teams to understand their results, giving more 'ownership' and thus better motivation.

However, the incorporation of new overseas operations increases the number of associated companies. Given Macduff's current taxable profits (£2.6million in the year ended 30 June 2024), this will not impact the UK tax payable (charged at 25%), but Macduff could become liable to pay its tax in the future in accelerated instalments (falling due during an accounting period) if more than six additional companies are incorporated (or profits increase). Hence, whilst the existing branches could be incorporated under UK ownership, we would recommend that this be the subject of ongoing review.

Given the internal policy of paying market value for assets transferred, Macduff will require additional funds to proceed with the reorganisation. This funding can be by way of debt or equity. The level of interest payable in the UK is such that restrictions on the immediate deductibility of additional interest may arise, due to the Corporate Interest Restriction rules, for funding by internal loans. Restrictions may also arise on external borrowings. It may, therefore, be preferable to fund these transfers by the issue of additional equity to avoid taxable interest income in Ruritania at the higher 35% rate with the potential for restricted or no UK tax relief available.

Expansion and restructuring plans

You are considering restructuring the branch operations of Norwal (including new operations in other overseas jurisdictions). At present all overseas operations operate as branches of Norwal so are liable to tax in both their country of operation and Ruritania. The current rate of Ruritanian tax has meant that no/minimal additional tax arises, because the local tax paid is approximately at least equal to the Ruritanian tax (assuming that the basis of calculation of profits is similar). However, following the anticipated increase in the tax rate in Ruritania the current structure will result in an additional cost arising as the local tax rates are below 35%.

You should therefore consider transferring the branches to another jurisdiction (the UK is suggested) or incorporating the branch operations into local companies. We understand that no exit or similar charges will accrue in Ruritania as there are no assets physically located in Ruritania. You should confirm this with your Ruritanian tax advisers and obtain local tax advice in the countries where the branches are physically located.

Incorporation of existing operations

The incorporation could be achieved by incorporating a new company resident in the relevant jurisdiction and transferring the net assets of the branch into the new company in exchange for shares.

The local company and tax rules should be reviewed. There may be tax charges arising locally on the transfer of the trade and assets of a branch to a new company. However, many jurisdictions have options to hold over any tax arising on the incorporation, effectively transferring the tax basis from the branch operation into the new company.

For example, had the branch been the overseas branch of a UK company prior to the incorporation of a new company located overseas, the tangible and intangible fixed assets will be treated as disposed of and reacquired at market value. A claim can be made to postpone the chargeable gains arising provided that the transfer is wholly or partly in exchange for shares issued by the transferee to the transferor and the transferor then holds at least 25% of the share capital.

Following the incorporation of a new overseas company, if that company were to be a subsidiary owned by Macduff, any profits arising outside of the UK would be outside the scope of UK (and Ruritanian) Corporation Tax, subject to the anti-avoidance rules discussed below.

Profits could be extracted from the overseas subsidiary through dividend payments to the UK. These would be exempt from UK tax, and in Norwal they would benefit from the lower rate of tax of 5% due to the application of the UK/Ruritania tax treaty. Any local withholding tax on dividend payments should be considered when assessing this option.

Transfer of the existing branch operations

As the transfer of branch operations by Norwal to MacDuff requires (legally) a change in ownership of the branch assets, it requires consideration (in the context of relevant local legislation) of whether any exit charges, stamp taxes etc apply. Post-transfer, if the branch operations are now owned by MacDuff, the existing UK branch (formerly owned by Norwal) will simply form part of the company's UK business. The other overseas branches will be taxable in the UK as overseas branches of MacDuff, with double tax relief available for the tax suffered in the country of operation. This structure means that no additional tax arises if the overseas jurisdictions have tax rates at or above the UK rate.

However, where local rates are below the 25% UK corporation tax rate, this structure would result in additional tax payable in the UK. To eliminate this additional cost, an irrevocable election can be made to exempt the overseas branch profits from UK Corporation Tax. The election should specify the accounting periods to which it will apply. It must be made prior to the commencement of that period. The election applies to all the company's branches, both profitable and loss making, subject to the operation of the streaming rules referred to below.

Should MacDuff Ltd make the branch exemption election, subject to the anti-avoidance rules discussed below, there will be minimal distinction on an ongoing basis between the branch and incorporation options unless there is local withholding tax on dividends in the countries of operation. In that case, the withholding tax cost could be eliminated by retaining branches rather than incorporating new overseas companies. However, as discussed below, if significant losses are anticipated to occur, the branch exemption election may not be beneficial which may impact upon the final decision as to the most tax efficient option.

Anti-avoidance rules

In certain situations, the profits of an overseas subsidiary of a UK company can be liable to UK tax.

The first situation concerns residence and whether the overseas subsidiary might be considered to be centrally managed and controlled in the UK. Given that the branches have been operational in the overseas territories for some years, it is unlikely that this will apply upon their incorporation, but it is good practice to regularly review where the strategic management decisions are being made.

Secondly, the Controlled Foreign Companies (CFC) rules should be considered. These are designed to prevent companies from artificially diverting profits away from the UK.

A CFC is a company which is not resident in the UK and is controlled by a UK resident. If the current branch operations were incorporated in the country in which they are located, and the shares of those new companies were held by Macduff, Macduff would control the subsidiary.

The profits of a CFC can be apportioned to the UK parent company if it cannot claim any of the exemptions and its profits pass through a 'gateway'.

The exemptions are

- Exempt period – a temporary exemption for foreign subsidiaries already carrying on a business when they first come under UK control. This only applies for the first twelve months and is not applicable to newly incorporated companies.
- Excluded Territories – a CFC is excluded from the CFC charge if it is resident and carries on a business in a country included in the statutory list of excluded territories and meets other conditions concerning anti-avoidance, nature of income and transfer of intellectual property from the UK.
- Low Profits – a de minimis test whereby no CFC charge arises on profits below £500,000 (with no more than £50,000 being non trading income) – whilst this may apply to certain branches, it is unlikely to apply more widely given the indicated profit levels.
- Low Profit Margin – exempts CFCs with high volume low value functions and applies if the CFC has a profit margin of no more than 10% of its relevant operating expenditure – again the branch results indicate that this exemption is unlikely to be widely relevant.
- Tax exemption – applies if the local tax amount is at least 75% of the UK tax that would have been charged on the CFC's profits.

Whilst the tax exemption is likely to apply to the existing operations – the lowest tax rate being 19% which is slightly higher than 75% of the UK rate of 25% - you should review the basis of calculation as different treatment of income and expenses could mean that the 75% threshold is not met.

These rules could impact the proposed expansion into Lithuania in view of the 15% tax rate applicable in that country. This could necessitate a more detailed review of those rules and a determination as to whether a Lithuanian subsidiary would result in chargeable profits being imputed to the UK parent company but only if its profits could be deemed to pass through one of the ‘gateways’. This could be the case if the operations are considered to be closely linked to the UK.

Similar anti-avoidance rules can apply in the case of overseas branches operated by a UK company where an exemption election has been made, meaning that these rules are unlikely to result in a distinction between the alternative structures.

Loss making operations

The above options – incorporation or the transfer of branches followed by a branch exemption election – are likely to be beneficial where the overseas operations are profitable as they result in these operations only being liable to tax in their country of operation. This gives a tax saving if the overseas rate is lower than that applicable in the UK.

However, if an overseas branch is loss making, such as the Spanish branch and the proposed operations in the Czech Republic and Lithuania, relief will be available in the UK for the losses if the branch is held by a UK company and no branch exemption election is made. Making the election would therefore eliminate the tax relief at 25% of the value of the losses. If the branch were retained in Ruritania the potential tax benefit will be higher following the increase of the tax rate to 35%.

It is important to compare the tax savings made in respect of the profitable jurisdictions with the potential benefit of accessing the losses in the UK when deciding whether to make the election if the branch route were to be adopted.

The table below shows the impact of each of the restructuring options assuming that all the branches are treated the same and there are no differences between the basis of calculation of tax in each of the countries involved. The projected results for the year ended 30 June 2025 are assumed to equate to the taxable profits.

Year ended 30 June 2025	No change (Note 1)	Branches of UK – no exemption (Note 2)	Branches of UK – exemption (Note 3)	Subsidiaries of UK (Note 3)
	£(million)	£(million)	£(million)	£(million)
UK branch	0.875	0.625	0.625	0.625
Portuguese branch	0.7	0.5	0.42	0.42
Polish branch	0.525	0.375	0.285	0.285
Spanish branch	(0.525)	(0.375)	0	0
Total	1.575	1.125	1.33	1.33

Note 1: If there is no change to the current structure, all profits and losses will effectively be taxed at the higher Ruritanian tax rate of 35%.

Note 2: In the absence of a branch exemption election, the net tax cost for each operation will be the UK tax of 25% as all local tax rates are lower than this.

Note 3: Following a branch exemption election or the incorporation of local subsidiaries, the tax charge will be the local tax payable. However, no benefit is recognised in connection with the Spanish result – this will only arise when the branch is profitable assuming the local rules allow the branch to benefit from the previous losses.

The table shows that the credit arising in the UK from the Spanish losses results in a lower tax charge if no branch exemption election is made. However, as the losses reduce in future years, the saving is likely to be offset by the higher tax charges arising on the Portuguese and Polish branches.

It is possible for branches to be held in different UK companies within a group structure so as to determine when it is beneficial to make the branch exemption election. All branches benefiting from the election could be held by the same company. However, at present the proposal is that the new group would only include one UK resident company so there is no such flexibility, unless an additional UK company were to be incorporated. Commercially this may not be desirable, and it would be important to ensure that any structure is commercially efficient.

There is a further consideration relating to loss-making branches. The UK tax rules defer the time at which the branch exemption takes effect if a company has brought forward losses when it enters into the election. The transitional rules look back to see what net losses have arisen in the six years prior to the otherwise first applicable accounting period. Net losses that have not, in that six-year period, been matched by subsequent profits result in an aggregate notional loss carried forward (known as Total Opening Negative amount – TONA) and the exemption does not take effect until all the losses brought forward are matched to profits that have been taxed.

This deferral is calculated on an aggregate basis unless the company makes a streaming election. The streamed amounts of the relevant territory are not aggregated with the results of branches in other territories and form a separate TONA which is matched against profits in the relevant territory only.

<u>Conclusion</u>

Subject to the reviews suggested above, the overall tax cost could be reduced on the proposed restructuring by ensuring that the Polish and Portuguese branches are excluded from the higher tax rates in either the UK or (in due course) Ruritania. This could be done by making the branch exemption election or establishing new local subsidiaries to conduct these activities. However, the existence of losses/potential future losses may restrict the benefits of the branch exemption election.

As a result, consideration should be given to transferring the branches to MacDuff Ltd in the UK as and when they are anticipated to give rise to taxable profits in the UK. This allows the highest rate of relief for the losses (35%) in Ruritania, but then restricts the tax charge on profitable activities to that in the local jurisdiction.

The use of subsidiaries may result in different administrative requirements or even tax treatments in the local jurisdictions so should therefore be verified prior to any action being taken.

Any newly incorporated subsidiaries will be associated companies for the purposes of the UK tax legislation. This could accelerate the payment of tax liabilities due to the payments on accounts regime as limits for accelerated payments are reduced proportionately dependent upon the number of companies in the group.

Financing considerations

It is considered beneficial to minimise the exposure to Ruritanian tax at 35% by moving the profitable branch operations into the UK if this can be achieved without significant exit charges.

It appears that the value of the branch operations exceeds the level of cash reserves available in Macduff and therefore one issue to consider is how the consideration for the transfer of these operations would be settled.

One option would be for Macduff to issue further share capital to Norwal. This would eliminate the need to increase the level of debt in Macduff because the equity investment could be used to finance the transfers.

The other option would be debt financing, either internally or externally. The annual interest cost of Macduff is already £1.8 million and therefore debt financing could result in the UK net interest expense exceeding the £2 million per annum de minimis level within the Corporate Interest Restriction (CIR) rules. Currently MacDuff should not be impacted by the CIR rules assuming that its total net UK interest expense remains below the de minimis level of £2 million.

Once a group's annual net interest expense exceeds the de minimis level, tax relief is not immediately available for UK interest expense in excess of the lower of:

- The group's worldwide interest cost, and
- A percentage of the UK's taxable earnings before interest, tax, depreciation and amortisation (tax-EBITDA). This percentage will be 30% unless the group elects to use the group ratio method, which is based on the level of external borrowings in the worldwide group.

Given that there is no borrowing in Norwal, the interest capacity is likely to be determined by the level of external borrowing . Hence any loans from Norwal are unlikely to be tax efficient. Once the UK interest cost exceeds £2 million, no UK tax relief will be immediately available, whilst the interest income may be taxable in Ruritania. Even without any CIR disallowance, the income arising in Ruritania is likely to be taxable at 35% whilst the maximum deduction in the UK would be at 25%, making this inefficient from a direct tax perspective due to the 10% rate differential. We would not therefore recommend debt funding from within the group.

Whilst direct external borrowing in the UK would increase the level of interest capacity, the level of interest expense could still be such that an element of this would be immediately disallowed. The potential additional interest charge should be compared with the level of UK profits before any external debt is taken on, with consideration being given to a further equity investment from Norwal if it appears that the interest would not be tax deductible in the UK.