

THE CHARTERED INSTITUTE OF TAXATION

APPLICATION AND PROFESSIONAL SKILLS

Taxation of Larger Companies and Groups

May 2021

TIME ALLOWED

3 HOURS 30 MINUTES

- In order to secure a pass in this exam, you will be required to demonstrate competence in each of three skills.

You will be assessed across your answer as a whole for Structure. A pass or fail grade will be awarded.

You will be assessed for competence in a number of broad topics for the following skills:

- Identification and Application
- Relevant Advice and Substantiated Conclusions

For each topic for each of these two skills, a grade will be awarded. The grades for those topics will be weighted and averaged to produce a final grade for each skill of 0, 1, 2, 3 or 4. A grade of 3 or 4 is required to demonstrate competence.

- All workings should be shown and made to the nearest month and pound unless the question specifies otherwise.
- Candidates who answer any law elements in this paper in accordance with Scots law or Northern Ireland law should indicate this where relevant.
- Scots Law candidates may provide answers referring to Land and Buildings Transaction Tax rather than Stamp Duty Land Tax.
- Except as set out below or indicated by additional information in the question, you may assume that 2020/21 legislation (including rates and allowances) continues to apply for 2021/22 and future years.

1) You MUST assume that the UK remains within the European Union.

2) You MUST ignore all temporary Covid related legislation including furlough, grants, loans and the reductions in VAT and SDLT rates.

Except in relation to points 1) and 2) above, candidates answering by reference to more recently enacted legislation or tax cases will not be penalised.

- You must type your answer in the space on the screen as indicated by the Exam4 guidance.

You are Tracy Stevens, a tax manager at Smith and Stevens LLP. Smith and Stevens LLP provides tax and accounting services to Woodley Adams Ltd, a subsidiary of Woodley Adams Corp, which is headquartered in Ruritania.

Your tax partner, James Smith, has been contacted by Olivia Peters, the Finance Director of Woodley Adams Ltd. Woodley Adams Corp is considering expanding its UK activities and Olivia has asked for tax advice on the proposed expansion.

James has asked you to draft a report for his review in response to Olivia's request. He has said that although Woodley Adams Ltd will be seeking separate advice on the Ruritanian tax implications, you should assume that the rules there are similar to the UK rules for the purposes of providing the report. The UK and Ruritania have a Double Tax Agreement that is in accordance with the OECD Model Convention and the corporate tax rate in Ruritania is 12%.

The following exhibits are provided to assist you:

EXHIBIT A: Email from Olivia Peters to James Smith

EXHIBIT B: Extracts from the Design and Build proposal

EXHIBIT C: Extracts from a report prepared by Olivia Peters for the Board of Woodley Adams Ltd concerning Harrington Products Ltd

EXHIBIT D: Pre-seen information

Requirement:

Prepare a draft report for the Finance Director of Woodley Adams Ltd recommending how they should proceed in relation to establishing a factory in the UK, the potential acquisition of Harrington Products Ltd, and how the expansion should be financed.

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EXHIBIT A

Email from Olivia Peters to James Smith

From: Olivia.Peters@woodleyadams.co.uk
To: James.Smith@smithstevens.co.uk
Date: 1 May 2021
Subject: Proposed expansion of the UK business

James

As discussed, I would like your advice in connection with a proposed expansion of our UK business.

UK manufacturing facilities

As you are aware, most of our current products are manufactured overseas by other group companies. In line with our global expansion plans, we plan to start manufacturing in the UK and to extend our product range to take advantage of the increased demand for adult crafting supplies within the UK market. With rents currently low for High Street shops, we are also considering opening our own shops and selling directly to customers.

We have identified two options to obtain the necessary manufacturing and storage facility:

Option 1) Construct a new building

We have identified an appropriate plot of land that is currently on the market for £6 million. An initial proposal for constructing a building on that land has been obtained – see attached **(EXHIBIT B)**.

Option 2) Acquire an existing factory and adapt it to meet our needs

We have identified a factory that is currently on the market for £10 million. It is owned by Harrington Products Ltd, a UK incorporated and tax-resident company which manufactures and retails children's educational toys and activity kits. This factory is surplus to the company's requirements and is currently tenanted on a short-term let, with a break clause that can be exercised with 30 days' notice, meaning that vacant possession would be available. We are aware that the factory was refurbished in 2019 at a cost of £2.5 million, of which £1 million was capitalised and the balance of £1.5 million was expensed for accounts and tax purposes as repairs. Although the factory has been suitably modernised, we will need to spend £5 million to convert it so that it can produce our required product ranges. This will primarily entail purchasing and installing new manufacturing plant.

Other expansion opportunities

During our site visit to look at the Harrington Products Ltd factory, we met with the Managing Director who is the majority shareholder. He has been considering retirement for some time, and the recent commercial challenges faced by the business have resulted in him further reviewing his plans. He would consider a sale of the business of Harrington Products Ltd if commercial terms could be agreed.

As well as the surplus factory, Harrington Products Ltd owns another factory and a warehouse as well as a number of retail premises on long leases. These leases have been renegotiated in the past 12 months and are on reasonable commercial terms. These retail premises are in several of the locations we have identified as suitable for our business. Acquiring the business of Harrington Products Ltd would allow us to expand quickly without the need to identify suitable retail premises in each target location and negotiate separate rental agreements with different

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landlords. In addition, children's educational toys and activity kits would sell well alongside our adult crafting supplies.

We have, therefore, decided to make an offer to buy the business of Harrington Products Ltd. While further negotiation is necessary, the initial indication is that, given the losses incurred in recent years, the shareholders would not require a premium for the business above the net asset value of £6.5 million. I have compiled a report for the Board concerning Harrington Products Ltd (**EXHIBIT C**). Clearly further work and full due diligence would be undertaken if we were to proceed with an acquisition of the business.

We will also need to decide how to finance the expansion. Woodley Adams Corp has surplus funds in Ruritania that could be made available to us. Alternatively, we could borrow up to £20 million from an external UK bank at an interest rate of 6%.

We will take advice from our Ruritanian tax advisers regarding the impact in Ruritania of our proposed UK expansion. Subject to that, we would like your advice on:

- 1) whether Woodley Adams Ltd should buy the factory from Harrington Products Ltd or construct our own factory;
- 2) whether Woodley Adams Ltd should buy the trade and assets or the shares of Harrington Products Ltd; and
- 3) how Woodley Adams Ltd should finance the expansion.

I look forward to hearing from you.

Regards

Olivia

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EXHIBIT B

Extracts from the Design and Build proposal

Design and Build proposal - New factory construction on Plot 1, Newlands Business Park
Prepared by AJ & Co.

Overview

AJ & Co specialise in commercial property design and project management and would oversee the construction of your new factory from start to finish. We are pleased to present our proposal to design and build your manufacturing and warehousing facility on Plot 1, Newlands Business Park.

Summary

The estimated costing can be summarised as follows:

| | |
|---|----------------|
| | £'000 |
| Construction of factory shell | 6,000 |
| Water and power supplies | 750 |
| Air conditioning | 750 |
| Manufacturing plant including installation | 4,500 |
| External works including car park and landscaping | 1,000 |
| Project management | <u>1,000</u> |
| Total | <u>£14,000</u> |

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EXHIBIT C

Extracts from a report prepared by Olivia Peters for the Board of Woodley Adams Ltd concerning Harrington Products Ltd

Overview

This report has been prepared based on information obtained during discussions with the Managing Director of Harrington Products Ltd on 11 April 2021 and publicly available information.

Financial information

Extracts from the accounts of Harrington Products Ltd for the year ended 31 December 2020, prepared in accordance with FRS102.

Income and Expenditure Account

| | <u>£million</u> |
|----------------------|-----------------|
| Turnover | 39.1 |
| Cost of Sales | <u>(27.1)</u> |
| Gross profit | 12.0 |
| Other income | 0.5 |
| Administrative costs | (12.1) |
| Interest payable | <u>(1.5)</u> |
| Loss before tax | <u>£(1.1)</u> |

Balance Sheet

| | <u>£million</u> |
|-----------------------|-----------------|
| Tangible fixed assets | 28.0 |
| Net current assets | 5.0 |
| Current liabilities | (3.5) |
| Long term creditors | <u>(23.0)</u> |
| Net assets | <u>£6.5</u> |
| Share capital | 1.0 |
| Revaluation reserve | 5.0 |
| Reserves | <u>0.5</u> |
| Total equity | <u>£6.5</u> |

Tax note

The company has an unrecognised deferred tax asset of £300,000 (2019 £100,000) relating to trading losses carried forward of £1.6 million. This asset will be realised if relievable profits arise in the future.

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Continuation

Properties

Harrington Products Ltd currently owns the freehold of its manufacturing site consisting of two factories and a warehouse. It is VAT registered and the option to tax has been exercised on all properties.

These properties are recognised in the company's books at their market value of £23 million in total, as follows:

| | <u>Factory 1</u> <u>£million</u> | <u>Factory 2 (currently rented out)</u> <u>£million</u> | <u>Warehouse</u> <u>£million</u> |
|---|-------------------------------------|--|-------------------------------------|
| Valuation | 10.0 | 10.0 | 3.0 |
| Original cost (2010) | | | |
| - Land | 1.0 | 1.5 | 0.5 |
| - Construction costs | 7.0 | 5.0 | 2.0 |
| Capitalised element of refurbishment (2019) | - | 1.0 | - |

It is estimated that chargeable gains, after indexation, of £1.4million would arise on sales of all the properties.

The long-term loan of £23 million is secured on these properties.

HMRC agreed that the following percentages of the construction and capitalised refurbishment costs of the factories and warehouses related to integral features:

Factory 1 – 30%
Factory 2 – 20%
Warehouse – 20%

The balance of the capitalised 2019 refurbishment costs were eligible for Structures and Buildings Allowances.

The company also leases 15 retail properties in key locations.

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EXHIBIT D

Pre-seen information

Client Information

Company name: Woodley Adams Ltd

Date of incorporation: 1 February 2001

Country of incorporation: United Kingdom

Ownership: Woodley Adams Ltd is a wholly owned subsidiary of Woodley Adams Corp. Woodley Adams Corp was incorporated in and is tax resident in Ruritania. It is owned by four Ruritanian domiciled and resident individuals. Woodley Adams Corp has a number of subsidiaries in Europe and North America. Apart from Woodley Adams Ltd, there are no other companies in the group that were either incorporated or are tax resident in the UK.

Finance Director: Olivia Peters

Number of employees: 750

Nature of business: Woodley Adams Ltd distributes a range of adult crafting activity kits including sewing, cross-stitch and papercraft sets throughout the UK through direct online retail and supply to independent retailers. The products are largely produced by fellow group companies with a small number, considered niche to the UK market, purchased directly from third party suppliers.

Group information

All companies in the group make up their accounts to 31 December and for the year ended 31 December 2020, all group companies were profitable. The group has no external debt.

Financial information

Woodley Adams Ltd's income statement for the year ended 31 December:

| | <u>2020</u> | <u>2019</u> |
|-------------------------|-------------------|-------------------|
| | <u>£million</u> | <u>£million</u> |
| Revenue | 116.0 | 91.2 |
| Cost of sales | <u>(61.5)</u> | <u>(48.5)</u> |
| Gross profit | 54.5 | 42.7 |
| Administrative expenses | <u>(50.5)</u> | <u>(38.2)</u> |
| Operating profit | 4.0 | 4.5 |
| Finance expense | <u>(1.2)</u> | <u>(1.3)</u> |
| Profit before tax | 2.8 | 3.2 |
| Tax expense | <u>(0.5)</u> | <u>(0.6)</u> |
| Profit after tax | <u><u>2.3</u></u> | <u><u>2.6</u></u> |

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Continuation

Woodley Adams Ltd's balance sheet at 31 December:

| | <u>2020</u> <u>£million</u> | <u>2019</u> <u>£million</u> |
|---------------------|--------------------------------|--------------------------------|
| Fixed assets: | | |
| Land and Buildings | 1.0 | 1.1 |
| Plant and machinery | 18.0 | 19.9 |
| Intangibles | 1.0 | 1.2 |
| Net current assets | 25.3 | 18.1 |
| Current liabilities | (15.2) | (10.0) |
| Long term creditors | <u>(19.0)</u> | <u>(19.5)</u> |
| Net assets | <u>£11.1</u> | <u>£10.8</u> |
| Equity: | | |
| Share capital | 8.0 | 8.0 |
| Reserves | <u>3.1</u> | <u>2.8</u> |
| Total equity | <u>£11.1</u> | <u>£10.8</u> |

Corporation Tax information

The Company Tax return for the accounting period ended 31 December 2019 was submitted on 22 November 2020 showing taxable profits of £2.5 million.

All previous returns were submitted within the statutory deadlines.

There are no open enquiries by HMRC into any of the returns.

The company has capital allowance pools with tax written down values carried forward at 31 December 2019 of £7.5 million (plant and machinery pool) and £1.2 million (special rate pool).

There are no trading or other losses brought forward as at 31 December 2019.

VAT

Woodley Adams Ltd is registered for VAT.

All of the company's outputs are taxable, so it recovers all input tax.

The company occupies rented premises. The landlord has not exercised the option to tax.