

The Chartered Institute of Taxation

Application and Professional Skills

Taxation of Larger Companies and Groups

May 2022

Suggested solution

Report to Bill Jones, Chief Financial Officer, Novic Ltd

Dispute with CHB Ltd and its resolution

Introduction

This report addresses the options available to the consortium (comprising Alpha plc, Beta plc and Gamma Ltd) for the future of Novic Ltd, in the light of the current dispute with CHB Ltd and the offer from Biopharma Inc to buy Novic Ltd.

The available options are to:

- a) allow the dispute to proceed to court; or
- b) settle the dispute at £100 million and enter into a royalty agreement with CHB Ltd; or
- c) sell Novic Ltd to Biopharma Inc (on the alternative bases offered).

In deciding which of the options should be pursued, the following issues should be considered:

1. Commercial implications of the proposed transactions.
2. Would damages awarded by the court be tax deductible, and if so, when?
3. Would the amount paid as a settlement be tax deductible, and if so, when?
4. How could any Corporation Tax loss arising from a settlement be relieved?
5. What are the capital gains implications of each option for each of the three consortium members?

This report is based on information provided at the meeting on 26 April 2022 with the Chief Financial Officer of Novic Ltd, and in the letter dated 2 May 2022 from Novic Ltd, and our understanding of the background to Novic Ltd and its financial position at 31 December 2021.

It is written for the Board of Novic Ltd. It may also be relied on by the Boards of Alpha plc, Beta plc and Gamma plc but only in respect of those companies' relationships with Novic Ltd and its current dispute with CHB Ltd. It should not be relied on by any other parties.

Our recommendations are made on the basis of UK tax law as it currently stands. You should check with us that there have been no material changes before undertaking any of the transactions envisaged in this report.

NGH LLP

May 2022

Executive Summary

If the intellectual property dispute proceeds to court, there is a greater than 50% chance of losing the case, causing Novic Ltd to fail and its business to be lost. In that event, it is unlikely that any tax relief would be available for the damages award. For those reasons, it is not recommended to go to court.

On the basis that the offer to buy Novic Ltd is at market value, either selling now or not selling does not confer any commercial advantage and that is a decision the consortium members must make as one, as Biopharma Inc will only buy 100% of the shares.

Agreeing a settlement of the dispute at £100 million will enable the business to continue where there is then a reasonable chance of the business becoming successful. Furthermore, insofar as £100 million is paid to preserve the business of Novic Ltd, it should be tax deductible, subject to checking that it would not be disallowed under anti-arbitrage tax legislation. You should seek to establish whether a deduction for a £100 million settlement will be allowed under UK tax anti-avoidance legislation. We would be happy to help you consider this further.

A settlement without an immediate sale of the company would enable the consortium to claim a large part of the £100 million as consortium relief in 2022, or later if preferred when the rate of relief would be higher.

A settlement and a sale create additional risks of the £100 million being disallowed, in whole or in part, either because it is capital (connected to the sale) or because of possible transfer pricing restrictions. The value of the deduction under a sale can be optimised by agreeing the settlement pre-sale, and drawing up an accounting period, all of which falls within the pre-sale period, so that the whole settlement amount is available for an immediate consortium relief claim, albeit at current rather than later, higher tax rates.

A sale now would generate large capital gains that would be taxable in Beta plc and Gamma Ltd, whereas a later sale after January 2023 would enable all three consortium members to claim Substantial Shareholding Exemption (SSE) and so have no taxable chargeable gains.

By deferring any sale until at least 2023, maximum and flexible consortium relief can be obtained for the available deduction for the settlement, and capital gains on sale can be eliminated. Subject to the commercial decision on whether a sale now will yield more or less value than a future sale, we recommend that settlement is reached at £100 million and that Novic Ltd is not sold. At a future date, the possibility of selling can be reconsidered, when additional tax liabilities on capital gains will not be triggered.

We recommend that such a settlement is funded by debt finance so that the consortium members retain flexibility of having that money repaid. This has no impact on the measure of capital gains on a sale, although would reduce the measure of capital losses, should Novic Ltd fail, which are of no immediate value anyway.

Issues

1. Commercial implications

If Novic Ltd does not reach agreement with CHB Ltd, the dispute will proceed to court in July 2022. Your legal advice is that Novic Ltd has a less than 50% chance of winning.

If Novic Ltd lost the case, the consortium members would have the choice of either:

- a) providing funds of £150 million to enable the court award to be paid but without any assurance that Biopharma Inc would enter into a licence agreement to enable Novic Ltd to continue trading, or agree to buy the company; or
- b) allowing Novic Ltd to become insolvent due its inability to pay the award in full, leading to its being put into liquidation. The consortium members would lose all or nearly all of their investment of £90 million between them.

If Novic Ltd won in court, it would be able to continue to develop its business, without having to pay future royalties or damages.

If Novic Ltd settles the dispute and enters into a licencing agreement with CHB Ltd, the consortium members will need to inject £100 million into Novic Ltd as debt or equity i.e., £33.3 million each.

If the settlement of CBH Ltd's claim is first funded by the consortium members injecting £100 million of equity, and Novic Ltd is then sold for £400 million, the sale price will exceed the initial investment of all three consortium members of £190 million by £210 million. Alternatively, the £100 million could be injected as loan, the company sold for £300 million, and the loan then repaid.

If an agreement is made with Biopharma Inc to sell Novic Ltd for £300 million, and the dispute is dropped, there will be no requirement to fund a settlement and the sale price will again exceed the initial investment of all three consortium members by £210 million (£300 million less £90 million).

In summary, a court case runs a high risk of the initial investment of £90 million being lost and potentially the cost of damages awarded of £150 million. In addition, the future value of a potentially valuable business could be lost. There would also be reputational damage to all three consortium members of having invested in a company that had faced IP infringement proceedings by using, without agreement, another's intellectual property. That could have future adverse implications for all three consortium members, particularly Alpha plc and Beta plc which, as listed companies, are subject to public scrutiny.

Funding a settlement would cost £100 million plus the cost of future royalties, though these would be met out of Novic Ltd's future profits.

Alternatively, selling Novic Ltd now would realise a profit of £210 million to the consortium members, although if the settlement is not funded and the dispute is waived, Novic Ltd would not incur a £100 million expense, and thus could not obtain a tax deduction for that amount (see below for further details).

2. Would damages awarded by the court be tax deductible, and if so, when?

For an expense to be tax relievable, it must be incurred wholly and exclusively for the purpose of the trade, it must not be of a capital nature, and it must not transgress any specific disallowances.

Civil damages incurred in a trade dispute are generally regarded as being for the purposes of the trade. Novic Ltd has made sales and so has a trade. There would be a trade loss that could be surrendered as consortium relief (see below) for an accounting period that ended before Novic Ltd went into liquidation.

However, if the trade ceased shortly after the award, either because the consortium members did not fund the award or a licencing agreement could not be agreed, the damages could be regarded as an expense of closing down rather than carrying on the business and be disallowed for tax purposes.

The damages are deductible when properly included in Novic Ltd's accounts in accordance with accounting principles. This will be when an obligation is established i.e., when any final Court decision is determined.

In summary, an award of damages might be tax deductible though runs the risk of disallowance in the event the business fails shortly afterwards

3. Would the amount paid as a settlement be tax deductible and if so, when?

Insofar as the settlement is entered into to protect and preserve Novic Ltd's trade, a sum payable in settlement of CBH Ltd's claim is an allowable revenue deduction. The commercial purpose should be documented, and reflected in the settlement agreement, to that effect.

A subsequent licence agreement with CHB Ltd, with annual fees paid for future use of the intellectual property, would also demonstrate that no capital asset of enduring benefit had been created. The royalty payments would be also deductible by Novic Ltd as expenses incurred wholly and exclusively for the purposes of its trade.

However, if the settlement were connected with the sale of the company to Biopharma Inc, it could be regarded as a capital payment and thus not allowable. Case law has established, as an example, that, compensation payments to retiring directors can be disallowed where they are part of the deal to sell a company.

Furthermore, the payment might be disallowed, in whole or in part:

- UK anti-tax arbitrage legislation could disallow the payment if CHB Ltd was a hybrid entity, and the receipt were not taxable in its hands.
- If the payment were agreed after Novic Ltd had been sold to Biopharma Inc, Novic Ltd and CHB Ltd would be connected persons and the payment would need to satisfy UK transfer pricing arm's-length principles.

In terms of the timing of the tax deduction, it will fall into the accounting period in which Novic Ltd bindingly admits liability and is included in its accounts applying accounting principles. The timing would be important in determining by whom and when relief for the loss arising can be claimed.

In summary, a deduction is likely to be available unless the settlement is connected with the sale of the company or if the anti-avoidance legislation, referred to above, were to apply.

4. How could the Corporation Tax loss be tax relieved?

If Novic Ltd is not sold

Novic Ltd is estimated to make a Corporation Tax loss of £50 million for the year ended 31 December 2022, before any resolution of the dispute. If the company is not sold by 31 December 2022, the loss is available to be surrendered against the profits of the three consortium members. If settlement of the dispute is reached by 31 December 2022, the loss will increase to £150 million. Each consortium member could claim up to one-third as consortium relief.

Alpha plc and Beta plc can each shelter £50 million of their anticipated profits of £100 million and £150 million respectively, whereas Gamma Ltd is unlikely to have Corporation Tax profits, after relieving existing losses brought forward and therefore could not claim any consortium relief in 2022.

Any unrelieved losses of Novic Ltd in 2022 are carried forward. They are then subject to restrictions of a maximum claim each year per claimant company of £5 million plus 50% its profits over £5 million.

Because of the increase of the Corporation Tax rate from 19% to 25% from 1 April 2023, Alpha plc and/or Beta plc might wish to defer claiming consortium relief until 2023 (when the effective rate is 23.5%) or 2024 (25%). Alpha plc and Beta plc have sufficient estimated future profits to absorb their

shares of Novic Ltd's losses in one year. Gamma Ltd is unlikely to have taxable profits before 2025, at which point its annual claim would be limited to its profits of £1 million per annum.

If Novic Ltd is sold

The trading losses of the accounting period of Novic Ltd for the year ended 31 December 2022 would be time-apportioned between the pre- and post-sale periods for consortium and group relief purposes.

Losses that arose following the date when arrangements were in place for Novic Ltd to be sold would not be available to be surrendered to consortium members. Subject to that, losses apportioned to the pre-sale period could be surrendered to Alpha plc and Beta plc as discussed above.

Losses apportioned to the post-sale period, could be claimed as group relief by Biop (UK) Ltd. However, its maximum claim would be limited to its annual profits of, say, £5 million per annum. If the apportionment was by reference to say a 30 June 2022 sale date, and the £100 million settlement payment was included, losses in the second half year would be £75 million (£150 million x 6 months/12 months). A significant part of that loss would still be unrelieved when Novic Ltd became profitable in 2025. At that point the remaining loss could be relieved by carry forward against those future profits (subject to the £5 million plus 50% of profits above £5 million per annum limit, depending on where the £5m allowance had been allocated in the group).

A shorter accounting period could be created by drawing up statutory accounts so that all of the £100 million settlement fell within one accounting period. For example, if the settlement were agreed immediately before a sale on 1 July, and accounts were drawn up to 30 June, the whole £100 million would be included in the losses to 30 June 2022 and would be available for immediate consortium relief, so long as arrangements were not in place at 30 June 2022 for Novic Ltd to be sold. However, if the losses were not so claimed, they would remain with Novic Ltd and could not be carried forward for consortium relief in future.

In summary, £100 million of losses (plus other trade losses of the company) would be available to Alpha plc and Beta plc if Novic Ltd was not sold and could be claimed for accounting periods that would maximise the rate of relief. On a sale, the use of a short accounting period to the date of agreement for sale would enable the consortium to claim £100 million of relief now plus other trade losses of Novic Ltd to 30 June 2022), but at the current rate. Otherwise, on a sale, the relief of losses surrendered to Biop (UK) Ltd could take many years and so realising the value for those losses would be equally delayed by many years.

5. Capital gains implications

Alpha plc currently has a base cost of £20 million for its shareholding in Novic Ltd, while Beta plc and Gamma Ltd have base costs of £35 million each.

If the court case were lost and Novic Ltd ceased trading, its shares would become of negligible value. Capital losses of £20 million, £35 million and £35 million, respectively, would arise either on negligible value claims being made or if the company is liquidated. Alpha plc's loss will not be allowable for corporation tax purposes because Substantial Shareholding Exemption (SSE) will still apply despite Novic Ltd no longer being a trading company, because it was a trading company within the preceding two years and under the control of Alpha Ltd. As Beta plc and Gamma plc will have held their shares in Novic Ltd for only 12 months, SSE will not apply, and their losses will be

allowable capital losses. However, none of the companies appears to have a chargeable gain against which the losses could be immediately utilised.

The three consortium members could fund equally a settlement by injecting either additional debt or equity of £33.3 million each. In the latter case, their allowable base costs would increase to approximately £53 million (Alpha plc), £68million (Beta plc) and £68 million (Gamma Ltd).

If Novic Ltd were subsequently to fail, capital losses of £20 million, £35 million and £35 million respectively (debt finance) or £53 million, £68million and £68 million (equity finance) respectively would arise and be available for carry forward.

As no capital gains are anticipated against which these capital losses could be relieved, debt financing, and thus the possibility of its being repaid, would be preferable.

On a sale of Novic Ltd, the sales price for the purposes of computing a capital gain would be the cash consideration received plus the present value of the right to future consideration for losses relieved in respect of the £100 million settlement payment. That value of losses is likely be small as there is uncertainty that the £100 million is tax deductible, and it will take many years for all the relief to be obtained. The value of losses can therefore be ignored in considering the gain on disposal.

On a sale at £400 million, chargeable gains would therefore be approximately £80 million (Alpha plc - £133 million minus £53 million)), and £65 million (£133 million minus £68 million) for each of Beta plc and Gamma Ltd.

On a sale at £300 million, with no additional equity having been injected, base costs would remain at £20 million, £35million and £35 million, respectively. Gains would again be £80 million (£100 million minus £20 million), £65 million (£100 million minus £35 million) and £65 million, respectively, for the consortium members.

Alpha plc has held more than 10% of the shares in Novic Ltd, a trading company (or intending trading company) for more than one year and so qualifies for SSE so its gain would not be chargeable. Beta plc and Gamma Ltd do not qualify for SSE as they have held their shares for less than a year, and so would not qualify for SSE on a sale before January 2023.

Therefore, their gains of £65 million each would be chargeable to Corporation Tax, at 19%, that is, tax of about £12.4 million each.

Any future consideration received in respect of the value of losses brought forward (e.g., losses being relieved in Biop (UK) Ltd) will not qualify for SSE and will give rise to additional chargeable gains.

In summary and leaving aside any future gains on consideration received for the future use of trading losses by Biop (UK)Ltd, there is a clear advantage in deferring a sale of Novic Ltd until at least January 2023 so that Beta plc and Gamma Ltd can, along with Alpha plc, qualify for SSE so that their gains on the sale of Novic Ltd would not be chargeable.

NGH LLP
May 2022