Item Response :

Report

Tax Consequences of Expansion for the Big Brands Europe plc Group

10 May 2020

Introduction

This report will cover three areas:

A: Whether Big Brands Europe plc's expansion should be funded via debt or equity.

B: The legal form of the entity used for expansion

C: The most tax efficient expansion option

The report has been prepared based on the tax laws operative at this date. The report will not be updated for future changes in tax law. The report has been prepared for the directors of Big Brands Europe plc only and should not be shared with any third parties without the prior consent of LMN LLP.

Executive Summary

- We recommend that the new activity is funded through equity finance. The UK corporation tax rate is higher than the equivalents abroad and so it is beneficial to keep the net interest expense position as high as possible in the UK company as tax is saved at a higher rate. The more restriction Corporate Interest Restriction regimes in Middleland and Commercia reinforce the benefits of maximising the UK expense position.
- We recommend the overseas expansion is effected through a permanent establishment of a UK company rather than an overseas incorporated company. This is because there will be a lower

administrative burden for the group. We recommend the UK company makes a Branch Exemption Election before year 4 in respect of the permanent establishment so the profits are subject to only the lower overseas rate.
- We note however this will not be possible for Middleland as the law mandates operations are carried out through a Middeland incorporated company.
- Overall, expanding into Commercia will be the most tax efficient option because the Commercia tax laws allow capital allowances to be claimed on land.

We recommend an equity financed UK company with a permanent establishment in Commercia

A: Debt or Equity Investment

This section will discuss the implications of making the investment in the new manufacturing operation via debt or equity.

We understand Big Brands Europe plc ("BBE") will borrow £50m to fund the investment at a rate of 5%. This will then be invested into a new company via equity or debt to fund the operation.

A1: Corporate Interest Restriction Position

The BBE group will be taking out debt funding for the expansion, resulting in an increase to its interest payments of £2.5m per annum. The Corporate Interest Restriction ("CIR") regime must therefore be considered when deciding on the funding structure for the expansion.

The BBE group currently experiences an interest restriction. The interest deductions are capped under the fixed ratio method at 30% of its aggregate tax-EBITDA. The expected disallowance for the 2019 period is £12m for the group as a whole.

If BBE provides equity funding, then the Net Tax Interest Expense ("NTIE") of the group will increase by £2.5m (£50m at 5%) to £62.5m

Similarly, if it provides debt funding to a UK company, the NTIE will increase by £2.5m. This is because the new UK company ("UK Newco") will have an interest debit, representing interest payable to BBE, which is exactly offset by an interest credit in BBE. The increase in NTIE will be the £2.5m payable by BBE.

If however debt funding is provided overseas, BBE will have an interest credit, representing interest receivable from the overseas company, without there being a corresponding Tax Interest Expense ("TIE"). This is because the corresponding expense amount will not be within the scope of UK Corporation tax ("CT") and does not qualify as a TIE. If BBE charges 5% on the loan, then BBE's NTIE will not increase overall and will remain at £60m.

The overseas territories do however operate interest restriction regimes. These regimes allow a deduction of interest up to 30% of accounting profits. This is more restrictive than the UK regime, which uses 30% of aggregate tax EBITDA instead. For example, in year 2, the 30% figure is compared to the £3m accounting profit for interest in Middleland and Commercia, but is compared to £7m EBITDA for UK purposes. This means £900k of interest would be deductible in Middleland or Commercia, compared to £2.1m in the UK.

Given the UK CIR regime is more generous than the Middleland and Commercia equivalents, it is beneficial for the BBE group to keep the net interest expense in the UK. To do this, the investment would be via equity rather than debt.

A2: Interest v Dividends

Interest

Debt financing results in interest payments being made to BBE.

BBE would be able to charge interest on a loan. As the loan is a transaction for the lending of money, interest charged by BBE would result in non-trade loan relationship credits in BBE, which are subject to UK corporation tax. If the loan coupon matches that on the loan payable by BBE, then the interest income and expense will net out to nil in BBE.

If BBE charges lower interest, this would lead to an overall non-trade loan relationship deficit in BBE. This would be deductible from its total profits, or surrenderable to another group company via group relief. If BBE charges a higher rate of interest, then BBE would have an overall non-trade loan relationship credit for the period, which would be subject to UK corporation tax at 19%.

Interest payments from overseas may be subject to withholding tax. The withholding tax rates in Middleland and Commercia are 10% and 20% respectively. While Middleland does have a Double Taxation Treaty ("DTT") in place with the UK, the DTT provides for interest to be charged at no more than 10%, so there is no further reduction available.

For a debt investment of £50m at 5%, £2.5m of interest would need to be remitted to the UK each year. In Middleland, this would result in £250k of withholding tax suffered, and in Commercia it would result in £500k of withholding tax suffered.

Unlateral relief for both would be available for BBE in the UK. Subject to a maximum of the UK corporation tax chargeable on the interest income, BBE would be able to claim a UK tax credit for the withholding tax suffered. The UK tax credit for the interest from Middleland would be the full £250k, while from Commercia it would be capped at £475,000, with £25,000 of withholding tax unrelieved. This is because the UK corporation tax rate of 19% is lower than the withholding tax rate of 20%.

For a debt investment, tax relief would be obtained in the territory invested in. For example, ignoring the effects of CIR, an investment in Middleland would result in a deduction in Middleland of £2.5m; saving £250k in corporation tax per period (Middleland tax is charged at 10%). An investment in Commercia would save £375k (being Commercia corporation tax at 15%). The UK equivalent position results in £475k of tax saving per year. Clearly, having the expense in the UK results in a higher corporation tax saving.

The overall cost is therefore the difference in corporation tax rate of the territory in which the interest deduction is obtained plus any withholding tax:

Territory of investment	UK	Middleland	Commercia
Interest differential	0	£250k	£125k
Withholding tax	0	0	£25k
Overall cost	0	£250k	£150k

Dividends

The return on an equity investment would be in the form of dividends. Dividends are not deductible in computing corporation tax liabilities in the UK, Middleland or Commercia. As dividends will not be deductible in any of the territories proposed, and because BBE will own 100% of the ordinary share capital, the dividends received by BBE will be exempt from UK corporation tax.

No withholding tax is chargeable in either Middleland or Commercia on dividends payable. This means that the full dividend declared in any of the proposed territories will be received in full by BBE.

An equity investment would mean that BBE does not receive any interest income and therefore the net interest expense remains in the UK with BBE.

A3: Summary

A debt investment effectively moves the £2.5m interest expense from BBE to the company invested in. Where this company is resident in a territory with a lower corporate tax rate (such as Middleland or Commercia), this results in tax being saved at a lower rate for the interest payable. Equity investment keeps the interest deduction in the UK and therefore saves tax at a higher rate.

Before considering the CIR position:

- An equity investment in Middleland will be £250k cheaper per annum than a debt investment.

- An equity investment in Commercia will be £150k cheaper per annum than a debt investment.

Further, as the overseas CIR position is more restrictive than the UK equivalent, using accounting profits instead of EBITDA, debt investment will result in higher interest disallowances.

We therefore recommend investing via equity rather than debt.

B: Trading Entity

The new entity could be either a company incorporated in the relevant territory, or a permanent establishment ("PE") of a UK company. This section will compare the tax position.

B1: Permanent Establishment

The profits of an overseas PE will be fully taxable in the UK Newco. As they will also be subject to corporate tax in the other territory, this could result in profits being taxed twice.

It is possible however for the tax suffered in respect of the PE profits to be unilaterally relieved against the UK corporation tax. The foreign tax suffered is given as a credit against the UK entity's UK corporation tax liability. As the rate of corporate tax in both Middleland and Commercia is lower than in the UK, the foreign tax will be relieved in full and the PE profits would effectively be taxed at the UK CT rate.

Losses of the PE would be able to be offset against any UK profits arising to the UK Newco. However, as the UK Newco is set up for the sole purpose of expanding the manufacturing operations, it is unlikely there will be any such profits if the PE is loss making.

It would be possible to make a Branch Exemption Election in respect of the overseas PE. This would mean that the profits of the PE would no longer be subject to UK CT. The only corporate tax suffered by the branch would be the overseas CT. As the rate is lower in both Middleland and Commercia, this would result in a tax saving equivalent to the difference between the UK CT rate and the overseas CT rates. When the branch is profitable, it is recommended that the election is made. The election must be made before the start of the accounting period for which it is intended to take effect.

While the PE is loss making, it is not advisable to make the election. This is because the losses would not be capable of being offset against the UK company's taxable profits. It is therefore advisable that the election is only made once the PE is profitable and its losses have been fully utilised.

As Middleland law mandates that activities must be carried out through a Middleland incorporated company, it would not be possible to operate there through a PE of a UK incorporated company.

If the group were to sell a PE in the future, then the UK CT would arise on the assets sold, based on the proceeds received less the cost.

B2: Incorporated Company

The other option is to incorporate a company in the territory being expanded into. As noted, this is the only option for Middleland operations.

The incorporated company would be an entirely distinct legal entity to the UK BBE companies. Its profits would be subject to CT in the overseas company only. Profits of the entity would be need to be remitted back to the UK via either dividends or equity, whereas the profits of a PE would automatically be those of the UK entity, without needing to be remitted.

As was discussed in Part A of this report, dividends would not suffer any withholding tax and would not be taxable in the UK. Interest would be deductible and taxable in the overseas territory and the UK respectively, and would suffer withholding tax of 10% in Commercia.

An incorporated company would also be a Controlled Foreign Company ("CFC") of the BBE group. In some circumstances, a CFC charge can arise in respect of CFCs. There are however wide ranging exemptions available which prevent a CFC charge from arising. As the CFC rules are anti-avoidance in nature, it is likely that one of the exemptions would be available for the BBE group. If you decide to expand via a CFC, then we can look at these rules in detail to ensure an exemption is available.

When an incorporated company is sold, and it is a trading company owned at least 10% for 12 months or more, the share disposal is exempt from UK corporation tax by virtue of the "Substantial Shareholding Exemption". It does not matter whether the disposed of company is UK resident or overseas resident.

B3: Summary

If the group decides to expand into Middleland, then it will have to create a Middleland incorporated company by virtue of the laws operative there.

If instead the group decides to operate in Commercia, then we recommend this is done through a PE because the administrative burden of operating a PE is less than a corporate entity. Once the PE becomes profitable and its losses are fully utilised, we recommend making the branch exemption election so that its profits are only subject to the lower overseas rate.

C: UK Corporate Tax Position

There are 4 options available for the expansion:

1. UK location through UK company
2. Middleland expansion through Middleland company
3. Commercia expansion through Commercia company
4. Commercia expansion through Commercia PE of UK company

This section will compare the UK corporation tax positions of these options. We have prepared these estimates based on an equity investment being made by BBE, as recommended in section A of this report.

C1: UK location through a UK company

This would result in an overall UK corporation tax cost of £2.61m over the first 4 accounting periods (See Appendix 1).

The company would be able to claim structures and buildings allowances in respect of the investment in the factory. This yields a deduction of 2% of the initial cost per accounting period.

The plant and machinery would be eligible for capital allowances of 18% per period on a reducing balance basis.

C2: Middleland location through Middleland company

The Middleland profits would be subject to Middleland corporation tax only. The Middleland tax payable would be £1.65m (Appendix 2).

C3: Commercia through Commercia Company

The Commercia profits would be subject to Commercia corporation tax only. The Commercia tax payable would be £0.54m (Appendix 3).

C4: Commercia through UK Company

The commercia profits would be subject to Commercia tax of £0.54m as above.

The UK company would also be taxed on the £5.4m year 4 permanent establishment profits, resulting in an additional £1.03m of UK tax payable.

If however a branch exemption election were made before the start of year 4, this would take the PE profits outside of the scope of UK corporation tax, with only £0.54m being due over the four periods.

C5: Summary

An expansion in Commercia will result in the least amount of tax due over the four periods modelled. This is primarily because the capital allowances regime there is the most generous, with allowances available on land.

The overall tax position will be the same whether this expansion is carried out via a permanent establishment or a Commercia incorporated company. We therefore recommend that the expansion into Commercia is carried out via a permanent establishment, because of the advantages described in section B of the report. A branch exemption election should be made before the start of the fourth accounting period to ensure the position is as tax efficient as possible.

Appendix 1 - Tax Cost of UK Investment

Newco Tax adjusted profits (£m)

Year	1	2	3	4
Accounting profit/loss	-5	3	7	15
Depn	4	4	4	4

SBAs (2%)	-0.3	-0.3	-0.3	-0.3
P&M (18%)	-3.6	-3.0	-2.4	-2
Interest cost	-2.5	-2.5	-2.5	-2.5
Taxable profits/(loss)	-7.4	1.3	5.8	14.2
B/f losses	0	-1.3	-5.8	-0.3
UK CT	0	0	0	2.64

Structures and buildings allowance given at a 2% rate per annum on factory cost.

Plant and machinery allowances given at a rate of 18% on a reducing balance basis.

If the investment is via debt, the Newco will bear the interest expense. If via equity, BBE will bear the cost. Overall, the UK position will be the same and therefore this has been included in the taxable profits calculation for Newco. If it was instead in BBE, it could instead be group relieved, resulting in the same overall position.

BBE net impact of nil (2.5m interest income and expense).

CIR position:

Year	1	2	3	4
Newco EBITDA	1	7	11	15
Existing group EBITDA	160	160	160	160
New EBITDA	161	167	171	175
Interest cap (30%)	48.3	50.1	51.3	52.5
Net tax int expense	62.5	62.5	62.5	62.5
Disallow on no invest	12	12	12	12
New disallow	14.2	12.4	11.2	10
Increase/(decrease)	2.2	0.4	-0.8	-2
UK CT cost/(saving)	0.42	0.08	-0.15	-0.38

Overall UK CT cost = £2.61m

Appendix 2 - Middleland Location, Middleland company

The Middleland corporation tax payable in the first 4 years would be:

Adjusted profits (£m)

Year	1	2	3	4
Accounting profit/loss	-5	3	7	15
Depn	4	4	4	4
Factory allowance (10%)	-1.5	-1.5	-1.5	-1.5
P&M (25%)	-5	-5	-5	-5
Tax adjusted profit/loss	-7.5	0.5	5.5.	12.5
b/f loss relief	0	-0.5	-5.5.	-1.5
Taxable profit	0	0	0	11
Tax payable (15%)	0	0	0	1.65m

Appendix 3 - Commercia Location Through Commercia company

Adjusted profits (£m)

Year	1	2	3	4
Accounting profit/loss	-5	3	7	15
Depn	4	4	4	4
Factory allowance (10%)	-1.5	-1.5	-1.5	-1.5
Land (10%)	-1.4	-1.4	-1.4	-1.4
P&M (25%)	-5	-5	-5	-5

Tax adjusted profit/loss	-8.9	-0.9	4.1	11.1
b/f loss relief	0	0	-4.1	-5.7
Taxable profit	0	0	0	5.4
Tax payable (10%)	0	0	0	0.54m