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Answer-to-Question-_1_

DRAFT REPORT FOR REVIEW BY PETER JONES

From:Stephens LLP

To: Joanne Grey

Date: 15 November 2024

Subject: Tax implications of Norwall Inc expansion and restructuring plans

Introduction

This report is prepared in response to the email revieved by Peter Jones from Joanne Grey on 1 November 2024. This report will set out the UK tax implciations concerning the proposed restructuring and consideration of the most approprirate financing options.

This report has been prepared solely for the use of Joanne Grey and the baord of directors of Norwal Inc ("NI"). No respoinsibiltiy will be accepted by Stephens LLP for the relieance upon the contents of this report by a third party.

The tax law applied is as at the time of writting. Should there be a delay in the expansion and restructuring plans the conclsions and reccomendations of this report may need to be reviewed for appropriateness.

Exectuive Summary

The purchase of the shares in Macduff Ltd ("MD") will result in stamp duty charges of

£7,685,000(Appendix 1)being payable within 30days of the purchase. Appropriate warranties and indemnitities should be sought in order mitigate any unforeseen liabilaities as the purchase of shares

So long as the central management and control and the place of effective management of MD continued to take place in the UK then it will retain its UK residancy status and be subject to UK corporation tax at 25%.

If this is not maintained it risks the residancy being established in Ruritania and therefore the trading operations being subject to local taxes at 35%.

To maxmise the use of the overseas trading losses in the early years of its expansion plan MD should operate the trading operations as an overseas branch to save Uk tax at 25%.

Once the branches become profitable in year 5 we would then reccomend that that either the branches are incorporated into overseas subsidaires or a PE exemption is made. We will require further information in order to advise which option would be more benefitical in this instance as it will depend on the losses that have arisen.

For the restrucuring plan, MD will acquire all the branches from NI at their market value. The UK PE will form part of the MD gains group and therefore the assets will transfer tax neutrally ie at their base cost.

As both the branches in Portugal and Poland are profit making and assuming that they remain to be profit making it is advised that instead of incororating the branches into overseas subsidaires where exit charges will arise on a future disposal, a branch exmeption election should be made. This is assuming that the branches have not made tax losses in the last 6 years. If this is not the case please let us know as it may change the outcome of our analysis provided.

If the Spanish branch remains in MD when then the election is made it will prevent MD from benefiting form the forecasted tax lossses in Spain. Therefore, we reccomend that this branch is transferred before the election is made to a newly incorporated UK subsidary where no PE election is made.

Funding the resucturing plan via debt would likely result in interest restrictions in MD and higher tax charges on the interest income in Ruritania at 25% rather than the 5% which dividends from UK subsidaireis are taxed at.

On the basis that no interest would likely be deductible in the UK and the interest income would be taxed at a higher rate of 35% in Ruritania, funding should be by way of equity.

Section A: Purchase of MD using cash reserves of NI

The purchase of the shares in MD will likely cost NI £1,537million, being the valye of the net assets of the company. NI will incur stamp duty taxes on the purchase of the shares of £7,685,000 (Appendix 1).Stamp duty charges are payable within 30days of the purchase.

No VAT will be due on the purchase of the shares as they are outside the scope of VAT.

Residancy

A company is determined to be UK tax resident by virtue of its incorporation or where its central management and control is exercised. MD will continue to be a UK tax resident entity following the actuisition by virtue of its incorporation in the UK and so long as its central management and control ("CM&C")continues to take place in the UK.

Central management and control is usually aligned to where the board meetings of the company takes place. If as a result of the acquisition these now take palce in Ruritania then CM&C may be established outside of the UK, causing MD to be dual resident, ie resident in both the UK and Ruritania. However, the UK offers double tax relief for any foreign taxes suffered.

Where there is a double taxation treaty in place which includes a non-discrimiation clause, residancy between the two territories can be established by place of effective management ("POEM"). This is generally understood to be where the day to day management decisions of the business take place e.g. accounts are kept, general management reside and untake day to day activities.

As the UK and Ruritania have recently established a double taxation treaty, it is vital to check if this clause is contained within the treaty.

To retain UK residancy and ensure the trading operations are taxed in the UK at 25% rather than in Ruritania at 35% in the future, we would highly reccomend that the board meetings of MD continue to take place in the UK and that the day to day management of MD continues to take place in the UK with little involvement from a strategic perspective from Norwall Inc.

<u>Groups</u>

Assuming that NI itself is purchasing the shares in MD, MD would become a wholly owned subsidary of NI, such that it would form part of a capital gains group with NI's UK permanent establishment.

Any transfers between members of a gains group occur on a tax neutral basis such that no gain and no losses would arise.

Any dividends paid by MD to NI will not be deductible for UK corporation tax, although no witholding taxes will apply. Although we understand that the reciept of dividends from a UK company will be taxed at 5% in Rurtiania.

Alternative

We have no explore the alternaitve of acquiring MD by way of its trade and assets through a newly incorporated Uk company. However if you would like us to explire this option for you please let us know.

Although we note stamp duty land taxes would be signficantly higher than that on a share purchase ie £37m (appendix 2).

Conclusion

Upon buying the shares of MD, NI will also be acquiring all of the historic liabilties of MD. Therefore we reccomend that appropriate warranties and indemnitities are be sought in order mitigate any unforeseen liabilaities as the purchase of shares

MD should also register to be part of the UK VAT group with the UK branch of NI.

Section B: Expansion into the new territories

In this section we have reviewed the UK tax consequences of expanding into new territories such as the Czech Republic or Lithuania either as a branch of a UK company or as a overseas subsidary of a UK company.

We have assumed that this expansion will be be through either the newly acquired company, MD or through a newly incorporated UK subsidiary of NI ("Newco") given the increase in tax rate in ruritania we have not considered this as an option.

In the analysis below we have initially assumed this will be through MD however where it would not be beneficial to do so we havehighlight this.

Overseas Branch

A UK company is subject to UK corporation tax at 25% on its worldwide income.

A branch is considered to be a fixed place of business through which business of the company is wholly or partly carried on. Therefore, any profits generated from an overseas branch will be taxable in the UK via MD.

We understand that it is expected that losses will arise in the early years of trading but will become profitable within 5 years. A UK tax benefit of operating through an overseas permanent establishment ("PE") is that any losses generated by the PE will be available to offset against UK corporation tax in MD which according to the latest financial information avaialble it was tax payig in the year ended 30 June 2024. This would save tax at 25% in the UK.

In the future, as the overseas tax rates in the two territories are lower than that of the UK when the PE's become profitable there will be additional tax due in the UK and therefore it will no longer be tax efficient to operate as overseas branches of MD.

There are then two options for MD to explore, either incorporate the branch into an overseas subsidary or make a branch exemption election.

Incorporation into an overseas subsidary

If the branch is incorporated then exit charges subject to UK corporation tax at 25% will arise for MD as a result as the assets leaving the charge to UK corporation tax. We would need more information in order to calculate any exit charges due.

MD would be required to notify HMRC of the incorporation and ensure that any taxes due would be settled within the required time period.

However, where the incorproation of the PE is wholly in exchnage for shares MD may be able to postpone the charge on the transfer of the assets to a non-Uk resident company. This would defer any chargeable gains arising until the shares in the overseas subsidairies were sold.

However, if at any time in the 6 years following the transfer either an asset which was transferred on incorporation is disposed of a chargebale gain will arise. We can provide further information on this if required.

Branch exemption election.

Alternatively, a branch election could be made, although we would reccomend that as this election is irrevocable and would apply to all current and future PEs if this option were to be pursued then Newco should be used.

The branch exemption election would apply from the first period following the exemption election. However, it will not apply until the losses generated by the PE's are matched against profits subject to UK tax. This would result in additional tax being payable in the UK.

Therefore, it may take some time for this election to take palce.

Overseas subsidary

If the expansion into the new territories, Czech Republic or Lithuania is by setting up overseas subsidaries then the profits generated in those territorties should not be subject to UK corporation tax in contrast to the option prposed above.

However, the signficiant disadantage of this option to the branch option discussed above is that the losses generated in the first years will also not be avaialble to offset against UK corporation tax.

Controlled foreign company

By virtue of MD holding 100% of the share capital the overseas companies would be controlled by MD. Therefore they would be controlled foreign companies ("CFC").

The CFC may be subject to a CFC charge to the extent that it has UK managed assets or risks. However, where either a CFC exemption is met or that the profits do not pass through a CFC gateway then no charge will arise.

Based on the current informtation shared it appears that a subsidary in Czech Republic would be eligble for the tax rate exemption as the tax rate in the territory would be > 75% of the tax rate in the UK. Unfortunately this would not apply to a subsidary in Lithuania as the tax rate is below the 75% threshold.

More information would be required to determine if any of the other exmeptions are met but considering the CFC gateways the trading income gateway would be applicable.

To the extent that the motive of operaitng in the territory is not a tax driven and the company is indpendant or capable to operate independantly of MD then no profits will pass through the gateway. We would require further information to conclude that no profits pass through the gateway but under the assumptions set out above it would not seem likely.

Conclusion

To maxmise the use of the overseas trading losses in the early years it appears most beneficial to operate as an overseas branch to save Uk tax at 25%.

Once the branches become profitable in year 5 we would then reccomend that that the branches are either incorporated or an exemption election is made. Further information and forecasts would be required to determine which would be the most beneficial.

Section C: Restrucuring plan

Transfer of branches from NI to MD

We understand that the NI would like to restructure the business to move the branches to a UK holding company i.e MD. No exit charges should arise in Ruritania on the transfer of the branches from NI to MD.

Local tax advice should be sought with the regards of the movement of the branches to the UK for any foreign tax implications.

We understand the board would like to understand the tax implications on the decision to either continue to operate the branches as overseas branches or to incorporate the overseas subsidaries once these have been transferred to MD.

The tax implcations of operating as an overseas branch or a overseas subsidary is largely the same as tax implications as set out in Section B. However we will consider the applicability to each branch in turn below.

UK Branch

As mentioned in Seciton A, the UK branch and MD will form part of a capital gains group, therefore the transfer of assets within a gains group will occur on a tax neutral basis, such that no gains or losses will arise on the transfer of the assets.

All the capital assets transferred from the UK branch to MD will be acquired at their base cost rather than their market value.

There will be no UK tax implcations on the incorporation of the UK branch to a UK company as the assets will not be leaving the scope of UK corporation tax.

Portugal Branch options

Once transferred by continuing to operate as an branch of MD, as the branch is profitable and the tax rate in Portugal is lower than that of the UK £1.72m (Appendix 3)of additional tax will be payable in the UK.

As mentioned in section B the profits of the overseas branch can be brought outside the scope of UK corporation tax by either making a branch election or incorporating the PE.

Exit charges will arise when an overseas branch of a UK company is incorporated equal to the market value of the assets £5m. Therefore, Uk corproation tax of £1.25m (£5m * 25%) could arise in the instances as set ou in section B.

Whereas, if the irrevocable exemption election is made by MD then no exit charge will arise and as long as no losses have been made in the previous 6 years, no losses will be required to be offset against UK profits.

Poland Branch options

The tax implciations of the options for the Polish branch are the same as set out above for the Portugal branch.

Exit charges will arise when an overseas branch of a UK company is incorporated equal to the market value of the assets £5m. Therefore, Uk corproation tax of £0.75m (£3m * 25%) could arise.

As the branch is profitable and the tax rate in Poland is lower than that of the UK £0.33m (Appendix 4)of additional tax will be payable in the UK if no action is taken.

Spanish Branch

Given that the spanish branch is loss making it would be more benefiticial for MD to continue the operations as a branch rather than a subsidary as MD could benefit from a UK tax saving of £1m (appendix 5). If the spanish branch was incorporated then none of the forecasted tax losses would be available for use in the UK.

To avoid the exemption election applying to the Spanish branch we reccomend setting up a new Uk company to which the spanish branch is transferred by MD as a NGNL transfer and therefore will not be subject to the PE exemption election.

Conclusion

In order to minimise the risk of exit charges arising and maxmise the losses available from the Spanish branch to offset against UK taxes we would reccomend that the Spansih branch is transferred to a Newco in which no PE election is made.

This would then allow an PE exemption election to be made by MD. Although we would likely to highlight that this election is irrecovable and thereofre, if any of the branches became loss making

The above is based on the assumption that no CFC charge would arise as it appears that the tax rate exemption is met for all the territories.

Section D: Funding of the restructuring

This seciton explores the tax implications of funding the £39million required for MD to acquire the branches from NI for their current market value.

Debt

If NI funds the restructring plan in MD via debt then as the group is large, the transaction must take plans on an arms length basis due to the transfer pricing regieme.

As a result MD will incur interest charges (non-trade loan relationship debits) on the £39m loan. These will in principle be dedctible against any UK profits generated by MD or group relieved against profits of the UK PE, saving tax at 25%.

However, there are a number of peieces of anti-avoidance legislation in the UK regarding interest dedcutions in particular the corporate interest restriction. This limits any interest charged over £2m. More information would be required in order to calculate the resitrcitoon in MD but given the current finance expense is £1.8m it is liekly that a restriciton will arise.

Howveer, a benefit of debt funding is that NI will have greater felxibility regarding the repayment of the loan. There are no tax implications on the repayment of a loan.

As there is a double taxation treaty ("DTT") in place between Ruritania and the UK any payment of interest from MD will be subject to witholding taxes of 10% and assuming that the interest income will be taxable in Rurtiania it will also be subject to income tax on the reciept of the interest income.

Equity

If NI invests the funds via equity in MD, then there will be no tax deductions available in MD for the payment of any dividends.

Furthermore, there is no witholding taxes on the payment of dividends from the UK. However, 5% tax would be payable on dividends recieved from UK subsidaires in Ruritania.

Assuming 5% is lower than the rate interest is taxed (assuming the local tax rate is 35%) it would appear more benefitical from a Ruritanian perspective to finance the restructuring through equity.

Appendices

Appendix 1: Stamp duty implications on purchase of Macduff shares

Net assets = £1,537m * 0.5% = £7,685,000

Appendix 2: Stamp duty land tax implication on puurchase of L&B

0% * £150,000= £0

2% * £100,000 = £2,000

5% * £750m = £37m

Appendix 3: Portugal branch tax position if a branch of Uk company

Portugal	2024	2025	2026	Total
	£m	£m	£m	
Taxable profit/(loss)	2	2	3	
local tax rate (21%)	0.42	0.42	0.63	
Uk tax rate (25%)	0.5	0.5	0.75	
variance	(0.8)	(0.8)	(0.12)	(1.72)

Appendix 4: Poland branch tax position if a branch of Uk company

Poland	2024	2025	2026	Total
	£m	£m	£m	
Taxable profit/(loss)	2	1.5	2	
local tax rate (19%)	0.38	0.285	0.38	
Uk tax rate (25%	0.5	0.375	0.5	

variance	(0.12)	(0.09)	(0.12)	(0.33)

Appendix 5: Spain branch tax position if a branch of Uk company

Spain	2024	2025	2026	Total
	£m	£m	£m	
Taxable profit/(loss)	(2)	(1.5)	(0.5)	
local tax	-	-	-	
UK tax saving	0.5	0.375	0.125	1