



The Chartered Tax Adviser Examination

November 2019

Taxation of Major Corporates

Suggested solutions

ANSWER TO QUESTION 1

To: Mary.Falconer@energydistributionservices.co.uk
From: Hiro Stein@energydistributionservices.co.uk
Date: X November 2019
Subject: Group financing

Mary

I refer to your email about the two financing transactions.

Loans – general tax treatment

In both cases, the loans will be taxed under the UK loan relationship rules, as they are money debts that have arisen from the lending of money. All profits and losses from the loans would generally be recognised as taxable income and deductible expenditure to the extent recognised in the financial statements. There is no distinction between revenue and capital – all amounts are brought into account as revenue amounts.

Where a loan is taken out for the purposes of a company's trade, the profits and losses from the loan are brought into account as trading receipts and expenses and therefore reflected in the trading profits.

Where, however, a loan is taken out for non-trading purposes, the profits and losses are aggregated. Where there is an overall net profit, this is charged to Corporation Tax as a non-trading loan relationship profit. Where there is an overall net loss, this is referred to as a non-trading loan relationship deficit. This can be:

- Carried back against a non-trading loan relationship profit in the previous 12 months;
- Set off against total taxable profits in the current year;
- Surrendered as group relief in the current year; or
- Carried forward and used against future profits (either of the company or surrendered to another group company).

The amounts brought into account for tax under the loan relationship rules includes any exchange gains and losses on the loan relationships.

These exchange movements will normally be calculated by reference to the company's functional currency. In the case of Energy Distribution Services plc, it has a sterling functional currency, and therefore foreign exchange gains and losses on any loans taken out by Energy Distribution Services plc in US dollars and euros will typically give rise to volatility in the company's taxable profits.

US loan

If we were to use Hark Ltd to make the loan to the US, we could make a Designated Currency election in order to calculate its profits by reference to US dollars rather than its actual functional currency, which is sterling.

It is possible to make this election as the majority of the company's assets and liabilities will be denominated in US dollars. The company has to be a UK resident investment company, but this will be the case at the point the loan is made.

The election can only have effect on a prospective basis, and therefore should be made before the loan is made.

Euro loan

The euro loan is hedging Energy Distribution Services plc's investment in the shares in Dix-Huit SA. This creates a potential mismatch as the shares will be a capital asset, and therefore will only give rise to a taxable gain or loss on a disposal of the shares.

There are, however, special rules called the Disregard Regulations, which address the situation where a loan is hedging the currency risk inherent in holding non-sterling denominated shares - any foreign exchange gain or losses on the loan are not brought into account for UK tax purposes. This rule always applies – there is no need to make an election but we ought to document the hedging relations in board minutes or make a file note.

The loan is considered to be hedging the shares up to the cost of the shares. However, we can make an election to take account of the underlying net asset value of the shares. This would allow a larger loan to be regarded as hedging the shares where the subsidiary has increased in value over the original investment. The election can be made at any time and has effect from the date specified in the election, which must be later than the date the election is made.

Any exchange gain or loss that is disregarded on the loan is potentially brought back into account under The Exchange Gains and Losses (Bringing into Account Gains or Losses) Regulations, often referred to as the 'EGLBAGL Regulations', when the shares are disposed of, as an adjustment to the consideration taken into account in calculating the chargeable gain.

The amounts would not, however, be brought back into account where any chargeable gain or loss arising on any subsequent disposal of the shares is exempt from Corporation Tax by virtue of the Substantial Shareholdings Exemption applying.

I trust that you find this helpful.

Regards

Hiro

MARKING GUIDE

TOPIC	MARKS	SUBTOTAL
Loans - Loan is a loan relationship. - Treatment of trading loan relationships - Treatment of non-trading loan relationships - Taxed on exchange movements - Normally calculated by reference to the company's functional currency. - Functional currency is sterling, hence tax volatility.	1 1 2 1 1 1	7
Designated currency election - If using subsidiary, could make a designated currency election of USD as the only asset would be USD. - This would reduce tax volatility	2 1	3
Euro exposure - Investment in shares will be a capital asset, not taxed on exchange movements until shares disposed of, hence mismatch. - However, the Disregard Regs would apply to disregard the exchange movements on the loan to the extent that its hedging ships, shares or aircraft. - EGLBAGL Regs apply on any disposal of the shares, assuming SSE does not apply.	1 2 2	5
TOTAL		15

ANSWER TO QUESTION 2

Our Address

Your Address

X November 2019

Dear Erica

Pop plc Proposed restructuring - Transfer pricing issues

Following our meeting last month, I have outlined below how the UK transfer pricing rules could apply to the restructuring ideas we discussed.

Transfer pricing – basic rules

The UK applies 'transfer pricing' rules to both cross-border and domestic transactions. These apply where:

- There is a transaction or arrangement between connected persons (the 'actual provision');
- The actual provision differs to the provision that would have arisen had the parties not been connected (the 'arm's length provision'); and
- The actual provision confers a potential tax advantage, when compared to the arm's length provision.

In effect, the transfer pricing legislation requires the UK tax rules to be applied on the basis of the 'arm's length provision' whenever the UK exchequer could otherwise be disadvantaged.

The rules only automatically apply to large companies. Given that the group's turnover exceeds €50 million and has more than 250 employees, it is considered large for this purpose.

OECD guidelines

The key to the application of these rules is identifying the correct arm's length price that should apply in a particular case. The UK transfer pricing rules specifically refer to the OECD guidelines, and therefore these should be used to determine the correct pricing methodology.

There are a number of methods that are permitted, depending on the particular circumstances. These are grouped as 'transaction methods' and 'transactional profit split methods'. Generally, HM Revenue & Customs (HMRC) prefer transaction methods as these are based on actual arm's length transactions, but these may not be appropriate in every situation.

Transaction methods

- Comparable uncontrolled price (CUP): This looks at equivalent transactions between third parties to determine the price. This is the strongest method where it is available, but it can often be difficult to find comparable transactions.
- Resale price (RP): This uses the actual retail price of a good or service, and then adjusts the price to compensate the reseller for costs incurred and a return for the functions undertaken.
- Cost plus (C+): Under this method, the price is determined by applying a mark-up on the basis of the costs incurred.

Transactional profit methods

- Transactional net margin method (TNMM): This examines the net profit for each entity as a percentage of its inputs (for example, costs, sales, assets and capital employed). A functional analysis will often be done under this method to determine the level of profit that each entity should receive. This will help identify comparables that can be used to determine the relevant level of net profit.
- Profit split: This requires consideration of the whole supply chain, and splits the overall profit based on the function performed by each entity involved. The contribution of each party should be considered and the profit apportioned appropriately (contribution analysis). Alternatively, each entity is allocated sufficient profit to provide it with a basic return, with the residual then being divided between the entities (residual analysis).

Application to Pop plc

To determine the correct pricing methodology it is important to assess what functions each company undertakes, and the risks that they take on. The pricing should then be set accordingly.

In this case, it would appear the carbon dioxide company is making a product where there is an active, observable market. This should, therefore, be used as a comparable uncontrolled price. Note that there is no exemption for UK-to-UK transactions – these are required to be treated as being undertaken on arm's length terms. However, HMRC is likely to consider this aspect to be low risk given that whichever company the profit is in will pay tax in the UK.

Next, the logistics company would seem to be an intermediary which carries minimal risk and employs minimal capital. It is not apparent that there is a direct comparable, and so a cost-plus approach would seem to be appropriate to provide the company with a small return.

The bottling company is carrying out both the bottling and marketing functions in India. While there may be examples of bottling companies purchasing the concentrate between

unconnected companies, there are likely to be significant differences in the product and the market. Typically in the case of a reseller, the resale minus pricing methodology would be appropriate. However, it would be necessary to ensure that the company is sufficiently reimbursed for its costs of bottling, which is likely to be capital intensive.

This would leave Pop UK Ltd as having the balance of the profits. This is the most difficult company to price given that it has developed the products and holds the valuable intellectual property. It would be appropriate to check that the return it is earning represents a reasonable level of return which compared with the capital it employs in the business.

Administration

The application of the transfer pricing rules is mandatory. Under self-assessment, a company has to keep records to justify the pricing methodology adopted in its tax computations. This will normally be part of a transfer pricing policy for the whole group.

You could approach HMRC to enter into an advanced pricing agreement (APA). This will need to be negotiated with HMRC, but once agreed, would give to certainty on the pricing methodology.

Typically with cross-border transactions, HMRC would expect a bilateral agreement so that the other fiscal authority is also bound by the pricing methodology. However, HMRC may accept an unilateral agreement where this is not possible.

Where HMRC contend that the transaction is not on arm's length terms, you could look to apply to use the 'mutual agreement procedure' to ensure that both jurisdictions accept the same pricing methodology and to avoid the risk of double taxation, providing that the relevant tax treaty permits this.

I trust that this helps you understand the implications of the proposed restructuring.

Yours sincerely

Tax manager

MARKING GUIDE

TOPIC	MARKS	SUBTOTAL
Transfer pricing framework: <ul style="list-style-type: none"> - Basic rule - Applies to Pop plc as is a large group 	2 1	3
OECD guidance: <ul style="list-style-type: none"> - Need to refer to OECD guidelines - CUP - Resale price - Cost plus - Transactional net margin method - Profit split 	1 1 1 1 1 1	6
Application to Pop group: <ul style="list-style-type: none"> - CO2 company comment - Logistics company comment - Bottling company comment 	2 2 2	6
Administration <ul style="list-style-type: none"> - Requirement to keep records - Potential to approach HMRC for APA - Potential to address double taxation through MAP 	1 1 1	3
PHS		2
TOTAL		20

ANSWER TO QUESTION 3

MS Pharma plc

Corporation Tax Computation – Year Ended 30 June 2019

	<i>Workings</i>	£
Property income	(W1)	5,100,000
Chargeable gains	(W2)	167,100
Expenses of management	(W3)	(2,757,300)
Taxable total profits		<u>2,509,800</u>
Corporation Tax liability @ 19%		476,862
Less: Surrender of unutilised RDEC (WTC Med)		(197,960)
Corporation Tax liability		<u>278,902</u>

W1 – Calculation of property income

The element of the premium taxable as income is calculated as follows:

$$£5,000,000 \text{ (premium)} - [£5,000,000 \times 9/50] = £4,100,000$$

This amount is added to the £1,000,000 rent received under the sub-lease resulting in total taxable property income of £5,100,000. The £250,000 expense related to amortisation of the lease premium is not deductible for Corporation Tax purposes.

W2 – Calculation of chargeable gain

The receipt of the premium is to be treated as a part disposal with the element representing property income excluded.

$$\text{Sale proceeds: } £5,000,000 - £4,100,000 = £900,000$$

The allowable expenditure is calculated as follows:

$$£35,000,000 \text{ (acquisition cost)} \times \frac{£900,000}{£5,000,000 + £40,000,000} = £700,000$$

It is then necessary to calculate indexation allowance:

$$\frac{[278.10] \text{ (RPI 12/17)} - 265.5 \text{ (RPI 01/17)}}{265.5 \text{ (RPI 01/17)}} = 0.047 \times £700,000 = £32,900$$

$$\text{Indexed based cost: } £700,000 + £32,900 = £732,900$$

$$\text{Chargeable gain: } £900,000 - £732,900 = £167,100$$

W3 – Expenses of management

	£
Due diligence fees (deductible where no decision to acquire)	2,757,300

Notes:

The following are not allowable expenses of management:

- Legal advice in connection with a rights issue is a capital expense.
- Professional fees in relation to establishment of an employee share ownership trust are a capital expense.
- The loss arising from impairment of the loan receivable due from MS Med GmbH as this is between connected parties.

WTC Med Ltd

Corporation Tax Computation – Year Ended 30 June 2019

	<i>Workings</i>	£
Profit before tax		8,945,000
Add:		
Depreciation of laboratory equipment	(W1)	450,000
Deduct:		
Capital allowances	(W2)	(3,000,000)
Relevant IP profits	(W3)	(1,936,895)
Taxable total profits after group relief		<u>4,458,105</u>
Corporation Tax Liability @ 19%		847,040
Less: R&D Expenditure Credit	(W4)	<u>(847,040)</u>
Corporation Tax Payable		<u>NIL</u>

W1 – Depreciation and amortisation

The depreciation expense of £450,000 must be added back, however, the amortisation expense of £150,000 is deductible (under s.729 Corporation Tax Act 2009).

W2 – Capital allowances

The £3,000,000 expenditure on the research and development laboratory is eligible for capital allowances at a rate of 100%.

W3 – Calculation of relevant IP profits

Step 1 – Separation of Relevant IP Income (“RIPI”) and Non-relevant IP Income:

All income relates to licensing of Patent 1 and Patent 2 and the RIPI is calculated as follows:

Turnover - royalty income	£ 20,000,000
RIPI	20,000,000

Step 2 – Streaming of RIPI:

	Patent 1 Income £	Patent 2 Income £	RIPI £
Royalty Income	12,000,000	8,000,000	20,000,000

Step 3 – Allocation of debits between IP sub-streams:

	Patent 1 Income £	Patent 2 Income £	Total £
R&D expenditure	4,800,000	3,200,000	8,000,000
Staff costs	900,000	600,000	1,500,000
Premises rental	1,200,000	800,000	2,000,000
Capital allowances	1,800,000	1,200,000	3,000,000
Total debits	8,700,000	5,800,000	14,500,000

Step 4 – Deduction of debits and 10% of routine trading deductions

	Patent 1 Income £	Patent 2 Income £	Total £
RIPI	12,000,000	8,000,000	20,000,000
Less:			
Debits (per Step 3)	(8,700,000)	(5,800,000)	(14,500,000)
10% of deductions	(690,000)	(460,000)	(1,150,000)
Qualifying Residual profit (QRP)	2,610,000	1,740,000	4,350,000

Calculation of percentage of routine deductions:

	Patent 1 Income £	Patent 2 Income £	Total £
Debits (per Step 3)	8,700,000	5,800,000	14,500,000
Add:			
Capital allowances	(1,800,000)	(1,200,000)	(3,000,000)
Routine deductions	6,900,000	4,600,000	11,500,000
10% of deductions	690,000	460,000	1,150,000

Step 5 – Deduct marketing assets return figure:

The benchmarking analysis undertaken for the group transfer pricing policy supports the patent royalty rate for both patents (i.e. 4% x £500,000,000 = £20,000,000).

As a consequence, no deduction required for marketing assets return.

Step 6 – Application of the relevant R&D fraction:

For each patent, the QRP is multiplied by a fraction being the lower of 1 or the fractions as calculated below:

Calculation of relevant R&D fraction for Patent 1:

D = £5,700,000

S1 = NIL

S2 = NIL

A = £1,000,000

$(£5,700,000 + 0) \times 1.3 / (£5,700,000 + £1,000,000) = 1.11$ (greater than 1)

Calculation of relevant R&D fraction for Patent 2:

D = £3,800,000

S1 = NIL

S2 = NIL

A = £2,000,000

$(£3,800,000 + 0) \times 1.3 / (£3,800,000 + £2,000,000) = 0.85$ (less than 1)

	Patent 1 Income £	Patent 2 Income £	Total £
QRP	2,610,000	1,740,000	4,350,000
Impact of fraction	-	(261,000)	(261,000)
Relevant IP Profits	2,610,000	1,479,000	4,089,000

The above RIPP of 4,089,000 is then subject to the fraction of 9/19 in order to calculate the deduction from profits – this gives a figure of £1,936,895. This means that CT at 19% on the taxable figure of £2,152,105 is £408,900 being the PB rate of 10%

W4 – Relief for R&D Expenditure Credit (RDEC)

Step 1

	£
RDEC for period	1,045,000
Less: Offset in current accounting period	(847,040)
Unutilised RDEC	197,960

Amount that may be surrendered against taxable profits of MS Pharma plc:

Amount capped at the lower of:

Step 2 – Calculate lower of:

	£
Unutilised credit from Step 1	197,960
RDEC for period multiplied by 81%	846,450
Amount carried forward to Step 3	197,960

Step 3 – Calculate lower of:

Unutilised credit from Step 2	197,960
PAYE and Class 1 NIC of employees	500,000
Amount available to surrender	197,960
Less: RDEC surrendered to MS Pharma plc	(197,960)
Balance of RDEC refundable by HMRC	NIL

MARKING GUIDE

TOPIC	MARKS
<i>Tax computation of MS Pharma plc:</i>	
Dividend income exempt per s.931F CTA 2009	1
Property income:	
Calculation of apportionment per s.217 CTA 2009	1
Calculation of taxable property income	1
Chargeable gains:	
Part disposal calculation per s.42 TCGA 1992	2
Calculation of indexed gain	1
Expenses of management:	
Allow due diligence fees per s.1219(2) CTA 2009	1
Disallow rights issue costs as a capital expense per s.1219(3) CTA 2009	1
Calculation of Corporation Tax payable	0.5
<i>Tax computation of WTC Med Limited:</i>	
Capital allowances:	
Add back depreciation and amortisation expense	1
Calculation of capital allowances due under s.441 CAA 2001	1
Patent box:	
Calculation of Relevant IP Income per s.357BH CTA 2010	1
Allocation of RIPI into sub-streams per s.357DA(1) CTA 2010	1
Allocation of debits into sub-streams per s.357DA(1) CTA 2010	1
Offset debits and credits and calculate deduction for 10% of routine deductions per s.357CI CTA 2010	1
No deduction required for marketing assets return per s.357BN CTA 2010	1
Calculate and apply R&D fractions to patents per s.357BLA CTA 2010	2
R&D Expenditure Credit:	
Offset of RDEC against Corporation Tax liability of WTC Med Ltd	1
Partial surrender of RDEC to MS Pharma plc	1
Calculation of Corporation Tax payable	0.5
TOTAL	20

ANSWER TO QUESTION 4

Private and confidential

To: Tim Fox, Group Head of Tax

Date: X November 2019

Review of UK Corporation Tax Issues – Report of findings

Introduction and scope of work

This Report summarises our findings and advice in relation to the following matters for the year ended 30 September 2019:

- Impact of the Corporate Interest Restriction (“CIR”) to UK group tax computations;
- Utilisation of tax losses; and
- UK tax issues relevant to the group transfer pricing policy.

Impact of CIR on the UK tax computations

In order to calculate any CIR it necessary to follow a number of steps to calculate relevant amounts:

Determination of worldwide group:

ExpertSales plc and its subsidiary companies are part of the worldwide group and this is relevant for determining certain amounts included in the CIR calculations.

The taxable results of ExpertSales plc, ESP Retail Ltd and Es Online Ltd (“the UK Group”) are to be adjusted by any disallowance and also form part of the CIR calculation.

Aggregate Net Tax-Interest Expense (“ANTIE”):

ANTIE represents the amount of interest for tax purposes that may be subject to CIR computed as:

	Amount (£)
<i>Tax-interest income amounts:</i>	
Interest on loan to ESP GmbH	8,000,000
Interest on loan to ESP Ltd	5,700,000
Interest on loan to ES Online	2,000,000
<i>Tax interest expense amounts:</i>	
Interest on external debt	(45,000,000)
Gross up of WHT credit (£570,000 / 19%)	(3,000,000)
Interest on loan to ES Online	(2,000,000)
ANTIE:	34,300,000

Notes:

- The forex gain on the currency forward is excluded as it relates to an underlying trading transaction.
- The CIR rules require an adjustment to tax-interest for any withholding tax credited against Corporation Tax payable. This assumes the company claims credit relief – see below for further details of this.

The fixed ratio method:

The first method used to calculate the CIR is calculated as the lower of:

- 30% of the worldwide group's aggregate tax-EBITDA; and
- The fixed ratio debt cap for the period, based on ANGIE

Aggregate tax-EBITDA:

This amount is a measure of the UK Group's taxable earnings before interest, tax, depreciation and amortisation:

	Amount (£)
Aggregate taxable profit	15,000,000
Add: Tax interest expense	34,300,000
Capital allowances	9,000,000
Deduct: Gross up of WHT credit (see above)	(3,000,000)
Aggregate Tax-EBITDA:	<u>55,300,000</u>

30% x £55,300,000 = £16,590,000 allowable interest expense.

Fixed ratio debt cap:

You have confirmed this amount to be £50 million for the period.

The basic interest allowance is therefore £16,590,000.

The group ratio method:

This alternative approach offers highly leveraged groups opportunity to increase the interest allowance.

The relevant percentage is calculated as:
$$\frac{50 \text{ (Qualifying Net Group-Interest Expense)}}{160 \text{ (Group-EBITDA)}}$$

31.25% x £55,300,000 = £17,281,250 allowable interest expense.

I would therefore recommend that the group elect to use the group ratio method as this gives a larger interest allowance for this period.

Calculation of disallowance:

The CIR for the period is £34,300,000 - £17,281,250 = **£17,018,750**

For simplicity, this amount should be allocated to ExpertSales plc, reducing losses available for group relief for the period to £19,981,250. The disallowance cannot be allocated to ESP Retail Ltd (as it has no tax interest expense) and only £2 million can be allocated to Es Online Ltd.

Utilisation of tax losses

Following recent reform to the legislation governing the offset of brought forward tax losses, greater flexibility now exists for obtaining tax relief for such losses however assessing the optimal position is more complex.

Assuming the CIR disallowance is allocated to ExpertSales plc, relief for tax losses may be claimed as follows:

	ExpertSales plc £	ESP Retail Ltd £	ES Online Ltd £
Estimated taxable profit / (loss)	(37,000,000)	50,000,000	2,000,000
Add: CIR disallowance	17,018,750	-	-
Losses available for group relief	(19,981,250)		
Group relief:	19,981,250	(17,981,250)	(2,000,000)
Profit / (loss) after group relief	-	32,018,750	-
Offset of brought forward tax losses:	- W1	(17,334,444)	-
Taxable profit / (loss)	-	14,684,306	-

W1:

The method for calculating the offset of brought forward tax losses in ESP Retail Ltd is as follows:

	Trading profits £	Non trading profits £	Total profits £
<i>Percentage split:</i>	<i>88.6%</i>	<i>11.4%</i>	<i>100%</i>
Taxable profits	44,300,000	5,700,000	50,000,000
Less: In-year reliefs	(15,931,388)	(2,049,862)	(17,981,250)
Profit after in-year reliefs	28,368,612	3,650,138	32,018,750
Allocation of £5 million allowance	(5,000,000)	-	(5,000,000)
Profits remaining after allowance	23,368,612	3,650,138	27,018,750
Profits available for shelter (50%)	11,684,306	1,825,069	13,509,375
Offset of pre-April 2017 trading losses (£11,000,000 - £5,000,000)	(6,000,000)	-	(6,000,000)
Offset of post-April 2017 trading losses (balance to c/f : NIL)	(4,500,000)	-	(4,500,000)
Offset of post-April 2017 non-trading losses (balance to c/f £1,165,556)	(1,184,306)	(650,138)	(1,834,444)
Utilisation of brought forward losses:			17,334,444
Taxable profits after loss relief:	11,684,306	3,000,000	14,684,306

In this case, it is optimal to offset the maximum amount of brought forward losses against 50% of the trading profits available for shelter of £11,684,306. Utilising the pre-trading losses as quickly as possible is tax efficient given offset is ring-fenced against profits of ESP Retail Ltd.

It is better to limit the claim for offset of non-trading losses brought forward, however, to leave sufficient interest income subject to Corporation Tax to fully offset the £570,000 withholding tax credit (£3,000,000 x 19% = £570,000).

UK tax issues relevant to the Group Transfer Pricing Policy

The Group Transfer Pricing Policy should extend to all related party debts involving UK companies. It should outline a methodology for determining an arm's length rate of interest and volume for intra-group loans.

This requires periodic benchmarking against similar debt for the retail sector and the group's external debt. It will also be important to ensure cash flow projections support companies being able to repay intra-group loans and related interest expense.

Where a UK tax resident company is deemed to have excess debt above what it is able to borrow externally from an unrelated party (e.g. a bank) it will be considered "thinly capitalised". Often debt cover ratios such as EBITDA to interest expense and debt to EBITDA will be considered in determining an arm's length level of debt.

Where a company is thinly capitalised, a proportion of any interest expense will be disallowed to the extent it relates to "excess debt". Interest will also be disallowed to the extent the interest rate is deemed excessive.

MARKING GUIDE

TOPIC	MARKS
<i>Impact for CIR to UK tax computations:</i>	
Note that ExpertSales plc and its subsidiaries part of the worldwide group [s.473 TIOPA 2010] and results of UK companies feature in CIR calculation	1
Calculation of Aggregate Net Tax Interest Expense [s.390 TIOPA 2010]	2
Explain adjustment for double tax relief [s.388 TIOPA 2010]	1
Application of “fixed ratio” method [s.397 TIOPA 2010]	2
Application of “group ratio” method [s.398 TIOPA 2010]	1.5
State that disallowance under group ratio preferable	0.5
<i>Utilisation of tax losses:</i>	
Adjust for CIR disallowance	0.5
Note group relief applicable and calculate position [s.99 CTA 2010]	1.5
Split out trading and non-trading taxable profits and deduct in-year relief [s.269ZF CTA 2010]	1
Allocate £5 million allowance [s.269ZR CTA 2010]	1
Offset of pre-April 2017 losses [s.45 CTA 2010]	1
Offset of post-April 2017 losses [s.45A CTA 2010 & s.463H CTA 2009]	1
State benefit of claiming reduced loss to maximise tax relief for WHT credit	1
<i>UK tax issues relevant to Group Transfer Pricing Policy:</i>	
Comment that transfer pricing policy should extend to related party loans [s.152 – 153 TIOPA 2010]	1
Note interest rate and volume to be benchmarked	0.5
Note that projected cash flows should also support intra-group loans	0.5
Explain situation where UK company thinly capitalised and considerations in determining arm’s length level of debt	1
Explain that excessive interest is disallowed	1
Presentation and higher skills	1
TOTAL	20

ANSWER TO QUESTION 5

Briefing Note

Delta Shopping Centre

- The transfer of the shopping centre will be treated as being a 'nil gain nil loss' transaction as both companies are part of the same chargeable gains group. A chargeable gains group comprises the parent ('principal company') and its 75% subsidiaries, provided that they are also 51% economic subsidiaries of the principal company. As a result the base cost for Titan Delta 2 Ltd will be the original cost paid by Titan Delta Ltd plus accrued indexation from the date of purchase to December 2017.
- The receipt of the dividend by Titan plc will be exempt from Corporation Tax as it is received from a controlled subsidiary.
- Normally a 'degrouching charge' arises where, following a 'nil gain nil loss' intra-group transfer, the transferee company leaves the capital gains group within six years. However, on the disposal of Titan Delta Ltd by Titan plc, there is no degrouching charge as Titan Delta Ltd and Titan Delta 2 Ltd leave the group at the same time.
- The basic chargeable gain on disposal of Titan Delta Ltd by Titan plc will therefore be:

	£ million
Proceeds	100
Cost	<u>(100)</u>
Chargeable gain	<u>nil</u>

- The Substantial Shareholdings Exemption will not be available as Titan Delta Ltd is not a trading company.
- However, it is likely that the steps undertaken constitute a 'value shifting' arrangement. This applies where there is a disposal by a company of shares in another company and:
 - a) Arrangements have been made whereby the value of those shares is materially reduced;
 - b) The main purpose (or a main purpose) of the arrangements is to obtain a tax advantage; and
 - c) The arrangements do not consist solely of the making of an exempt distribution.

Consideration will need to be given as to whether a main purpose of the arrangements is to avoid tax. This will be the case where the obtaining of the tax advantage is more than an incidental benefit. We should identify where there are any commercial reasons for the restructuring, or whether the arrangements were undertaken to attempt to reduce the tax liability on the disposal.

Where this applies, the gain is to be calculated as if the consideration for the disposal is increased by such amount as is just and reasonable having regard to the arrangement.

- As a result, the gain would be increased a gain of £84.9 million. This is calculated as:

	£ million
Proceeds	250
Cost	(100)
Indexation allowance (£100m x 0.651)	<u>(65.1)</u>
Chargeable gain	<u>84.9</u>

$$(278.1-168.4)/168.4 = 0.651 \text{ (3 d.p.)}$$

- Stamp Duty Land Tax of £12,489,500 would be due by Titan Delta 2 Ltd on the initial transfer of the property (0% of £150,000 plus 2% of £100,000 plus 5% of £249,750,000).
- SDLT group relief may be available where the property is transferred between companies that are part of the same 75% group. However, SDLT group relief is denied where the transfer is part of an arrangement, the main purpose (or a main purpose) of which is to avoid tax.

Chi Shopping Centre

- The chargeable gain on the disposal of the property by Titan Chi Ltd will be:

	£'000
Proceeds	45,000
Cost	(10,000)
Indexation allowance (£10m x 0.845)	<u>(8,450)</u>
Chargeable gain	<u>26,550</u>

$$(278.1-150.7)/150.7 = 0.845 \text{ (3 d.p.) (Note: This uses indexation from December 1995.)}$$

- The dividend received by Titan plc will be tax exempt as it is received from a controlled subsidiary.
- The liquidation of Titan Chi Ltd will constitute a capital disposal by Titan plc. The basic allowable loss will be:

	£ million
Proceeds	10
Cost	(40)
Allowable loss	<u>(30)</u>

- However, this arrangement will constitute a depreciatory transaction. This applies where a company (the 'first company') has a holding in another company (the 'second company') and the following conditions are fulfilled:
 - The holding amounts to 10% of that class of share;
 - A distribution has been made to the first company in respect of the holding; and
 - The effect of the distribution is that the value of the holding is materially reduced.

Where this applies, the loss is reduced on a just and reasonable basis. Note that it cannot create a gain. As a result of the £35 million dividend, the capital loss will be reduced to nil.

Conclusions

- There may be errors in the tax computations. In particular, the Titan group may have understated its tax liabilities in respect of chargeable gains and Stamp Duty Land Tax.
- It is therefore recommended that confirmation be obtained as to how the transactions have been treated and whether adequate provision has been recognised in the accounts. In addition, consideration should be given to adjusting the purchase price or at least including an indemnity to cover any additional tax.

MARKING GUIDE

TOPIC	MARKS	SUBTOTAL
Delta Shopping Centre		
- Nil gain nil loss transfer	1	
- No degrouping charge, as both companies leaving at the same time.	1	
	0.5	
- No SSE, as not trading.	0.5	
- Distribution exempt	1	
- Calculation of gain before adjustment	2	
- Value shifting rules apply	2	8
- Stamp duty – no group relief / calculation		
Chi Shopping Centre		
- Gain on the disposal of the property – calculation	1	
- Distribution exempt	0.5	
- Gain on liquidation – capital	1	
- No SSE, as not trading	0.5	
- Calculation of loss before adjustment	1	
- Depreciatory transaction rules apply	2	6
Conclusions / recommendations	1	1
TOTAL		15

Note: Credit will be given to candidates who present answers based on Land and Buildings Transaction Tax (LBTT).

ANSWER TO QUESTION 6

File note

Tax treatment of leasing transaction

The lease of the industrial machinery should be treated as a “long-funding lease” for tax purposes as the 25-year term exceeds the standard 5-year term for a short lease and is accounted for as a right of use asset under IFRS 16.

The lessor is not entitled to capital allowances that may instead be claimed by Plastic Slicer Limited as lessee based on the net present value of the minimum lease payments on commencement of the lease.

The asset will be regarded as a “long-life asset” for capital allowance purposes and included in the special rate pool. Expenditure in the special rate pool is subject to an 8% writing down allowance on a reducing balance basis.

The finance cost accruing on the lease payments is tax deductible for the lessee in line with the accounting treatment.

Calculation of deferred tax provision

There is a difference between the rate which the lease is depreciated for tax purposes and accounting purposes.

A deferred tax liability of **£324,000** arises at 30 June 2009 calculated as follows:

	Opening position 31 December 2018 £	Movement during accounting period £	Closing position 30 June 2019 £
NBV of fixed asset	30,000,000	(600,000)	29,400,000
NBV of lease liability	(30,000,000)	472,404	(29,527,596)
NBV of asset / liability	-	(127,596)	(127,596)
TWDV of assets (W1)	30,000,000	(2,400,000)	27,600,000
TWDV of liabilities	(30,000,000)	472,404	(29,527,596)
	-	(1,927,596)	(1,927,596)
Net temporary difference	-	(1,800,000)	(1,800,000)
Deferred tax liability (17% tax rate)	-	(306,000)	(306,000)

W1:

Capital allowances for period:

$$£30,000,000 \times 8\% = £2,400,000$$

Criteria for deferred tax asset recognition

Unrelieved tax losses and other potential deferred tax assets should only be recognised in the financial statements of a company to the extent that that it is probable that the temporary difference will reverse in the foreseeable future, and that taxable profits will be available, against which the temporary difference will be utilised.

In order to recognise an asset such as tax losses, a company should therefore be able to provide evidence of future profitability.

MARKING GUIDE

TOPIC	MARKS
<i>Tax treatment of leasing transaction:</i>	
State that lease should be a “long-funding lease” and relevant conditions per [s.70 CAA 2001]	2
State that asset should be treated as a “long-life asset” [s,91 CAA 2001]	0.5
Note that asset included in the special rate pool and depreciated at a rate of 8% on a reducing balance basis [s.101 – 102 CAA 2001]	1
Note that interest tax deductible for lessee	0.5
<i>Calculation of deferred tax provision:</i>	
Calculation of book value of temporary differences	2
Calculate capital allowances due for six-month period	1
Correctly calculate deferred tax asset and effective tax rate	1
<i>Criteria for deferred tax asset recognition:</i>	
State the criteria for recognising a deferred tax asset	1
Note possible requirement to provide evidence of future profitability	1
TOTAL	10