Institution **CIOT - ATT-CTA**
Course **CTA APS Taxation of Larger Companies and Groups**

Answer-to-Question-_1_

FROM: Langston Adams LLP

TO: The Board of Baffin Hood plc

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SUBJECT: Tax implications of the proposed acquisitions of Beneke Orr Ltd and M&D Garages

Introduction

This Report has been prepared solely for use by the Board of Baffin Hood plc (BH).

No responsibility will be accepted for any reliance placed on the contents of this Report by third parties.

The tax law contained within this Report applied at the time of writting.

The Report will explain the UK tax implications of the proposed acquisitions of Beneke Orr Ltd (BOL) and M&D Garages (MDG) as well as the funding considerations of these acquisitions.

Executive summary

Acquisition of Beneke Orr

The acquisition of BOL by BH using cash consideration of £25 million would required additional debt funding from the bank. This would attract additional interest payable by BH of £1 million per year, on which there will be no tax relief given there is no capacity under the Corporate Interest Restriction (CIR) regime.

The acquisition of BOL by BH for the issue of loan notes worth £25 million to the shareholders would not result in additional debt funding from the bank until the loan notes were due for redemption. However, interest of £1,750,000 would be payable each year to the individual shareholders on which there will be no tax relief under the CIR regime.

Additionally, income tax at 20% of £350,000 will need to be withheld on the interest payments and paid to HMRC along with the submission of quarterly CT61 returns.

However, the acquisition by way of cash or loan notes does not dilute the holding in BH by Simon Green (SG) and his family.

The acquisition of BOL by BH for the issue of 4,000,000 of shares in BH to the individual shareholders at £6.25 per share will save £25 million of debt funding for BH. Additionally, dividends can

be paid to the shareholders out of post-tax profits which does not impact the CIR position of the group.

However, the acquisition by way of share consideration does dilute the holding in BH by SG and his family from 80% to 74%.

The £10 million of losses brought forward in BOL will not be available for utilisation on future profits of BOL if the trade is changed following acquisition by BH.

No UK VAT consequences would arise on the acquisition of BOL as the acquisition of shares is exempt from VAT.

UK stamp duty of £125,000 would be payable by BH regardless of how the consideration of £25 million is structured.

Acquisition of M&D Garages

BH can either acquire the trade assets of MDG directly by its UK trading subsidiary BUK or it can incorporate and Irish subsidiary to acquire the trade and assets of MDG.

Should BUK acquire the trade and assets of MDG it will create another overseas permanent establishment (PE) this time in Ireland. Without a PE exemption election, this will BUK will suffer both UK and Irish tax on the activities of its PE, although unilateral double tax relief can be claimed. This option

allows BUK to utilise any trading losses in the first few years against its taxable trading profits, decreasing its UK CT liability.

Should the trade and assets of MDG instead be acquired by a newly incorporated Irish subsidiary of BH, no UK tax implications will arise as the Irish subsidiary will be taxable in Ireland only, subject to the controlled foreign company (CFC) rules.

However, it is unlikely that any losses generated will be available to surrender to the BH group as the Irish subsidiary will not be UK tax resident and will therefore not form part of BH's group relief group.

Any profits could be repatriated by way of exempt dividends which would not be taxable in BH.

Both options will require BH to obtain additional bank funding of £15 million which is considered below.

Funding considerations

Should bank funding be required for both the acquisition of BOL and MDG, the amount borrowed would need to be £40 million which would result in yearly interest payments of £1.6 million.

Should bank funding only be required for the acquisition of MDG,

smaller bank funding of £15 million would be needed which would result in much lower yearly interest payments of £0.6 million.

Currently, sufficient interest capacity is not available under the CIR regime to take deductions for the interest for tax purposes. However, the interest capacity will increase on acquisition of both BOL and MDG as positive EBITAs are expected from 2024 which should enable the BH to not be adversely affected for corporation tax purposes.

Recommendations

Acquisition of Beneke Orr

It is recommended that BOL is acquired for the issue of 4 million shares in BH to the individal shareholders of BOL. This will save BH the need for acquiring additional funding of £25 million in an already highly leveraged group, with no expected tax relief for interest exepenses.

Additionally, BH has sufficient distributable reserves to pay out dividedns to the shareholders on which tax does not need to be withheld. This saves additional compliance burdens as well as additional tax liabilities.

Although SG and his family's shareholding will be diluted, they will still retain control of the BH group.

It is also recommended that the trade of BOL is not majorly changed so as to preserve to use of the brought forward losses against future taxable profits in BOL (initially) and the BH group after a period of five years has passed.

Acquisition of M&D Garages

It is recommended that the trade and assets of MDG are acquired by BUK for £15 million injected into it by a £15 million bank loan acquired by BH.
Although this will create another UK PE for BUK, it does not create an additional CFC and enables any early year losses generated to be utilised in BUK.

Once this business is profit making, it is recommended that the business is incorporated into an Irish company to eliminate the UK CT payable on the profits of MDG.

Funding considerations

It is recommended that only £15 million of debt is acquired from the bank for the purchase of MDG in cash. This will create additional interest payable of £600,000 per year, however, sufficient additional interest capacity for CIR purposes would be created by 2024 on acquisition of both BOL and MDG based on the projected EBITDA figures provided.

It is not recommended that loan notes are issued to the sellers on acquisition of BOL without prior benchmarking, as interest deductions may also be restricted under the thin capitalisation rules as the interest rate is much higher than that of the bank debt.

Section A: Acquisition of Beneke Orr Ltd

This section will consider the UK tax implications for BH on the acquisition of BOL by either cash consideration, loan note consideration and share consideration.

It will also consider the loss position of BOL and the future availability of the £10 million trading losses brought forward.

(A1): Losses brought forward

As BH will acquire 100% of the share capital of BOL, it will join a group relief group with BH and BUK such that losses can be claimed and surrendered between this entities freely, subject to certain restrictions.

Any losses brought forward in a company can only be surrender up to 50% of taxable profits of the company claiming the losses. This capacity can be increased on allocation of the group £5 million deductions allowance.

However, the main issue with acquiring a company with losses is that they are subject to specific anti avoidance provisions to prevent loss buying.

These rules apply following a change in ownership of a company, which will happen to BOL on its acquisition by BH. If this is then followed with a major change in the nature or conduct of BOL's trade either in the three year before or five years after the acquisition, the losses will be blocked and will not be available for future use against BOL's profits. This can be avoided if care is taken to not change the activities of the company following the acquisition.

Following a change in ownership, the losses in BOL will not be available to surrender to BH or BUK until a period of five years has passed.

(A2): Cash consideration

The benefit of structuring the consideration by way of cash, is that the shareholding of SG and his family is not diluted and will remain at 80%.

However, this option does present a number of potential drawback which are highlighed below.

Interest payments

If BH were to acquire BOL for cash consideration of £25 million, it would need to obtain bank funding for the full amount at an interest rate of 4% per annum.

As calculated in Appendix B, this would created additional yearly interest of £1 million for BH. Debt funding is usually advantages given the deductibility of interest expenses for corporation tax purposes, however, this advantage is removed when there is not sufficient interest capacity under the CIR rules which is currently the case for the BH group.

As such, this interest expense would be added back for tax purposes creating additional CT of £190,000 per year. However, this is subject to the potential increase in interest capacity that could be generated for CIR purposes following the acquisition of both BOL and MDG as discussed in Section C of this Report.

Consideration for the Sellers

It is important to note that the Seller's may not be willing to structure the transaction for cash consideration as this will create capital gains tax liabilities even with the potential availablility of business asset disposal relief (BADR) at 10%. This may mean a higher offer would be needed if this route is

pursued.

As noted, this Report does not consider the tax considerations for the sellers of BOL and they would need to seek their own seperate tax advice on the disposal of their shares.

(A3): Loan note consideration

Similarly to above, structuring the consideration by way of loan notes will also not dilute the shareholding of SG and his family.

Additionally, no immediate funding is required for the purchase of BOL as loan notes of £25 million will instead be issued to the individals.

However, this option also presents the following drawbacks which are highlighted below.

Interest payments

As loan notes of £25 million will be issued to the shareholders, interest will need to be paid at 7% per annum.

As calculated in Appendix A, this generates additional interest payments for BH of £1.75 million per year. Similarly to above, this creates an issue in relation to the deductibility of interest for corporation tax purposes as there is not currently

sufficient capacity under the CIR.

Additionally, as interest would be being paid to individuals rather than a UK bank, this will create withholding tax obligations for BH.

BH would need to withhold income tax at 20% on the interest payments made to the individuals which creates an additional tax liability of £350,000 per year, as calculated in Appendix A. BH would also need to prepare and file quarterly CT61 returns which would be due along with any tax payable 14 days after each quarter end.

Seller considerations

This option is preferable to the Sellers, as any capital gain on sale of their shares is instead frozen until the loan notes (being QCBs) are either redeemed or sold.

Additionally, they have a guaranteed return on their QCBs as interest must always be paid to QCB holders unlike dividends to equity holders. As noted above, the Sellers are not able to rely on any advice provided in this Report and they must seek their own advice.

(A4): Share consideration

Should BH instead acquire BOL in exchange for an issue of shares by BH to the individual sellers, bank funding would not be required.

This will save BH additional bank debt when it is already highly leveraged. This also removes any additional issues in respect of the CIR position, as there will be no additional interest expense generated by either acquired bank funding or payments to shareholders.

Instead, dividends would be payable to the sellers, subject to sufficient distributable profits of BH, which are paid after post-tax profits in BH. Unlike payments of interest, the payment of dividends by BH would not suffer any withholding tax or related compliance obligations.

Dilution of shareholding for SG and his family

As shares would need to be issued by BH to the current shareholders of BOL in exchange for BH acquiring 100% of the share capital in BOL, this will dilute SG and his family's holding in BH.

As the consideration needs to be worth £25 million, 4 million of shares at the share price of £6.25 would need to be issued by BH to the sellers.

This would increase the number of ordinary shares in BH from 50 million to 54 million.

As calculated in Appendix A, this would reduce the shareholding of SG and his family from 80% to 74%. Although a dilution has occured, this will not cause SG and his family to lose control over the BH group and therefore this should not cause any issues.

<u>Seller considerations</u>

This option will not be as well received by the shareholders as they are only obtaining a shareholding of 7.4% (between them) in BH and therefore may not get preferential treatment for tax purposes even though this is carried out for bona fide commercial reasons. This is because the percentage holding by the individuals after they have acquired their shares may not be sufficiently large and may still trigger capital gains tax consequences on sale rather than deferal until their shares are later sold.

However, dividends are likely to be payable and will be subject to lower rates of tax by the individuals and this may therefore still be a good option for them. Again, it is recommended they seek their own advice prior to the sale.

It is recommended that transactions in securities clearance is sought from HMRC prior to the transaction should this be structured by loan notes or shares.

(A5): Other tax implications

No UK VAT would be payable on acquisition of the shares of BOL as this is an exempt transaction for UK VAT purposes.

Stamp duty at 0.5% of the £25 million consideration of £125,000 would be payable by BH on acquisition, regardless of how the consideration is structured.

Section B: Acquisition of M&D Garages

The acquisition of MDG can only be structured as a trade and asset deal for cash as requested by the Sellers.

This section of the Report will consider the options available to the BH group on how this acquisition can be structured and the resulting tax consequences. Firstly, the acquisition by BUK of the trade and assets of MDG will be considered. Secondly, the acquisition of the trade and assets of MDG by a newly incorporated Irish subsidiary of BH will be considered.

(B1): Trade and asset acquisition by BUK

The acquisition of the trade and assets of MDG would case BUK's balance sheet to be increased by the market value of the assets as they are direct acquisitions.

To be able to acquire the trade and assets, BH would need to acquire a bank loan of £15 million and this would need to be injected into BUK by way of a further loan or subscription of shares so that BUK has sufficient fund to acquire the business. The funding considerations are discussed in Section C of this Report.

However, this acquisition will create an Irish PE for BUK as the trade and assets of MDG are all carried out and held in Ireland.

Irish PE

As BUK is UK incorporated and tax resident, it is subject to UK corporation tax at 19% (25% from 2023) on its worldwide income and gains, including that of its overseas PEs.

This should not cause too much of an issue for BUK, as it already has a number of overseas PEs and is therefore familiar with the UK CT obligations in relation to overseas PEs.

If a PE exemption election has not already been entered into by BUK, the trading losses generated in the initial period of ownership will be available to utilise against the UK taxable profits of BUK, reducing the UK CT payable by BUK which is advantageous.

However, when the Irish PE becomes profit making for tax purposes (forecast from 2024), Irish tax at 12.5% will be suffered on profits in addition to UK CT at 25% on the same profits, causing double taxation for BUK.

Under UK domestic law, BUK can claim double tax relief for the foreign tax suffered which will reduce the effective UK tax rate on this income from 25% to 12.5%. Additionally, further relief may be available under the UK-Ireland double tax treaty.

Future incorporation of Irish PE

Given the low CIT rate in Ireland of 12.5%, it would be advantageous to incorporate the PE when it becomes profit making so that it does not suffer UK CT in addition on these profits.

The UK gives favourable tax treatment in that any gains on disposal of the Irish PE asset by BUK to an new Irish subsidiary can be postponed in full if the Irish subsidiary issues share to BUK in exchange. This can be discussed in further detail and we would be happy to assist you in this regard if this option is considered.

An Irish subsidiary would however have additional considerations for UK tax purposes and these are discussed in section B2 of this Report.

(B2): Trade and asset acquisition by Irish subsidiary

An alternative approach would be for BH to incorporate an Irish subsidiary to acquire the Irish trade and assets of MDG directly.

As noted above, this option would also require BH to obtain bank funding of £15 million and this would need to be injected into the new Irish subsidiary by way of debt or equity to enable the new entity to have sufficient funds to make the purchase. This is discussed in more detail in Section C of this Report.

This is not likely to have any direct UK tax consequences for BH, subject to the controlled foreign company rules discussed below.

Controlled foreign company (CFC)

The incorporation of a new Irish subsidiary would created a CFC for BUK as it would own 100% of the share capital of the new company.

The CFC rules can bring profits of overseas subsidiaries within the charge to UK tax unless any of the exemptions are met.

There are a number of exemptions under the CFC rules which provide exemption for companies with low profits and profit margins, jurisdictions with sufficient taxes, as well as a list of specifically excluded territories.

Ireland is not an excluded territory for CFC purposes and it also has a much lower tax rate than the UK, as such, it is not likely to meet any of the exemptions and will create UK taxable profits unless its profits pass through one of the five gateways.

Four of the five gateways will not be applicable to MDG as it is a trading company rather than an investment business within interest income or an insurance business.

As such, it will only create a CFC charge is it passes through gateway one which is in relation to profits attributable to UK activities. As MDG does not have any UK managed assets and bears no UK managed risks, it is likely the safe harbour test will be met and therefore a CFC apportionment should not arise on an Irish subsidiary carrying on the activities of MDG.

Profit repatriation

Under this option, consideration would need to be given to how profits will be repatriated from the Irish subsidiary to BH and the Irish tax consideration such as Irish withholding tax would need to be considered.

If dividedns were paid from the new subsidiary to BH these would be exempt from UK CT as they would meet the controlled subsidiary dividend exemption.

Losses

Any losses generated in the early years of trade in the Irish subsidiary cannot be group releived as it is a non-UK company and therfore these losses will not have a UK benefit unlike the PE option above.

Section C: Funding considerations

Under both acquisitions, bank funding will be required unless the acquisition of BOL is structure for either loan note or share consideration.

Should BOL be acquired for cash consideration, £40 million of debt would be required from the bank and this would attract interest of £1.6 million as calculated in Appendix B.

This amount can be lowered to £15 million of debt funding if BOL is acquired for either share or loan note consideration as discussed above. This would produce smaller interest payments of £0.6 million for BH.

As the BH group do not have sufficient interest capacity under the CIR rules, this will lead to disallowances of interest deductions in the UK tax computation of BH resulting in more CT payable.

However, the acquisition of the two businesses could lead to additional interest capacity for CIR as discussed below.

(C1): Impact on the CIR rules

As calculated in Appendix B, the expected EBITDA forecast for both BOL and MDG are expected to be positive by 2024.

As BOL is a UK company which will be 100% acquuired by BH, it will join the UK CIR group of BH. As such, its tax-EBITDA will need to be aggregated with that of BH's and BUK's for the purposes of the CIR calculation.

This will also be the case for MDG, but only if it is acquired by BUK as a trade and asset deal, rather than by way of an Irish subsidiary.

This will increase the interest capacity of the group as calculated in Appendix B. By the year 2024, under the fixed ratio method, BOL alone should generate sufficient interest capacity to cover the additional interest exepense incurred by the group, whether this is on £40 million of debt or £15 million of debt such that this should not generate add backs in relation to this interest. As such, the BH group should not be negatively impacted by CIR.

(C2): On-lending to BUK or new Irish subsidiary

If BH takes out a £15 million loan from the bank and on-lends this to BUK or the Irish subsidiary by way of debt it should ensure this is done on arm's length terms as it is a large group for transfer pricing purposes.

A loan to BUK would not create any additional net interest expense for the BH group as the interest payable by BUK would be offset by the interest income in BH.

Irish tax considerations should be sought prior to any loans being entered into with a new Irish subsidiary as this may have adverse interest deductibility or WHT rules to consider.

Should these funds instead be injected by way of equity, dividends would be payable by either BUK or the Irish subsidary which would not be subject to UK corporation tax by BH as it will benefit from the controlled company dividend exemption.

Appendicies

Appendix A:

Stamp duty on acquisition of Beneke Orr

£25,000,000 x 0.5% = £125,000

<u>Interest payable per year to the individual shareholders under loan note consideration</u>

£25,000,000 x 7% = £1,750,000

WHT at 20% = £350,000

<u>Share consideration - calculation of how many shares to issue</u>

£25,000,000 / £6.25 per share = 4,000,000 shares

<u>SG and family holding in BH</u>

Prior to the share issue: 50,000,000 x 80% = 40,000,000

Following the share issue: 40,000,000 / 54,000,000 = 74%

Appendix B: Funding considerations

Interest payable to the bank on funding of £40 million:

£40,000,000 x 4% = £1,600,000

Interest payable to the bank on funding of £25 million:

£25,000,000 x 4% = £1,000,000

Interest payable to the bank on funding of £15 million:

£15,000,000 x 4% = £600,000

Potential additional interest capacity under the fixed ratio method if Beneke Orr is purchased:

	2022	2023	2024	2025	2026
EBITDA	0	1	9	15	17
Fixed ratio at 30%	0	0.3	2.7	4.5	5.1

Potential additional interest capacity under the fixed ratio method if M&D Garages is held in Baffin UK

	2022	2023	2024	2025	2026
EBITDA	(2)	(2)	4	10	15
Fixed ratio at 30%	(0.6)	(0.6)	1.2	3	4.5