The Chartered Tax Adviser Examination

Sample Paper

Application and Professional Skills

Taxation of Larger Companies and Groups

Suggested solutions

Draft report prepared for the Diversified plc

7 November 2018

To the Board of Diversified plc

This report has been prepared to advise the Board of the tax and other issues arising from the transactions proposed by the Diversified plc Group.

This report has been prepared by Tax Advisory Services Ltd and is intended solely for use by the Diversified plc group. We will accept no responsibility for any reliance placed on the contents of this report by third parties.

The tax law contained in this report applies at the time of writing.

EXECUTIVE SUMMARY

Diversified plc needs to raise funds of £6.7 million to reduce current borrowings. The funds may be raised through undertaking two transactions: the disposal of Ares Ltd; and the sale of two properties on the merger of Bishop Ltd and Cable Ltd.

In order to maximise the post-tax position and raise the required funds, we recommend the following:

1. River House and Millwheel House are disposed of by Bishop Ltd, followed by the transfer of its trade and assets to Cable Ltd. Disposing of the properties first will increase the cash position by £28,500 as loss relief can be claimed to reduce the gains arising on the properties by utilising £150,000 of the projected trade losses for the quarter to 30 June 2018. This will raise £1,248,700 of the required funds and accelerate tax relief on £150,000 of trade losses.

2. Transfer the remaining trade losses of £300,000 to Cable Ltd to relieve future profits arising in the transferred trade. The two trades should continue to be streamed following the merger.

3. Bishop Ltd should be liquidated before 17 December 2018 in order to generate an allowable capital loss of £854,300 that can be used to reduce the taxable gain arising on the disposal of the Ares Ltd shares. The transfer of the trade from Bishop Ltd to Cable Ltd will not result in any additional tax liabilities.

4. The shares in Ares Ltd are sold as this will generate £172,000 higher post tax proceeds than would arise on a trade and asset disposal. The gain arising on the disposal of the shares should be reduced by the capital loss arising on the liquidation of Bishop Ltd, resulting in post tax proceeds of £5,478,317.

The combined post tax proceeds of both transactions will be £6,727,017 thereby achieving the group's objective of raising £6.7 million to reduce current borrowings.

Sale of Ares Ltd

1 Sale of shares

A disposal of the Ares Ltd shares will be a chargeable disposal for Corporation Tax resulting in a chargeable gain of £3.6 million (£6 million proceeds less £2.4 million cost).

The Stamp Duty cost of the share purchase has not been quantified as this will fall on the purchaser.

Substantial Shareholdings Exemption (SSE)

Providing that all conditions are satisfied then SSE will exempt the gain. To qualify there are three conditions that must be met for the 12 months prior to the disposal. These are that:

a) Diversified plc must be a holding company of a trading group;

b) Diversified plc must own at least 10% of the shares in Ares Ltd; and

c) Ares Ltd must be a trading company.

The first condition is met as the group as a whole is predominantly a trading group.

The second condition is met as 100% of the shares have been owned by Diversified plc since March 2011.

However, it is not clear whether the third condition is met because Ares Ltd has been renting out its warehouse space, which is investment rather than trading activity. If the investment activity is considered ‘substantial’ then it will compromise the trade status of the company. HM Revenue & Customs (HMRC)’s interpretation of ‘substantial’ is 20% or more and this test is applied to a number of factors including the asset base, income, costs, profits and management time of key individuals. Given that one-third of the warehouse has been let out since January 2016, it is likely that SSE would be denied in this instance.

Without the SSE, the gain of £3.6 million will be taxable at 19% resulting in Corporation Tax of £684,000 and post-tax proceeds of £5,316,000 (Appendix 1).

Points to consider

The purchase price may be influenced by the following:

- Availability of trade losses of £480,000.

This will depend on what the purchaser intends to do with the trade of Ares Ltd. Any major change in the nature or conduct of the trade of Ares Ltd within three years of the purchase date would result in the brought forward losses being lost.

- Consequences of leaving a capital gains group.

As a wholly owned subsidiary, Ares Ltd is a current member of Diversified plc’s capital gains group.

Any historic group transactions concerning intangible fixed assets (IFAs) or land and buildings with Ares Ltd should be reviewed prior to the purchaser’s due diligence exercise to ensure there will be no degrouping charges or Stamp Duty Land Tax (SDLT) arising when Ares Ltd leaves the group.

2 Sale of trade and assets

The sale of the trade and assets of Ares Ltd will result in a cessation of trade and the end of a chargeable accounting period for Ares Ltd.

Freehold property

A gain of £3,390,000 (being the difference between the market value £5.2 million less the cost £1.81 million) will arise, resulting in Corporation Tax at 19% of £644,100.

No SDLT would arise to Ares Ltd as this would be payable by the purchaser.

Plant and machinery

If the Tax Written Down Value (TWDV) amount is less than the market value of £360,000, a balancing charge would arise and would be taxable at 19% in Ares Ltd. We need to know the TWDV figure to determine the final tax position.

Stock

Taxable profits of £10,000 will arise, being the difference between the market value of £170,000 and the cost £160,000. Corporation Tax at 19% x £10,000 will result in a liability of £1,900.

Debtors and current liabilities

No tax implications should arise as the purchaser would take these on at their book value.

Trade losses

The brought forward trade losses of £480,000 will remain with Ares Ltd but these cannot be group relieved.

Point to Consider

Given the estimated total market value of £5,790,000 and the fact that the trade losses cannot be acquired through a trade and asset deal, a potential purchaser is unlikely to pay £6 million for the trade and assets of Ares Ltd after the due diligence exercise.

Assuming the proceeds are £5,790,000, the post tax proceeds would be £5,144,000 (Appendix 2) after taking into account the Corporation Tax liabilities on the property sale and the profit arising on the stock. There might also be a potential balancing charge on the plant and machinery.

Diversified plc would then need to consider either dissolving Ares Ltd or leaving it as a dormant company.

Value Added Tax

The sale of shares will be an exempt disposal. As a result, no VAT can be recovered on the cost of adviser's fees, which relate directly to the disposal of the shares.

An asset sale will create normal VAT charges unless the transfer falls within the definition of a Transfer of a Going Concern (TOGC).

For TOGC to apply the purchaser must be VAT registered and we would need to confirm with the purchaser that the business will be carried on in the same way, with no significant breaks in trading. The VAT on the adviser's fees will be recoverable using the normal input VAT recovery rules.

Summary

On the assumption that SSE is denied due to the investment activity in Ares Ltd, a sale of the shares would give post tax proceeds of £5,316,000 whereas a sale of the trade and assets would give post tax proceeds of £5,144,000, which could be further reduced if a balancing charge arises on the plant and machinery.

We recommend that the shares of Ares Ltd are sold as this increases the cash position by £172,000.

Transfer of Bishop Ltd trade and assets to Cable Ltd

In order to maximise the post tax position, it will be important to consider the timing of both the transfer of trade and the sale of the remaining properties in Bishop Ltd. There are two ways of achieving the same outcome, firstly by transferring the trade and then disposing of the properties before Bishop Ltd is liquidated or secondly by disposing of the properties and then transferring the trade before Bishop Ltd is liquidated.

1) Transfer of trade followed by disposal of properties

The transfer of trade and assets to Cable Ltd will mean a cessation of trade for Bishop Ltd and the end of a chargeable accounting period for Corporation Tax purposes.

Mountain View

Chargeable gain

Bishop Ltd and Cable Ltd are in a capital gains group together as they are wholly owned direct subsidiaries of Diversified plc. Therefore the transfer of the property will be tax neutral in that neither a gain nor a loss will arise, thus the property will be transferred to Cable Ltd at its original cost of £700,000. This will form the base cost for Cable Ltd on an eventual disposal of the property.

As there is a loan secured against the property, it will be necessary to obtain the lender's consent to the transfer. For the purpose of this report, it is assumed that the lender will allow the transfer of the loan to Cable Ltd, but there could be a fee charged by the lender for doing this.

Stamp Duty Land Tax (SDLT)

Bishop Ltd and Cable Ltd are both controlled by Diversified plc meaning that they are connected companies and in a SDLT group.

Normally on the transfer of a property, a SDLT liability would arise based on the market value of the property at the transfer date. However, an exemption is available for companies in a SDLT group.

The exemption will be withdrawn if Cable Ltd were to leave the group within three years of the transfer date and Cable Ltd would be liable for the SDLT within 30 days from that time.

Plant and machinery

Succession rules will apply to the transfer of plant and machinery provided that certain conditions are satisfied.

The first condition is that a 75% interest in the transferred trade is owned by a person at some time within the twelve months before the transfer date and a 75% interest in the transferred trade is owned by the same person at some time within two years from the transfer date. This condition will be satisfied as both Bishop Ltd and Cable Ltd are wholly owned subsidiaries of Diversified plc. The transferred trade will therefore continue to be owned by the parent company.

The second condition is that both Bishop Ltd and Cable Ltd are within the charge to UK Corporation Tax. This condition will be satisfied as both companies are UK tax resident.

The succession rules will automatically apply meaning that the plant and machinery will be transferred at its TWDV resulting in no balancing adjustments for Bishop Ltd.

Cable Ltd would not be entitled to claim either first year allowances or the annual investment allowance in respect of the transferred plant and machinery.

Stock

The transfer of stock between connected companies is deemed to take place at market value. If the market value is greater than the original cost, this will result in additional taxable profits for Bishop Ltd.

A joint election is available that will enable the stock to be transferred at the higher of the original cost and actual proceeds. If the election is made and no consideration is allocated to the stock then it will be transferred to Cable Ltd at cost, therefore eliminating additional profits for Bishop Ltd.

Cable Ltd will acquire the stock at its original cost and the profit on disposal will arise in Cable Ltd when the stock is sold. The election must be made within two years from the end of the accounting period in which the transfer takes place.

Trade losses

When a trade is transferred out of a company, all losses generally stay with the company and cannot be transferred. However the succession provisions outlined above also allow for trade losses to be transferred.

There are two main issues to consider on the transfer of the trade losses:

(1) The amount of the losses transferred will be restricted if Bishop Ltd is left insolvent after the transfer. Bishop Ltd will be insolvent if it is left with excess liabilities.

    From the information provided, the trade losses of £450,000 are available to transfer to Cable Ltd and will not be restricted (Appendix 3).

    This is assuming that the secured loan is transferred and that Cable Ltd is paying no consideration for the trade and assets**.**

(2) The trade losses transferred can only be relieved against the first available profits of the transferred trade of Bishop Ltd and this will require careful consideration if the plan is to

merge the two trading activities.

Even if the two trades are identical, HMRC will require separate streaming of each trade so as to ensure that the transferred losses are only relieved against the future profits of Bishop Ltd's trade. Failure to stream the results of each trade in this way will lead to the transferred losses being forfeited.

Capital losses

The capital losses brought forward of £50,000 will remain with Bishop Ltd. As these were realised before Bishop Ltd joined the Diversified group they cannot be utilised within the group.

Value Added Tax (VAT)

As both companies are within a VAT group there, are no VAT issues arising on the transfer of the trade and assets.

Sale of remaining properties

Following the cessation of trade, Bishop Ltd should dispose of the two remaining properties resulting in gains of £470,000 (Appendix 4). The capital loss bought forward of £50,000 will reduce the taxable gains to £420,000 resulting in a Corporation Tax liability of £79,800 (£420,000 x 19%).

Post-tax proceeds of £1,220,200 would then be available to reduce current group borrowing (Appendix 5).

Liquidation of Bishop Ltd

Given the balance sheet position of Bishop Ltd following the transfer of trade and the disposal of the remaining properties, the disposal of the shares will result in a capital loss of £882,800 (Appendix 7). However if the SSE conditions are satisfied on a disposal of shares then this loss would not be allowable for tax purposes.

As already discussed, one of the conditions requires that the investing company, Diversified plc, owns at least 10% of the shares in the 12 months leading up to the disposal date. Bishop Ltd has been a wholly owned subsidiary since 18 December 2017.

If the liquidation were to take place more than 12 months from the acquisition date then SSE would apply to disallow the capital loss as the investment activity in Bishop Ltd, representing 10% of the company's annual turnover would not be viewed as significant.

We would therefore advise that any disposal of the Bishop Ltd shares is undertaken before 17 December 2018, which would then enable the capital loss on the liquidation of Bishop Ltd to be allowable. This loss can be relieved against group gains (discussed further below).

2) Disposal of properties followed by transfer of trade

If the properties were disposed of first then the chargeable gains of £420,000 (Appendix 4) could be further reduced by a current year loss claim. Bishop Ltd has trade losses in the quarter to June 2018 of £150,000, which would reduce the taxable gains to £270,000. Corporation Tax of £51,300 would arise (£270,000 x 19%), resulting in post tax proceeds of £1,248,700 (Appendix 6), increasing the cash position by £28,500 (£1,248,700 - £1,220,200).

The tax implications on the transfer of the trade would be as discussed above with the exception that the losses transferred to Cable Ltd would be reduced to £300,000. However accelerated tax relief is available for the current year losses of £150,000 and as the post tax proceeds have increased, the capital loss on the liquidation of Bishop Ltd will be reduced to £854,300 (Appendix 7).

Summary

Taking into account the above tax implications and in order to maximise the overall post tax position, it will be more beneficial to realise an allowable capital loss rather than realise a gain that would be exempt.

We recommend that River House and Millwheel House are sold first and then the trade and assets in Bishop Ltd are transferred to Cable Ltd. Once Bishop Ltd is liquidated, a substantial allowable capital loss will arise that can be used to shelter group gains.

The transfer of freehold Mountain View, plant and machinery and stock will not result in any additional liabilities in Bishop Ltd in the cessation period regardless of when the properties are sold. However disposing of the properties before the trade is transferred will maximise the post tax proceeds and accelerate tax relief on £150,000 of trade losses. The remaining trade losses of £300,000 can be transferred to Cable Ltd and will be carried forward against future profits of Bishop Ltd's trade.

Conclusion

The allowable loss of £854,300 arising on the liquidation of Bishop Ltd could be used to reduce the gain arising on the disposal of the Ares Ltd shares increasing the post tax proceeds to £5,478,317 (Appendix 8).

The total post tax proceeds would then be £6,727,017 (Appendix 9), achieving the group's objective of raising £6.7 million to reduce current borrowing and improve the overall cash position.

APPENDIX

Appendix 1

Post-tax proceeds – disposal of the Ares Ltd shares

	£
Proceeds of sale	6,000,000
Less CT liability	(684,000)
Post-tax proceeds	£5,316,000

Appendix 2

Post Tax Proceeds – Disposal of the trade and assets of Ares Ltd

	£	£
Proceeds of Sale		5,790,000
Less CT Liabilities		
Property	644,100	
Stock	1,900	(646,000)
Post Tax Proceeds		£5,144,000

Appendix 3

Transfer of trade losses from Bishop Ltd to Cable Ltd

	£	£	£
Trade Losses			450,000
Assets left in Bishop Ltd			
River House	450,000		
Millwheel House	380,000		
Other Current Assets	75,000	905,000	
Liabilities left in Bishop Ltd			
Current Liabilities		(178,000)	
Bishop Ltd is Solvent		727,000	
Trade Losses Available to Transfer			450,000

Appendix 4

Gains on disposal of Properties remaining in Bishop Ltd

	£	£
River House		
Market Value	850,000	
Less Cost	(450,000)	400,000
Gain		
Millwheel House		
Market Value	450,000	
Less Cost	(380,000)	70,000
Gain		
Net Gains		470,000
Less Capital Losses B/F		(50,000)
Chargeable Gain		420,000
CT @ 19%		79,800

Appendix 5

Post Tax Proceeds – Disposal of properties in Bishop Ltd following the transfer of trade

	£	£
Proceeds of Sale		
River House	850,000	
Millwheel House	450,000	1,300,000
Less CT Liability		(79,800)
Post Tax Proceeds		£1,220,200

Appendix 6

Post Tax Proceeds – Disposal of properties in Bishop Ltd before the transfer of trade

	£	£
Proceeds of Sale		
River House	850,000	
Millwheel House	450,000	1,300,000
Less CT Liability		(51,300)
Post Tax Proceeds		£1,248,700

Appendix 7

Loss on Liquidation of Bishop Ltd

	Transfer of trade followed by disposal of properties £	Disposal of properties followed by transfer of trade £
Assets remaining after transfer of trade		
After tax proceeds of sale of properties (Appendices 5 & 6)	1,220,200	1,248,700
Debtors	75,000	75,000
Creditors	(178,000)	(178,000)
	1,117,200	1,145,700
Cost of shares	(2,000,000)	(2,000,000)
Allowable Capital Loss	£882,800	£854,300

Appendix 8

Post Tax Proceeds – Utilising the capital loss realised on the liquidation of Bishop Ltd

	Disposal of Shares £
Gain on disposal	3,600,000
Less Capital Loss (Appendix 7)	(854,300)
Taxable Gain	2,745,700
Corporation Tax at 19%	521,683
Proceeds of Sale	6,000,000
Less CT Liability	(521,683)
Post Tax Proceeds	5,478,317

Appendix 9

Total Post Tax Proceeds

	Disposal of Shares £
Disposal of Ares Ltd Shares (Appendix 8)	5,478,317
Disposal of Properties in Bishop Ltd (Appendix 6)	1,248,700
Total Post Tax Proceeds	£6,727,017