The Chartered Institute of Taxation

Application and Professional Skills

Taxation of Larger Companies and Groups

May 2023

Suggested solution

Report to the Board of Sparkby plc

On what actions should be taken to keep the overall corporate tax liability to a minimum

Introduction

This report has been prepared for the Board of Sparkby plc to consider what actions should be taken to move the tax residences of subsidiary companies and/or to move physical locations of trades to keep the group's overall corporate tax liability to a minimum over the next four years, taking account of the grant position in Benignland.

It should not be relied on for any other purposes or by any other persons.

This report is based on our current understanding of:

a) the corporate tax and grant regimes in the UK, Arcadia, Benignland and Candyland; and
b) the projected taxable profits/(losses) of Sparkby plc and each of its subsidiary companies.

We have assumed that:

a) without any actions being taken, 15% corporate income tax will be suffered on the accounting profits of all overseas trades; and
b) there will be no material changes to tax law, or the availability of, or conditions attaching to grants in any of the UK, Arcadia, Benignland and Candyland in the four years to 31 March 2027.

Before implementing our advice, it is recommended that independent tax advice is taken in each of Arcadia, Benignland and Candyland and that we, the tax department, are asked to advise on changes to, or new, UK tax legislation that would impact on the advice given in this report.

Alex Jones
Head of in-house tax department of Sparkby plc
May 2023

Executive Summary

In respect of each of the three subsidiary companies:

a) We should physically relocate the trade of Anwood Ltd to the UK.
b) We should not move the trade of Broadton Ltd in the short term but should claim the grant aid that is available there for new capital expenditure. We should, however, seek to broaden that company's client base to reduce dependency on Benign Autos Inc, with a view to moving the trade to the UK at a future point to take advantage of tax reliefs in the UK.
c) The trade of Croxhume Ltd should not be moved because the tax payable if the trade is left in Candyland is lower than would be payable if the trade were liable to UK tax.

The proposed overseas minimum tax rate of 15% is higher than current rates in our overseas locations, but still lower than the UK rate of 25%. However, there are significant tax reliefs available in the UK that are not available against profits taxed overseas, consisting of capital allowances of £50 million a year for four years in Anwood Ltd and in Broadton Ltd (so

£100 million per annum in total), and interest expense deductions of up to £90 million per annum.

Interest deductions are restricted where they are referrable to profits not subject to UK tax. However, we have calculated that every £100 million of profits subject to UK Corporation Tax attracts £30 million of interest deduction.

The effect of obtaining these reliefs is that the profits of our subsidiary companies, if subject to UK tax, would be reduced from £100 million each per annum to £20 million in each of Anwood Ltd and Broadton Ltd, and £70 million in Croxhume Ltd.

We could bring profits within the UK tax net by moving trades and/or corporate residence of overseas companies. Double tax relief is available to relieve any overseas tax, by credit, against UK tax payable, although the relieved overseas tax cannot exceed the UK tax payable on a company-by-company basis.

We have compared the group tax payable under our present structure with that payable for each of the four years to 31 March 2027 under different scenarios of moving some or all of trades to the UK.

If no moves were made, the liability would be £45 million per annum. The lowest overall tax liability, at £25 million per annum, is achieved by moving the trades of Anwood Ltd and Broadton Ltd to the UK.

However, the availability of grant aid in Benignland complicates the issue. If we left Broadton Ltd's trade there, the group tax liability increases to £35 million per annum, but we would receive £8 million grant aid per annum, thus reducing the total tax liability to £27 million. The £2 million difference is almost certainly less than the profits we would lose by moving the trade to the UK, because of the likely loss of the Benign Autos Inc business. Therefore Broadton Ltd's trade should be kept in Benignland.

We should seek to build up new business to replace the Benign Auto Inc business and take a future decision on when would be the financially beneficial time to move the trade to the UK, bearing in mind the financial loss (repayment of grant) and reputational risks of doing so within the 10 years qualifying period from receipt of grant aid.

Background

The OECD has proposed that there be a minimum rate of corporate income tax of 15% in all territories. Under the current structure of the Sparkby plc group, all its profits (without deductions for capital allowances and interest) will be subject to tax at 15%.

As the projected levels of profits, losses, capital allowances (if available) and grants of all group companies are the same for each of the next four years, we have based our considerations and calculations on a single year that will be representative of each of the four years.

We have considered the following factors in reaching our recommendations:

1) Availability of losses and capital allowances in the UK;
2) Disallowances under the UK corporate interest restriction (CIR) rules;
3) How to bring trading profits into the UK tax regime;
4) Projected group tax liabilities of different scenarios; and
5) Impact of grant availability in Benignland.

Our analysis illustrates whether the availability of the UK tax reliefs for capital allowances and the losses of Sparkby plc are more advantageous than leaving profits outside the scope

of UK tax, and instead being taxed at 15% in the overseas territories without those reliefs being available.

1. Availability of losses and capital allowances in the UK

The non-trading loan relationship ('NTLR') losses incurred by Sparkby plc are in respect of interest on external borrowings. We have assumed that the small profits from the trade of provision of management services are relieved by a very small part of these losses, and that part does not materially reduce the amounts of losses remaining available to be otherwise relieved.

The NTLR losses are available to be relieved against other profits chargeable to UK tax within the group by way of group relief, subject to restrictions which are separately considered under paragraph 2 below. They are not however available to be relieved against profits that are outside the scope of UK tax.

Capital expenditure to be incurred by Anwood Ltd and Broadton Ltd will qualify for capital allowances if their trades are within the charge to UK tax, at £50 million per annum per company. Those allowances are deductible in computing UK taxable profits. The trades in question do not have to be carried on in the UK to qualify for capital allowances. However, if a trade is not subject to UK tax, the allowances are not available. Furthermore, no allowances are available in Arcadia or in Benignland.

Accordingly, if the trades are subject to UK tax, the UK taxable profits of each subsidiary after capital allowances are:

a) Anwood Ltd: £100 million - £50 million = £50 million
b) Broadton Ltd: £100 million - £50 million = £50 million
c) Croxhume Ltd: £100 million

2. Disallowances under the UK Corporate Interest Restriction (CIR) rules

The amount of finance costs that can be relieved against profits taxable in the UK (i.e. the interest capacity of the group) is limited to the greater of:

a) 30% of UK taxable profits before interest, tax, depreciation and amortisation ('tax EBITDA'); and
b) the ratio of the group's worldwide external interest expense to the group's EBITDA profits (i.e. before interest, tax, depreciation and amortisation) multiplied by the group's tax EBITDA.

Under the Sparkby group's current structure, there are no UK taxable profits (and so no tax EBITDA). Therefore, applying both of the above rules (either 30% of zero, or 90/300 x zero) means that the group has no interest capacity and so none of the interest payable by Sparkby plc on the external loans may be deducted in computing taxable profits.

However, the profits of each of Anwood Ltd, Broadton Ltd and Croxhume Ltd (£100 million each) represents one-third of global profits (before relief for interest and capital allowances), so that the profits of each trade, if brought within the UK tax regime, would generate £30 million of interest relief (£100 million at 30% or 100/300 x £90 million).

Therefore, each company's profits, if within the UK tax regime, would be liable to UK tax on the following total profits (after capital allowances, and interest deducted as group relief):

a) Anwood Ltd: £50 million (as above) - £30 million interest = £20 million
b) Broadton Ltd: £50 million (as above) - £30 million interest = £20 million
c) Croxhume Ltd: £100 million (as above) - £30 million interest = £70 million

In summary, for every trade that is brought into the UK corporate tax regime, an additional £30 million of interest relief per annum can be accessed.

3. How to bring trading profits into the UK tax regime

UK Corporation Tax is charged on global profits of UK tax-resident companies (subject to an election to exempt overseas permanent establishments) and on profits of non-UK tax resident companies that arise from trades carried on in the UK through permanent establishments.

A company is UK tax resident if it is incorporated in the UK, or its central management and control is exercised in the UK. 'Central management and control' means the place where strategic business decisions are taken. This typically would be where board meetings take place. If a company is tax resident in the UK and in some other country by reason of the laws of that other country, a tie-breaker clause in the standard OECD treaty establishes that the residence of the company is to be determined by agreement between the competent authorities of both states, having regard to the company's place of effective management (POEM), its place of incorporation and other relevant factors. POEM is determined by taking into account various factors, including where board meetings are held, where the CEO and other senior executives usually carry on their activities, where the senior day-to-day management of the company is performed, where the company's headquarters are located, and where the accounting records are maintained.

Taking each subsidiary in turn:

- Anwood Ltd is already UK tax resident, but its profits are taxed only in Arcadia by reason of the election made by the company in the UK to exempt the profits of its permanent establishments from UK tax. The election is irrevocable, so Anwood Ltd cannot reverse it to bring the profits of the trade into the UK tax regime. However, the profits of the trade can be brought into the UK tax regime by:
  a) Anwood Ltd physically moving the Arcadia trade to the UK, at which point the election becomes of no application as there are no overseas permanent establishment activities; or
  b) transferring the trade to a UK tax-resident group company (say a new company) which would not make the election for exemption, but leave the trade located in Arcadia.

  No tax would be payable in Arcadia insofar as the trade was not physically located there. Moreover there are no UK tax consequences for Anwood Ltd in respect of either of the above transactions by virtue of the rules that apply to transactions between UK group companies.

- Broadton Ltd is resident in Benignland. Its trading profits can become subject to UK tax either by:
  a) relocating the trade to a permanent establishment in the UK; or
  b) moving the company's central management and control to the UK.

  In both cases the profits would also continue to be taxed in Benignland, at 5%, because Broadton Ltd would continue to be tax-resident in Benignland and taxed there on its worldwide income.

  Exposure to Benignland taxation could be avoided however by transferring the trade to a UK resident company which would carry on the trade in the UK rather than Benignland.

- Croxhume Ltd can be made UK tax resident by moving its central management and control to the UK to make it UK resident. So long as effective management is also

exercised within the UK, under the tie-breaker article of the UK/Candyland double taxation agreement, Croxhume Ltd is likely to be UK tax resident only, though its profits would still be taxed in Candyland (as they would arise to a permanent establishment now located in Candyland). It should be noted however, as already intimated, that Croxhume Ltd becoming UK resident under the treaty is subject to agreement between the tax authorities of both the UK and Candyland (which may be a drawn-out process, take time to achieve and incur additional expense). Alternatively, the trade could be transferred to a UK permanent establishment of Croxhume Ltd, or to a newly incorporated UK tax-resident company. The profits of the trade would be taxed only in the UK as Candyland does not tax trades located outside Candyland.

It should be noted that there are no exit tax charges in any of the overseas territories, so that physically relocating trading activities to the UK or effecting the migration of an overseas resident company to the UK would not expose the group to any such charges.

Accordingly, it is possible to bring the profits of the trade of each company within the UK tax regime and to decide whether also to leave the profits of each trade subject to tax in its current location.

4. Projected group tax liabilities of different scenarios

Each of Arcadia, Benignland and Candyland tax the profits of trades carried on within their territories. Additionally, Benignland also taxes global trading profits of Benignland-incorporated companies. Currently, the profits of each subsidiary in each of Arcadia, Benignland and Candyland are taxed only in those territories respectively as follows:

a) Anwood Ltd: £100 million at 10% =£10 million
b) Broadton Ltd: £100 million at 5% = £5 million
c) Croxhume Ltd: £100 million at 10% =£10 million

If profits are brought within the UK tax regime, they would be liable to Corporation Tax as follows:

a) Anwood Ltd: £20 million at 25% = £5 million
b) Broadton Ltd: £20 million at 25% = £5 million
c) Croxhume Ltd: £70 million at 25% = £17.5 million

Insofar as profits are also taxed overseas, either because the trade continues to be carried on in that territory or in the case of Benignland because it taxes global profits, double tax relief (DTR) relieves overseas tax suffered by credit against the UK tax, up to the amount of the UK tax, either under double tax agreements, or by way of unilateral UK relief. Therefore, the maximum tax payable by each company is the greater of the amount of UK tax and the amount of overseas tax.

Under the proposal to tax overseas profits at a minimum of 15%, if no action is taken, overseas profits will suffer tax of £45 million (£100 million at 15% for each company).

However, if the trades of Anwood Ltd and Broadton Ltd are brought within the UK tax regime, but Croxhume Ltd left in Candyland, the annual tax liability is minimised as follows:

a) Anwood Ltd: £20 million at 25% = £5 million (UK only; no Arcadia tax liability)
b) Broadton Ltd: £20 million at 25% = £5 million (UK tax £5 million if trade transferred to a UK tax-resident Newco) or UK tax £5 million less DTR £5 million (i.e. no UK tax), plus Benignland tax £5 million (if trade remains within Broadton Ltd)
c) Croxhume Ltd: £100 million at 15%= £15 million (Candyland 10% rate effectively increased to15%)

Therefore, from a tax perspective, the best option is to move the trades of Anwood Ltd and Broadton Ltd within the UK tax regime and leave Croxhume Ltd and its trade in Candyland, to give total tax liabilities of £25 million, on the bases described above.

5. Impact of grant availability in Benignland

Grant aid of £8 million is available in Benignland for each of the four years if the capital investment is made in respect of a trade located in Benignland. The grants are repayable, with 10% annual interest, if the trade ceases to operate in Benignland within ten years of the grant being made.

Therefore, if we kept the trade of Broadton Ltd in Benignland and located only the trade of Anwood Ltd to the UK, our annual group tax liability would increase from £25 million (if both Anwood Ltd's and Broadton Ltd's trades were moved to the UK) to £35 million, as Broadton Ltd's profits would be taxable at 15% rather than the current 5%. However, the grant aid of £8 million per annum in Benignland would effectively offset the additional tax liability, in part, thus reducing the group's total tax liability to £27 million per annum. This is still higher than £25 million if both Anwood Ltd's and Broadton Ltd's trades were transferred to the UK and in itself would not justify keeping the trade in Benignland.

However, Benign Autos Inc is committed to buying parts from Benignland-based businesses wherever commercially viable. Therefore, there is a significant risk that we would lose our trading relationship with that company if we moved the trade to the UK. The contract with Benign Autos Inc is an important part of the overall trade and profits of Broadton Ltd, and the possible loss of that business, in the event of our moving the trade to the UK, is likely to outweigh the small tax advantage of moving the trade to the UK.

We could leave the trade in Benignland and claim the grant aid. In the meantime, we could expand the business with new contracts with entities other than with Benign Autos Inc. If we could replace, at least in part, the Benign Autos Inc business, we could then relocate the trade to the UK to take advantage of the lower UK tax payable and repay, with interest, the grants so far received. An appraisal would be required of the overall advantage of lower UK taxes as compared with the need to repay grants and interest (if within ten years) and potential loss of profits should the Benign Autos Inc business be lost.

If a relocation to the UK were to take place within ten years of the first grant being received, we would be reneging on our undertaking that the Benignland government requires, as a condition of the grant aid being made available, that we would remain in Benignland for at least ten years. At the very least, that would damage the group's reputation for integrity, which in turn could reduce our ability to do business successfully in the future. It might, depending on whether the undertaking was contractual, also lead to a legal dispute with the Benignland government, which could be costly in monetary and reputational terms.