The Chartered Tax Adviser Examination

November 2020

Application and Professional Skills

Taxation of Larger Companies and Groups

Suggested Solution

Burrey plc
Report concerning the acquisition of Stormback Ltd
X November 2020

Introduction

This report considers and advises on the tax consequences of the acquisition of Stormback Ltd.

The report is prepared for the sole use of Burrey plc. It is based on current legislation and if there are any delays in proceeding, further advice should be sought to ensure that there are no changes to legislation that could impact on the advice given.

Executive summary

The acquisition of Stormback Ltd should be made by Burrey plc and consideration for the acquisition should be in the form of an issue of new shares in Burrey plc to the shareholders of Stormback Ltd. This benefits the UK tax position of Burrey plc as it does not increase borrowings, which may lead to an amount of interest restriction. It also prevents an upfront capital gains tax liability arising on the existing shareholders of Stormback Ltd.

The acquisition of Stormback Ltd will result in the company's R&D expenditure having to be relieved under the R&D expenditure credit (RDEC) rules, instead of the more generous SME 'enhanced deduction' regime. This will reduce both the amount of qualifying R&D expenditure and amount of tax relief going forward.

To maximise the R&D claim on expenditure for the year ended 31 March 2021, we recommend that if acquisition is expected to be on or before 31 March 2021, an accounting period is ended on the day before acquisition. This would allow relief to be claimed under the SME regime, resulting in a higher level of qualifying expenditure and a greater amount of relief.

The brought forward losses in Stormback Ltd will be reduced as a result of the errors in its Company Tax returns. Penalties may also be charged. The directors of Stormback Ltd should make full and prompt disclosure to HMRC regarding the R&D expenditure and the loan documentation, in order to reduce the potential penalties.

After acquisition, we recommend setting up a Company Share Option Plan (CSOP) for the two key employees in Stormback Ltd that you wish to retain. This will ensure continued incentivisation, as well as providing tax benefits for both the employees, in the form of a potential tax-free uplift in the value of the shares, and the Burrey group, in the form of statutory deductions against trading profits.

Acquisition of the shares of Stormback Ltd

You have stated that you wish to acquire all of the share capital of Stormback Ltd, with the consideration in the form of cash or shares or a sensible alternative (including perhaps a combination thereof).

Using cash as consideration for the acquisition

An advantage of this approach for Burrey plc and its shareholders is that the acquisition would not dilute existing shareholdings. However, a disadvantage is that the acquisition would increase borrowings in the Burrey group. As there is currently little capacity in the UK for immediate tax relief on any additional interest expenses, the additional interest expense may be disallowed in whole or in part as a result of the Corporate Interest Restriction (CIR) rules. Further analysis would need to be undertaken to determine this.

Consideration in the form of cash would create capital gains tax liabilities in the hands of the shareholders of Stormback Ltd of up to 20% of the gain. Business asset disposal relief, a

relief available for individuals that reduces the tax rate on certain disposals of shares down to 10%, may not apply to the disposal of the shares in Stormback Ltd as the company has not been trading for at least two years (having started its trade on 1 March 2020). However, we would require further information in order to determine whether or not the shareholders would have the means of sheltering the gain, for example, by losses or reinvestment into qualifying assets.

Using shares in Burrey plc as consideration for the acquisition

The advantage to Burrey plc of this option is that there would be no immediate cash outflow in the group. It avoids the need for additional borrowing, the consequences of which are discussed above.

As cash consideration would result in a tax liability of up to 20% of the gain on disposal, the shareholders of Stormback Ltd may prefer to receive shares. If the acquisition is made by Burrey plc, then as the entire share capital of Stormback Ltd is being acquired, the shareholders would be treated as having made neither a disposal of their shares in Stormback Ltd nor an acquisition of shares in Burrey plc; instead the original shareholding and the new shareholding would be treated as the same asset and as having been acquired on the same date that the original holding was acquired. The existing shareholders would therefore not incur a capital gains tax liability as a result of the transaction, until the shares in Burrey plc are sold.

As well as avoiding an upfront tax liability, the directors will benefit from owning quoted shares in that they could control the timing of future disposals of the shares in order to manage future capital gains tax liabilities. A further advantage is that the directors would be immediately incentivised to a certain extent in relation to the group's operations, in addition to the effect of any separate share scheme that could be made available to them (see below).

Using QCBs as consideration for the acquisition

Although not referred to in the meeting notes, the consideration could also be in the form of qualifying corporate bonds (QCBs). Using QCBs is effectively issuing loan stock in Burrey plc at normal commercial rates to the shareholders of Stormback Ltd as consideration.

The benefit for the shareholders of Stormback Ltd of using QCBs, particularly over cash, is that although a chargeable gain would be calculated on the disposal of shares, the receipt of QCBs as consideration means that the gain would be 'frozen' and would only become payable as and when the shareholders dispose of the QCBs. Any gain on disposal of the QCBs would not itself be taxable on the shareholders.

From the perspective of the Burrey group, interest would be payable on the loan stock and so the issues over increased borrowings and the risks of a restriction under the CIR rules remain.

Other taxes

Based on consideration of £20 million, Burrey plc would incur a 0.5% Stamp Duty charge of £100,000 on acquisition of the shares. No VAT would be payable as the purchase of shares is exempt from VAT.

Recommendation

From the Burrey group's tax perspective, we recommend financing the acquisition through an issue of new shares in Burrey plc. This avoids the need for the Burrey group to take on additional borrowing, incurring additional interest expense, which may not be immediately relievable. It also prevents an immediate capital gains tax liability arising on the shareholders of Stormback Ltd, which could otherwise make the disposal less attractive.

We further recommend that discussion be held with the shareholders of Stormback Ltd to understand their preferences in terms of cash, shares and loan notes (QCBs), or a mixture thereof, so that a mutually beneficial solution can be found.

Research and development

As Stormback Ltd has fewer than 250 employees and has not yet recognised any turnover, it falls within the R&D relief regime for small and medium sized companies (SMEs). This allows an enhanced deduction for qualifying R&D expenditure to be claimed by the company with the result that the total trading deduction allowed is equal to 230% of the company's qualifying R&D expenditure for the period. The first R&D claim has been submitted in the company's first return after commencement of trade (i.e. the one-month period ended 31 March 2020). The claim covers all expenditure incurred since the company first began its activities, as under the normal rules for pre-trading expenditure all pre-trading expenditure incurred in the seven years before commencement of trade is deemed to have been incurred on the first day of trading, i.e. 1 March 2020.

It is the clear from the information provided that 100% of the R&D expenditure incurred up to 31 March 2020 has been treated as qualifying for relief. This is incorrect, and the impact of this is discussed below in relation to the HMRC enquiry.

The forecast tax result for the year ended 31 March 2021 is based on the same error but the position for that period is made more complicated by the proposed acquisition.

If the acquisition takes place before 31 March 2021, this will affect Stormback Ltd's R&D claim for the whole of that accounting period. Although Stormback Ltd is an SME at the moment, it will cease to be an SME for the whole of the accounting period in which it is acquired by the Burrey group, as its turnover and balance sheet totals and employee numbers for that period must be taken together with those of the Burrey group.

This will mean that the only R&D relief available to Stormback Ltd in this period is the R&D expenditure credit (RDEC). This is a taxable credit, calculated at 12% of qualifying R&D expenditure, which is used to discharge the company's tax liability or is paid to the company. Additionally, the company will no longer be able to claim R&D relief for the work subcontracted to other companies.

Under the SME regime, the company is forecast to have a current period trading loss of approximately £2.1 million (Appendix 1). Assuming there are sufficient future profits against which to utilise this trading loss, these losses have a potential value of up to £399,000 (£2.1 million at 19%).

Under the large company regime, however, the company is forecast to have a taxable profit of £125,000, together with an RDEC of approximately £155,000 (Appendix 1). The RDEC would be used to discharge the tax liability of £23,750 (£125,000 at 19%) and the balance of £131,250 could be paid to the company. Overall, this is a reduction in benefit of £267,750, depending on how quickly the losses would have been utilised.

If you anticipate using the losses quickly, it would be worthwhile structuring the acquisition in a way that allows the R&D expenditure incurred prior to acquisition to be relieved under the more generous SME rules. If the acquisition were planned for after 31 March 2021 then the R&D claim for that year would be entirely within the SME regime. However, if acquisition is planned for earlier than 31 March 2021, then the most effective solution would be for Stormback Ltd to end an accounting period on the day before acquisition; this would have to be done by drawing up statutory accounts to this date. In this way, there would be a complete accounting period in which the company is an SME for the whole of the period, again allowing the R&D expenditure for that period to be relieved under the SME rules.

Changing the period of account would need the agreement of the current shareholders, and may incur additional fees, and you will need to determine whether these are outweighed by the potential maximum benefit of £267,750.

HMRC enquiries

HMRC have raised an enquiry into two areas of Stormback Ltd's Company Tax return for the one-month ended 31 March 2020. Any changes made as a result of the enquiry are likely to reduce the brought forward trading losses on acquisition.

R&D expenditure

The return for this period contains the company's first R&D claim. The tax history suggests that no deduction has been claimed for the R&D expenditure in a previous return.

It appears that the R&D claim that has been submitted has assumed that all R&D expenditure charged to the income statement qualified in full under the R&D rules. This is not correct, as only 65% of expenditure on externally provided workers and subcontractor payments can qualify for the R&D scheme. Additionally, it may be the case that not all of the staff costs are directly and actively (in whole or in part) attributable to the R&D work, but we would need more information to be able to quantify that.

As shown in Appendix 2, the impact of this error is a reduction in trading losses of approximately £1.1 million. It is likely that given the size of the error, HMRC will seek to impose a penalty on the grounds that the error was careless. As the accounts manager responsible for completing and submitting the return has now left, it is difficult to say whether they could argue that the error was in fact deliberate.

The penalty would be based on the 'potential lost revenue', which for a wholly unused loss is calculated at 10% of the error, i.e. £109,200. If the error is deemed to be careless then the maximum penalty is 30% of the potential lost revenue, i.e. £32,760. This could be halved if the company gives full but prompted disclosure of information.

If HMRC decides that the error was deliberate, the maximum penalty would increase to 70% of the potential lost revenue, i.e. £76,440. Again, this could be halved to £38,220 if Stormback Ltd gives full disclosure of information.

Loan relationship debits

The potentially applicable anti-avoidance legislation here relates to a loan having an 'unallowable purpose' and the discounting of the interest-free loan. Transfer pricing legislation is not relevant here as the bank loan is an unconnected third-party loan and the interest-free loan is from an individual, one of the shareholder/directors, to whom the transfer pricing legislation does not apply.

A loan has an unallowable purpose if the reason for the loan is not among the business or other commercial purposes of the company. For Stormback Ltd, there are strong commercial reasons for the initial bank loan, as no R&D work could have been carried out without it. There are also commercial reasons behind the subsequent interest-free loan, as cumulative expenditure had exceeded the amount of the initial loan.

It would therefore be unlikely that HMRC could successfully argue that either loan had an unallowable purpose.

However, there is an additional restriction that applies to the interest-free loan made by Leslie Dry on 1 April 2019 (a shareholder in the company). Stormback Ltd, as debtor, is claiming a deduction for notional financing charges under FRS 102 in respect of the unwinding of the discount in relation to the loan. However, Leslie Dry, the creditor, is not being taxed under the loan relationship rules on the credit corresponding to the notional financing charges recognised by Stormback Ltd (because the loan relationship rules do not apply to individuals). In this asymmetric situation, relief for the debit will be denied.

Once HMRC become aware of the situation, they are likely to enquire into the return for the period ended 29 February 2020 as this also includes a deduction for the discount, as part of a non-trading loan relationship deficit (NTLRD). The penalty is £5,000, being 10% of the total ‘potential lost revenue’, that is 10% of the £50,000 annual notional financing charge in relation to the unwinding of the discount (i.e. £800,000 - £650,000 = £150,000, spread over three years). The penalty may again be increased for carelessness, but the amount of the increase will be insignificant.

Recommendation

We recommend that full and prompt disclosure be made to HMRC regarding the R&D expenditure and the loan documentation. If Stormback Ltd is acquired, the Burrey group will take on the tax history of the company, which will include the enquiries and liabilities to any penalties.

We also recommend that a specific indemnity is included in the sale and purchase agreement for the potential penalties, or that the penalties are taken account of in adjusting the consideration for the shares.

Brought forward losses

As at 31 March 2020 and after correcting for the errors identified above, Stormback Ltd should have a trading loss carried forward of £14.2 million and a NTLRD carried forward of £1.5 million (Appendix 3). £122,500 of the NTLRD is a pre-April-2017 loss and so can only be utilised against future non-trading profits arising in the company. The other losses can be used against any future profits. The trading loss will be augmented by the £2.1 million loss arising in the period to 31 March 2021 (see Appendix 1) if, as recommended above, the acquisition of Stormback Ltd is timed so that it can take advantage of R&D relief for SMEs.

The trading losses are subject to the ‘change in company ownership’ provisions. These apply if, within the period starting three years before the acquisition and ending five years after the acquisition, there is a major change in the nature or conduct of the trade. If these provisions apply, the trading losses would not be available after the acquisition.

Whether or not a major change has occurred can be subjective and you would need to consider the impact of all changes made to the running of the business both before and after acquisition. If the changes, when taken together, do not constitute a major change, the trading losses should be available in full for offset against future profits arising in Stormback Ltd, subject to the fact that the maximum loss offset for each period is the company’s allocated group deductions allowance plus 50% of any profits in excess of the deductions allowance.

The commencement of trade on 1 March 2020 should not in itself constitute a ‘major change’ in the trade.

Retention of key personnel

You have identified two key employees that you wish to retain, Alicia Addams and Ben Brittany. These employees currently hold unapproved share options that will vest on 1 January 2023. If the options are exercised, this would dilute the Burrey group’s shareholding in Stormback Ltd so that Stormback Ltd would no longer be a wholly owned subsidiary. Additionally, as the options are unapproved, the employees would suffer an Income Tax charge on the difference between market value of the shares at the date of exercise and the amount, if any, paid to exercise the options.

To avoid this potential future dilution, you would need to cancel the options, or agree with the employees for them to release or surrender them, which may reduce the chance of retaining the employees after the acquisition. Any amounts the company may pay to the employees in consequence of the cancellation or release is likely to be taxable on the employees as employment income.

In order to ensure on-going incentivisation, we suggest you agree with the two employees that in exchange for them releasing their options, they acquire new, approved share options in Burrey plc. Note that depending on the terms of the options, you may need to provide an additional element of financial compensation for giving up the existing options (although again this will be taxable as their employment income). As well as preventing the dilution of the shareholding in Stormback Ltd, using an approved share scheme provides a tax benefit for the employees as there would no longer be an Income Tax charge on exercise of the options.

There are a number of approved share and share option schemes, but of the schemes available, we would recommend using a Company Share Option Plan ('CSOP'). Unlike other schemes such as a Share Incentive Plan or a 'Save As You Earn' scheme, which must be offered to all employees, a CSOP allows a company to grant share options to selected employees. EMI options cannot be used as the Burrey group is too large, its total gross assets exceeding £30 million.

For Corporation Tax purposes, Burrey plc would be entitled to a deduction against taxable profits for the costs incurred in setting up the scheme and for on-going incidental running costs. There are no tax consequences as a result of granting the options, but a statutory deduction is available when the options are exercised, equal to the market value of the shares at date of acquisition less any amounts paid by the employee. This statutory deduction is allowed instead of the actual amounts posted to the income statement in respect of the share scheme (other than the incidental running costs noted above), which are not tax-deductible.

Appendix 1 – Forecast tax position for the year ended 31 March 2021

R&D claim and Corporation Tax calculation under the large company regime for the year ended 31 March 2021:

	£'000
Consumables	500
Staff costs	600
Subcontracted work (note 1)	-
Externally provided workers (note 1)	195
Total qualifying R&D expenditure	1,295
R&D expenditure credit at 12% (rounded)	155

Corporation Tax calculation:

	£'000
Estimated trading loss	(2,500)
Add back enhanced deduction (£1.9 million x 130%)	2,470
Add on taxable RDEC	155
Corrected estimated trading profit	125

Tax liability at 19% = £23,750.

R&D claim and Corporation Tax calculation under the SME regime for the year ended 31 March 2021:

	£'000
Consumables	500
Staff costs	600
Subcontracted work (note 2)	325
Externally provided workers (note 2)	195
Total qualifying R&D expenditure	1,620
R&D uplift at 130%	2,106

Corporation Tax calculation:

	£'000
Estimated trading loss	(2,500)
Add back overstated enhanced deduction	2,470
Deduct actual enhanced deduction	(2,106)
Corrected estimated trading loss	(2,136)

Notes

1) Under the large company RDEC regime, expenditure on work subcontracted to other companies does not constitute qualifying R&D expenditure incurred by the company that contracts out the work (i.e. Stormback Ltd), and only 65% of the expenditure on externally provided workers is treated as qualifying expenditure.

2) Under the SME regime, only 65% of the expenditure on subcontracted work and externally provided workers is treated as qualifying expenditure.

Appendix 2 – R&D calculation for the period ended 31 March 2020

Qualifying expenditure incurred from incorporation up to 31 March 2020:

	£'000
Consumables	1,600
Staff costs	2,000
Subcontracted work (note 1)	975
Externally provided workers (note 1)	585
Total qualifying R&D expenditure	5,160
R&D uplift at 130%	6,708

	£'000
R&D deduction claimed in return (£6 million x 130%)	7,800
R&D deduction actually claimable	(6,708)
Reduction in losses	1,092

<u>Notes</u>

1) Only 65% of the expenditure on subcontracted work and externally provided workers is treated as qualifying expenditure.

Appendix 3 – Loss position at 31 March 2020 (after adjusting for errors)

Trading loss:

	£
Reported loss for month to 31 March 2020	15,300,000
Reduction in R&D enhanced deduction	(1,092,000)
Remove deduction for discount on interest-free loan [(£800,000 - £650,000)/3 x 1/12]	(4,167)
Trading loss carried forward as at 31 March 2020	14,203,833

Non-trading deficit (interest at 7% on bank loan of £7 million):

	£
Three months to 31 March 2017	122,500
Year to 31 March 2018	490,000
Year to 31 March 2019	490,000
Eleven months to 29 February 2020	449,167
Non-trading deficit carried forward as at 31 March 2020	1,551,667