Institution **CIOT - ATT-CTA**
Course **CTA APS Taxation of Larger Comps**

Answer-to-Question-_1_

From: Tax Partner

To: Bill Jones

Date 12th May 2022

Subject: Dispute with CHB Ltd

This report is intended for use by Novic Ltd and the consortium members.

This report addresses the tax implications arising from settling the dispute with CHB Ltd either by remunerating CHB Ltd for use of a licence or by selling Novic Ltd, or a combination of the both.

No responsibility is accepted 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.

The report will cover the following:

Section A: Intellectual Property Conpensation

Section B: Paying royalties for use of Intellectual Property

Section C: Sale of Novic Ltd

Section D: Paying royalties for use of Intellectual Property, followed by sale of Novic Ltd

Abbreviations:
Alpha - Alpha plc
Beta - Beta plc
Gamma - Gamma Ltd
SSE - Substantial Shareholding Exemption

Executive Summary

Based on the four options the best are:

- Pay CHB Ltd royalties for use of the intellectual property
- Sale Novic Ltd for £300m

Depending on whether the shareholders Alpha, Beta and Gamma wish to retain it shareholding in Novic Ltd will determine which option is chosen.

<u>Pay CHB Ltd royalties for use of the intellectual property</u>

By paying CHB Ltd a royalty for future use of the intellectual property it has mitigated the compensation claim that it is probable to lose for a cheaper amount of £100m instead of £150m.

The £100m royalty payment itself is a tax deductible expenditure and the post tax cost to Novic Ltd is £81m, as the £19m tax loss can be used by Novic Ltd itself in the future or its consortium members.

Novic is expected to be highly profitable in 2025, and this option allows it's current shareholders to maintain shareholding.

Additional funding is required from the current shareholders to settle the intellectual dispute and ensure enough funding to complete its current project and there is a risk that the project will fail.

If funded via a loan, then Novic Ltd will be entitled to further coporate tax deduction by way of interest, subject to coporate interest restriction rules.

If funded via equity, the shareholding will remain equal, and the consortium members will have a higher base cost when selling their shareholding. There is no corporate tax relief available from funding via equity.

<u>Sale Novic Ltd for £300m</u>

By selling Novic Ltd for £300m to Biopharma Inc, the intellectual property dispute is closed, and the shareholders have more certainty about the security of their investment. Although the project may make significant profits from 2025, if it was to be unsuccessful Novic Ltd will no longer be commercially viable, and this would be a capital loss for the shareholders.

As Novic Ltd has not made research and development claims and Biopharma Inc will have the benefit of brought forward unrestricted trade lossses, Novic Ltd should arrange a higher selling price.

It is highly recommended that the whole sale is made post January 2023, once all 3 shareholders have held at ownership for at least 12 months, so they qualify for SSE, which will exempt the gain. Biopharma Inc is also not willing to buy less than 100% of the share capital of Novic Ltd, so Novic Ltd can only be sold in full by the consortium members and not partially.

To conclude Biopharma Inc is proposing to pay £260m in excess of Novic Ltd net assets as at 31 March 2022. The Novic Ltd shareholders need to decide whether they wish to cash-out of their investment making a large gain and if they do ensure it qualifies for SSE, or they wish to continue owning Novic Ltd, by settling the intellectual property dispute with the potential that they they could make substantial profits but at a risk of the company failing. The £260m excess that Biopharma is offering is in respect of the Novic Ltd potential.

Section A: Intellectual Property Conpensation

CHB is seeking compensation of £150m for lost sales, from either selling the drug themselves or licencing the drug out. As legal advice has determined that there is more than a 50% success in CHB favour should this go to court, Novic Ltd must enter a provision in its accounts for £150m.

HMRC will accept the provision as royalty payments are otherwise deductible expenditure, and the £150m is a reliable estimate of what CHB Ltd would have earned itself.

Novic Ltd will make a greater loss by £150m, but will receive a corporate tax relief of £28.5m (Appendix A) in the future, to be offset against future profit subject to deductions allowance. This will be beneficial to Novic in 2025 when it expects to be highly profitable. Alternatively the consortium members may take a share equal to the ownership as consortium relief.

Novic Ltd currently does not have enough cash to settle the potential £150m compensation that it owes, the consortium members have agreed to provide an equal share of the required funding. If this is funded by loans then Novic Ltd will have interest expense, which will increases losses further, Novic Ltd will likely be subject to CIR provisions which restrict the amount of interest expense a company can claim in its accounts.

If the consortium members fund by equity, no interest will be payable, however the base cost of their shareholding will increase and this will reduce the gain on future sell of Novic Ltd.

Even after additional funding to settle the compensation claim, Novic Ltd still requires £35m in order to conclude its current project, which the company's success depends on.

More information is required to confirm this point on funding.

If Novic Ltd chooses to proceed to court, it is taking a risk that it will be legally obligated to pay CHB £150m. This appears to be an unlikely option and other options are considered below.

<u>Section B: Paying royalties for use of Intellectual Property</u>

By Novic Ltd agreeing to pay £100m for an arms length royalty agreement with CHB Ltd, this is £50m cheaper than the compensation that may be due.

As the royalty payment is in relation to a trading intangible fixed asset, the tax treatment follows the accounting treatment that this payment is deductible from trade profits. Therefore Novic Ltd loss in the year 2022 will increase by £100m, this will generate a £19m (Appendix B) deferred tax asset as it will be offset against future profits, subject to deductions allowance. This will be beneficial to Novic Ltd in 2025 when it expects to be highly profitable. Alternatively the consortium members may take a share equal to the ownership as consortium relief.

As Novic Ltd will be paying a royalty to a non-UK resident company in a country that does not have a double tax treaty with the UK, Novic Ltd will be required to withhold 20% as withholding tax which is £20m (Appendix C). This is reported to HMRC on a Form CT61 on a quarterly basis when the royalty is paid.

Although this option is £50m cheaper, Novic Ltd still does not have enough cash, therefore the comments in relation to funding above still apply.

This option allows the consortium members to retain their shareholding in Novic Ltd which is expected to be highly profitable in 2025, however Novic Ltd now requires a cash injection in order to pay the royalty fee and to continue with its current project which will be funded by the consortium members. Consortium members can receive consortium relief for increased loss in Novic Ltd, this will be more beneficial to Alpha and Beta on projected future taxable profits.

Section C: Sale of Novic Ltd

Novic Ltd being sold for £300m generates a £210m gain for the consortium members (Appendix D) split as follows:

Alpha £80m

Beta £65m

Gamma £65m

(Appendix E)

Alpha qualifies for substantial shareholding exemption (SSE) and therefore the gain of £80m that Alpha makes from the sale of Novic Ltd is exempt as Alpha has held at least 10% shareholding for at least 12 months and Novic Ltd is a trading company.

Beta and Gamma do not qualify for SSE as they have not held at least 10% shareholding for at 12 months.

Beta will pay £12.35m corporation tax on its gain (Appendix F)

Gamma will pay £12.16m corporation tax on its gain (Appendix G)

The accounting period will continue and Novic Ltd will retain its VAT number and records. No VAT applies on the sale of shares. There is a potential asset degrouping charge, if the property was transferred into Novic Ltd by Alpha.

Novic Ltd will no longer be part of a consortium group with Alpha, Beta and Gamma, therefore the consortium members will no longer be able to take their share of Novic Ltd losses as consortium relief.

Biopharma Inc will be paying far in excess of the net assets of Novic Ltd, it is therefore paying for Novic Ltd current reserach and development and its potential for its project being a success.

As the current projected losses brought forward in Novic Ltd, before research and development claim adjustments will be £50m, Biopharma Inc will be able to offset future profits by this loss and reduce its tax payable. At current corporate tax rates this is worth £9.5m to Biopharma Inc (Appendix H). Biopharma Inc may be able to group relieve this to Biop Ltd which is UK resident company making £5m profit a year, and thus not pay corporation tax for 10 years based on current profit levels.

It is unlikely that Biopharma Inc will be caught by the major change in conduct or nature of trade rules, which is to prevent companies buying loss making companies to access their losses. This is because Biophamra Inc group is carrying on the same trade in the pharmaceutical business.

There has been no research and development relief taken into account in the financial statement or the tax computation. The rules allow for reserach and development claims to go back 2 years, therefore for year ended 31st December 2020 and 2021. There is additional tax lossses value in Novic Ltd, which the shareholders should recognise when agreeing the sale price. More information is required to determine the value of potential reserach and development claims.

Biopharma Inc will pay Stamp Duty Reserve Tax of £1.5m (Appendix K) on the £300m purchase of shares, however this does not affect Novic Ltd.

This option closes the matter on the intellectual property dispute with CHB Ltd, and provides more certainty for its shareholders in the event of its current project failing and resulting in a loss of investment, which would be a capital loss for its shareholders. To recognise the brought forward loss benefit to Biopharma Inc the selling price should be increased by £9.5m and more when considering research and development. It would be beneficial for Beta and Gamma to delay the sale until they have had ownership for at least 12 months in order to qualify for SSE which will exempt the gain.

Section D: Paying royalties for use of Intellectual Property, followed by sale of Novic Ltd

By paying CHB Ltd £100m to settle the intellectual property dispute and then selling Novic Ltd for £400m, the shareholders will receive the same net proceeds before tax and adjustments of £300m.

Biopharma will pay additional stamp duty reserve tax of £2m compared to £1.5m (Appendix J).

Alpha, Beta and Gamma will make greater chargeable gains presuming settling the £100m was funded by loans rather than equity. Alpha's gain will still be exempt, but Beta and Gamma will pay additional tax on the gain as follows (Appendix I):

Alpha - Exempt

Beta - £18.68m

Gamma - £18.3m

The consortium members are paying an additional £12.66m in corporation tax under this option.

Despite paying more stamp duty reserve tax, an advantage of this option for Biopharma Inc is that it will receive Novic Ltd with greater losses of £100m for settling the intellectual dispute which is worth £19m to them (Appendix B). The £100m will be a taxable receipt for CHB Ltd. Novic Ltd should agree a higher price to recognise the tax benefit of £19m for Biopharma Inc.

This option is similar to the above however it is not recommendeded as it results in the consortium members paying additional corporation tax on the sale of its shareholding in Novic Ltd, for the same net proceeds of selling directly to Biopharma without having to reach a settlement on the intellectual property dispute. There is also additional administration matters of needing to settle the intellectual property dispute and funding Novic Ltd via a loan.

Appendix A

Compensation	£150m		
CT rate 19%	£28.5m		

Appendix B

Royalty	£100m		
CT Rate 19%	£19m		

Appendix C

CT 61			
Royalty	£100m		
20% WHT	£20m		

Appendix D

	£				
Sale Proceeds	300m				
Equity Alpha	(20m)				
Equity Beta	(35m)				
Equity Gamma	(35m)				
Gain	210m				

Appendix E

	Alpha	Beta	Gamma		
Ownership	1/3	1/3	1/3		
Sale proceeds share	£100m	£100m	£100m		
Equity Investment	(£20m)	(£35m)	(£35m)		
Chargeable Gain	80m	65m	65m		

Appendix F

Beta	£		
Chargeable gain	65m		
CT at 19%	12.35m		

Appendix G

Gamma	£		
Chargeable gain	65m		
c/y trading loss	(1m)		
	64m		
CT at 19%	12.16m		

Appendix H

	£		
brought forward trading loss	50m		

CT at 19%	9.5m		

Appendix I

	Alpha	Beta	Gamma
Ownership share	1/3	1/3	1/3
Proceeds	£133.33m	£133.33m	£133.33m
Equity	(£20M)	(£35m)	(£35m)
Gain	£113.33m	£98.33m	£98.33m
c/y trading loss	0	0	(£2)
Chargeable gain	£113.3m	£98.33m	£96.33m
CT at 19%	SSE exempt	£18.68m	£18.3m

Appendix J

Shares	£400m		
Stamp Duty REserve Tax rate	0.5%		
Stamp Duty reserve tax	£2m		

Appendix K

Shares	£300m		
Stamp Duty Reserve Tax rate	0.5%		
Stamp Duty Reserve Tax	£1.5m		