The Chartered Institute of Taxation

Application and Professional Skills

Taxation of Larger Companies and Groups

May 2021

Suggested answer

REPORT TO WOODLEY ADAMS LTD ON UK EXPANSION PLANS

Introduction

This report has been prepared for Woodley Adams Ltd to consider:

1. The options for establishing a factory in the UK;
2. The potential acquisition of Harrington Products Ltd; and
3. Financing the expansion.

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

It is based on information provided in your email of 1 May 2021 and held in our files and on legislation currently in force. If there is a delay in implementing our recommendations, a significant fiscal event (such as a Budget), or a change in circumstances, confirmation should be sought as to whether this affects the conclusions and recommendations in this report.

Smith and Stevens LLP

May 2021

Executive summary

As part of the commercial decision on factory procurement, taxes must be considered. Despite the additional tax relief available on a new build, and higher Stamp Duty Land Tax (SDLT) costs arising on purchasing an existing factory, overall, it will cost £3.6 million more to build a new factory than acquire the existing factory currently owned by Harrington Products Ltd. Hence in the absence of commercial reasons, the acquisition of the factory from Harrington Products Ltd is recommended.

In respect of purchasing the business of Harrington Products Ltd, a trade and assets purchase rather than a share purchase is recommended. The absence of any VAT or SDLT costs on a share purchase gives a cost saving on the initial acquisition but this is eliminated by the future tax reliefs available on an asset purchase.

This avoids any historical liabilities, and should cost no more, even if the vendors seek an increase in consideration to combat the double taxation arising on an asset deal.

If shares are purchased, no value should be attributed to the company's trading losses as future relief for these may be denied, although some benefit may be available through a disclaimer of earlier capital allowances.

The acquisition should be partially debt financed from a group loan, benefiting from the differential between the UK and Ruritanian tax rates, capped at a level (estimated to be £13 million) that keeps the UK net tax-interest expense below £2 million with an equity investment providing the balance of the funds required.

New factory construction or adaptation

The tax treatment of the two options is as follows.

Factory construction: Corporation Tax

If a new factory is constructed, tax relief will be available through the capital allowances regime or through the chargeable gains regime on an ultimate disposal of the factory.

No immediate tax deduction is available in respect of the acquisition cost of the land and certain external and landscaping costs - see Appendix 1. On disposal, a chargeable gain will be calculated with deductions available for the expenditure.

Capital allowances will be available for much of the construction expenditure, giving annual deductions against taxable profits. Expenditure on plant and machinery is held in a 'general' pool and deductions are available on a reducing balance basis at 18% per annum. Relief on 'integral features' such as heating, lighting and electrical systems is at a lower 6% rate.

There may also be more immediate deductions. In addition, the 'Annual Investment Allowance' (AIA) provides a 100% allowance for investment in plant and machinery up to a specified limit, (currently £200,000). This allowance can be claimed on eligible integral features, significantly accelerating relief.

Structures and Buildings Allowances (SBA) are available for buildings used for the purpose of a business. The SBA is calculated at a flat rate of 3% of qualifying expenditure per annum, from first business use, pro-rated if appropriate.

Appendix 1 shows an estimate of the allowances available, indicating that, subject to the effect of pro-rating the SBA, the initial deduction will be approximately £1.4 million, saving tax of approximately £257,000.

Future savings will be lower as the AIA has already been claimed, and allowances other than SBA are calculated on a reducing balance basis. Assuming for illustrative purposes that all of the expenditure qualifying for capital allowances can be written off under the regime, the total relief over the life of the factory will be £12.9 million, including the allowances in the first year, giving a tax saving of about £2.5 million at the current tax rate of 19%.

Other Taxes

VAT - Whilst the sale of land is prima facie exempt from VAT, the seller may have exercised the option to tax the land, meaning that VAT at 20% will be charged on the purchase price. Hence the sale of the land is a taxable supply allowing the seller to recover the VAT on any associated costs. Provided that your business remains engaged in fully taxable activities, any VAT suffered will be recoverable (subject to potential claw back through the Capital Goods Scheme if there is a change in use of the property within 10 years). However, any VAT charged could increase the SDLT payable. The position should therefore be clarified with the seller.

SDLT would be payable on the acquisition as follows:

	£
£150,000 at 0%	0
£100,000 at 2%	2,000
£5,750,000 at 5%	287,500
Total	£289,500

These calculations assume no VAT on the consideration for the land purchase. Such VAT at 20% would result in £60,000 additional SDLT. SDLT is added to the base cost of the factory and will be relieved when the factory is disposed of.

Factory acquisition and adaptation: Corporation Tax

If the existing factory is acquired from Harrington Products Ltd and adapted, the tax position will be different. The SBA is only available on construction after 29 October 2018. Hence the deductions will be restricted to approximately £24,000 per annum (3% on the £800k qualifying expenditure on the 2019 refurbishment).

However, additional tax deductions may be available on the purchase price, being capital allowances on integral features within the property. The amount stated as being consideration for the fixtures within the property sale and purchase agreement is not directly relevant for tax purposes.

The availability of tax deductions depends on the original expenditure on the factory. The rules are designed to ensure that total eligible expenditure is relieved once only. Hence where the seller could have claimed allowances on the fixtures within a property, the purchaser's allowances are restricted to the disposal value used by the seller, for capital allowances purposes, for the relevant fixtures, which is capped at original cost. Agreement of the value to be included in the agreement, or by election, therefore becomes part of the negotiations if there are eligible fixtures within the property. The maximum amount deductible would be the original qualifying cost of £1.2 million (20% of cost of £5 million and refurbishment £1 million).

Assuming £5 million to adapt the factory which all qualifies for plant and machinery capital allowances, with the AIA of £200,000 available, the maximum relief, including that on integral features and SBA as above, in the first year is £1,184,000.

Allowance	**Notes**	**£'000**
Structural Building Allowance	3% on £800,000 2019 refurbishment	24
Annual Investment Allowance	Applied to integral features	200
Integral features allowances	6% on 1,000,000 (balance of integral features)	60
Plant and machinery allowances	18% on £5 million adaptations	900
Total		1,184

Assuming again for illustrative purposes that all of the expenditure qualifying for capital allowances can be written off under the capital allowances regime, the total relief given in respect of total qualifying expenditure of £7 million will result in a tax saving of about £1.33 million at the current tax rate of 19%.

Other Taxes

VAT – the purchase of a commercial building is exempt from VAT unless it is a 'new' commercial building i.e. one that is less than 3 years old. As the seller, Harrington Products Ltd, has exercised the option to tax in connection with the building VAT would be chargeable but recoverable as explained above. The transfer is not outside the scope of VAT as the transfer of a going concern as Woodley Adams Ltd will not continue to let the property.

SDLT - Stamp Duty Land Tax would be payable as follows:

	£
£150,000 at 0%	0
£100,000 at 2%	2,000
£9,750,000 at 5%	487,500
Total	£489,500

£100,000 of SDLT would also arise on the £2million VAT charged by Harrington Products Ltd. SDLT is added to the base cost of the factory and will be relieved when the factory is disposed of.

Conclusion

Appendix 2 summarises the potential costs of each option showing that the after-tax cost of the new-build project is approximately £3.6 million higher than buying and adapting the existing factory.

You should therefore only proceed with the construction of a new factory if there are benefits of a new purpose built factory that cannot be achieved by adapting the Harrington Products Ltd factory, meriting the additional £3.6 million cost, particularly as it will take over 30 years for all the benefits of the tax savings to be achieved.

Business Acquisition

In order to acquire the business of Harrington Products Ltd, you could buy the shares of the company, or the assets themselves. The analysis below assumes that all assets/liabilities would be acquired at their current carrying value in the accounts. The vendors' circumstances may mean that the consideration could depend on the route taken – see below.

Asset purchase

Purchasing the fixed assets would result in SDLT costs, offset by tax relief over the life of the assets as explained above, as shown in Appendix 3.

Current assets and liabilities would be taken on at the consideration attributed to them. It may be preferable to refinance the long-term loan with internal debt – see financing discussion below.

An asset deal could result in additional tax arising for the vendors as chargeable gains could arise within the company, together with tax liabilities on the distribution of the proceeds to the shareholders.

Based on the estimated chargeable gains of £1.4 million and in the absence of capital losses or any other shelter for these gains, Corporation Tax at 19% of £266,000 would arise, meaning that the vendors may seek increased consideration.

Acquiring the business of Harrington Products Ltd is likely to be regarded as a "Transfer of a Going Concern" (TOGC) for most parts from a VAT perspective. This means that it will not be regarded as a supply and no VAT will be chargeable, provided you carry on the same kind of business as that previously carried on by Harrington Products Ltd.

However, Factory 2 is likely to fall outside the TOGC treatment as it has previously been used as a rental property and its future use will be as a manufacturing facility (ie you do not intend to use the assets in carrying on the same kind of business as the seller). As the option to tax has been exercised on this property, it will be subject to VAT. This will however be recoverable on the basis that you continue to use the property for manufacturing in the future. Should this use change over the 10 years following acquisition there could be a clawback of this VAT under the "Capital Goods Scheme" (CGS). As stated above however there will be an additional SDLT charge on the VAT.

In order to satisfy the TOGC criteria on the other properties, you must exercise the option to tax on these before acquiring them, and we can assist you with this. As part of the due diligence process we need to establish if the other properties are subject to the CGS because if so, the use would again need to be monitored, though if they continue to be used for manufacturing, there should not be an issue.

Share purchase

Commercially, a share purchase means that all assets and liabilities remain with the company, necessitating additional due diligence and appropriate warranties and indemnities. There would also be no option to choose which assets were purchased, unlike with an asset purchase.

No VAT would be payable because share acquisitions are exempt from VAT.

Stamp duty is payable at 0.5% on the transfer of shares, being £32,500 on an acquisition value of £6.5 million.

There would be no immediate tax deductions for expenditure on shares. This would only be available on the ultimate sale of the shares and may not be relevant if any gain or loss on the sale of the shares were exempt as a result of the Substantial Shareholdings Exemption.

Buying the company's shares means that there are no changes to the tax position of Harrington Products Ltd itself. Future capital allowances will be based on the existing values of the pool. Given the high level of AIA in recent years, it is likely that relief has largely been obtained in respect of eligible spend during the recent refurbishment, reducing the future tax relief which may therefore be significantly lower than the on-going depreciation charge. Additional due diligence may clarify if this is in part the reason for the high level of tax losses carried forward within the company.

The existence of significant tax losses in Harrington Products Ltd could be beneficial in the future as these losses may be available to offset against future profits of the business. However, there are rules that restrict the use of trading losses following a change in ownership.

If at any point within the period starting three years before and finishing five years after a change in ownership, there is a major change in the nature or conduct of the trade, the rule applies to prevent brought forward losses being offset against future profits.

If the manufacture of your products (ie adult crafting activity kits) in the factory were to form part of the future business of Harrington Products Ltd (which sells children's educational toys and activity kits), this could constitute a major change in the nature of its trade. Several factors would be considered including the products produced and the retailing methods used (for example, consumer versus wholesaler or distributor). Some changes that can be made in the first five-year period which do not constitute a major change in the nature or conduct of the trade include changes to keep pace with new technology (unlikely to apply given the recent refurbishment of the factory), the adoption of new management techniques and rationalisation include the dropping of unprofitable product lines.

There may be some value to buying the company to access the losses if you believe that any changes to be made would be within the above constraints, and that the underlying business could become profitable. Nevertheless, we would recommend that minimal value be attributed to these losses given the possibility that relief may be denied.

It might be possible to revise the 2019 tax return (prior to 31 December 2021) and subsequent return to disclaim capital allowances. This could reduce the level of losses and give higher deductions for capital allowances in current and future periods that are not restricted in the same way by the above anti-avoidance rules. The value of this would be dependent upon how the tax losses arose, but assuming they are attributable entirely to the company having claimed capital allowances, the maximum benefit would be approximately £300,000 (being 19% of the £1.6 million loss), which would not be realised immediately.

Conclusion

Appendix 4 summarises the initial costs and potential for future tax savings for each option indicating a benefit of £699,000 to the asset purchase route. Whilst purchasing the share capital would mean no SDLT is incurred and Stamp Duty is only charged at 0.5%, this would reduce the future available tax relief in connection with the assets (restricted to any value remaining in the capital allowance pools within the company, likely to be low in view of the recent high levels of AIA), subject to any benefit arising from a disclaimer of capital allowances in earlier years.

Whilst the potential tax charge of £266,000 within the company on an asset deal may mean that the vendors would require additional consideration of this amount which, together with the potential benefit if a maximum capital allowances disclaimer allows access to future relief, could largely offset the indicated benefit of £699,000, we would recommend an asset purchase in view of the flexibility as to the assets and liabilities acquired and commercial benefits such as not acquiring historical liabilities in the absence of a compelling reason to do otherwise.

Financing

The decision whether to finance the UK expansion through internal funding or external borrowings will be influenced by commercial and tax factors.

The money to achieve the expansion plans will need to be advanced to Woodley Adams UK Ltd, either in the form of an external loan, or, if from the parent company, as a loan or as equity.

Equity funding

Any return on an equity investment would be dividends, not tax deductible in the UK, and, if the Ruritanian tax rules are like the UK in this respect, not taxable in Ruritania with no requirement to withhold tax on dividend payments.

Debt funding

However, if funds are loaned to Woodley Adam Ltd by Woodley Adams Corp, transfer pricing rules will require that interest be charged on an arm's length basis. You have indicated an interest rate of 6% if borrowing externally so this should be the starting point for deciding the rate. You should also consider if the amount lent is appropriate. If the amount of a loan exceeds that which would have been advanced by a third party, some or all the interest charged may not be deductible. Your belief that funds of £20 million could be accessed externally may support the deductibility provided you do not exceed this level of debt.

Prima facie, any interest will be taxable in Ruritania at 12% and deductible in the UK at 19% indicating that the group will benefit overall from funds being advanced as debt rather than equity with a potential saving based on the 7% differential.

The lending does not appear to be for an unallowable purpose and so a restriction on the amount of interest deductible by Woodley Adams Ltd is unlikely on that account. However, the Corporate Interest Restriction (CIR) rules must also be considered. Since the group has no external debt, it is assumed that all existing loans made to the company are intra group and hence the group ratio method of working out the company's interest capacity will not provide a better result than the fixed ratio method. If Woodley Adams UK Ltd takes out an external bank loan, the interest payable on that loan would be tax deductible, providing it is less than 30% x tax-EBITDA (earnings before interest, tax, depreciation and amortisation). However, because of the operation of the fixed ratio debt cap, which caps deductible interest at the external interest expense of the worldwide group, the existing interest expenses (£1.2 million) could be disallowed in whole or part. To avoid any CIR disallowance, Woodley Adams UK Ltd could be advanced further debt finance up to approximately £13 million. Interest at 6% would be £780,000 and together with the existing £1.2 million interest (total £1.98m), this would be below the CIR's £2 million de minimis disallowance rule.

If the shares of Harrington Products Ltd were purchased, that company would become part of the same CIR group, meaning that a restriction would be likely to apply on a similar basis to that explained above as the total interest expense across the UK companies would need to be considered.

Conclusion

Given the disallowance of any interest expense in excess of £2 million, with the associated income still potentially liable to Ruritanian tax, we recommend that the expansion be financed with a mixture of parent company debt and equity. Debt should not exceed £13 million to ensure that the total UK interest expense remains below £2 million so that interest is deductible in the UK at 19% and taxable in the parent company at 12%.

Appendix 1

<u>Analysis of costs and tax relief on factory construction costs</u>

Whilst a detailed review of actual expenditure would ultimately be required, estimated capital allowances available are:

	General plant and machinery	Integral features	Structures and Buildings Allowance	Annual investment allowance	No immediate relief	Total
	£'000	£'000	£'000	£'000	£'000	£'000
Land	-	-	-	-	6,000	
Factory shell	-	-	6,000	-	-	-
Water and power supplies	-	750	-	-	-	-
Air conditioning	-	750	-	-	-	--
Manufacturing plant	4,500	-	-	-	-	-
External works	-	-	-	-	1,000	-
Subtotal	4,500	1,500	6,000	-	7,000	19,000
Project management apportioned	350	115	460	-	75	1,000
Annual investment allowance	-	(200)	-	200	-	--
Total – qualifying	4,850	1,415	6,460	200	-	12,925
- Non qualifying	-	-	-	-	7,075	7,075
Allowances in year one 18%/6%/3%/100%	873	84.9	193.8	200	-	1351.7

Appendix 2

Comparison of net costs of alternative factory procurement

The table below summarises the initial costs and savings associated with alternative options

Description	Construction Costs/(savings) £'000	Adaptation Costs/(savings) £'000
Land	6,000	-
Acquisition	-	10,000
Construction	14,000	-
Adaptation	-	5,000
Subtotal	20,000	15,000
SDLT	289.5	489.5
SDLT on VAT (construction if applicable)	60	100
Initial cost	20,349.5	15,589.5
Potential tax saving over life of assets 12,925/7,000@19%	(2,455.8)	(1,330)
Net	17,893.7	14,259.5
Potential benefit of adaptation	3,634.2	

Appendix 3

Analysis of costs and tax relief on acquisition of trade and assets of Harrington Products Ltd

Asset	Factory 1	Warehouse	Factory 2	Other fixed assets	Total
Valuation	£10 million	£3 million	£10 million	£5 million	£28 million
SDLT – linked transactions 150,000@0% 100,000@2% Balance at 5% Total				-	 0 2,000 1,137,500 1,139,500
Potential SDLT on VAT	100,000	30,000	100,000		230,000
Total capital expenditure					1,369,500
CA qualifying expenditure (30/20/20% on construction cost of properties)	2.1 million	0.4 million	1.2 million	5 million	£8.7 million
SBA			0.8 million		£0.8 million
Total					£9.5 million
Potential total tax saving (19%x£9.5m)*	-	-	-	-	£1.8 million

* Assuming again for illustrative purposes that all of the expenditure qualifying for capital allowances can be written off under the capital allowances regime

Appendix 4

Comparison of net costs of Harrington Products Ltd acquisition

The table below summarises the initial costs and savings associated with the alternative options assuming that the TOGC rules are applicable to the asset purchase.

Description	Assets Costs/(savings) £'000	Shares Costs/(savings) £'000
Shares	-	6,500
Fixed assets (Appendix 3)	28,000	-
Net current assets	1,500	-
Long term loans	(23,000)	-
Subtotal	6,500	6,500
Stamp Duty	-	33
SDLT	1,139	-
Initial cost	7,639	6,533
Additional tax saving over life of assets (Appendix 3)	(1,805)	-
Net	5,834	6,533
Potential benefit on acquisition of trade and assets	699	-