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# Application and Interaction

(Ensure this number matches your candidate number on your desk label and on your candidate attendance letter)

Centre Code

Date of Examination

Tick box if you have answered in accordance with Scots Law

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## Instructions

Your script will be scanned electronically. Failure to comply with these instructions may lead to your paper not being marked. You must:

- Complete the details on this page and on the answer pages using BLACK or BLUE ballpoint pen only.
- Write on one side of the page.
- Not write in the margin areas indicated.
- If you have used additional pages, please add your candidate number and the question number to these pages.
- Do not put blank pages into the envelope at the end of the exam.

**Please do all of the above before the end of the examination.**

	Tick question attempted	For use by examiner only
1		
2	✓	
3		
4		
5		

FORMAT & STYLE OF ANSWER	MAXIMUM MARKS	MARKS AWARDED
<p>The answer is set out in the format demanded. Thus, if it is a letter, it will be properly set out as a letter with addresses, date, "Dear X" and conclude "Yours sincerely" etc. If it is a report, it will give some indication as to what it is about and who it is for.</p>	1	
<p>The report or letter should contain an introduction setting out the terms of reference, information being relied on etc. It should also contain a summary of the key findings and recommendations.</p>	2	
<p>The body of the letter or report should be laid out in a clear way with appropriate headings so that the reader can navigate around it easily and spot the key areas without reading the entire document to try to find a discussion of, for example, income tax on some employment related shares.</p>	1	
<p>The answer "flows" so that a logical chain of thought presented to the reader rather than a series of random comments (which may nevertheless be technically correct).</p>	1	
<p>The style of writing should be appropriate to what is being produced. For example, a report to a client or lay person (which will always be the main element of a question) should not contain large numbers of legislative references whereas a technical note to the tax partner should. Technical advice should be conveyed in style appropriate to the reader.</p>	2	
<p><b>RELEVANCE OF ANSWER</b></p>		
<p>The answer does not contain large amounts of irrelevant material which would only serve to confuse a client.</p>	2	
<p>Technical knowledge (which will be rewarded through the technical marks and should not affect the awarding of these marks) has been directly applied to the specific circumstances of the reader and has this resulted in an answer tailored to their circumstances.</p>	3	
<p>The question(s) posed has/have been answered.</p>	2	
<p><b>PROVISION OF ADVICE</b></p>		
<p>The report gives advice. This means that where possible it should come off the fence and suggest the best option rather than simply giving a list of unweighted possibilities which fail to give the client an answer to their real problem: what should I do?</p>	4	
<p>Advice should include relevant and appropriate planning for the future.</p>	2	
<p>Advice should be commercial. This means that candidates should consider the bigger picture rather than narrowly focussing on saving tax.</p>	2	
<p><b>TOTAL HIGHER SKILLS AND PRESENTATIONAL MARKS</b></p>	22	

Report

To : Adam McKenzie, FD, Rainbow plc

From : Joanna Graves, Tax Manager, SBG Lovell LLP

Date : 3 November 2017

Subject : Tax implications of possible restructuring  
of the Rainbow plc group.

Introduction

This report has been prepared based on the

following facts :

- Your email to John Williams dated

2 November 2017

- an extract of the Group Structure

Diagram (enclosed)

- Details of the assets of Kentucky  
Ltd (K Ltd) and Maine Ltd (M Ltd)  
(enclosed).

This report covers :

- the tax implications for the Rainbow group on the transfer of management of K Ltd.
- the tax implications of the disposal of shares/assets of M Ltd
- the tax status of key employees regarding a possible share scheme.

Please note that this report has been prepared under the terms of our engagement agreement with Rainbow Plc:

The individuals referred to below are not clients of our firm and so they should seek independent tax advice regarding their personal circumstances as the advice provided here is general.

No third party may rely on the advice contained in this report without our permission.

### Executive Summary

- no 'transactions in securities' adjustment will apply to Rainbow plc and its subsidiaries as Rainbow plc is listed.
- The group should set up an EMI scheme if possible.
- the assets of M Ltd should be sold, not the shares
- the sale of M Ltd's assets should occur before migration
- the sale of K Ltd's assets/shares should be 6 years after migration to prevent gains arising on Rainbow plc.

The tax implications for the Rainbow group of the transfer of management of K Ltd

A company is UK resident for tax purposes if it is UK incorporated (statute definition) and if not UK incorporated, then centrally managed and controlled from the UK (case law definition).

~~As K Ltd is not UK incorporated~~

UK ~~can~~ tax resident companies are liable to UK corporation tax <sup>(CT)</sup> on their worldwide income and gains.

Therefore, for K Ltd to cease being liable to UK CT, it will need to lose its UK tax residence status.

As K Ltd is not UK incorporated, this can be achieved by moving the location of central management and control outside the UK (to Ruritania) and ensuring the

(POEM)  
Place of effective management is in Ruritania.

K Ltd will then be able to evidence a change in tax residence jurisdiction via the 'tie breaker' clause in the double tax treaty (DTT) between the UK and Ruritania.

HMRC deem the location of 'central management and control'<sup>(CMAC)</sup> to be where the highest level of authority resides. We would need to clarify the purpose of K Ltd's detailed reporting to Rainbow plc (UK) as this may keep the CMAC in the UK if strategic decisions are being made.

The POEM is generally where the day to day management of the business resides. As all operational and strategic management will be moved to Ruritania, this is likely to satisfy the condition under the DTT.

~~It will~~ Regarding the location of the CMAC, it will help K Ltd's case that the new board is resident in Ruritania.

In conclusion, following the stated plan is likely to be effective in the change of residence of K Ltd ('migration') from the UK to Ruritania.

The point above regarding the reporting to R plc should be clarified and documented as well as all Board meetings

Also no Board meetings should be held in the UK or any strategic / operational decisions in the UK.

### The tax effect of migration

On migration, K Ltd will be deemed to have disposed of all assets and reacquired these at market value (MV) immediately prior to the migration.



Please refer to Appendix 1 for a calculation of these chargeable gains / taxable profits which will arise on this disposal.

The tax implication for each type of asset is:

- M Ltd shares :
  - Even though K Ltd holds a substantial shareholding ( $\geq 10\%$ ) of M Ltd for the previous 12 months and K Ltd is likely to qualify as a trading company, this disposal will not qualify for the standard participation exemption (SSE) as M Ltd is a not trading company.
  - K Ltd will be liable to stamp Duty on the <sup>reacquisition of</sup> ~~the~~ shares ( $= 7.8m @ 0.05\% = 390k$ )
  - There will be no VAT payable on the shares.

- Plant + machinery : Balancing charges/allowances will arise in the period prior to migration.

The disposal proceeds entered

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in the capital allowance calculation will be the lower of the cost and disposal proceeds (i.e. 100k).

- Goodwill : This has been internally generated since June 2002 (i.e. post April 2002) and so is classed as a 'new' intangible fixed asset and does not fall within the chargeable gains regime. Instead a trade profit will arise of £750 k.

- Trading stock : profit on this disposal will constitute trade profits.

### Administration of migration

Guidance regarding the administration can be found in HMRC's statement of Practice 2/90.

Prior to migration, K Ltd must obtain approval of the arrangements for settling any outstanding tax liabilities from HMRC.

In order to obtain approval, K Ltd must provide specified information including:

- intended date of migration
- statement of tax liabilities and proposals for securing payment
- name, UK address and place of incorporation of K Ltd
- its tax district and reference number
- copy of the latest set of accounts

Non-compliance with this notification being provided, the persons responsible, including individual directors, could be charged with penalties.

Also if any tax remains unpaid for 6 months post the migration date, HMRC

can seek recovery of the liabilities from other group companies.

### Other tax implications and reliefs on migration

No VAT will be payable as the transfer will constitute a 'transfer of going concern' and so be outside the scope of VAT.

The Ruritanian authorities may not withhold 5% tax on the dividends paid between Ruritanian companies but this should be confirmed by a Ruritanian tax specialist.

The dividends prior to migration could be paid gross following an application to the tax authorities to apply the terms of the DTT.

K Ltd can elect ~~within 2 years~~ for the gains on disposal to be postponed under s187 TCGA 1992 as K Ltd is at least a 75% subsidiary of Rainbow plc

and Rainbow plc is UK tax resident.

It is the net gain which can be deferred but a proportion of the gain would come into charge on the earlier of:

- (i) - K Ltd disposing of any of the transferred assets within 6 years of migration
- (ii) - K Ltd no longer being a 75% subsidiary of ~~AA Ltd~~ Rainbow plc
- (iii) - Rainbow plc no longer being UK tax resident.

The charge will accrue on Rainbow plc.

As the group has plans to sell the shares / assets of K Ltd within 3 years, ~~the~~ the gains will become chargeable under (i) or (ii) above.

In conclusion, on Migration, large gains and profits will arise on K Ltd. The gains can be postponed.

Paper Ref

A&I

Question No.

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Your Candidate No.

I advise the ~~migration~~ ~~is~~ ~~post~~ sale of ~~shares~~ / assets of K Ltd is postponed until 6 years from migration as the gains will no longer be chargeable.

Furthermore, the migration will bring about an end to the accounting period of K Ltd which will affect tax payment deadlines.

~~Group wide rollover relief can also~~

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The tax implications on the disposal of the shares/assets of M Ltd.

Disposal of the assets

When a UK company sells a chargeable asset, such as a property, it will be liable to CT at 19% on the chargeable gains.

M Ltd acquired its three properties from other group companies. As all subsidiaries are 100% owned by Rainbow plc, this means the companies form a 'chargeable gains group'.

Assets transferred between companies in a CG group transfer at 'no gain, no loss' under s171 TCGA 1992.

This means that the transferee company acquires the asset at the transferor company's base cost uplifted for indexation relief.

Please refer to Appendix 2 for a calculation of the gains/losses which will arise on disposal of the properties.

Stamp Duty Land Tax will be payable by the purchaser, not M Ltd.

VAT will need to be added to the sale price if an 'option to tax' has been made.

The total chargeable gains will be £2.692m at 19% is £511.48k of corporation tax will be due ~~£2.1m~~ in quarterly installment payments (assuming M Ltd is large).

We advise utilising rollover relief where possible. This will rollover the gains into a new <sup>qualifying</sup> assets base cost. The investment will need to be made within 1 year prior and 3 years post the disposal of the properties. All sale proceeds must be reinvested else a gain will be



chargeable in the proportion of sale proceeds not reinvested (compared to total sale proceeds).

This rollover relief will reduce the base cost of the new asset and so effectively eternal ~~not~~ deferral can be achieved.

This relief can ~~also~~ be claimed on a CG group wide basis, e.g. by Rainbow plc, which we advise.

The relief must be claimed within 4 years of the end of the accounting period of disposal of the properties.

### Disposal of the shares

As detailed briefly above, the disposal of the share in M Ltd is unlikely to qualify for the Substantia Shareholding Exemption.

If the SSE applied it would apply automatically and would exempt any gain/loss arising.

As M Ltd would be leaving the CG group within 6 years of the various properties being transferred, degrouping exit charges will arise on the properties, equal to the MV at original transfer less the original base cost.

Please refer to Appendix 3 for a calculation of these gains.

We can therefore see that larger gains will arise on the sale of the shares (in the absence of SSE which would exempt the degrouping charges) and so advise a disposal of the ~~shares~~ <sup>assets</sup> is made.

In conclusion, this sale of shares ~~or~~ assets should be made ~~before~~ <sup>after</sup> K Ltd migrates, this is because UK CT @ 19% (assuming an AP end of 31/3/18) <sup>+ no Runtanian tax</sup> on the gain will be less than the gain on the shares on migration plus the 16% Runtanian tax on shares.

The tax status of key individuals and share option schemes.

Individuals who are UK tax resident will be liable to income tax on employment income and capital gains tax on capital gains.

IT will be charged at 20%, 40% or 45%, ~~at~~ and CGT will be charged at 10% or 20%, dependant on the adjusted net income of the individuals.

Employees vs. self-employed

Generally, employees have much more legal protection of their employment status compared to self-employed.

Employees will pay national insurance contributions at ~~£~~ 13.8% whereas ~~emp~~ self-employed persons will pay at 9/11%.

From the ~~can~~ companies perspective it is better for the workers to be self-employed as there will be a lower tax burden (no NIC), no need for PAYE reporting, and less legal protection in terms of finishing a work contract.

The company should be careful to review the status of its workers as it is sometimes not clear whether a worker is employed / self-employed. The company can use HMRC's online tool to help understand if enough hallmarks are present and which legal + tax treatment will apply.

### Employee share option schemes

There are three main alternatives :  
EMI schemes, CSOP schemes and non-tax advantaged schemes.

Generally we would advise opting for an EMI scheme where available due to the enhanced ~~de~~ tax relief available.

The share <sup>option</sup> schemes referred to allow the employer to offer them to selected employees.

For EMI and CSOP, there will be no IT charge on the profit of MV on exercise less option price paid. There will be this charge for the non-tax advantaged schemes.

There will be a CGT charge on the gains on shares arising between the option exercise and disposal of the shares and so shares should be disposed of immediately after exercise. Relief is given for the profits charged to IT.

The employer company will qualify for CT deductions on the <sup>profits</sup> ~~amount~~ paid by the chargeable on the individuals.

The relief is available when the employees receive beneficial ownership of the shares.

The company issuing the options must satisfy certain conditions, regarding maximum number of employees and assets held.

There is CT relief for the set up costs of the CSOP scheme.

Appendix 1 - Deemed gains / profits  
on migration of K Ltd  
(indexation relief ignored)

Asset	SPs = MV	Cost	gain
Factory	400k	200k	200k
Warehouse	450k	350k	100k
Fixed PM	150k	100k	50k
Trading stock	300k <del>200k</del>	200k	100k (trade profit)

Gains = 350k  
trade = 100k  
profit



Appendix 2 - Disposal of Mainie properties

	Birmingham	Leeds	London
	£'000	£'000	£'000

Sale proceeds	2 000	2 200	3 500
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less cost	(1 300)*	(1 600)*	(1 500)
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less indexation allowance	<del>Sept 2012</del>	<del>Sept 2012</del>	July 2015 - Dec 2004
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$$1500 \times \frac{258.6 - 189.9}{189.9}$$

$$= 1500 \times 0.362$$

$$= (543)$$

less indexation allowance	<del>Nov 2017</del> - sept 2012	<del>Nov 2017</del> - sept 2012	Nov 2017 - July 2015
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$$1500 \times \frac{261.1 - 258.6}{258.6}$$

$$= 1500 \times 0.010$$

$$= (15)$$

Chargeable gain/ (loss)	650	600	1 442	Total 2 692K
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(assumes disposal in November 2017).

\* as there was a transfer from stock to fixed assets, we have assumed no election was made to transfer at base cost. This will need to be confirmed.

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Appendix 3 - gains on sale of MLtd shares  
(indexation relief ignored)

Gain on the shares of MLtd:

MV @ 31/12/17 = 7 800 000

less cost = 6 000 000

1 800 000

chargeable  
gain

	Birmingham	Leeds	London
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MV@ July 2015	1 350	1 600	3 000 000
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less cost	<u>1 350</u>	<u>1 600</u>	<u>1 500 000</u>
	—	—	1 500 000

⇒ total gains £3.3m

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Plan CT/IHT/VAT/CGT/admin/accounting ethics/law/SD/SDLT/WHT

① implications on R group of migration

- residence of K Ltd → likely to change
- migration → tax effect (dispose of all assets)
  - delay tax charge (no EV reliefs) (but lost < 3yrs)
  - TCGA 1992 (notify HMRC + pay tax)
- how to change residence

VAT - no :: TOGC  
SD?

- future sale of Kentucky
  - ← 3yrs
  - shares - SSE
  - assets - outside UK tax net
- wider group effect: fewer associates, DIVIDENDS - WHT
- conclusion: K Ltd cease to be liable to UK tax? NO

② implications on R plc + M Ltd on sale of shares/assets

Shares: SSE? no because not trading  
£7.8m no VAT  
no trans. in securities

compare to  
Ruritania tax  
16%

Assets: degrouping < 6yrs of s171  
£7.7m calculation of gains  
SDLT, no VAT (option to tax)  
rollover

- timing of disposal: delay to ~~get~~ avoid degrouping
- conclusion: sell shares/assets? before/after migration?

③ Possible share scheme options

CT tax relief + residence of indiv's?  
ITEPA legal + tax: employees vs. self emp.

EMI

CSOP

Non-tax adv.

recommend  
EMI

CONCLUSION: