THE ADVANCED DIPLOMA IN INTERNATIONAL TAXATION

December 2016

PAPER 2.09 – UNITED KINGDOM OPTION

ADVANCED INTERNATIONAL TAXATION (JURISDICTION)

TIME ALLOWED – 3¼ HOURS

You should answer **FIVE** out of the nine questions: **BOTH** questions from Part A; **ONE** question from Part B; and **TWO** questions from Part C.

Part A questions are worth 25 marks each. Part B questions are worth 20 marks. Part C questions are worth 15 marks each.

You should aim to spend approximately half of your exam time answering Part A, and the remaining half answering Parts B and C. The amount of time you spend answering each question should correspond broadly to the number of marks available for that question.

As you are using the on-screen method to complete your exam, you must provide appropriate line breaks between each question, and clearly indicate the start of each new question using the formatting tools available.

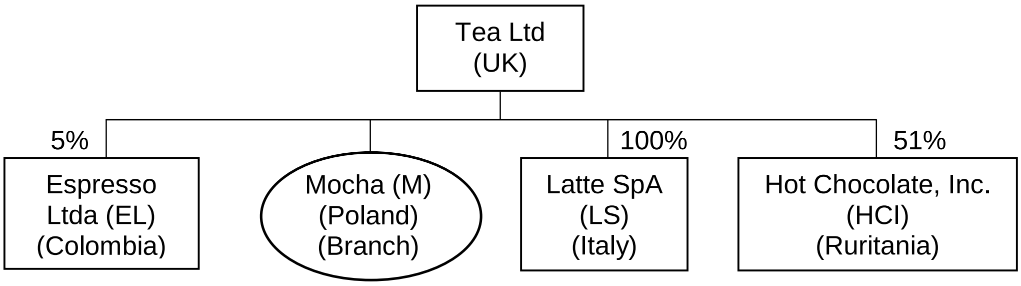
All workings should be made to the nearest month and Pound Sterling, unless the question requires otherwise.

Marks are specifically allocated for presentation.

PART A

You are required to answer BOTH questions from this Part.

1. Tea Ltd is a company based in the United Kingdom, with the following overseas interests:



Tea Ltd has taxable profits for the year to 31 March 2016, having received cash distributions from its non-UK operations and investments as follows:

	EL (£)	M (£)	LS (£)	HCI (£)
Profit before tax for the year to 31 March 2016	3,000,000	2,000,000	1,000,000	5,000,000
Local tax on profits	900,000	300,000	300,000	900,000
Net dividend received by Tea Ltd	47,500	0	180,000	950,000
WHT on receipt	2,500	0	20,000	50,000

Tea Ltd's consolidated accounts show turnover of £500 million, a balance sheet of £150 million and 1,500 total employees.

Tea Ltd established the M branch in Poland in 2013. The year to 31 March 2016 is the first year in which M has been profitable. Tea Ltd has not made an election in respect of profits earned by M.

The investment in LS is held as a combination of ordinary and preference shares. The distribution received by Tea Ltd represents a 6% annual dividend paid on the preference shares.

The double tax treaty between Ruritania and the UK states that, unless dividends are taxed in the UK as income, a 30% withholding tax rate is to be applied to dividends. If the dividends are taxed as income in the UK, this rate reduces to 5%.

You should assume that the percentage investment in each entity by Tea Ltd is equal to the percentage voting rights and/or dividend entitlement held by Tea Ltd in each entity. No entity receives a tax deduction in respect of dividends paid. All goods and services are charged at an arm's length rate, and all transactions are for commercial, non-tax, purposes.

1) **You are required to estimate the UK Corporation Tax liability in relation to the above amounts for Tea Ltd, for the accounting period ending 31 March 2016. You should provide an explanation of the treatment of the above foreign profits, and explain any assumptions you have made.** (14)

2) **Tea Ltd supplies goods from the UK to M, LS and Hot Chocolate for use in their cafes. Tea Ltd also provides management services to these entities. You are required to explain the VAT treatment of these supplies.** (6)

Continued

1. Continuation

3) "Now that the UK has an exemption for dividends and for branch profits, tax should no longer be a factor when a UK company considers whether to operate overseas through a branch or a subsidiary".

You are required to provide reasons why you agree or disagree with this statement. (5)

Total (25)

2. Rally AB is a Swedish resident company within the transport sector and conducts operations worldwide. It specialises in the installation of railway lines and signalling equipment, as well as the manufacture of trams and railway carriages. Rally AB has entered into a Joint Venture (JV) agreement with a UK-resident construction company, in order to bid for a significant project in the UK. It is proposed that a JV company will be set up in the UK to facilitate the project.

The JV is currently in the process of bidding for the project, which will comprise construction and installation of new tramlines and trams in a number of major UK cities. The project is expected to start in January 2018, for a duration of five years.

Historically, Rally AB has undertaken the negotiation process for such projects by sending its sales director, Hugo, to the relevant territory in which the project is to take place.

Hugo is married with two children, aged 6 and 10. He and his family are expected to arrive in the UK on 1 December 2016. Rented accommodation in the UK will be provided by Rally AB to Hugo and his family for the duration of his stay in the UK. Hugo will be using one of the rooms in his UK accommodation as an office. An additional office has been set aside by Rally AB's JV partner, for Hugo's use, for the entire duration of the bidding process. Hugo is expected to remain in the UK until October or November 2017, but his salary will continue to be paid by Rally AB in Sweden.

Hugo will also be meeting with existing and potential customers of Rally AB during his stay in the UK, with a view to winning new projects.

Once the project starts, other Rally AB employees will be seconded to the UK for periods of between six months and five years.

You are required to:

1) Comment on whether or not the activities undertaken by Hugo prior to the commencement of the project will create a UK Permanent Establishment (PE). You should assume that the OECD model Treaty is in place between Sweden and the UK. (10)

2) Explain Hugo's UK tax residency position. (15)

Total (25)

PART B

You are required to answer ONE question from this Part.

3. ABC Holdco Ltd (ABC) is a UK incorporated and tax resident company. It was set up on 1 February 2015 in order to facilitate the acquisition of a UK group of companies by a US resident company (US, Inc.). ABC's ordinary share capital is wholly owned by US, Inc.

On 15 February 2015, ABC obtained a £30 million loan from an external bank together with a loan of £15 million from US Inc. On the same day, ABC acquired 100% of the shareholding in the UK group of companies for a total consideration of £40 million, comprising cash £35 million and preference shares of £5 million. The preference shares were issued by ABC to the founder shareholders.

ABC has an accounting period end of 31 March and its consolidated financial statements for the period from 1 February 2015 to 31 March 2016 show the following:

Consolidated Statement of Comprehensive Income

	£
Turnover	5,000,000
Cost of Sales	(2,000,000)
Gross Profit	3,000,000
Administration expenses	(3,000,000)
Amortisation of intangibles	(1,000,000)
Exceptional costs	(1,000,000)
Interest payable	(6,000,000)
Loss before tax	(8,000,000)

Consolidated Statement of Financial Position

	£
Intangible assets	41,000,000
Tangible fixed assets	1,000,000
Debtors	4,000,000
Cash	2,000,000
Creditors	(15,000,000)
Total assets less current liabilities	33,000,000
Creditors falling due after more than one year	(40,000,000)
Net liabilities	(7,000,000)

Capital and reserves

	£
Called up share capital	1,000,000
Profit and loss account	(8,000,000)
Equity attributable to owners of the parent company	(7,000,000)

The following financing costs are shown in the financial statements for the period to 31 March 2016:

Bank	£750,000
US, Inc.	£4,500,000
Founder shareholders	£750,000

Continued

3. Continuation

The above payments have not yet been paid by ABC.

You are required to:

1) **Comment on the thin capitalisation position of ABC. Your answer should include any actions to be taken by the company in order to obtain tax relief on interest payments for the year to 31 March 2016.** (10)

2) **Explain the withholding tax position, in relation to payments made under the various financing arrangements.** (5)

3) **Explain the EU Directive rules concerning interest paid between associated companies based in Member States of the European Union, and how the rules would affect ABC if its parent company was based in an EU Member State rather than in the United States.** (5)

Total (20)

4. You advised Selina Jones two years ago on the sale of her internet start-up company to a large US multinational.

Since the sale, Selina has moved from London to America and married a US citizen. You have previously advised her that she will not be resident in the United Kingdom for the 2016 tax year.

You have received the following email from Selina:

Hi there

I hope this finds you well and things are still busy for you.

I'm trying to get organised before the end of the tax year. My US accountant will file the US returns, but I remember you saying that I may still need to pay tax in the UK?

I've attached a schedule of the amounts I should receive this year – could you let me know what the UK tax position will be? As you know, I am living in the US now, and from your earlier advice I shouldn't be regarded as UK-resident. I don't see how the UK can have any taxing rights on my income or that I should file a UK tax return. Everyone keeps telling me how high US tax rates are, so presumably there won't be UK tax to pay as well!

I haven't sold my London flat yet. I do miss living there but I've had some interest in it and will hopefully complete by the end of the year. The profit should be in the region of £1 million. I'm not interested in artificial tax planning, but if there is any easy way of reducing tax on that I would be interested to hear about it!

Many thanks
Selina

Income	*Amount receivable in year ending 5 April 2016 (£)*
Interest from UK bank account	*1,200*
Interest from US bank account	*2,400*
Dividends from UK share portfolio	*3,000*
Gains on UK shares	*5,000*
Royalties (paid from a UK company)	*25,000*
Rent from London flat	*3,600*

Your preliminary research has provided the following extracts from the UK-US treaty:

"Interest arising in a Contracting State and beneficially owned by a resident of the other Contracting State shall be taxable only in that other State."

"Royalties arising in a Contracting State and beneficially owned by a resident of the other Contracting State shall be taxable only in that other State."

"*Income derived by a resident of a Contracting State from real property, including income from agriculture or forestry, situated in the other Contracting State may be taxed in that other State.*"

Continued

4. Continuation

"…*dividends may also be taxed in the Contracting State of which the company paying the dividends is a resident and according to the laws of that State, but if the dividends are beneficially owned by a resident of the other Contracting State, the tax so charged shall not exceed, except as otherwise provided…. (b) 15 per cent. of the gross amount of the dividends in all other cases."*

You are required to prepare a response to Selina. Your response should:

1) **Explain how the UK tax system applies to her income and gains as a non-resident, and what provisions are in place to limit double taxation.** (6)

2) **Set out whether the income and gains identified by Selina will be subject to tax in the UK, and how this tax will be charged.** (14)

Total (20)

PART C

You are required to answer TWO questions from this Part.

5. York Ltd (York) is the parent company, incorporated in the United Kingdom, of the following companies:

   - Carlisle Ltd (Carlisle), a UK-resident company;
   - Leeds HK Pte (Leeds), a Hong Kong-resident company; and
   - Swindon US, Inc. (Swindon), a US-resident company.

   The group is involved in the creation of digital games, and has a worldwide customer base. Carlisle is predominately a R&D company, and 50% of its employees are involved in creating new products and enhancing existing products. In addition, Carlisle has trading activities and possesses a significant share of the UK and European market. Over the course of a number of years, the group has created some very highly regarded products and has an excellent reputation within the digital gaming sector.

   The group companies all have an accounting period to 31 March and are regarded as large.

   York holds all patents and trademarks of the products created by the R&D team, and all other intellectual property (IP). An independent valuation was recently performed, which recorded a value of £25 million and a royalty rate of between 5% to 7%, as at 31 March 2016.

   Leeds and Swindon act as distributors of the products in their respective regional areas and are charged a 5% royalty based on turnover by York. The turnover of Leeds and Swindon was HK$5.5 million and US$8 million for the year to 31 March 2016, respectively.

   In view of the tremendous market growth over the last few years, the group finance director (FD) is currently reviewing the group's strategy and available options to reduce its effective tax rate. One option which has suggested to the FD by his team is to set up a Special Purpose Vehicle (SPV) company in Jersey, which has a 5% corporate tax rate.

   The SPV will be the ultimate holding company of the group, and its primary function will be to hold all IP and other investment property acquired by the group in the future. The SPV will charge Carlisle, Swindon and Leeds an annual royalty of 25% based on the value of IP. Additionally, it is proposed that the group's sales and invoicing functions will be transferred to the SPV and centralised in Jersey. The SPV will house a small team, who will be responsible for customer contracts and agreements, orders and invoicing. Therefore, the existing invoicing structure will be changed to the following:

   - All customer contracts will be effected between the customer and SPV.

   - All invoicing and debt collection function will be transferred to SPV. SPV will charge Carlisle, Swindon and Leeds a management fee for for the provision of this service at a rate of 5% of sales turnover.

   - Carlisle will make all supplies to SPV at cost plus 3%.

   - Carlisle, Swindon and Leeds will continue to manage client relationships and business development. Additionally, Carlisle will continue to operate its R&D centre and create new products.

   You are required to comment on the proposed structure, from a Diverted Profits Tax perspective. (15)

6. In 2000, Atlas, Inc., a US resident company, set up a wholly owned subsidiary, Zeus Ltd (Zeus), in the United Kingdom to act as a hub for the European market. Zeus acts as a distributor of automotive components manufactured in the US. The components are shipped to the UK, where they are stored in various strategic locations before being shipped to customers based in the UK and Europe.

Zeus has wholly owned subsidiaries in China, India and Japan. These subsidiaries service customers in the relevant territories. The Zeus branding is used on all products, and Zeus receives 5% royalties based on the subsidiaries' turnover.

In 2010 Zeus moved into brand new, purpose-built building which cost £5 million. This move allowed Zeus to continue its expansion and achieve its target growth in the European market.

In 2012 Zeus acquired the shareholding of one of its main UK competitors, Hercules Ltd (Hercules), for a consideration of £10 million. Subsequently, Hercules' business and assets were hived up into Zeus for a loan consideration left outstanding on its balance sheet. Hercules became dormant thereafter.

Zeus has an excellent reputation within its industry sector, and has a significant customer base.

Following the result of the recent referendum for the UK to leave the European Union, the group is currently considering relocating Zeus to Luxembourg so that it can continue to have easy access to the European market which is critical for its future growth. Zeus's assets are as follows:

Asset	Historical Cost (£)	Book Value (£)	Open Market Value (£)
Stock		5,000,000	5,000,000
Building	5,000,000	4,000,000	10,000,000
Plant & machinery	8,000,000	6,000,000	3,000,000
Cash at bank		1,000,000	1,000,000
Goodwill	3,000,000	2,000,000	50,000,000
Other intangibles (e.g. customer list, patents, software)			100,000,000
Investments in subsidiaries		50,000,000	50,000,000

You are required to:

1) **Comment on how Zeus can become non-UK resident. You should assume that the Double Tax Treaty between the UK and Luxembourg follows the OECD Model.** (5)

2) **Comment on the potential Corporation Tax implications of the relocation of Zeus from the UK to Luxembourg.** (5)

3) **Calculate the potential gain subject to exit charge, ignoring indexation allowance. Capital allowances of £3 million have been claimed to date.** (5)

Total (15)

7. Your client, George, has been told by a friend that he would benefit from setting up an offshore trust for the benefit of his grandchildren. The assets to be transferred to the trust would be a portfolio of commercial investment properties, both in the United Kingdom and abroad.

George will have no residual interest in the trust property, and would like the capital to remain in the trust until either his death or his two grandchildren both reaching the age of 21 (whichever occurs last), at which time it will be equally split between the grandchildren. Income would roll up in the trust, or could be used for educational expenses for George's grandchildren at the discretion of the trustees.

George moved to the UK fifteen years ago and has been resident since then. He grew up in Canada, where he has extended family. George visits his Canadian family regularly and intends to eventually retire there.

George is coming in for a meeting tomorrow.

You are required to prepare notes for your partner on the UK tax implications of the proposed arrangements, identifying whether there could be a UK tax benefit for George and what anti-avoidance provisions will need to be considered. (15)

8. Your firm provide tax advice for Gearz Ltd, a company resident in the United Kingdom which designs and manufactures gearboxes for Formula One cars.

At present, Gearz Ltd only has operations in the UK; however it is expanding quickly. The following issues have been raised by Nikki, the chief financial officer at Gearz Ltd.

1) An offer has been made to a French designer. The designer will be employed by the UK company but will work from his home in Paris where he lives with his family. He will travel to the UK as and when needed, and is expected to be in the UK for less than one day per week. Gearz Ltd will reimburse all expenses for travel and accommodation for the designer's trips to the UK.

2) It is likely that a US-resident individual will be appointed to the board of directors of the UK company. She will visit the UK for board meetings and associated briefing meetings, which are expected to amount to ten days per year. The remuneration for this role includes director's fees together with a substantial grant of equity.

3) The US director will also provide consultancy services to the UK company with regard to US safety standards. She will receive a consultancy fee for these services.

   In order to facilitate paying the US director and certain other US expenses, Gearz Ltd will establish a bank account in the US, denominated in US dollars.

You are required to draft an email to Nikki, setting out the UK tax implications of the matters raised. (15)

9. A partner in your team asks you to draft a response to the following email from a partner in the Transaction Taxes group.

> *Good morning*
>
> *We are undertaking a due diligence exercise on the WebGo group for a potential purchaser. WebGo has developed an algorithm which it uses to provide analysis of online consumer behaviour, and the group has a number of large contracts with global brand leaders.*
>
> *WebGo is entirely UK-based, except for an Isle of Man subsidiary, IoMWeb Ltd. The Isle of Man company contracts with third parties, and has a subcontract agreement with the UK. It is very profitable but only appears to have one employee.*
>
> *When we asked about the Isle of Man company, the vendor told us this:*
>
> *"The UK group was the subject of an HMRC transfer pricing enquiry in 2013. It was agreed with HMRC that the transactions between the Isle of Man subsidiary and the UK have been priced on an arm's length basis. There have been no substantial changes to the arrangements since this agreement.*
>
> *On the basis that the transfer pricing is correct, there is a proper attribution of value between the UK and the Isle of Man such that there can be no exposure to UK tax on the subsidiary's profits."*
>
> *Please can you advise on whether this needs to be examined further?*
>
> *Many thanks*
> *Helena*

You are required to draft an email explaining whether there could be any additional UK tax risks associated with the existence and activities of the Isle of Man subsidiary, notwithstanding the fact that the transfer pricing is on arm's length terms.

You are not required to consider the position for years prior to the year ending 31 December 2015. (15)