Report to the Board of Directors

AC Ltd

MSc Corporate Governance

Management Accounting and Taxation

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INTRODUCTION

Purpose

This report commissioned by the Board of Directors of AC Ltd, focuses on a number of important taxation issues including income tax, VAT, Corporation Tax and taxation relating to overseas activity.

Background Information

AC Ltd is a large manufacturing organisation based in the UK. It is assumed that the company was incorporated in the UK and is therefore a UK resident. Currently the business produces fashion clothing and sells to outlets in London and the UK. The Directors of AC Ltd are considering the expansion of the business through two methods;

1. Through expansion of operations overseas; both EC and other countries, and,
2. By acquiring a controlling interest in a UK company involved in retail sales of household appliances.

Supporting Information

Throughout this report references are made to taxation guidance notes, websites, legislation and journals that will be of value to the Directors of AC Ltd when making future decisions.

PART 1 EMPLOYMENT TAX IMPLICATIONS

i) PAYE Procedures on Employing Staff

Emolument payments (which are cash payments other than expense payments) made to employees and directors by UK employers are subject to Pay As You Earn (PAYE). PAYE is based on the Income Tax (Employments) Regulation 1993.

To calculate PAYE, the Inland Revenue (IR) issues tax codes that determine the amount of deductions for each employee. It is the responsibility of the employer to calculate NIC and tax payments. Details of the tax codes can be found in appendix 1.

PAYE thresholds (level of earnings at which tax becomes payable) can be found in appendix 2.

At year end (for PAYE the year end is 19 May) the following forms need to be returned to the IR by the employer:

- P35 – Employers Annual Return which is details of all tax and NICs paid during the year
- P14 (2003-2004) End of Year Summary for each employee
- P60 which is the last part of the End of Year Summary Form and must be given to the employee.

It is the responsibility of the employer to pay tax to the IR within 14 days of the end of each income tax month (the 19th day of each month).

It is important to note that from 1st January 2004 benefits in kind will become part of the PAYE system. The employer "will be responsible for computing the taxable value of any benefit in kind provided by him, and for ensuring that PAYE is calculated both on monetary payments to the employee, and on that value" (Dowley, 2003).

Further information regarding current tax codes and levels of earnings can be found each year in Tax Data produced by Tolley's, or on the IR website (www.ir.gov.uk/employers).

ii) Round-sum Expense Allowance

Directors[1] and P11D[2] employees may be given an allowance for expenses such as travel and entertaining and this is known as a round-sum allowance.

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[1] The Income and Corporation Taxes Act 1988 (ICTA, 1988) states that the term 'director' includes "directors of companies and any person in accordance with whose instructions the directors are accustomed to act." (Inland Revenue, 2003). Further, the Act states that "a director is any person who-

Round-sum allowances should be entered in full in gross emoluments and on the director's or employee's P11D form where a deduction may be claimed for all the expenditure which is for genuine business purposes.

The expenditure is tax deductible where the employee can substantiate expenditure out of the allowance as "wholly, exclusively and necessarily" incurred in the performance of the duties of the employment.

Generally, travel expenses that are incurred through business use are partly tax deductible and the employee should keep detailed records of such expenses. A round-sum allowance specifically used for entertaining is dis-allowed for tax purposes.

The IR may grant dispensation so that certain reimbursed expenses need not be reported on form P11D. General information regarding such expenses can be found in the IR publication, Expenses and Benefits: A tax guide 480 (2003).

iii) Telephone Rental and Calls Reimbursement to Employees

Private Use
Where the telephone is supplied to the employee or director and is used exclusively for private calls then the payments should be entered as gross pay.

Business Use and/or Joint Use
The rent of a telephone installed for business reasons, but not used "wholly and exclusively" in the performance of duties is not tax deductible because it is not deemed to have been incurred in the performance of the employment duties.

If the expenditure on phones has a dual purpose (i.e. for both personal and business use) and therefore no part of it is allowable. Therefore the full amount of the rental paid by the employer is treated as a benefit in kind.

(a) is a manager of the company or otherwise concerned in the management of the company's trade or business, and
(b) is, either on his own or with one or more associates, the beneficial owner of, or able, directly or through the medium of other companies or by any other indirect means, to control 20 per cent or over of the ordinary share capital of the company".

[2] Employees fall within the P11D category where remuneration, together with benefits in kind received and any reimbursed expenses is at least £8,500 per year. This also includes most company directors. Employers must provide employees with details of the taxable amounts for benefits shown on the P11D, after submitting a P11D form to the IR each tax year.

ICTA, 1988 Section 155 AA states that the provision of a mobile telephone for an employee's use for business purposes is classified as a non-taxable emolument and is deductible from gross emoluments unless they can be converted into cash by the employee. This includes line rental and calls for that telephone paid for directly by an employer.

iv) Christmas Gifts to Employee

Gifts of assets to employees count as taxable benefits, or the sale to the employee of assets at less than their market value (ICTA, 1988; Section 19, 156 (3) and (4)).

Certain gifts received by an employee are tax exempt if certain conditions are satisfied. These are:

- the gift consists of goods or a voucher or token only capable of being used to obtain goods;
- the person making the gift is not the employer or a person connected with the employer;
- the gift is not made in recognition of the performance of services by the employee;
- the gift has not been directly or indirectly procured by the employer or person connected with the employer;
- the gift cost the donor £150 or less, and
- the total cost of all gifts made by the same donor to the employee, or to members of the employees family or household, during the Income Tax year is £150 or less (IR, 2003).

Christmas gifts such as Christmas boxes in cash should be included as gross pay and on form P11D.

PART 2 EXPANSION TO OVERSEAS COUNTRIES

Tax Implications of Setting Up Overseas Operations

AC Ltd is liable to UK tax on any worldwide income and gains as the company is resident in the UK (Hodgkiss, 2001).

The Directors should firstly consider the most effective method of expansion overseas. This may include opening a branch or trading through an overseas resident subsidiary. Tax and legal considerations should be taken into account when deciding on the country(ies) where the trade will be carried out. Attention should be given to local tax legislation.

Branch

If AC Ltd choose to open a branch overseas then the profits will be taxed under rules of Schedule D Case 1. If the branch were to make losses then relief can be claimed under ICTA, 1988 (Section 393, 393a), against the UK profits of the company.

Subsidiary

If the company chooses to trade through a subsidiary then taxation will be charged against profits through the country where it is resident. Any dividends received by the UK parent country will be taxed.
As there is no group relief on subsidiary trading, if losses are expected then trading through a branch would be preferable.

Double Taxation Relief (DTR)

Double taxation (DT) occurs when the same income, profits and gains are taxed in the country where they are generated and also in the UK, where the parent company is resident. DT also applies to dividends and interest paid by overseas companies to UK shareholders.

The effect of DTR is to ensure that no more than the higher rate of tax from either of the countries is paid.

Types of DTR*:*

*O*ff setting foreign tax against the UK tax (double -tax agreement)
"Where there is a relevant double taxation agreement, this will usually list the foreign taxes for which the UK will give tax credit relief. If there is no double taxation agreement, or the agreement does not mention a particular foreign tax, tax credit relief may still be due under special provisions in UK domestic legislation" (IR6, 2002).

A list of the UK's double taxation agreements are shown in appendix 3.

Relief by credit against the UK tax liability or by a deduction for the foreign tax

Unilateral relief is a tax deduction (from the UK liability) of the lower of either the foreign tax suffered, or, the UK tax on overseas income.

"Relief can be obtained for foreign tax paid by claiming a credit for the foreign tax paid against the UK tax payable on the relevant source of income" (IR6, 2002).

In relation to dividend income paid by subsidiaries to UK resident companies, foreign tax can be charged as withholding tax or underlying tax. Withholding tax is deducted from the income sent out of the country of origin. Underlying tax is charged on the profits out of which dividends are paid.

Income to UK resident companies from interest payments is usually taxable at source. The person who receives the interest must make the claim for double-taxation relief.

Foreign tax as an expense
Relief can also be obtained by treating the overseas tax as though it was an expense of the source of income.

Recent legislation, FA 2000 and FA 2001 have made changes to the way in which the UK gives relief for double taxation. This relates specifically to unrelieved foreign tax (which is now carried back or forward until relieved).

Local Tax Legislation Overseas

As the EC is now considered a single market, the supply of goods between countries in the EU is zero-rated for Value Added Tax (VAT). However, the Directors should be cautious of recent legislation to combat VAT fraud. Penalties have been introduced for a failure to make VAT returns due to fraud or neglect (O'Neill and Campbell, 2003). "The measures will allow Customs to impose liability for payment of lost VAT on suppliers or recipients of goods either side of a missing trader, even if they were not knowingly involved in the fraud" (Oliver, Laushmar & Nisse, 2003).

For countries outside the EC exports are zero-rated. This is because VAT (or the local country equivalent) usually has to be paid at time of entry by the importer.

Further information on Importing and Exporting and VAT can be found at the HM Customs and Excise webpage (www.hmce.gov.uk).

Transfer Pricing and manipulation of transfer pricing

Transfer pricing is the setting of prices for goods and services that are transferred between parent and related companies. Where the company is based in different

countries then the effect that the transfer price has on the taxable company profits can be substantial.

In an associate company based overseas where tax rates are lower than the UK, a company could seek to obtain tax advantages by selling goods or services at an artificially low price. To counteract these potential tax advantages the UK, along with many other countries, legislates that "cross boarder trading" and financial transactions between affiliated companies should be carried out according to the "arm's length standard". "This means that the terms and pricing of such transactions undertaken in the course of conducting business (such as the sale and purchase of goods and services) and in the provision of finance (both borrowing and lending) should be the same as if the transactions had been between completely independent parties" (IR, 2003).

Where local country tax legislation does not agree on transfer pricing policy this may result in double-taxation or less than single taxation.

The requirement for smaller multi-nationals to comply with transfer pricing is no less than large multi-nationals (Hickman, 2001). There are a number of options available to companies to assist with the burden of compliance.

1. It is possible to have a written agreement between a business and the IR to resolve issues to do with transfer pricing. This is known as an Advance Pricing Agreement (Section 85, FA (1999)).
2. The price of goods can be set using internal benchmarking of product prices.
3. Software systems exist which can support transfer pricing.
4. The materiality of prices should be assessed. In the OECD (1995) guidelines for transfer pricing prioritisation and attention should be given to goods and services which are material

Further information on expansion to overseas markets can be found on the IR website (www.inlandrevenue.gov.uk/international/).

PART 3 DC LTD

The purchase of a controlling interest in one company by another company is known as an acquisition (ICSA, 2000). For AC Ltd to have controlling interest of DC Ltd, over 50% of shares would need to be purchased. If AC Ltd were to purchase 75% of the ordinary share capital of DC Ltd then a group would be formed.

DC Ltd Trading Losses

Trading losses can be off set by a company against any other income or chargeable gains in the same accounting period, the preceding period or carried forward for relief against income from the same trade in future periods (Murphy, 2001). Losses of the final 12 months of a trade can be carried back three years. Losses are set against more recent periods before earlier periods.

If AC Ltd form a group with DC Ltd then profits and losses are calculated separately for each company. Generally, Under S393 (1) AC Ltd would not be able to carry forward losses from DC Ltd and set off against available profit as they are involved in different trades (manufacturing fashion clothing and retail sales of household appliances). However, group relief generally allows trading losses to be surrendered by one company and set against the profits of other companies in the same group (S 402-413).

DC Ltd has incurred trading losses of £110,000. Following acquisition, it is important for DC Ltd to preserve the relief for trading losses. Under S 393 (1) Relief for trading losses will be lost if;

- The nature and ownership of the trade of DC Ltd is not preserved for at least 3 years from the acquisition.
- DC Ltd's trade reduces to a negligible level and there is consequently a change of ownership (this can occur at any time).

DC Ltd Capital Losses

DC Ltd has capital losses of £60,000. Relief for capital losses remains with the acquired company and may be brought forward and set off against future capital gain. Thus, DC Ltd can use this relief against gains on its own assets. This relief can be carried forward indefinitely.

However, a capital gain may never be carried back and relieved against capital gain for earlier periods. Also, capital losses may not be set against any form of income.

Relief for losses is a changeable area and Directors of AC Ltd should consult IR website for information. Journals such as the "Taxing Times" produce up to date information on relief for losses.

PART 4 FINANCING THE EXPANSION

To finance the expansion of the business there are two options available to AC Ltd; through the issue of shares (equity) or by loan capital (debt). There are advantages and disadvantages of raising finance by these two methods.

Raising Finance through Issuing Further Shares

If AC Ltd raises finances through issuing shares then there may be some weakening of control over the company by the Directors as shareholders have a right to attend and vote at members meetings.

Whilst the costs of issuing equity capital are treated as capital expenditure and are not allowed as a deduction, the 2003 Budget announced a review to improve the tax treatment of the costs for equity finance. These costs include legal fees. The cost of servicing share capital (dividends) is not allowed as a deduction in arriving at the chargeable profit. Dividends are paid out of after-tax profits. The rates for dividends paid to investors are 10% for income below the basic rate limit and 32.5% above it. A 10% tax credit is set against the tax due (IR (Insert), 2002-2003).

Individuals who subscribe to shares in an eligible Enterprise Investment Scheme (EIS) company may claim income tax reduction based on the amount invested (IR, 2003). Investors can claim relief at 20% of up to £150,000 of investment per year (Wareham et al, 2002) and up to a maximum of £25,000 relief can be carried back to the previous tax year (one-half of the amount invested). Losses incurred when disposing of an EIS may be relieved against income and capital gains.

AC Ltd must comply with strict guidelines to be eligible for EIS. AC Ltd can use the capital gained through EIS to purchase DC Ltd as long as:

- DC Ltd does not have any assets other than a qualifying trade, or assets used wholly for the purpose of the trade, and,
- The trade is transferred to the acquiring company as soon as possible after the trading company has been acquired.

Further information on EIS can be found in document IR137, The Enterprise Investment Scheme: Business series.

Raising Finance through Loan Capital

The costs of servicing debt (interest payments) and setting up loans are deductible. The loan can either be relieved under Schedule D1 profit if it is a trading loan and under FA 2002 if it is a non-trading loan.

Investors are more likely to provide finance through loan capital as there is more security than equity finance. Investors pay 10% income tax below the starting rate limit, 20% below the basic rate limit and 40% if it exceeds the basic rate.

CONCLUSIONS AND RECOMMENDATIONS

Directors of AC Ltd will need to persuade potential investors that their investment in the company is sound. AC Ltd, whilst currently successful and in a relatively stable environment, is carrying out a series of diversifications which may put the company at risk. This is because;

- The company is acquiring DC Ltd which has a poor trading record, and AC Ltd has no experience of sales of household appliances;

- The company has no experience in setting up and running operations in overseas countries.

Due to the risky nature of the expansion, investors are more likely to have an interest in loan capital. Such an investment is considered less risky than investment in share capital, not only when considering taxation. If a company falls into administration or liquidation then loan creditors have more protection. Also, companies are only obliged to pay dividends to shareholders when they are making a profit. Interest on loans must be paid, at a pre-agreed amount.

AC Ltd will need to consider all options for expansion overseas. The two most important considerations are the method of expansion and the location for expansion. It is less risky to trade in EC as there is no indirect taxation. Also, the EC have established guidelines for direct taxation and double-taxation agreements. However, there may be benefits of expansion to non-EC countries where resources may be cheaper and more readily available, and new markets may be found.

AC Ltd should be cautious about conducting both methods of diversification at one time. Taxation should be part of the basis for decision-making but other factors must be considered. For example, the potential markets for overseas development should be investigated and all financial information regarding DC Ltd considered.

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APPENDICES

Appendix 1

Current Tax Codes

A, is the basic personal allowance plus one half of the children's tax credit and the IR estimates that you are liable at the basic rate of tax.
H, is the basic personal allowance plus the full Children's Tax Credit and the IR estimates that you are liable at the basic rate of tax.
D, followed by a number means that the employees pay should be taxed at the higher rate (40%)
K, followed by a number enables additional tax, in respect of benefits and so on, to be deducted.
L, is the basic personal allowance.
P, is the full personal allowance for those aged 65-74.
V, is the full personal allowance for those aged 65-74 plus the full married couple's allowance for those born before 6 April 1935 and aged under 75 and the IR estimates that you are liable at the basic rate of tax.
Y, is the full personal allowance for those aged 75+.
T, is any other items the IR needs to review in your tax code or if you ask the IR not to use any of the other tax code letters listed.
BR means that tax will be deducted at the basic rate (22%) with no tax-free allowances.
NT means that no tax is to be deducted.
0T means that there are no allowances, salary is charged at progressive rates.

The IR publishes a leaflet (P3) which is available from the local tax office or from the IR website.

Foreman and Mowles, (2002).

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Tax Tables

Lower rate	**10%**
Basic rate	**22%**
Higher rate	**40%**

The PAYE thresholds (level of earnings at which tax becomes payable) for 2003 are

£89.00	Weekly
£385.00	Monthly

The tax rates are

Starting rate	10%	£0.00 to £1,920
Basic rate	22%	from £1,921 to £29,900
Higher rate	40%	over £29,900

Appendix 3

List of the UK's double taxation agreements

- A double taxation agreement is an arrangement entered into between the Governments of two countries to resolve taxation issues affecting them both. Agreements can also be obtained from Her Majesty's Stationery Office as Statutory Instruments.
- The UK has negotiated agreements with a large number of other countries. A model agreement has been published by the Organisation for Economic Cooperation and Development, and most UK agreements broadly follow this model. However, each agreement is unique and therefore reference must always be made to the detailed text in question.
- Agreements contain provisions designed to eliminate or relieve double taxation in respect of income of different types. The aim is either to tax income in one country only or, if both countries tax the income, to ensure that the aggregate amount of tax imposed by the two countries together should not exceed the amount of tax payable in the country with the higher charge to tax (IR6, 1994).

On 1 February 1994 comprehensive double taxation agreements were in force between the UK and the countries listed (see Note1). Agreement s which had terminated by that date are not listed (although in particular cases these could still be relevant in relation to tax liabilities for back years). The numbers in the right hand column of the list are those of the relevant Statutory Instruments.
You can find out whether there have been any changes to this list by contacting the Inland Revenue, International Division (Double Taxation), Strand Bridge House,138142 The Strand, London WC2R 1HH.

Country	**Agreement (and any amending protocols)**
Antigua	1947 No.2865 1968 No.1096
Australia	1968 No.305 1968 No.707
Austria[2]	1970 No.1947 1979 No.117
Bangladesh	1980 No.708
Barbados	1970 No.952 1973 No.2096
Belarus (formerly Byelorussia)[3]	1986 No.224 (Soviet Union)
Belgium	1987 No.2053
Belize	1947 No.2866 (British Honduras) 1968 No.573 (British Honduras) 1973 No.2097
Botswana	1978 No.183
Brunei	1950 No.1977

	1968 No.306 1973 No.2098
Bulgaria	1987 No.2054
Canada	1980 No.709 1980 No.1528 1980 No.1996
China	1984 No.1826
Croatia[4]	1981 No.1815 (Yugoslavia)
Cyprus	1975 No.425 1980 No.1529
Czech Republic	1991 No.2876 (Czechoslovakia)
Denmark	1980 No.1960 1991 No.2877
Egypt	1980 No.1091
Falkland Islands	1984 No.363 1992 No.3206
Faroe Islands	1950 No.1195 (Denmark) 1961 No.579 1967 No.163 (Denmark) 1968 No.307 1969 No.1068 (Denmark) 1971 No.717 1973 No.1326 (Denmark) 1975 No.2190
Fiji	1976 No.1342
Finland	1970 No.153 1973 No.1327 1980 No.710 1980 No.710 1985 No.1997 1991 No.2878
France	1968 No.1869 1971 No.718 1973 No.1328 1987 No.466 1987 No.2055
Gambia	1980 No.1963
Germany	1967 No.25 (Federal Republic of Germany) 1971 No.874 (Federal Republic of Germany)
Ghana[5]	1947 No.2868 (Gold Coast) [1993 No.1800]
Greece	1954 No.142
Grenada	1949 No.361

	1968 No.1867
Guernsey	1952 No.1215
Guyana	1992 No.3207
Hungary	1978 No.1056
Iceland	1991 No.2879
India	1993 No.1801
Indonesia[6]	1975 No.2191
Ireland (Republic of)	1976 No.2151 1976 No.2152
Isle of Man	1955 No.1205 1991 No.2880
Israel	1963 No.616 1971 No.391
Italy	1990 No.2590
Ivory Coast (Cote D'Ivoire)	1987 No.169
Jamaica	1973 No.1329
Japan	1970 No.1948 1980 No.1530
Jersey	1952 No.1216
Kenya	1977 No.1299
Kiribati	1950 No.750 (Gilbert and Ellice Islands) 1968 No.309 (Gilbert and Ellice Islands) 1974 No.1271 (Gilbert and Ellice Islands)
Korea (Republic of)	1978 No.1299
Lesotho	1949 No.2197 (Basutoland) 1968 No.1868
Luxembourg	1968 No.1100 1980 No.567 1984 No.364
Malawi	1956 No.619 (Federation of Rhodesia and Nyasaland) 1964 No.1401 1968 No.1101 1979 No.302
Malaysia	1973 No.1330 1987 No.2056
Malta	1962 No.639 1975 No.426
Mauritius	1981 No.1121 1987 No.467
Montserrat	1947 No.2869

	1968 No.576
Morocco	1991 No.2881
Myanmar (formely Burma)	1952 No.751
Namibia	1962 No.2352 (South Africa) 1962 No.2788 (South West Africa) 1967 No.1489 (South Africa) 1967 No.1490 (South West Africa)
Netherlands	1980 No.1961 1983 No.1902 1990 No.2152
New Zealand	1984 No.365
Nigeria	1987 No.2057
Norway	1985 No.1998
Pakistan	1987 No.2058
Papua New Guinea	1991 No.2882
Philppines	1978 No.184
Poland	1978 No.282
Portugal	1969 No.599
Romania	1977 No.57
Russia (Russian Federation)[3]	1986 No.224 (Soviet Union)
St Kitts	1947 No.2872 (St Christopher and Nevis)
Sierra Leone	1947 No.2873 1968 No.1104
Singapore	1967 No.483 1978 No.787
Slovak Republic	1991 No.2876 (Czechoslovakia)
Slovenia[4]	1981 No.1815 (Yugoslavia)
Solomon Islands	1950 No.748 (British Solomon Islands) 1968 No.574 (British Solomon Islands) 1968 No.574 (British Solomon Islands)
South Africa	1969 No.864
Spain	1976 No.1919
Sri Lanka	1980 No.713
Sudan	1977 No.1719
Swaziland	1969 No.380
Sweden	1984 No.366
Switzerland[2]	1978 No.1408 1982 No.714
Thailand	1981 No.1546

Trinidad and Tobago	1983 No.1903
Tunisia	1984 No.133
Turkey	1988 No.932
Tuvalu	1950 No.750 (Gilbert and Ellice Islands) 1968 No.309 (Gilbert and Ellice Islands) 1974 No.1271 (Gilbert and Ellice Islands)
Uganda	1993 No.1802
Ukraine	1993 No.1803
United States of America	1980 568
Uzbekistan[3,6]	1986 No.224 (Soviet Union)
Yugoslavia[4]	1981 No.1815
Zambia	1972 No.1721 1981 No.1816
Zimbabwe	1982 No.1842

Notes

1 The UK is currently negotiating new agreements with a large number of countries. As at 1 February 1994 these included: Argentina, Azerbaijan, Belarus, Bolivia, Colombia, Estonia, France, Kazakhstan, Latvia, Lesotho, Lithuania, Malta, Mexico, Mongolia, Namibia, the Russian Federation, Venezuela and Vietnam.

2 Further protocols with Austria and Switzerland, amending the original agreements, have been signed; as at 1 February 1994 that with Austria had been put before Parliament, as a first step towards bringing it into force.

3 The UK's agreement with the former Soviet Union is currently to be regarded as in force between the UK and Belarus, the Russian Federation and Uzbekistan. The position with regard to other former Soviet republics not included in the list is less clear, but the UK will in all cases apply the provisions of the agreement on the basis that it is still in force (until such time as new agreements take effect with particular countries).

4 The UK's agreement with Yugoslavia is currently to be regarded as in force between the UK and Croatia and Slovenia. The position with regard to other parts of what was Yugoslavia was undetermined as at 1February 1994.

5 The 1993 entry for Ghana is a new agreement which will replace the earlier one shown, but it had not entered into force as at 1 February 1994. While the necessary processes in the UK to implement the agreement have been completed, Ghana has yet to complete its processes.

6 New agreements with Indonesia and Uzbekistan, replacing the existing ones, have been signed and as at 1 February 1994 had been put before Parliament, as a first step towards bringing them into force.