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Course **CTA APS Taxation of Larger Comps**

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Section 1	**2283**	**11661**	**14457**
Total	**2283**	**11661**	**14457**

Answer-to-Question-_1_

Draft Report

From: Smith and Stevens LLP
To: Olivia Peters, Finance Director, Woodley Adams Ltd
Date: 5 May 2021
Subject: Proposed expansion of Woodley Adams Ltd

INTRODUCTION

This Report has been prepared for Olivia Peters, the Finance Director of Woodley Adams Ltd ("Woodley Adams").

This report is intended solely for use by Olivia Peters and the Boards of the companies concerned in the proposed transactions. No responsibility will be accepted for any reliance placed on the contents of this Report by third parties.

This Report is based on the tax law in force in the UK at the time of writing. As separate advice is being taken on local taxes in Ruritania, this report does not address any tax implications arising in that territory.

The Report will explain the tax implications of the proposed transactions to be entered into by Woodley Adams, and is structured as follows:

Section A: Acquisition of factory or construct new factory
Section B: Acquisition of the trade & assets or shares of Harrington Products Limited
Section C: Options to finance the expansion

EXECUTIVE SUMMARY
- If the decision to acquire Harrington is not made, Woodley

Adams should acquire their factory, as this is less costly than purchasing the land and constructing a new factory.
- The acquisition of the shares is likely to achieve a lower selling price than an acquisition of the trade and assets, therefore it is recommended that you purchase the shares.
- An equity investment through the subscription of shares is recommended, in order to avoid withholding tax risk and disallowable interest risk.

SECTION A: ACQUISITION OF FACTORY OR CONSTRUCT NEW FACTORY

The acquisition of either the existing factory from Harrington Products Ltd ("Harrington") or the land for construction will depend on a number of commercial considerations, aside from the tax consequences. For example, the location of the factory must be suitable to attract an appropriate workforce and be in an appropriate location to enable a low cost, timely delivery of products to the retail stores or online retail customers.

A1) Acquisition of factory from Harrington

Harrington have taken the option to tax their properties, therefore the acquisition of the factory will give rise to VAT and Stamp Duty Land Tax liabilities for Woodley Adams.

VAT will be chargeable at the standard rate of 20%, assuming the proposed price of £10m is exclusive of VAT this would add £2m to the consideration required, bringing the total to £12m. As Woodley Adams will be making taxable supplies, this input tax will be recoverable. The Capital Goods Scheme will appy to the proposed works, this will review, over a ten-year period, the amount of VAT initially recovered and adjusts this by the reference to subsequent use of the building.

SDLT is payable on the VAT inclusive price:

£150,000	0%	£0
£100,000	2%	£2,000
£11,750,000	5%	£587,500
£12,000,000		£589,500

In order for the factory to be capable of manufacturing Woodley Adam's products, it requires a further £5m in expenditure on purchasing and installing new plant. This would all be qualifying for capital allowances at 18%, with an earlier deduction of the first £1m of expenditure in the year of purchase by using the annual investment allowance. The current corporation tax rate is 19% so this gives a tax saving of £950,000.

Total cost of the acquiring the factory is therefore:

Purchase price net of VAT	£12,000,000
SDLT	£589,500
Recoverable VAT	(£2,000,000)
Conversion	£5,000,000
Capital allowance tax relief	(£950,000)
Total	£14,639,500

A2) Acquisition of land and construction of new factory

The purchase of the land for £6m will attract SDLT as outlined below:

£150,000	0%	£0
£100,000	2%	£2,000
£5,750,000	5%	£287,500
£6,000,000		£289,500

The purchase of land will not incur a VAT liability.

The proposed design and build expenditure as prepared by AJ & Co

would be categorised as follows for capital allowances purposes.

Construction of factory shell	£6,000,000	SBA
Water & power supplies	£750,000	Integrals
Air conditioning	£750,000	Integrals
Plant inc. installation	£4,500,000	Plant
External car park & landscaping	£1,000,000	Non-qualifying
Project management	See note below	

Construction of the factory shell will qualify for Structure and Buildings Allowances at 3% per year, with relief beginning once the building starts being used. The acquisition cost of land does not qualify for the SBA, nor does any associated SDLT.

Water & power supplies and air conditioning are considered integral features for capital allowances and attract relief at 6%. The relief can be realised earlier as they qualify for the annual investment allowance.

The purchase and installation of plant qualifies for plant & machinery allowances at 18%.

External car parks and landscaping do not qualify for the SBA regime, therefore no corporation tax relief is available.

The project management fees ought to be allocated to the assets acquired, where they would follow the same treatment as the asset. However, as this is likely a time consuming task and potentially some costs are not able to be allocated, HMRC allow us to allocate the expenses the pools at the same ratio as the rest of the expenditure.

Therefore, 6/13 goes to SBA (£461,538), 1.5/ 13 to integrals (£115,384), 4.5/13 to the plant pool (£346,154) and the remaining

1/13 is non-qualifying (£76,924).

Total non-qualifying is therefore £1,076,924 leaving £12,923,076 as qualifying, earning tax relief at 19% of £2,455,384.

Total cost of acquiring the land and constructing a factory is

Land	£6,000,000
SDLT	£289,500
Development	£14,000,000
Capital allowances	(£2,455,384)
Total	£17,384,116

A3) Recommendation

The acquisition of the factory would cost £14,639,500 inclusive of SDLT and assuming recovery of the input VAT, which is cheaper than the acquisition of land and construction of the new factory, despite the availability of the Structures and Buildings Allowance.

There are other considerations to be made on the acquisiton of the existing factory, for example it recently required £1.5m of repairs which may indicate it is an old building and the overall quality of the structure should be considered, particularly when comparing to a new build factory. Similarly, a new build property may run into its own hidden costs during the construction process, so further due diligence and consideration of the commercial appropriateness of each property should be performed.

Overall however, the least expensive option from an after tax cost perspective is the acquisition of the existing land from Harrington.

Section B: Acquisition of the trade & assets or shares of

Harrington Products Limited

Option 1) Acquiring the trade and assets of Harrington

The trade losses carried forward of £1.6m would remain with Harrington in a trade and asset transfer, a cash tax cost of £304,000, assuming Woodley Adams would have been able to continue the Harrington product offering without a major change in the nature of the trade and turned the business around to start generating profits.

If the price paid for the trade and assets exceeded market value, the excess would be treated as goodwill and recognised as an intangible asset in the accounts of Woodley Adams. No tax relief would be available on the amortisation of this intangible asset is available to be acquired.

The goodwill could be minimised by allocating the price paid to any goodwill not recognised in the Harrington accounts, such as any value attached to the Harrington brand, which should be possible considering the business has operated for at least 10 years. Specialist advice should be taken in this regard. Tax relief would then be available on this intangible asset, either in line with amortisation in the accounts or at 4%.

Capital allowances would be available on the plant and machinery purchased. To be able to claim CAs on any fixtures acquired within the buildings, Woodley Adams and Harrington would need to make a joint election to state how much of the sale price relates to fixtures.

The acquisition is likely to be a "transfer of going concern" ("TOGC") for VAT purposes, in which case no VAT needs to be charged. The conditions require the "same kind of business" to be continued, as per the email dated 1 May 2021, there is an

intention to continue producing the Harrington products, therefore this condition should be met. The other conditions, shown below are met.

- The assets transferred form a business in their own right
- Harrington is VAT registered
- No significant break in trading is planned

The SDLT incurred on the acquisition of the three properties, assuming the valuation of each is paid totalling £23m, would be £1,139,500.

The chargeable gain of £1.4m on sale of the properties is payable by Harrington. The £23m debt is secured on the properties, however this will need to be settled by Harrington in advance of the transfer to Woodley Adams.

Woodley Adams would be able to determine which of the leases on the 15 retail premises it would prefer to acquire, rather than acquiring all leases.

The transfer of the leases may require consent from each landlord, and the landlord may wish to inspect Woodley Adams as a prospective tenant. The transfer of the leases may give rise to a capital gain by Harrington as they are long-term leases, though more information is required.

Option 2) Acquiring the shares of Harrington

Woodley Adams would take over the commercial history and liabilities of Harrington in this scenario. The high level of debt and the introduction of additional financing costs may be a concern to Woodley Adams.

Woodley Adams currently has £1.2m of finance expenses, and the

acquisition of shares without refinancing of the property debt would introduce a further £1.5m into the UK group. This pushes the company over the £2m de minimis threshold for the corporate interest restrictions, so there may be a restriction imposed on the deductibility of interest, even though it will be to external parties. As the company is generating tax losses, it is also reducing the tax EBITDA of the UK group, making a restriction more likely.

The purchase of shares is not subject to VAT so no charge would arise.

Woodley Adams would incur a 0.5% Stamp Duty charge on the consideration paid for the shares.

The trading losses may be available for use by Woodley Adams provided there is no major change in the nature of the trade by Harrington, as set out in the "change of company ownership" provisions. Ceasing the manufacture and sale of children's toys and converting this to the manufacture and sale of adult crafts would be considered a major change in the nature of trade, and would block the trading losses from being used.

You have mentioned continuing to sell the childrens toys therefore there may be some scope to utilise these losses, should that business become profitable.

Recommendation

The acquisition of shares is riskier as Woodley Adams acquires the liabilities and commercial history of Harrington, though is likely to be less costly for Woodley Adams. This would involve acquiring the property debt along with the rest of the business, which would likely make it possible for a lower price to be negotiated with Harrington. Should the trade and asset transfer

route be taken, Harrington may seek full recovery of the value of the properties in order to pay off the debt.

Section C: Options to finance the expansion

The investment to acquire Harrington could be financed through one of the following options:

1) Equity investment
If Woodley Adams Corp subscribed for additional shares in Woodley Adams Ltd, and Woodley Adams Limited subscribed for new shares in Harrington Products Ltd, the investment could be made without generating a new loan relationship.

There would therefore be no payment of interest by Harrington, which reduces the scope for a non-deductible interest charge. The financing could be obtained either from cash reserves or an external source in Ruritania, and would earn a tax deduction at their corporation tax rate of 12%. While lower than the UK rate, it is better solution than having any additional interest disallowed under the Corporate Interest Restriction rules.

Profits could be repatriated to Ruritania through dividends, with a restriction to the amount of reserves available in Harrington.

As there is a double tax treaty in place, there is no withholding tax imposed on dividends leaving the UK.

2) Debt investment - From Woodley Adams Corp

This is likely to result in an element of interest being disallowed for UK corporation tax purposes under the CIR rules. Currently Woodley Adams has £1.2m of finance expense and Harrington has £1.5m of interest expense. This leaves a potential disallowance of £0.7m before further financing is placed in the

UK group. As noted in section B, Harrington is currently generating tax losses, therefore reducing the tax EBITDA of the UK entities in the group.

The rate of interest would need to be set at an arm's length, with many factors impacting the rate. If Woodley Adams can get a 6% rate from an external bank, this is likely to be rate that would need to be imposed.

A further consideration may be needed with regards to the withholding tax position of the interest. The UK withholding tax rate is 20% on interest, though this may be reduced by the double tax treaty, though only after HMRC have provided clearance to apply the reduced rate.

3) Debt investment - External finance directly to Harrington

This produces the same result as option 2, though reduces the risk of withholding tax.

The 6% rate may be higher than an arm's length rate, though it is still likely to result in at least some element of disallowed interest.

Recommendation

The equity investment is the best option for financing the expansion.

Dividends will come from after tax profits and won't be taxable income in Ruritania, though will also not face any withholding tax risk or disallowable interest risk.