Application and Professional Skills

Chartered Institute of Taxation
Excellence in Taxation

Taxation of Larger Companies and Groups

(Ensure this number matches your candidate number on your desk label and on your candidate attendance form)

LON	Centre Code
06112019	Date of Examination

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Instructions

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DRAFT REPORT

To: Jenny Jorkins
From: Bruce Ballymore at DS&Z (UK) LLP
DATE: 6 November 2019
Subject: Structure of potential acquisition of Danbridge Ltd's business.

This report is based on information provided to us by you. No liability will arise from reliance on this report by a third party. The law is correct as at time of writing.

Scope

You have asked us to prepare a report on the best way to structure an acquisition of Danbridge's Ltd's business. This is to be in the form of a trade and asset sale or a share sale. ~~as~~

Executive Summary

Chanman Europe Ltd ('Chanman Europe') is setting up a new subsidiary Chanman Retail Ltd ('Chanman Retail') to enact either a share acquisition or a trade and asset acquisition of Danbridges Ltd ('Danbridges')

Trade and asset

This structure would be ideal to ensure any liabilities, particularly the ongoing HMRC enquiry, are left behind in Danbridges. However, losses are not able to be transferred with a trade and asset sale meaning the £72m trade losses and £12 capital losses would be left behind.

Share sale

Acquiring the entire share capital of Danbridges would bring it into the Chanman Europe group relief group. The losses would stay in Danbridges but could be group relieved after 5 years depending on if there has been a major change in the nature of conduct of the trade. However, warranties and indemnities should be sought from Dangroup AB over the potential transfer pricing adjustment arising from HMRC's enquiry.

Hive up

~~Fo~~ If Chanman Retail undertook a ~~hive up of assets~~ share acquisition, it could be followed up by a hive-up of

the trade and assets to Chanman Retail. *
Consideration would have to be given as to any liabilities left behind in Danbridges ~~but the losses~~ for the use of losses. This would mitigate any gains on disposal again and could result in capital loss in Chanman Retail if Danbridges was then liquidated.

Recommendation

This is ultimately a commercial decision but based on tax consequences a share sale would be advised. If this could be followed by a hive up of assets then the goal of Chanman Retail to buy the trade and assets and make use of the losses could be realised.

* There would not be any tax charges arising from this.

1. <u>Acquisition of trade and assets</u>

An acquisition of Danbridges trade and assets would mean leaving the liabilities behind and anything that Chanman Retail ~~were~~ was not interested in purchasing.

This would be advantageous as there is an open enquiry into the transfer pricing policies of Danbridges. Whilst the outcome would likely result in a ~~a~~ transfer pricing adjustment in Danbridges favour (as it paid too much for purchases), there are other negative connotations and consequences of having an open HMRC enquiry which Chanman Retail would not want.

<u>Losses</u>

As the companies are not connected, the losses would be stranded in Danbridges ~~comp~~ and could not be transferred to Chanman Retail.

<u>Future disposal</u>

If ~~the~~ Chanman Retail decided to dispose of unoccupied and poorly performing stores then a chargeable gain would arise. Based on current valuations, the disposal of the unoccupied buildings alone would realise a gain of (5 stores × £400,000 gain) £2m. This could only be mitigated by way of rollover relief if Chanman Retail purchased further stores in 12 month prior or 36 month after disposal. Otherwise, it would be chargeable.

Deductibility of costs

All costs paid for Danbridges business would be deductible either through adjustment to trading profit or against the gain on future disposal of chargeable assets.

Value of company

Based on current market values, ~~the~~ ~~comp~~ Danbridges is worth £21.4m (Appendix 2.1). This is higher than the value of the shares as the liabilities can be left behind.

It should be noted that as the goodwill is being purchased after 8 July 2015, no deduction for amortisation can be claimed.

Other taxes

If ~~the~~ Danbridges is treated as a transfer of a going concern then the acquisition is outside the scope for VAT. If just the properties are sold then as no option to tax has been made by either side then ~~VA~~ the sale of buildings is exempt.

Stamp duty land tax will be payable on transfer of chargeable assets. This will be in the region of £2.94m (Appendix 1.2)

Recommendation

Commercially, it would be advisable to leave all liabilities relating to a potential HMRC enquiry behind. However as Chanman Retail is interested in obtaining the losses of Danbridges, a trade and asset sale would not allow this.

Furthermore there are potential gains on disposal from the sale of unwanted stores which it would be defficult to mitigate.

If a trade and asset sale had to be undertaken, we would recommend negotiating with the vendor to dispose of the unwanted stores prior to the sale.

2. Acquisition ~~Transfer~~ of Shares

If Chanman Retail purchases the share capital of Danbridges then they will acquire all of the assets and liabilities of the company. This could include any unforeseen liabilities arising from the HMRC enquiry.

Losses

On acquisition of share capital, the losses will transfer with Danbridges. Danbridges will also become a member of the Chanman Europe group relief and capital gains group as Chanman Europe will have over a 75% effective holding in Danbridges.

There are restrictions on the use of the losses, however.

Pre-April 2017 losses

~~These losses~~ The ~~£7.5m~~ 4.5m of trading losses ~~arising in the year~~ brought forward at 31 December 2018 will have to be split between those arising pre and post April 17. Those arising pre will only be able to offset profits of the same trade in the future. No group relief is available.

Post-April 2017 losses

The rest of the £45m trading losses and the £27m arising in the year to 31 December 2019 will be able to utilised against any profits of the company.

They may also potentially be able to be group relieved after a period of 5 years from the change in ownership.

Capital losses

These can only be used on disposal of chargeable assets owned by Danbridges at time of transfer.

Further restriction

There are also rules surrounding a major change in the nature or conduct of a trade where there has been a change of ownership. If this happens 5 years after the change in ownership, the brought forward losses could be extinguished. This can be if a small or negligable trade is revitalised or if there are large changes to the way the company does business. ~~Whd~~

Whilst Danbridges is heavily loss making its trade is not neglible. However Chanman Retail should be careful not to make too many changes. ~~HMT~~ Guidance states that rationalisation is not in of itself a major change but changes should be monitored to ensure ~~the~~ a major change + see end of report does not occur (these can be small changes that accumulate into a major change).

Disposals

As discussed above, a £2m gain on disposal would arise if the unoccupied properties were sold.

As capital losses transfer, these could be used to offset the gain as they arise in Danbridges and relate to assets existing and held at time of ~~transfer~~ sale. Given the large amount of losses this would likely cover the disposal of all unprofitable stores.

Deductibility of costs

The~~se~~ costs associated with the share purchase would not be deductible as they are capital. Given the comany is in a net liability the value of the shares will be in the region of £10m (£2m for capital and £8m for premium).

Other taxes

No VAT is payable as shares are exempt.

Stamp duty would be payable at 0.5% consideration. If £10m is paid then this would be £50,000.

Recommendation

This would allow Chanman Retail use of losses but there would be restriction around their use. Chanman Retail would have to carefully monitor changes to ensure no major change in nature or conduct of trade.

If a share sale is implemented, we recommend getting suitable warranties and indemnities to cover the potential transfer pricing liability that may arise from HMRC's enquiry.

We would also recommend bringing Danbridges into the Chanman Europe VAT group as soon as possible.

Acquiring the shares could also mean that the substantial shareholding exemption should apply (if held longer than 12 months), meaning no gain would arise on sale.

③ An alternative - Hive up.

An extension and possible solution to the fact that Chanman Retail wants to purchase the trade and assets but retain the losses would be a hive up.

This would involve the share purchase as described above but ~~also~~ would be followed by a trade + asset hive up to Chanman Retail.

Succession

Special rules apply when two companies are 75% connected and transfer the trade to ensure no tax consequences.

An accounting period would end in Danbridges.

Plant and machinery would transfer at tax written down value (this would be price allocated in share sale assuming this hive up happens soon after the share sale).

Stock would transfer at market value (41.4m) unless Danbridge and Chanman Retail elected for it to transfer at cost (again this would price elected to it).

Chargeable assets and the intangibles

would transfer at no gain no loss / tax neutral basis as both companies are in a gains group.

Most importantly, trade losses transfer with the trade so Chanman Retail could utilise them. The restrictions on group relief would still apply for a period of 5 years.

There would also be a limit on the amount of losses transferred based on the liabilities left behind. * see end of report ~~Based on the current forecasts, Chanman Retail could still utilise £68m (Appendix 2).~~

Capital losses cannot transfer with a succession but if Danbridges sells the unwanted properties, it can use the capital losses against the gains.

Once the unwanted stores are disposed of, then Chanman Retail could look to liquidate Danbridges. This won't be an exempt disposal as Chanman has not held the shares for 12 months but ~~will~~ could result in a capital loss which could potentially be used at a later date if left over liabilities are higher than any left over assets.

Other taxes

VAT will not apply as long as Danbridges is brought into the Chanman Europe VAT group.

~~As SDLT~~ SDLT will not be payable on any stores hived up as both companies are in an SDLT group relief group.

Recommendation

A Hive up would allow Chanman Retail to acheive their objective of acquiring the tax losses without holding onto the shares of Danbridges. Consideration would have to be given to the amount of liabilities left behind but if the main concern is ~~the~~ HMRC enquiry, this liability has not been quantified and therefore should not restrict losses.

Furthermore, if the properties to be disposed of are left in Danbridges, then the capital loss can be utilised to reduce any gain.

* The amount of losses are restricted to the amount of liabilities left in the company exceeding assets left behind. We would need to look into this in more detail if this route was undertaken to understand ~~if~~ the value of any unwanted and unoccupied stores was greater than any liabilities (including potential results of the HMRC enquiry). This would ensure all trade losses could be transferred.

† A major change is usually one that represents changes to product lines (not rationalisation of unprofitable ones), a change in customer base or a change in markets.

Appendix 1.1 - Value of trade and assets

MV of properties	
20 x £1m	
60 x £650k	59m
Intangible assets	8m
inventory	
£36m x 1.15	41.4m
Trade receivables	10m
Liabilities	(97m)
Total value	21.4m

Appendix 1.2 → SDLT payable of properties

MV of properties		£59m
0 - 150,000	@ 0%	0
~~150,001 - 250~~ 100,000	@ 2%	2000
58.75m	@ 5%	2,937,500
	Total SDLT	2,939,500

Plan

Scope

ES

Purchase of shares.

→ purchase all company. Pay £5m being price of shares less net assets.

→ ~~B~~ come into group relief + gains group.

→ NGNL transfer.

→ use trade losses. Capital losses can only be used by D on assets owned before transfer. This could be used to offset disposal gain. 5 × 400,000

→ purchase potential liabilities

→ group relieve for 5 years

→ MCINOCOT → 5 years after transfer extinguish b/f losses. Rationalisation okay but keep an eye on.

→ SSE on future disposal

→ costs non-deductible

→ SD on share price.

→ bring into VAT group

→ VAT ~~ext~~ exempt on shares

SWS

(c) Purchase of trade and assets
Leave liabilities behind
~~but losses limited by amount of trade left.~~
Pick and choose.
Intangible = £11m → no deduction for amortisation.
~~PPE~~ → Property at ~~NBV~~. 80 properties
→ pay the gain = 400,000 × 20
→ SDLT on acquisition
→ losses left behind can't transfer.
→ VAT → exempt as on old buildings.

(3) Transfer of Shares then hive up.
limit amount of losses by liabilities
but can take the trade + assets and then
by £5m. liquidate the third company.
Succession rules.
Can't transfer capital losses but dispose
of properties prior to hive up. NGNL.
IFAs would be tax neutral
Still won't be able to group relief for 5 yrs.

no SDLT as intergroup.

ES - Chanman Retail

1. T+A

→ losses stay behind but leave liability

→ net assets = £28m MV = 20 × 1m + 60 × 650k

59m + 8m + 41.4 + 10 - 97 = 21.4m 20m = 59m 39m

→ disposal of unoccupied buildings alone would realise a gain of £5 × 400,000.

→ deduction on purchase costs

→ SDLT

2. Shares VAT

£10m → all ~~£0~~ company liabilities → WEI

→ restricted use of losses MCNOCOT 5yr SR

→ no DGC.

→ same disposal on buildings but capital losses can set these off as owned before transfer.

→ no deduction on costs SD.

3. Hive up.

→ Succession rules. → brought into VAT group

→ losses limited by liabilities left behind £5m.

→ possible liquidation → SSE but only if held for 12m although capital loss would arise offset.

SDLT

Appendix 2.1 → restriction of losses transferred.

losses are restricted by amount of liabilities left behind. This the amount that the liabilities exceed the assets.
Based on FY19 forecasts, this is £92m - £97m = £5m.