The Chartered Institute of Taxation

Application and Professional Skills

Taxation of Larger Companies and Groups

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Suggested solution

REPORT TO BAFFIN HOOD PLC

ACQUISITION OF BENEKE ORR LTD AND M&D GARAGES

Introduction

This report considers and advises on the UK tax consequences of the acquisitions of Beneke Orr Ltd and M&D Garages.

The report is prepared for the sole use of Baffin Hood 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.

Langston Adams LLP
November 2022

Executive summary

The consideration for Baffin Hood plc's acquisition of the shares of Beneke Orr Ltd could be in the form of cash, loan notes or an issue of Baffin Hood plc shares.

Bearing in mind the interest costs and effect of the Corporate Interest Restriction (CIR) legislation on the tax deductibility of those costs, we would recommend a share exchange, but this might not be acceptable to the current majority shareholders if the dilution of shareholding results in a loss of control.

Cash consideration financed by bank borrowing at a 4% interest rate would be the next best option for Baffin Hood plc, but the vendors might prefer consideration through an issue of loan notes at a 7% interest rate over cash, given the potential capital gains tax advantage.

The brought forward losses in Beneke Orr Ltd should be available to utilise against the future profits of the company subject to ensuring that the change in company ownership provisions do not apply.

The trade and assets of Beneke Orr Ltd could be transferred to Baffin UK Ltd when acquired but to do so may carry the risk of being not able to utilise the losses.

Regarding the structuring of the acquisition of M&D Garages, there are three options: (1) set up an Irish resident company as a subsidiary of Baffin Hood plc; (2) make M&D Garages a permanent establishment (PE) of Baffin UK Ltd; or (3) make M&D Garages a PE of a new UK resident company.

Overall, we recommend option 3. This would make effective use of the early year losses with the least compliance costs and creates the option to elect for any profits of the PE to be exempt from UK tax at a later appropriate time.

<u>Acquiring the shares of Beneke Orr Ltd</u>

Baffin Hood plc will purchase all of the share capital of Beneke Orr Ltd, with the consideration in the form of either cash, loan notes or an issue of new shares in Baffin Hood plc to the shareholders of Beneke Orr Ltd.

In terms of borrowing costs, the cheapest option would be a share exchange, followed by a bank borrowing at an interest rate of 4%, followed by an issue of loan notes at an interest rate of 7%.

Dilution of existing shareholdings

The purchase price of £25 million would be met by an issue of 4 million shares at £6.25. Simon Green and his family currently hold 80% of the 50 million issued £1 shares which is 40 million. If the consideration is met by the issue of shares, then the family will hold 40 million of the 54 million shares which is around 74%.

This is a significant change as the minority shareholders would be in a position to oppose any special resolutions the family wished to make.

However, given that the vendors of Beneke Orr Ltd have indicated that they would not wish to take an active part in the conduct of the business, and would be content to just receive dividend income and that it would require almost all the minority shareholders to act together, the family may not consider this to be a realistic risk.

Position of the vendors

The current shareholders of Beneke Orr Ltd, the vendors, have indicated a preference for loan notes over cash consideration. It is likely that the capital gains tax position of the vendors is as follows:

Consideration for shares of Beneke Orr Ltd	**Possible capital gains tax position of vendors**
Cash	Immediate capital gains tax payable on the disposal of shares.
Loan notes	The receipt of loan stock would be qualifying corporate bonds (QCB) and as such, any capital gain calculated on the disposal of the shares would be ‘frozen’ and only become payable as and when the QCBs are disposed of.
Share exchange	As the entire share capital of Beneke Orr Ltd is being acquired by Baffin Hood plc, the vendors would be treated as having made neither a disposal of their shares in Beneke Orr Ltd nor an acquisition of shares in Baffin Hood plc. 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. As the Baffin Hood plc shares are quoted, the vendors can control the timing of future disposals of the shares in order to manage future capital gains tax liabilities.

Therefore, from a tax perspective, loan notes or shares will give the vendors flexibility as to when any capital gains tax liability arises which may have advantages particularly with Business Asset Disposal Relief.

Impact on the corporate interest restriction position

Given the corporate interest restriction (CIR) position of the group, any additional interest costs, whether through loan notes or bank borrowings, would be disallowed. However, given the additional expected tax-EBITDA from the Beneke Orr Ltd business, it may be possible to reactivate any restricted interest by year four.

The CIR is calculated by comparing the interest capacity for a period of account to the net tax-interest expense. Should the effect of the acquisition result in the interest capacity being greater than the net tax-interest expense for the period, the 'excess' amount can be used to reactivate previously disallowed amounts and claim them in the period. Therefore, the effect can be identified without reference to the full details of the group's position.

The acquisition will affect both the interest capacity and the net tax-interest expense as follows:

Interest capacity

Year	Increase in tax-EBITDA per performance forecast	Increase in interest capacity 30% of tax-EBITDA
	£million	£million
2023	1	0.3
2024	7	2.1
2025	15	4.5
2026	17	5.1

Net tax-interest expense

Shares		£nil
Bank loan	4% of £25 million	£1 million per annum increase
Loan notes	7% of £25 million	£1.75 million per annum increase

Comparison of each type of consideration over the four years

Increase in interest capacity less increase in tax-interest expense:

Year	Shares	Bank loan	Loan notes
	£million	£million	£million
2023	0.3	0.3 – 1 = (0.7)	0.3 – 1.75 = (1.45)
2024	2.1	2.1 – 1 = 1.1	2.1 – 1.75 = 0.35
2025	4.5	4.5 – 1 = 3.5	4.5 – 1.75 = 2.75
2026	5.1	5.1 – 1 = 4.1	5.1 – 1.75 = 3.35
Total	12	8	5

Thus, overall, even if the consideration is by way of loan notes, the impact of the acquisition of Beneke Orr Ltd should have a positive impact on the CIR position of the group.

Overall conclusion

The best option for Baffin Hood plc would be a share exchange in terms of interest costs and the impact on the CIR position. If a share exchange is not acceptable to the current majority shareholders, the next best option for Baffin Hood plc would be cash consideration financed by a bank borrowing. However, this could be the least preferred option for the vendors, although without knowing more about their personal circumstances it is not clear precisely what impact it may have for them, particularly if Business Asset Disposal Relief is available.

Using Beneke Orr Ltd's losses

As at 31 December 2022, Beneke Orr Ltd should have trading losses carried forward of £10 million. None of these losses are pre-April 2017 and so they can be used to set against any taxable total profits generated by the company subject to the comments below.

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 Beneke Orr Ltd.

If Beneke Orr Ltd already operates in much the same way as Baffin UK Ltd, and there is no need for fundamental change to assimilate it, the loss relief restrictions mentioned above are unlikely to apply. However, the turnaround in results, when realised, may lead to an enquiry by HMRC. We recommend retaining documentation so in the event of an enquiry, the company is able to satisfy HMRC that there has not been such a major change.

The maximum loss offset for each period may be restricted in certain circumstances. The use of losses brought forward can be limited. Effectively if the profits against which they are claimed are less than £5 million (the deductions allowance) then relief can be claimed against all the profits. Where the deduction allowance is exceeded, only up to 50 percent of any additional profits can be claimed.

The brought forward losses will be ring fenced for five years following the acquisition and can only be used against the profits of Beneke Orr Ltd (i.e. they cannot be surrendered as group relief to Baffin UK Ltd). The forecast results would suggest that the losses will be utilised well before the five-year point as further explained below.

On assumption that the taxable profits are similar to the EBIT figures in the performance forecasts (which broadly means that accounting depreciation is similar to tax capital allowances), the £1 million profit in year two can be relieved by the losses brought forward. The forecast loss in the first year may be surrendered as group relief.

In year three, the projected profits are £9 million. The maximum amount that can be claimed is the deduction allowance of £5 million plus 50% of the remainder, which is £2 million, totalling £7 million. This will leave £2 million as taxable profit.

The £2 million balance of unused losses remaining (that is £10 million brought forward less £1 million in year two and £7 million in year three) can be fully utilised against the £11 million profit in year four.

Summary of losses position

Year	Estimated taxable profits/(losses) £million	Utilisation of losses £million	Beneke Orr Ltd losses balance £million
2023	(5)	To surrender as group relief	10 brought forward
2024	1	1	9
2025	9	7	2
2026	11	2	0

Since your current group strategy is for all UK trading activity to be conducted through Baffin UK Ltd, you may wish to consider transferring the trade and assets from Beneke Orr Ltd to Baffin UK Ltd. Were the trade of Beneke Orr Ltd to be transferred before the losses were utilised, it may be possible to stream the losses against the proportion of profits applicable to that company. However, there is some uncertainty about this, and considerable additional compliance work is involved.

Therefore, we would only recommend that you do this only once all the losses have been utilised.

You should also ensure that no major changes are made to the nature of the Beneke Orr Ltd trade until the losses have been used. If any changes are contemplated, you should contact us so that we can consider whether they may affect the loss relief.

Structuring the acquisition of M&D Garages

There are three options for integrating the M&D Garages business into the Baffin Hood group:

1. Set up an Irish Newco, an Irish resident company as a subsidiary of Baffin Hood plc;
2. Make M&D Garages a permanent establishment (PE) of Baffin UK Ltd; or
3. Make M&D Garages a PE of UK Newco, a UK resident company.

1. Set up Irish Newco

Baffin Hood plc could incorporate a wholly owned subsidiary company in Ireland, Irish Newco, and acquire the trade and assets of M&D Garages through that company. It would be preferable to finance this company by an injection of equity rather than an intra group loan as the interest receivable would be taxed in the UK and the interest payable relievable in Ireland. This would increase tax in the current period in the UK while only increasing losses in Ireland.

Although any losses incurred by Irish Newco would not be available to surrender to the UK group companies, they might be available to be carried forward against the projected profits of Irish Newco. Advice should be taken on this matter in Ireland.

As well as being incorporated in Ireland, Irish Newco would also need to be centrally managed and controlled in Ireland rather than the UK so that it would not be subject to UK Corporation Tax. The advantage of this is that the Corporation Tax rate in Ireland is lower than the Corporation Tax rate in the UK. If Irish Newco were subject to UK Corporation Tax, double tax relief for any Irish tax paid should be available.

Where the central management and control is exercised is a question of fact, and the group would need to ensure that all key decisions regarding the management of Irish Newco takes place in Ireland. The directors of Irish Newco would need to have autonomy in their decision-making and should ensure that they discuss and record in board meetings or other contemporaneous records the rationale behind their decisions so it is clear that they have not simply rubber stamped any decisions made by a UK parent company. Although the directors of the UK parent company can have influence over the decisions, they should not usurp the authority of the Irish directors.

Should the facts support the case that the company is actually centrally managed and controlled in the UK, it will be resident for tax purposes in the UK, but also tax resident in Ireland by virtue of incorporation. The issue will need to be resolved by the Competent Authorities of each jurisdiction. The additional compliance work involved would be a disadvantage as well as the additional UK Corporation Tax payable if the company were found to be UK tax resident.

If Irish Newco is not tax resident in the UK, it would fall within the definition of a controlled foreign company (CFC) of its UK parent company. Under the UK CFC legislation, profits of foreign companies can be attributed to and taxed in the UK, for UK tax purposes. But the trading status of Irish Newco means that is it unlikely that any of its profits would be attributable to, or be taxable in the UK.

2. <u>M&D Garages as a PE of Baffin UK Ltd</u>

This option would result in Baffin UK Ltd having a PE in Ireland with the funds required to acquire the assets being raised by way of a bank loan. A PE is not a separate entity in its own right but is part of a company resident in another territory, in this case the UK. PE profits are taxable in both the home country as well as the country of corporate ownership, therefore any profits arising from the Irish PE would be taxable in both Ireland and the UK. The profit or loss of the PE would need to be calculated, for UK tax purposes, using UK Corporation Tax legislation and the PE would be treated as a separate and independent enterprise from the rest of the company. Any transactions between the two parts of the company would need to be priced in accordance with the arm's length principle. A reasonable proportion of overheads may be applied to such transactions and also expenses incurred by a connected company may be taken into account. There may be some differences in the way taxable profits are calculated for Irish tax purposes and you may wish to take advice from an Irish tax professional.

However, no tax liability would arise in the first two years as losses are forecast. The losses would reduce the profits made by the rest of Baffin UK Ltd.

As the Irish PE moves into profit, it will be subject to tax in both Ireland and the UK, however double tax relief will be available to reduce or eliminate any UK tax. There are two methods of giving double tax relief - by allowing a credit against the UK tax due on those profits for any overseas tax paid on them, or by exempting the profits from UK tax altogether by way of an election. If an election were made, it would cover all the overseas PEs of Baffin UK Ltd. Furthermore, once made, the election is

irrevocable. Therefore, an alternative more advantageous approach, may be to transfer the M&D Garages business to a locally incorporated Irish Newco once it becomes profitable, although some of the disadvantages mentioned under the first option above might still apply. We would be happy to provide further advice to you on the potential future restructuring at the appropriate time.

3. M&D Garages as a PE of UK Newco, a UK resident company

A new UK incorporated company (UK Newco) owned by Baffin Hood plc could be established and the M&D Garages business operated as a PE of that company. The company could be funded by way of intragroup loan as both the interest income and interest expense would arise in the UK and would net off in the CIR calculations, thereby having no overall tax effect.

The losses arising could be surrendered as group relief for UK Corporation Tax purposes. In addition, the election to exempt foreign PEs from UK tax (mentioned under option 2) can be made in respect of this PE alone and not having any impact across the whole group. The exemption will not apply until the early year losses have been matched by profits.

Overall conclusion

Option 3, whereby a UK Newco operates a PE in Ireland, makes the most effective use of the early year losses and avoids many of the compliance issues involved under the other two options. It would also allow the foreign PE election to be made at an appropriate time when the business becomes profitable. We therefore recommend this option.