



The Chartered Tax Adviser Examination

May 2009

The Application and Interaction of Taxes

TIME ALLOWED – 3 HOURS

For your convenience, the questions in this paper may be broadly categorised as follows:

- Question 1 Taxation of Individuals, Trusts and Estates
- Question 2 Taxation of Companies
- Question 3 Taxation of Owner-Managed Businesses
- Question 4 VAT and other Indirect Taxes

- You should answer only **ONE** out of the four questions.
- Each question carries 100 marks (including marks for presentation).
- Each question includes 22 marks specifically allocated for presentation including the format of your answer, layout, style and the suitability and relevance of your advice.
- Write on one side of the paper only. Do not write in the left-hand margin.
- All workings should be shown and made to the nearest month and pound unless the question specifies otherwise.
- Candidates who answer the law elements in this paper in accordance with Scots law or Northern Ireland law should tick the appropriate box on the front of the answer folder.

1. You are acting as taxation adviser to a junior probate assistant dealing with the administration of the estate of the late Helen Robinson who died on 31 January 2009 at the age of 74. Helen had been a widow since her husband died five years ago leaving all of his estate to her absolutely. Helen and her husband had always been resident and domiciled in the UK.

Attached as **EXHIBIT A** is a letter from the probate assistant requesting your advice.

EXHIBIT B sets out a summary of the income and capital gains of Helen in the period from 6 April 2008 to her date of death and **EXHIBIT C** gives other information concerning her estate.

The probate assistant suggests a meeting would be useful once you have responded to the letter to enable any other issues to be considered in establishing the tax liabilities arising as a result of death and to consider any planning or administrative matters that should be considered. He has requested that you prepare a report in advance of that meeting setting out these details for consideration.

The following Exhibits are attached to assist you:

EXHIBIT A: Letter from the probate assistant

EXHIBIT B: Income and capital gains of Helen Robinson in the period to the date of death

EXHIBIT C: Information concerning the estate of Helen Robinson

You are required to:

- 1) **Write a letter to the probate assistant responding to the matters contained in his letter.** (38)
- 2) **Compute the taxation liability of Helen for 2008/09.** (22)
- 3) **Draft the report setting out matters for discussion with the probate assistant.** (40)

Total (including 22 presentation marks) (100)

EXHIBIT A

Letter from the probate assistant

P R Bates
Death and Taxes Co
Dark Side
DS1 4TT

Exam candidate
Exam Centre
Case Day
CT4 4TT

08 May 2009

Dear Sirs

We have received four chargeable event certificates from UK life offices in respect of single premium life assurance policies on Helen's life. These policies have now paid out as a result of her death and the proceeds of £250,000 presumably do not form part of her taxable estate. The certificates show the following:

Continued

1. *Continuation*

Policy 1	Chargeable gain £5,140	Full policy years	5
Policy 2	Chargeable gain £21,966	Full policy years	2
Policy 3	Chargeable gain £8,484	Full policy years	1
Policy 4	Chargeable gain £13,440	Full policy years	6

We assume there should not be any tax liability on these policy gains received during the administration period but shall appreciate your confirmation.

For many years prior to her death, Helen had held the sole life interest under a trust established by her sister on 3 June 1989 and we think, but cannot be certain, this continued up to her death. Following the changes introduced by Finance Act 2006 we think that we can ignore this trust when computing the Inheritance Tax due on Helen's estate, although we do perhaps need to consider the future of this trust. Under the original terms of the trust deed her daughter Susan and then her grandchildren will succeed to the life interest and the trust assets at death comprised quoted shares at a value of £450,000 and your comments concerning this aspect would be appreciated.

We assume the whole of our charges in dealing with the estate will be deductible in computing the liability to Inheritance Tax. In addition we assume that your charges in advising of the potential liabilities will similarly be deductible but your confirmation would be appreciated. Please also supply a brief summary of all deductions that are allowable.

There are many matters on which I am uncertain in relation to this estate and I wonder whether it may be better for you, as executor, to prepare all of the papers and to apply for the grant of probate yourself and perhaps you would let me have your comments.

Yours faithfully

P R Bates

EXHIBIT B

Income and capital gains of Helen Robinson in the period to the date of death

	£	
Gross Pensions	7,930	(tax deducted £695)
Untaxed interest	1,450	
Taxed interest received	4,500	
Gain on disposal of assets inherited from husband	63,565	
Income from trust	7,200	

Continued

1. *Continuation*

EXHIBIT C

Information concerning the estate of Helen Robinson

On 6 August 2002 Helen established a discretionary trust to benefit her daughter and grandchildren and settled cash of £250,000, which she felt was within her nil rate band such that no Inheritance Tax was payable and no form of return was lodged.

On 4 June 2004 Helen gave to her daughter Susan a one half share in her main residence but Helen continued to live there and pay all outgoings. Susan lived with Helen for part of her time up until the death and she now inherits the remaining share in this property. In 2004 the property was valued at £550,000 and it was valued at £700,000 at the date of death.

On 4 July 2005 Helen transferred another £250,000 into the discretionary trust to benefit her daughter and grandchildren but once again no Inheritance Tax was paid and no form of return was lodged.

Each year Helen also made gifts of £10,000 to Susan.

Beyond those gifts described, Helen made no further gifts during her lifetime.

The estate of Helen at death also comprised the following

	£
Cash at bank	250,000
Land used by a neighbouring farmer	100,000
Antiques and artwork in the home	350,000

2. You have recently been engaged to act as the tax adviser of Mongoose plc, a company incorporated and tax resident in the UK. The company has extensive property investment and development interests. The newly appointed chief executive is considering three separate commercial transactions which will significantly affect the future operations of the company.

You have been provided with the following information:

EXHIBIT A: Current group structure of Mongoose plc.

EXHIBIT B: A letter from the lawyers of Mongoose plc regarding transaction 1: A possible variation to the share capital of that company.

EXHIBIT C: An e-mail from the property director of Mongoose plc regarding transaction 2: Arrangements concerning an existing investment in an office building.

EXHIBIT D: A briefing note regarding transaction 3: The activities of India Ltd.

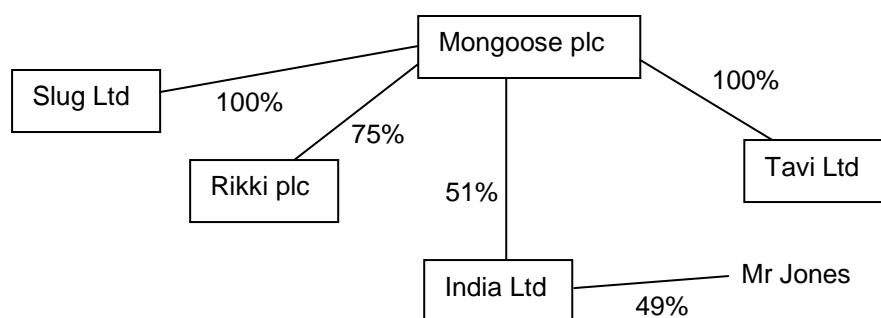
You are required to prepare a report for the chief executive explaining the UK taxation consequences which will arise from the three transactions. Your report should primarily cover the impact of the transactions on Mongoose plc. However, the chief executive has also asked you to comment briefly on any significant tax risks which could arise that could significantly influence the negotiating position of the other parties to these transactions.

The following marks are available for each section of the report:

Transaction 1	(45)
Transaction 2	(30)
Transaction 3	(25)
Total (including 22 presentation marks)	(100)

EXHIBIT A

Current group structure of Mongoose plc



Mongoose plc has net annual rental income of £2 million after interest costs. The company has a head office staff of 15 who are all engaged in property and investment related activities.

Rikki plc is a property investment company which is managed primarily by the directors of that company. At present Mongoose plc owns 75% of the shares of the company, the Smith family own 15% and the balance is owned by senior management.

Tavi Ltd owns the freehold of an office building one floor of which is let to Mongoose plc. The remaining floors are let to third parties.

Slug Ltd runs a small travel agency business.

Continued

2. *Continuation*

EXHIBIT B

A letter from the lawyers of Mongoose plc regarding transaction 1

Ms T Dee
Chief Executive
Mongoose plc
Tikki House
St Austell
Cornwall

Slap Dash & Partners
Padstow
Cornwall

1 May 2009

Dear Terri,

Rikki plc

As you are probably aware the three shareholder groups have been considering a change in the capital structure of this property investment company for several months. Your predecessor was dealing with the negotiations on behalf of Mongoose plc.

At present the only shares in issue are ordinary £1 shares which were issued at par. There are 1 million shares currently in issue. There have been no changes to the shareholdings since the company was incorporated ten years ago. Current market value could be as high as £10 a share.

At one time the different shareholder groups did consider using a purchase of own shares to re-align their interests. However, this option has been rejected as, although the company has grown significantly in value over the last few years, there are insufficient funds available to use this route.

Two possible transactions are currently being considered. Whichever route is adopted it is envisaged that after three years the following levels of (direct or indirect) ownership in the equity of Rikki plc will prevail:

Senior management of Rikki plc	60%
Mongoose plc	35%
The Smith family	5%

I understand that the main drivers to this transaction are that the members of the Smith family wish to realise most of their investment in the medium term and the management of the company have indicated that they do not feel they are sufficiently incentivised by their current level of equity participation.

As the company is also involved in some property development activities it is vitally important in current market conditions that the future cash flows of the business can be determined so that adequate funding from the bank can be obtained.

Under the terms of the shareholders' agreement of Rikki plc changes of this nature to the capital structure of the company require unanimous approval.

Option 1 – New Company

A new company (Newco) will be established to acquire all of the ordinary share capital of Rikki plc. The shareholders will be given an opportunity to exchange their shares in Rikki plc for ordinary shares or loan notes (or a combination of both) in Newco. At the time of issue it is envisaged that the market value of the shares and loan notes in Newco acquired by the shareholders will be broadly equivalent to their current interests in Rikki plc. The loan notes will carry no entitlement to interest and will be redeemed in full in 2011.

Continued

2. Continuation

Option 2 - Preference Shares

A variation of the share capital of Rikki plc will take place. Shareholders will be given the option of exchanging some or all of their ordinary shares for a new issue of preference shares. The preference shares will carry a right to enhanced dividends over the next three years. At the end of this period the preference shares will have no rights over the assets of the company and will be cancelled. Some work on the likely values of the ordinary and preference shares has already been undertaken by your auditors. I understand that as a consequence of this particular transaction it is likely that the long-term value of ordinary shares retained by the shareholders will be substantially enhanced.

I feel that these options are likely to have significant tax consequences for all parties. As you are aware our tax partner has had a nervous breakdown and as a result I am unable to provide you with any help regarding the tax analysis of these proposals. I suggest you refer this matter to your tax advisers for their comments before the next shareholders meeting which is due later this month.

Kind regards

Yours
James Burke

cc The Smith family and senior management of Rikki plc

EXHIBIT C

An e-mail from the property director of Mongoose plc regarding transaction 2

From: BertF@mongoose.co.uk
To: TerriD@mongoose.co.uk
1 May 2009
Subject: Tikki House

Hi Terri,

I recently ran into Danielle Dare from Snake plc. Apparently they are awash with surplus cash at the moment and are actively engaged in acquiring property for development in the town. I mentioned that we were about to move from Tikki House to our new offices in Plymouth. Danielle thinks the directors of Snake plc would be interested in acquiring the property.

I said that at the current valuation of £10 million we would make a substantial gain on this property and we were not too keen on paying the Corporation Tax that would arise. Danielle said that we might be able to roll over this gain against the cost of the lease on our new head office.

Danielle knows an awful lot about tax and said that Snake plc had just carried out some tax planning on a similar property transaction which avoided Corporation Tax and Stamp Duty Land Tax. If I understood her correctly this is what we would need to do.

- 1) We set up a new 100% subsidiary of Tavi Ltd (the company which currently owns Tikki House). We lend the new subsidiary a lot of cash and it buys Tikki House at market value. The profit on the property is realised and paid to Mongoose plc as a dividend.
- 2) Snake plc then subscribes for a new class of shares in Tavi Ltd and somehow we waive our rights to the assets of the company. Snake plc then injects cash into the subsidiary and our loan is repaid.
- 3) Our shares in Tavi Ltd become worthless and we make a thumping tax loss which we can carry forward to set against future capital gains.

Continued

2. *Continuation*

- 4) We have provided deferred tax of £1 million in respect of the revaluation surplus on Tikki House and we will be able to write this amount back giving a further boost to our post-tax earnings.

The loan repayment and the dividend receipts paid to Tavi Ltd will be tax free and Snake plc makes a Stamp Duty/SDLT saving because they acquire shares not property.

This sounds a really good idea and I suggest we speak to the directors at Snake plc as soon as possible.

At present Snake plc has no other connection with Mongoose plc.

By the way, I have arranged to meet with our quantity surveyor next week to ensure that he captures the information required for our capital allowance claims on the fixtures and fitting cost of the new head office. Getting this type of information in the past has been a bit of a nightmare so I want to deal with this issue upfront. If you would like to be present at the meeting please let me know.

Regards

Bert

EXHIBIT D

Briefing note regarding transaction 3: The activities of India Ltd

India Ltd was incorporated in the UK in 2004 and acquired a plot of land in 2005 for £2 million. These funds were provided by Mongoose plc by way of an interest free loan. The company has share capital of £1,000 which was issued at par.

In 2006 planning permission was obtained to construct an office building on the site. During 2007 the site was cleared and the foundations of the building were laid. The property was shown in the 2007 financial statement as stock/work in progress valued at £3 million. In 2008 Mongoose plc and Mr Jones (the 49% shareholder) were both short of funds and the property market suffered a downturn. As a consequence development operations on this site were suspended.

An unconnected company, Granny Ltd, has approached the shareholders of India Ltd with a view to acquiring the property with the intention of building a residential nursing home. If permission to change the proposed use of the site can be obtained, Granny Ltd is prepared to pay £5 million for either the freehold of the property or the shares in India Ltd. If the shares are sold Granny Ltd has stipulated that the freehold interest must be shown as a fixed asset investment in the accounts of the company.

Mr Jones is currently in danger of becoming insolvent and has suggested an immediate sale of his shares to Mongoose plc for £1 million. The previous chief executive was inclined to accept this proposal to be followed by a sale of the property, rather than the shares. The profit arising on the property sale would then be distributed to Mongoose plc as a tax free dividend and a capital loss would then be claimed on the liquidation of India Ltd.

The local authority is expected to announce its decision regarding the change of use of the site in the very near future.

3. You are employed by Brightling on Sea Accountants in their tax department. The firm has acted for David and Susan Coster, aged 64 and 63 respectively, for many years. They own Superior Garden Buildings Ltd, a trading company incorporated in the UK. The Costers have two sons, Paul and James, aged 26 and 29 respectively.

Catherine Soper, the tax partner who deals with the tax affairs of the Costers and their company, has recently received a letter from Paul Coster (**EXHIBIT A**). Catherine is planning to meet with Paul in the near future and, in advance of this meeting, would like you to prepare an internal report for her dealing with the principal taxation issues arising from his letter.

She has also recently met with David and Susan Coster and has prepared some notes of this meeting (**EXHIBIT E**).

You are required to:

- 1) **Write an internal briefing report for Catherine Soper detailing the principal tax issues arising from the letter from Paul Coster. You should assume that the proposed partnership business will be treated as trading income. Your report should include a calculation of the expected taxable profit or loss for the year ended 30 June 2010, a summary of the points that need to be covered in a partnership agreement and also briefly address any tax implications that may arise for David and Susan Coster and Superior Garden Buildings Ltd.** (48)
- 2) **Prepare a report to David and Susan Coster addressing the points identified in the notes of the recent meeting between them and Catherine Soper.** (52)

Total (including 22 presentation marks) (100)

The following exhibits are reproduced to assist you:

EXHIBIT A: Letter from Paul Coster

EXHIBIT B: Extract from surveyor's valuation report

EXHIBIT C: Quote for building work at Sea View, Brightling on Sea

EXHIBIT D: Note of telephone conversation with HM Revenue & Customs

EXHIBIT E: Notes of meeting between Catherine Soper and David and Susan Coster on 5 May 2009

EXHIBIT F: Extracts from client files

Continued

3. *Continuation*

EXHIBIT A

Letter From Paul Coster

Mrs C Soper
Brightling on Sea Accountants
44 Financial Row
Brightling on Sea

Paul Coster
14 Back Lane
Brightling on Sea

1 May 2009

Dear Catherine,

Further to our recent telephone conversation, I set out below our forthcoming plans and would be grateful if you could give this some thought before we meet in a couple of weeks.

My wife, Maria, and I are planning to commence in partnership on 1 July 2009 running a caravan/camping park. My parent's company has some spare land on the coast for this which will be rented to us at an annual rent of £6,000 per year. It is possible that we may purchase this land at some future point. If this were to happen Mum and Dad have indicated that they would be prepared for the land to be sold at 75% of its market valuation. For your information, I thought it might be useful to include a copy of a valuation report recently prepared by a local firm of Surveyors regarding this land.

As you may be aware, until recently I have been working in a local call centre earning around £15,000 per year. Maria works for a local advertising agency where she currently earns in excess of £100,000 per year. Naturally this keeps her pretty busy and whilst she is willing to help out how and when she can, it is anticipated that most of the running of the business will be undertaken by myself. She will be helping with the provision of capital to finance the initial capital expenditure etc. which is referred to further below.

We have already undertaken some preliminary promotional work this year to set the business up which cost £2,000 and are expecting pitch fees and other sales in the first year to 30 June 2010 to be £30,000. Our forecasts indicate that our running costs for the first year will amount to £10,000 (including rent, power, telephone and other office and advertising costs). After this we expect a substantial increase in profits going forward.

Over the course of the coming year we are planning to build a toilet/shower block as well as a swimming pool at the site for use by the visitors. For your information I have also included a copy of the quote recently obtained from the builder that we are planning to use for this work. We will also be installing some electrical hook-ups for visiting caravans and will be purchasing some caravans for permanent installation. The caravans will be used for holiday lettings and will cost £40,000 (inclusive of VAT).

Work on the toilet/shower block and swimming pool will start this July and hopefully be completed by the end of August. John, the electrician that we will use for the hook-ups, is an old family friend and has told us that this will cost £16,000 plus VAT. We are planning to undertake this work during the winter when things are quieter. To help us out, John has told us that he is willing to only receive payment for half of the hook-ups in winter and is prepared to wait until the following July before the balance needs to be paid for.

In addition we have already bought some garden equipment (lawn mower etc) that will be used to look after the grounds when we start. This cost £7,500 (including VAT).

I would be grateful if you could advise me of the main taxation implications arising from the above when we meet, together with any comments which you think will be helpful. In particular we are not planning to register for VAT in the first instance but would welcome your comments regarding this, particularly as we seem to be incurring a lot of VAT on initial set up costs. Please note that I am aware of general self-assessment procedures and also the assessment of trading income so do not need any advice in these particular areas.

I look forward to meeting you in the near future.

Yours sincerely,

Paul Coster

Continued

3. *Continuation*

EXHIBIT B

Extract from surveyor's valuation report

Brightling on Sea Commercials
St George's House
George Street
Brightling on Sea

Valuation of property

The valuation is undertaken in accordance with the Royal Institution of Chartered Surveyors Valuation Manual and is of Market Value.

Land owned by Superior Garden Buildings Ltd at Sea View, Brightling on Sea

Freehold £100,000 (One hundred thousand pounds)

Rental Value £8,000 (Eight thousand pounds) per annum

EXHIBIT C

Quote for building work at Sea View, Brightling on Sea

Bill's Buildings
24 Chapel Street
Brightling on Sea

Quotation for the construction of a toilet/shower block and swimming pool at Sea View, Brightling on Sea

<u>Toilet/Shower Block</u>	£
Construction of timber building to brick base in accordance with attached plans, price to include all doors and windows	30,000
Thermal insulation of the building	3,000
Installation of complete electrical system	5,000
Installation of central heating and cold and hot water systems. As per your instructions this price includes £3,000 of equipment appearing on the Energy Technology list	6,000
Installation of sprinkler and fire alarm system	2,500
Installation of washbasins, showers and sanitaryware	3,500
All in accordance with attached plans	<u>50,000</u>
Swimming Pool	<u>25,000</u>
Total price (inclusive of VAT)	<u><u>£75,000</u></u>

Continued

3. Continuation

EXHIBIT D

Note of telephone conversation with HM Revenue & Customs

We spoke to HM Revenue & Customs on 7 May 2009. They confirmed that in view of the level of services to be provided by the Costers as with other similar businesses in the area the caravan/camping park will be treated as trading income.

EXHIBIT E

Notes of Meeting between Catherine Soper and David and Susan Coster on 5 May 2009

David Coster ('DC') and his wife ('SC') are approaching retirement. They own equally all of the shares in Superior Garden Buildings Ltd ('SGB Ltd'). SGB Ltd manufactures garden buildings for the UK market. The company has traded for many years having originally been set up by DC's father. The company makes up its accounts to 31 March each year.

Having worked in the business since leaving school DC inherited all of the company shares following his father's death in May 1990. DC gifted half of these to SC in May 1995.

Their son James ('JC') has previously worked for a competitor until a couple of years ago when a decision was made that he would enrol upon a higher level joinery course to learn more about modern production techniques. He has lived a considerable distance away from Brightling on Sea for some time. Having completed this course he will rejoin the family business in the near future.

As well as a basic salary of £45,000 per year, which will be paid monthly, DC is planning to help his son relocate to Brightling on Sea by giving him £10,000. He will also be provided with a company vehicle (either a van or a car), possibly fuel for this vehicle and a mobile phone. JC will also be entitled to a bonus based on the company's performance for its accounting year.

The plan is that JC will become a director of SGB Ltd upon joining and that DC's and SC's shares in SGB Ltd will be gifted to JC within the next couple of years. These shares have an approximate current market value of £1,500,000.

Both DC and SC have made adequate provisions for their retirement independent of SGB Ltd.

DC also personally owns some property located away from the main trading premises which SGB Ltd uses in its trade. DC has been charging an annual rent of £5,000 per year for this. He is planning to retain this following the disposal of his shares but may dispose of this at a later date.

DC and SC want to know the principal tax implications arising from (i) the proposed salary package to JC and (ii) the proposed gift of shares to JC. In the case of (ii) they also want to know in outline terms how the shares are transferred.

It was agreed that we will prepare a report for their attention addressing these issues.

EXHIBIT F

Extracts from client files

History of shares in Superior Garden Buildings Limited ('SGB Ltd')

DC inherited 1,000 £1 ordinary shares in SGB Ltd from his late father in May 1990. This represented all of the issued share capital of SGB Ltd.

The probate value in May 1990 was £50,000.

The market value of the shares in May 1995 was £150,000.

4. You act as the tax manager for the firm Gillams, Chartered Tax Advisers. The tax partner at your firm, Jeremy Ryan, has forwarded to you a letter (**EXHIBIT A**) received from Carl Creevy, Head of Tax for Hotels R Us plc, which is the holding company for a multinational hotel chain. Mr Creevy followed this with another short letter a few days later (**EXHIBIT B**). You have also received an e-mail and attachment from Jeremy Ryan (**EXHIBIT C**) further to his meeting with the prospective new client.

You are required to:

- 1) **Prepare a covering letter and report for Jeremy Ryan to send to Carl Creevy in accordance with the instructions given by Jeremy in EXHIBIT C.**
(65)
- 2) **Write a technical briefing report for Jeremy Ryan explaining the issues concerning the recovery of VAT on professional fees and on catering at the air show.**
(35)

Total (including 22 presentation marks) (100)

The following exhibits are attached to assist you:

EXHIBIT A: Letter from Carl Creevy, Head of Tax, at Hotels R Us plc

EXHIBIT B: Further letter from Carl Creevy

EXHIBIT C: E-mail from Jeremy Ryan of Gillams, attaching notes of meeting with client

EXHIBIT D: Current group structure and details of shareholdings (prior to Project Amethyst)

EXHIBIT A

Letter from Carl Creevy, Head of Tax, at Hotels R Us plc

Hotels R Us plc
Banford Retail Park
Commercial Street
Ringford
RD7 1AA

20 April 2009

Our Ref: CC

Jeremy Ryan
Tax Partner
Gillams Chartered Tax Advisers
High Street
Longford
LG1 1JS

Dear Jeremy

Project Amethyst

Following a recent meeting of global executives, a decision was taken to proceed with Project Amethyst. This will be a significant restructuring exercise for the UK group for which we will need specialist advice from your firm. We do not wish to involve our existing advisers, Willing Workers & Co, with this exercise, but we will retain their services for all other ongoing matters. We are happy for your firm to contact them if necessary.

Continued

4. *Continuation*

Current group structure and brief history

As you know, the Hotels R Us brand was developed in the USA in the 1970's. During the 1990's the relevant US corporations came under the ownership of the UK Correlli group, which subsequently changed its name to become the group known as Hotels R Us plc (HRU). However, despite this acquisition, the global franchise remains under the ownership of Hotels R Us Inc in the USA.

Critical to brand franchising is uniform quality and specifications across all branded hotels. Each hotel, wherever located worldwide, remains contracted, either directly or indirectly, to the HRU global franchise owner, Hotels R Us Inc, in the USA. The franchise/licence agreements give the user access to the brand systems and trademarks, and also give the hotel owners access to the global reservations system, marketing and similar programmes. UK hotel owners also participate in the HRU loyalty scheme, discussed below.

Project Amethyst proposal

We have decided that the best direction for the UK group is to follow a strategy of reducing substantially our interests in hotel ownership, and focus on the US centred franchise business. We believe this will lead to greater profitability and will enable us to return capital to shareholders. The restructuring will involve the sale of our UK hotel interests, with the condition that the purchaser enters into franchise agreements with respect to all these hotels. Currently each of our 40 UK hotels is owned by individual property owning companies. These companies are all wholly owned by HRU Properties Ltd, which in turn is wholly owned by HRU plc. All companies involved are members of the HRU UK VAT group. Sale will be to an independent third party at open market value.

At the current date, no decision has yet been taken as to whether the portfolio of hotels should be sold as either a straight sale of assets or by a sale of shares of the companies owning the hotels. We are aware that the final transaction may be negotiable depending on the bargaining position of the purchasing company with reference to its tax costs. I should therefore like some guidance on the merits and demerits of an asset or share sale, from the perspective of both the vendor and the purchaser, in order that I can report back to the Board. I should also like details of the tax implications arising from the sale.

Stamp taxes

The potential purchasers have concerns about stamp taxes. They are aware that they will pick up a sizeable unrecoverable tax cost from the overall deal. They still seem to believe that these are voluntary taxes or at least that there is no urgency to file and pay the tax.

As well as providing details of the rates for a sale share or asset sale, could you also comment on the consequences of failure to stamp and the penalties for late stamping or late delivery of returns? We do not want any unnecessary problems when we look to finalise the deal.

Insurance Premium Tax

We have a wholly owned subsidiary, HRU Insurance Services Ltd, which provides buildings insurance for all HRU hotels globally.

The purchaser does not have a captive insurance company or any satisfactory insurance arrangements. The purchaser would like to ensure continuity of insurance and to benefit from our existing arrangements if at all possible. Further, for strategic reasons, it would like to have an insurance business within its own structure. Likewise, in conjunction with the aims of Project Amethyst, we do not wish to retain segments of the business surplus to our requirements in the UK. We would therefore welcome your advice on the necessary restructuring.

4. *Continuation*

Loyalty scheme

Finally, we require brief clarification about the VAT position concerning our loyalty scheme, pending the sale of the hotel portfolio to a third party.

As you are aware, the HRU group runs a loyalty scheme in the UK, whereby it issues points to guests for stays in our hotels. The scheme is administered by HRU Group Services Ltd on behalf of UK hotels. Guests may redeem those points either against stays in any HRU hotel in the UK or against other products. Where guests choose hotel bookings, the individual hotels will accordingly seek to charge HRU Group Services Ltd for the points redeemed. The scheme will remain in place following the sale and franchisees will redeem points in the same manner as existing owned hotels.

We are aware that there is some ongoing litigation in the courts about loyalty schemes. Could you please briefly explain the relevance of this to Hotels R Us and the implications that will arise upon the proposed sale of our hotel portfolio?

You will appreciate that this exercise is confidential in nature and we would expect your firm to act accordingly. I look forward to hearing from you.

Yours sincerely

Carl Creevy
Head of Tax

EXHIBIT B

Further letter from Carl Creevy

Hotels R Us plc
Banford Retail Park
Commercial Street
Ringford
RD7 1AA

22 April 2009

Our Ref: CC

Jeremy Ryan
Tax Partner
Gillams Chartered Tax Advisers
High Street
Longford
LG1 1JS

Dear Jeremy

Project Amethyst – Further Developments

I am writing further to my letter dated 20 April 2009. I wish to update you with the views of our auditors about professional costs. I also wish to seek your advice on a practical issue concerning the group at the moment.

Recharge to the USA

Our auditors have looked at the transaction from a direct tax perspective and believe that the correct approach from a transfer pricing analysis would be to recharge a proportion of the professional costs to the US company owning the franchise, HRU Inc. This company

Continued

4. Continuation

continues to own the global franchise to the HRU name, and therefore maintains a leading brand position in the UK market. Thus benefits accrue to HRU Inc, which should accordingly bear a proportion of the costs incurred. Having carried out a pricing exercise, we have decided to recharge approximately 40% of the costs, and this amount will be invoiced to HRU Inc prior to year end.

We require detailed guidance of the implications of this action on the VAT recovery for professional fees. Note that the recharge leaves a higher level of profits in charge to UK Corporation Tax.

Air show

We have an issue with a German hotel within the European group of companies.

Hotels R Us Munich is a hotel directly owned by the group company, Hotels R Us Munich GmbH. The company is registered for VAT in Germany. Luftfahrt Deutschland GmbH is an unconnected German company, also registered in Germany for VAT. It trades within the aviation industry. It participated in a trade show in the UK in December 2008 and requested the HRU Munich hotel to provide catering at this event for its whole entourage. I understand that this is a 'one-off' activity.

HRU Munich sent its own staff to the UK to manage the catering event, and exported some equipment from Germany to the UK in order to provide the catering. However it also made purchases in the UK of food and beverages, rented equipment, and temporarily hired local staff.

Hotels R Us Munich GmbH received professional advice in Germany that its receipts from the trade show should be subject to German VAT. Accordingly it issued tax invoices to Luftfahrt Deutschland GmbH in Germany and accounted for the output tax. The total value of the services invoiced was in excess of €500,000.

The hotel has also been advised that it can recover the UK VAT incurred in respect of the catering. However, there is much confusion over how it is able to do this; for instance, can it send the UK VAT invoices to HRU in the UK? Alternatively, should it novate contracts to the UK? Would there be a danger that HRU Munich GmbH would have to register for VAT in the UK?

I look forward to hearing from you.

Yours sincerely

Carl Creevy
Head of Tax

EXHIBIT C

E-mail from Jeremy Ryan of Gillams, attaching notes of meeting with client

To: Mike Moran – Tax Manager
From: Jeremy Ryan – Tax Partner
Subject: Meeting with Hotels R Us
Date: 28 April 2009
Attachment: Notes of Client Meeting

Mike

As you know, I met yesterday with the new hotel chain client, Hotels R Us plc. I have attached my notes from the meeting for your attention.

Continued

4. Continuation

I should be grateful if you could draft a covering letter and a report for me to send to Carl Creevy in response to the queries in his two letters. I would like to consider further the position in relation to VAT on professional fees and on the catering at the air show. Therefore, rather than deal with these issues in your report to Carl, I would like you to prepare a technical report for me on the issues concerning VAT recovery for professional fees and the catering at the air show.

Regards
Jeremy Ryan

ATTACHMENT TO EXHIBIT C

Outline notes of a meeting held with Hotels R Us Group on 27 April 2009

Discussed Project Amethyst transaction.

- Client intends to complete transaction prior to its year-end on 30 June 2009.
- Purchaser will be a UK company. Identity and details of purchaser cannot be revealed as yet.
- Client has yet to decide on sale route – whether sale of assets or sale of shares.
- Sale to be for cash at open market value.
- Initial discussions have been held a while ago with HM Revenue & Customs about VAT recovery of professional fees, which have been incurred over a period of several months. Given that a final decision has not yet been made, HM Revenue & Customs would not give any rulings. However, agreed that VAT on costs incurred up to the date of a decision would be recoverable in line with general overheads of the business.
- UK VAT group is fully taxable. The annual VAT liability for the group is well in excess of £3 million.
- HRU has exercised the option to tax in relation to all UK hotel properties.
- Each hotel owning company holds a freehold interest in that property.

EXHIBIT D

Current group structure and details of shareholdings (prior to Project Amethyst)

NB All companies are UK registered unless otherwise indicated. Share holdings outside the UK and the USA are ignored, with the exception of HRU Munich GmbH. All subsidiaries are 100% owned by their immediate parent company.

