Chartered Institute of Taxation
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The Chartered Tax Adviser Examination

November 2019

Application and Professional Skills

Taxation of Larger Companies and Groups

Suggested solution

Chanman UK Ltd
Report concerning the acquisition of Danbridges Ltd
XX November 2019

Introduction

This report considers three options for the acquisition of Danbridges Ltd, highlighting the tax implications for each option and advising on the best way to structure the acquisition from a tax perspective.

This report is prepared for the sole use of Chanman UK Ltd. 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 three potential acquisition structures discussed in this report are:

- Option 1: Acquisition of the shares in Danbridges Ltd;
- Option 2: Direct acquisition of the trade and assets of Danbridges Ltd;
- Option 3: Hive down of the trade and assets of Danbridges Ltd into a Newco, followed by acquisition of the shares in Newco.

The first two options are in accordance with your letter dated 1 November 2019; the third option provides a possible way of acquiring the accumulated trading losses as part of a trade and asset acquisition.

We recommend option 3 because it is the most tax-efficient and also reduces the commercial risks involved. Under this acquisition structure, the accumulated trading losses should be available to be relieved in Newco following the acquisition, subject to a number of considerations. This structure also results in an uplift in base cost of Danbridges Ltd's chargeable assets to current market value. However, the ongoing transfer pricing enquiry and the 'change in company ownership' rules increase the uncertainty over the amount of trading losses available to the Chanman group after acquisition.

Under option 1, Danbridges Ltd should be able to keep its trading losses, which can be used against future profits, and its capital losses, which can be used against certain future chargeable gains. Additionally, the Stamp Duty charge on a share acquisition is much lower than the SDLT charge arising on a trade and asset acquisition. However, again the on-going transfer pricing enquiry and the 'change in company ownership' rules increase the uncertainty over the amount of trading losses available to the Chanman group after acquisition, and there are additional risks in relation to potential historic tax liabilities and the risks inherent to acquiring a company in administration.

Under option 2, Chanman Retail Ltd would be able to assign a value to, and recognise on the balance sheet, certain intangible assets such as brand value. Amortisation of these assets would be deductible for tax purposes. Additionally, capital allowances will be available on the full purchase price of the qualifying assets, whereas under the other options capital allowances are only available on the tax written down value. However, the trading losses and capital losses would be lost as they would not transfer with the trade.

If option 1 or option 3 is chosen, we recommend that a more detailed analysis of the transfer pricing position is undertaken to determine whether you would be able to continue to defend the position after the acquisition. We also recommend that you review the impact of all planned changes made to the running of the business, both before and after acquisition, in order to reduce the risk of the trading losses being lost under the 'change in company ownership' provisions.

If option 2 is chosen, we recommend that a review is undertaken to identify and assign a value to any intangible assets that Danbridges Ltd have not recognised in their accounts (for example, the Danbridges brand). We also recommend that a joint election be made to agree the amount of the sale price of the properties that relates to the fixtures within those properties.

General points regarding the acquisition of Danbridges Ltd

The best acquisition structure for the Chanman group will depend on a number of commercial considerations other than the tax consequences. For example, you will have to assess the commercial risks of acquiring a company in administration.

I would first draw your attention to the following general points, based on the information in the due diligence report and the statutory accounts of Danbridges Ltd.

Danbridges Ltd in administration

The main objective of administration is to rescue the company as a going concern and, if the company cannot be rescued, to achieve a better result for the company's creditors as a whole than would be likely if the company were put into liquidation. You should be aware that, because it would not be in the interest of the administrator to risk personal liability, it may not be possible to obtain any warranties and indemnities. You should therefore consider whether the increased risk outweighs any potential benefits that could be obtained from acquiring the business.

There is also the possibility that the company may cease trading before the acquisition. If the acquisition is not undertaken before cessation of trade, there would not be a 'trade' to acquire and much of the analysis laid out below would no longer be valid. One particular consequence is that the accumulated trading losses would be lost, regardless of the structure of the acquisition.

Transfer pricing enquiry

The due diligence report states that there is an on-going transfer pricing enquiry into the 2016 tax return. It is currently difficult to assess how strong the company's position is or estimate the impact of a successful challenge by HM Revenue & Customs. We recommend that a more detailed analysis of the position be undertaken to determine whether you would be able to continue to defend the position after the acquisition. Please let us know if you would like us to perform that further analysis.

If Danbridges Ltd were not able to defend its position, the impact would be a reduction in the price that it is deemed to acquire stock at, which would in turn reduce the reported tax trading loss. As the enquiry covers all purchases of stock made by Danbridges Ltd in 2016, the impact could be substantial. Furthermore, the 2017 and 2018 returns would also be impacted, and HM Revenue & Customs may also be able to raise discovery assessments into earlier years' returns, which could result in tax being payable and the overall loss position being reduced or eliminated. Please also note that interest will be charged on the additional tax liabilities, and penalties may also be imposed depending on whether the error was careless, deliberate but unconcealed, or deliberate and concealed.

If the chosen acquisition structure allows the Chanman group to access the trading losses of the Danbridges business, the transfer pricing enquiry would have a negative effect on the amount of losses that are available to the Chanman group after acquisition. Furthermore, by acquiring the shares of Danbridges Ltd, the Chanman group would also be exposed to the potential additional prior year tax liabilities. Ordinarily, a full indemnity against the liability would be recommended; however, as noted above, it may not be possible to get an indemnity from the administrator.

Tax losses in Danbridges Ltd

Current forecasts show that Danbridges Ltd has accumulated trading losses of £45 million and capital losses of £12 million, with further losses accruing during 2019. The value of these losses to Chanman UK Ltd may influence the acquisition structure.

If the acquisition structure allows these losses to 'transfer' with the Danbridges business to the Chanman group, the trading losses arising before 1 April 2017 can only be utilised against future profits of the same trade. There is no such restriction on losses arising after 1 April 2017, which may be set against total profits of the company carrying on the trade.

The transferred losses cannot be surrendered as group relief within the Chanman group for a period of five years following the change of ownership. Losses arising in the Danbridges business after acquisition will be available to relieve taxable profits arising in Chanman UK Ltd by way of group relief.

Option 1: Acquisition of the shares in Danbridges Ltd by Chanman Retail Ltd

The Chanman group would take over the commercial history and liabilities of Danbridges Ltd. Of particular concern is the ongoing transfer pricing enquiry and the fact that Danbridges Ltd is currently in financial difficulties.

There should be no immediate Corporation Tax charge on the acquisition as there are no degrouping charges that would crystallise.

No VAT would be payable on the acquisition by Chanman Retail Ltd, as the purchase of shares is not subject to VAT.

Chanman Retail Ltd would incur a 0.5% Stamp Duty charge on the consideration paid for the shares.

Availability of losses

As noted above, the amount of trading losses available may be impacted by the ongoing transfer pricing enquiry, which HMRC is likely to carry on in Newco. The enquiry could result in a reduction or elimination of the overall loss position.

After acquisition of Newco, the trading losses would be 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 for use 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 trade both before and after acquisition. You have already mentioned potential rationalisation of the stores and/or product offerings; such a rationalisation is specifically excluded by HMRC guidance from being a major change. However, you would also need to consider other changes, such as changes in suppliers or customers.

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 Newco, subject to a) any losses arising before 1 April 2017 cannot be utilised against future non-trading profits, and b) the maximum loss offset is the company's allocated group deductions allowance plus 50% of any profits in excess of the deductions allowance.

The capital losses would also stay with Danbridges Ltd, but would be considered 'pre-entry' losses. This means the loss could only be offset against gains arising either on the disposal of assets held by Danbridges Ltd at the date of acquisition by Chanman Retail Ltd, or on assets bought by the group after acquisition but used in Danbridges Ltd's trade.

Option 2: Direct acquisition of the trade and assets of Danbridges Ltd by Chanman Retail Ltd

All of the losses would remain in Danbridges Ltd and would not transfer to Chanman Retail Ltd. Assuming that the Chanman group is able to turn the Danbridges business around to start generating taxable profits and that the trading losses would otherwise have been available, the absence of those trading losses represents a maximum cost to the Chanman group of approximately £12 million (£72 million at the UK Corporation Tax rate of 17%).

If the price paid for the trade and assets exceeds the market value of the net assets, the excess would be treated as goodwill and recognised as an intangible asset in the accounts of Chanman Retail Ltd. However, no tax relief would be available for the amortisation or impairment of this goodwill.

To minimise the amount of goodwill and instead allocate the price paid to other intangible assets that qualify for tax relief, you should identify and assign a value to any intangible assets that Danbridges Ltd has not recognised in its accounts. As you have mentioned that the Danbridges brand is still quite valuable despite the downturn in sales, it may be worth obtaining specialist advice to assign a value to the brand, which can then be recognised as an intangible asset.

Tax relief would be available on these intangible assets, either in line with the amortisation recognised in the accounts or at a fixed rate of 4% per annum if an election for this is made.

Capital allowances would be available on the qualifying assets (i.e. plant and machinery) purchased. To be able to claim allowances on any fixtures included within the acquired buildings, Chanman Retail Ltd and Danbridges Ltd would need to make a joint election to state how much of the sale price relates to the fixtures.

From a VAT perspective, the acquisition is likely to be treated as a 'transfer of going concern' (TOGC), in which case no VAT will need to be charged. Chanman Retail Ltd will need to become VAT registered in order to satisfy the TOGC criteria. Chanman Retail Ltd could have a separate registration to the existing Chanman VAT group, but we recommend that Chanman Retail Ltd becomes part of the VAT group as this should reduce administrative costs and prevents VAT being charged on supplies to and from the other UK group companies.

As the Chanman VAT group is not partially exempt it will not be subject to certain anti-avoidance legislation on the TOGC, which would otherwise impose a VAT charge.

The total estimated Stamp Duty Land Tax (SDLT) charge arising on the acquisition of the properties owned by Danbridges Ltd would be £2.9 million (see Appendix 1). The SDLT charge could be reduced by ensuring that the unoccupied properties are excluded from the transfer (reducing the overall consideration accordingly), as this should not affect the transfer of the trade.

An alternative way to reduce the overall tax liability would be to negotiate a lower price for the properties to compensate for the SDLT charge. If the UK business is looking for future expansion, the additional properties may prove useful, although it may prove commercially more expedient to rent, rather than purchase, any further properties.

Danbridges Ltd would be subject to tax on the chargeable gains arising on the sale of its properties, plus any net profit on disposal of the other assets. Based on the internal analysis prepared by Danbridges Ltd, the total estimated chargeable gain arising would be approximately £8 million (20 stores with an average chargeable gain of £400,000). This gain should be covered by the brought forward capital losses of £12 million and so would not result in a tax liability.

Option 3: Hive down of Danbridges Ltd trade and assets into a Newco, then acquisition of Newco

Step 1: Hive down of trade and assets from Danbridges Ltd into Newco

A new company ('Newco') would be incorporated as a 100% UK subsidiary of Danbridges Ltd. The entire trade and assets of Danbridges Ltd would then be transferred into the Newco. This could be financed either by way of an intercompany payable in Newco (to be repaid once the Chanman group acquires Newco), or by treating the contributed assets as a subscription for shares.

The hive down would have the following tax consequences:

- The accumulated trading losses of £72 million in Danbridges Ltd would prima facie transfer to Newco along with the trade and assets. The capital losses of £12 million, however, would remain in Danbridges Ltd.

  However, as Danbridges Ltd is insolvent, the amount of trading losses passing to Newco may be subject to a restriction. The restriction would apply if the amount of liabilities in Danbridges Ltd not transferred to Newco exceeds the sum of the amount of assets not transferred to Newco, plus any consideration given by Newco in respect of the transfer; the trading losses capable of being transferred would then be reduced by this excess.

  Careful consideration should therefore be given to the assets and liabilities being transferred. For example, it may be beneficial to exclude the stores that you would consider selling from the transfer in order to reduce this restriction.

- For tax purposes, assets qualifying for capital allowances would transfer at their tax written down values and not consideration paid.

- Stock would be deemed to transfer at market value. A joint election to substitute the higher of cost and actual consideration paid would not be possible as the market value is not higher than cost.

- All transfers of chargeable assets (i.e. the properties) and intangible assets from Danbridges Ltd to Newco would be tax-neutral, meaning that they would be deemed to be transferred at an amount that prevents either a tax gain or loss arising in Danbridges Ltd.

- The VAT consequences of the hive down would depend on whether Danbridges Ltd and Newco elect to form a VAT group, although the outcome would be effectively the same in either scenario. If a VAT group exists at the time of the transfer, the transaction would be ignored for the purpose of charging VAT. It is perhaps unlikely that a VAT group would be formed by the administrators as this would cease as soon as the sale took place and the control criteria was no longer satisfied. This is however a matter for the administrators. However, even if a VAT group did not exist, VAT should not be chargeable on the transfer assuming that it meets the conditions of a 'transfer of a going concern'. There are a number of conditions to meet, but if the entire trade is transferred, and Newco is VAT-registered, then the conditions should be met.

- SDLT would be chargeable on the consideration for the properties owned and leased by Danbridges Ltd. SDLT group relief would not be available on the transfer if it is found that there are 'arrangements' in place at the time of the transaction for another company (i.e. Chanman Retail Ltd) to obtain control of Newco but not of the vendor (i.e. Danbridges Ltd). If there are no 'arrangements' in place, then SDLT group relief would be available to exempt the transactions; however, group relief would then be withdrawn on the disposal of Newco (and SDLT charged by reference to the market value of the properties at the time of their transfer), assuming this occurs within three years of the hive down.

- As calculated with option 2, the total SDLT charge would be approximately £2.9 million - slightly less if unoccupied stores were excluded from the acquisition.

The principal tax liability arising from the hive down would therefore be the £2.9 million SDLT payable on the transfer of the properties. The liability would arise in Newco prior to the acquisition by the Chanman group, and so the purchase price may need to reflect the liability.

Step 2: Acquisition of all the shares in Newco by Chanman Retail Ltd

The acquisition would have the following tax consequences:

- Newco would leave the capital gains group that it was in with Danbridges Ltd. As Newco would own both chargeable assets and intangible assets that were transferred to it by Danbridges Ltd as part of the hive down, this would trigger degrouping charges on these assets.

  The degrouping charges on the chargeable assets would be added to the consideration received by Danbridges Ltd for the disposal of its shares in Newco. However, if the disposal qualifies for the substantial shareholdings exemption (SSE) (as is likely to be the case) then the degrouping charges will not give rise to a tax liability.

  The benefit of this is that the chargeable assets would effectively receive a tax-free uplift to market value, which would reduce any chargeable gain arising on a future disposal of the assets.

  As the market value of intangible assets is equal to their accounting value, no degrouping charges should arise on these.

- No VAT would be payable on the acquisition by Chanman Retail Ltd because the purchase of shares is not subject to VAT. Following acquisition of the Newco shares, a decision could then be taken on whether it should join the Chanman VAT group.

- Chanman Retail Ltd would incur a 0.5% Stamp Duty charge on the consideration paid for the shares.

- As noted above, if SDLT group relief was available at the time of the initial hive down, the acquisition of Newco would cause the £2.9 million SDLT liability to crystallise.

As with option 1, the ‘change in company ownership’ provisions would apply. The same analysis discussed in option 1 would apply here regarding the availability and future utilisation of the trading losses.

Similarly, as with option 1, the amount of trading losses available may also be impacted by the ongoing transfer pricing enquiry. The enquiry could also result in extra tax being paid in respect of prior periods.

Appendix – Stamp Duty Land Tax calculation

Total estimated consideration:

	£
Freehold properties (£1,000,000 x 20)	20,000,000
Assignment of leases (£650,000 x 60)	39,000,000
	59,000,000

The acquisitions will be treated as one 'linked' transaction with consideration of £59 million. The estimated SDLT arising is therefore:

	£
£150,000 x 0%	0
(£250,000 - £150,000) x 2%	2,000
(£59,000,000 - £250,000) x 5%	2,937,500
SDLT payable	2,939,500

ASSESSMENT NARRATIVE

Structure

A simple pass or fail will be awarded.

Identification and Application

The following are the relevant topics for assessment with their weightings:

1	40%	Identification of the issues surrounding the use of trading losses and capital losses, including effect of the TP enquiry, change in company ownership provisions, and effect of acquisition.
2	10%	Potential impact of the transfer pricing enquiry, including reduction in losses, discovery assessments, and the enquiry staying with the losses.
3	10%	Commercial considerations of the transaction, in particular the potential impacts of Danbridges Ltd being in administration, including lack of warranties & indemnities and risk of taking on liabilities.
4	10%	Other relevant points identified in a discussion of a direct trade and asset acquisition, including treatment of goodwill and identification of other IFAs.
5	15%	Other relevant points identified in a discussion of a hive down and share sale, including capital allowances, stock, chargeable assets, intangible assets and degrouping charges.
6	10%	Stamp taxes considerations in the discussion of the various acquisition structures, including Stamp Duty on shares, SDLT on properties, group relief and impact of "arrangements"
7	5%	VAT considerations in the discussion of the various acquisition structures: sale of shares, transfer of going concern and hive down

A grade of 0,1,2,3, or 4 is awarded for each topic. The weighting is applied to that grade to produce a weighted average grade. Thus, supposing a candidate scores 3, 2, 3, 2, 4, 2 and 2 respectively on the above topics, this will equate to weighted scores of 1.2, 0.2, 0.3, 0.2, 0.6, 0.2 and 0.1. The total of these scores is 2.8. This is then converted to a final absolute grade by rounding up or down to the nearest grade. Thus, scores in the range 2.5 to 3.49 will be a grade 3. In this example, the candidate will score a grade 3 overall and secure a pass for this skill.

Relevant Advice and Substantiated Recommendations

The following are the topics for assessment with their weightings:

65%	Advice and recommendation, with reasons, on the most appropriate acquisition structure to undertake.
30%	Advice and recommendations regarding the future use of trading losses.
5%	Other advice and recommendations specific to the acquisition structure recommended.

The final grade will be determined for this skill in the same way as for Identification and Application.