Taxation of cross-border mergers and acquisitions

United Kingdom

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United Kingdom

Introduction

The United Kingdom (UK) tax environment for mergers and acquisitions (M&A) continues to change in response to the fiscal climate, perceived competitiveness pressures from other countries and challenges to existing UK legislation under EU non-discrimination principles.

This report begins by reviewing recent changes that are likely to affect the approach to transactions. This report proceeds by addressing three fundamental decisions that face a prospective purchaser:

- What should be acquired: the target's shares or its assets?
- What will be the acquisition vehicle?
- How should the acquisition vehicle be financed?

Of course, tax is only one piece of transaction structuring. Company law governs the legal form of a transaction, and accounting issues are highly relevant when selecting the optimal structure. These areas are outside the scope of this report, but some of the key points that arise when planning a transaction are summarized within this report.

Recent developments

The following summary of UK tax considerations is based on current tax legislation up to and including the Finance (No.2) Act 2015. This summary also refers to anticipated developments as at the beginning of February 2016.

Deductibility of interest

In response to recommendations of the Organisation for Economic Co-operation and Development (OECD) under Action 4 of its Action Plan on Base Erosion and Profit Shifting (BEPS), the UK is expected to apply a fixed ratio rule of tax relief for net interest of 20 to 30 percent of earnings before interest, tax, depreciation and amortization (EBITDA), with effect from 1 April 2017. It remains to be seen what exclusions the UK will allow and what impact these will have. The UK's worldwide debt cap provisions are likely to be repealed or amended when the fixed ratio rule is introduced.

Goodwill and intangibles

With effect from 8 July 2015, amortization is no longer available on the purchase of goodwill, customer-related information, customer relationships and unregistered trademarks.

Diverted profits tax

This new tax applies from 1 April 2015 at the rate of 25 percent of the diverted profits relating to UK activity. It aims to catch profits being diverted away from the UK and primarily targets transactions where:

- UK profits are diverted by the exploitation of the permanent establishment rules, or
- tax advantages are created by means of transactions or entities lacking economic substance.

Asset purchase or share purchase

An acquisition in the United Kingdom usually takes the form of a purchase of the shares of a company, rather than its business and assets, because capital gains on the sale of shares may be exempt. From a tax perspective, the capital gains consequences, the likely recapture of capital allowances (tax depreciation), and possible double taxation on extracting the sales proceeds are all likely to make asset acquisitions less attractive for the seller. The benefits of asset acquisitions for the purchaser have been reduced as purchased goodwill no longer attracts a tax deduction. Some of the tax considerations relevant to each method are discussed later in this report. The relative advantages are summarized at the end of this report.

Purchase of assets

A purchase of assets usually results in an increase in the base cost of those assets for both capital gains tax and capital allowances purposes, although this increase is likely to be taxable to the seller. In addition, historical tax liabilities generally remain with the company and are not transferred with the assets. Of course, the purchaser may still inherit defective practices or compliance procedures, so the purchaser may wish to carry out some tax due diligence to identify and address such weaknesses.

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Purchase price

For tax purposes, it is necessary to apportion the total consideration among the assets acquired. It is generally advisable for the purchase agreement to specify the allocation, which is normally acceptable for tax purposes, provided it is commercially justifiable. However, two statutory rules affect the allocation of the purchase price. The first stipulates that the open-market value of trading stock must be substituted in calculating the profits of the seller unless the purchaser acquires the stock for their own trade. The second requires that the purchaser's cost of acquisition and the seller's disposal proceeds for capital allowance purposes be calculated through a just apportionment of total consideration.

Goodwill and intangibles

Goodwill purchased from a third party on or after 8 July 2015 is not deductible.

With the exception of customer-related information, customer relationships and unregistered trademarks, other separately identifiable intangible assets are written off for accounting purposes over their expected useful economic lives. Such amortization is deductible for tax purposes in line with the accounts.

Depreciation

Depreciation of other assets charged in the accounts is ignored for tax purposes. UK tax legislation enables the cost of certain assets to be written off against taxable profits at a specified rate by means of capital allowances. Allowances are available for certain tangible assets (e.g. plant and machinery) and certain intangible assets (e.g. patents and knowhow), except that intangible assets created or purchased on or after 1 April 2002 usually fall within the separate regime mentioned above.

The UK capital allowances regime has been significantly amended in recent years. Allowances for industrial and agricultural buildings are no longer available, having been phased out over the period from 2008–11.

No tax write-off is normally available with respect to office buildings or shops, although some fixtures in such buildings may themselves qualify for capital allowances. The annual rate of tax write-off for plant and machinery is 18 percent (on a reducing-balance basis) and 8 percent (reducing-balance) for certain other assets (e.g. integral features of a building).

There are special rules for cars, certain other assets, and small and medium-sized companies. Accelerated allowances and tax credits are also available for research and development expenditure. Allowances may be recaptured where the disposal of an asset yields proceeds in excess of its tax written-down value.

Tax attributes

Tax losses and capital allowances pools are not transferred on an asset acquisition. They remain with the company or are extinguished.

Where the purchaser wishes to acquire a company's trade together with its tax trading losses (or capital allowances pools), the trade can be transferred to a new company (Newco), which is then sold to the purchaser. Generally, provided any liabilities not transferred to Newco are balanced by assets not transferred together with the purchase consideration for the assets transferred, the losses can be transferred with the trade and used in Newco (subject to potential restrictions where there is a major change in the nature or conduct of that trade — see purchase of shares). This route would crystallize any chargeable gains inherent in the underlying assets transferred. Such gains are treated as additional consideration for the shares and so may be exempt.

This treatment is not applicable to gains arising on intangible assets created or purchased after 1 April 2002, which continue to crystallize in the Newco.

Value added tax

Value added tax (VAT) is levied at the rate of 20 percent on many goods and services, although goods exported from the UK are not charged with VAT. The transfer of a business as a going concern is outside the scope of VAT, provided certain conditions are met. The effect of the transfer must be to put the new owner in possession of a business that can be operated as such. Therefore, a sale of assets is not in itself the transfer of a business as a going concern.

Professional advice should be sought where land or buildings are being sold. Complications arise where the transferor previously elected to bring such assets within the scope of VAT.

Transfer taxes

Stamp duty (or stamp duty reserve tax — SDRT) is levied on instruments transferring ownership of shares and applies at the rate of 0.5 percent.

Transfers of land and buildings in England, Wales and Northern Ireland are subject to stamp duty land tax (SDLT). From 1 April 2015 SDLT was replaced in Scotland with the land and buildings transaction tax (LBTT). SDLT will also be replaced in Wales from 1 April 2018. The rates of SDLT on commercial purchases, lease premiums and other non-rent payments range from 1 percent, where the value transferred exceeds 150,000 British pounds (GBP), to 4 percent, where the value exceeds GBP500,000. For LBTT the commercial rates are applied progressively, the lowest rate is 3 percent which applies to consideration above GBP150,000 and the top rate is 4.5 percent, which applies to consideration above GBP350,000. Lease rents are taxable at 1 percent of the net present value of the rent payments where the GBP150,000 threshold is

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exceeded. There is a relief for leases where property has been sold and leased back to the seller.

Certain transfers within groups or on company reorganizations are exempt from stamp duty, SDRT, LBTT and SDLT, or attract duty at a reduced rate.

Purchase of shares

The purchase of a target company's shares does not result in an increase in the base cost of that company's underlying assets (although assets that were transferred to that target company from a retained group company within 6 years of the purchase may be re-based to their market value at the time of the transfer). There is no deduction for the difference between underlying net asset values and consideration.

Tax indemnities and warranties

In a share acquisition, the purchaser is taking over the target company together with all related liabilities, including contingent liabilities. Therefore, the purchaser normally requires more extensive indemnities and warranties than in the case of an asset acquisition. An alternative approach is for the seller's business to be transferred into a newly formed subsidiary with a view to the purchaser taking a clean company.

Where significant sums are at issue, it is customary for the purchaser to initiate a due diligence exercise, which would normally incorporate a review of the target's tax affairs. However, there are a number of transactions where the principle of caveat emptor (let the buyer beware) applies and warranties and indemnities are not given. These situations typically include the acquisition of a UK-quoted (listed) company, a purchase from a receiver, liquidator or private equity house, and, in some cases, an acquisition of shares owned by individuals not involved in the management of the target.

Tax losses

In principle, carried forward UK tax losses generated by the target company transfer along with the company. A company's brought forward income-type losses (e.g. trading losses) cannot be offset against the profits of other companies through group relief. In principle, they may be offset against the company's own future profits of the same type. The use of brought forward capital losses can be subject to severe restrictions; broadly, such capital losses may only be set off against future chargeable gains on assets held before the change in ownership or acquired for use in the trade or business from third parties after the transaction.

Where a UK target company with trading losses is acquired (whether directly or by the acquisition of its immediate or ultimate parent company), it may use those losses against its own future trading profits, provided there has been no major change in the nature or conduct of its trade 3 years before and 3 years after the date of acquisition. If the purchaser intends to undertake a major rationalization of the trade or wishes to inject elements of its own trade into the target, it may be advisable to wait until at least 3 years have passed from the date of acquisition.

Where the target has investment business, there is an additional condition to satisfy on a change of ownership in order to preserve certain non-trading losses. The use of brought forward losses (e.g. financial losses, management expenses) for such companies is also restricted where there is a significant increase in the company's capital within the 3 years after the acquisition. For this purpose, capital includes both debt (including accrued interest) and equity. For changes of ownership as of 1 April 2014, a significant increase means an increase of GBP1 million or more that represents an increase of at least 25 percent.

As of 20 March 2013, further restrictions have been placed on access to tax attributes following a change in ownership of a company.

The restrictions apply where the tax written-down value of assets qualifying for capital allowances exceeds their book value by:

- GBP50 million or more, or
- GBP2 million or more and the benefit conferred by the allowances is not insignificant compared to the total benefits derived from the transaction

In these cases, losses created by claiming capital allowances can no longer be surrendered as group relief and must be carried forward in the company purchased.

The surrender as group relief of losses arising from deductions that are highly likely to arise after a change in ownership is precluded where obtaining relief for such deductions was a main purpose of the change in ownership. A complementary measure prevents relief from being obtained via the transfer of profits to the purchased company.

The purchase agreement should indicate whether the purchaser or seller has the right to use the target company's pre-acquisition tax losses. In particular, the extent to which the seller has the right to use losses by way of group relief needs to be clarified. For group relief purposes, a loss arising in the accounting period in which the acquisition takes place is often apportioned on a time basis between the pre-acquisition element (available to the seller, subject to possible restrictions) and the post-acquisition element (available to the purchaser). Where the seller does not or cannot claim group relief for pre-acquisition losses, they are carried forward in the target company. The indemnities and warranties in the sale and purchase agreement normally refer to the arrangements agreed between the parties.

Crystallization of tax charges

The purchaser should satisfy itself that it is aware of all assets transferred to the target during the preceding 6 years by other UK companies within the seller's group. The sale of the target company causes gains inherent in those assets at the time

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of transfer to crystallize. Such gains are treated as additional consideration for the shares, so they may be exempt.

This treatment is not available in certain circumstances where the seller of the transfer shares is a non-UK parent company or to gains arising on intangible assets created or purchased after 1 April 2002. Such gains continue to crystallize in the subsidiary, so the purchaser may wish to obtain an appropriate indemnity from the seller.

Pre-sale dividend

In certain circumstances, the seller may prefer to realize part of the value of their investment as income by means of a pre-sale dividend. The rationale here is that the dividend may be subject to no or only a low effective rate of UK tax but reduces the proceeds of sale and thus the gain on sale, which may be subject to a higher rate of tax. The position is not straightforward, however, and each case must be examined on its facts.

Transfer taxes

Stamp duty is payable at the rate of 0.5 percent on the value of the consideration given for shares in a UK company. It may be possible to eliminate this liability by replacing a share purchase with a transaction in which the target's share capital is cancelled and new shares are issued to the purchaser. This process can be complex and time-consuming, however, so it tends to be used only in larger transactions. Alternatively, it may be possible to reduce the liability where the target has issued debt that will be repaid on the transaction.

Choice of acquisition vehicle

Several potential acquisition vehicles are available to a foreign purchaser, and tax factors often influence the choice. There is no capital duty on the introduction of new capital to a UK company or branch (or to a UK-registered societas Europaea).

Local holding company

A UK holding company is typically used where the purchaser wishes to ensure that tax relief for interest is available to offset the target's taxable profits (see this chapter's information on funding) or taxable profits of other UK companies (or UK permanent establishments of non-UK companies) already owned by the purchaser.

The ability to group-relieve losses (and, in a share acquisition, offset tax-deductible interest in the acquisition vehicle against UK taxable profits of other companies in the combined post-acquisition group) depends, broadly, on the relevant companies being in a 75 percent group relationship. This requirement may be satisfied where the companies have a common corporate parent, whether a UK-resident or non-resident company.

Foreign parent company

The foreign purchaser may choose to make the acquisition itself, perhaps to shelter its own taxable profits with the financing costs. This does not necessarily cause any tax problems because the UK does not tax the gains of non-residents disposing of UK shares (unless held for the purpose of a trade carried on through a UK branch) and does not levy withholding tax (WHT) on dividends. However, the UK does charge WHT on interest (certain exceptions apply, notably where the debt is structured as a quoted Eurobond or deep discount security). So, where relevant, an intermediate company resident in a more favorable treaty territory may be preferred, or other structures or loan instruments that do not attract a WHT liability may be considered.

Non-resident intermediate holding company

Where the foreign country taxes capital gains and dividends received from overseas, an intermediate holding company resident in another territory could be used to defer this tax and perhaps take advantage of a more favorable tax treaty with the UK. The purchaser should be aware that certain UK treaties contain anti-treaty shopping provisions that may restrict the ability to structure a deal in a way designed solely to obtain tax benefits.

Local branch

As an alternative to the direct acquisition of the target's trade and assets, a foreign purchaser may structure the acquisition through a UK branch. The UK does not impose additional taxes on branch profits remitted to an overseas head office. The branch is subject to UK tax at the normal corporate rate, currently 20 percent as of 1 April 2015, falling to 19 percent as of 1 April 2017 and to 18 percent as of 1 April 2020. Where the UK operation is expected to make losses initially, a branch may be advantageous since, subject to the tax treatment applicable in the head office's country, a timing benefit could arise from the ability to consolidate losses with the profits of the head office.

Unlike the disposal of a UK subsidiary by a non-resident, a disposal of a UK branch to a third party triggers a tax liability on any capital gains. However, there are provisions that should enable a transfer of the branch's trade and assets to a UK group subsidiary without any immediate UK tax cost, subject to certain conditions.

Joint venture

Joint ventures can be either corporate (with the joint venture partners holding shares in a UK company) or unincorporated (usually a UK partnership). Partnerships generally are considered to provide greater flexibility from a tax viewpoint. For example, where the joint venture is expected to make losses initially, the partners should be able to offset their shares of those losses against the profits of their existing UK trades.

By contrast, unless one of the joint venture partners has a 75 percent interest, the losses of a joint venture company are available to its owners only where the conditions for UK consortium relief are met. Broadly, this relief enables a corporate shareholder holding 5 percent or more of a loss-making UK company to use its share of the losses against the profits of any UK companies within its 75 percent group, provided 75 percent or more of the shares in the joint venture company are owned by companies of which none owns less than 5 percent. For this purpose, the 75 percent

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group cannot be traced through non-European Economic Area (EEA) subsidiaries.

In practice, there may be non-tax reasons that lead a purchaser to prefer a corporate joint venture. In particular, a corporate body may enable the joint venture partners to limit their liability to the venture (assuming that lenders do not insist on receiving guarantees from the partners). One common structure involves the parties establishing a jointly owned UK company that borrows to acquire the UK target. Interest paid can offset the target's profits, while relief for any excess interest may be available to UK partners (or, in some circumstances, other 75 percent-owned UK subsidiaries of non-UK partners) by means of a consortium relief claim.

Choice of acquisition funding

A purchaser using a UK acquisition vehicle to carry out an acquisition for cash needs to decide whether to fund the vehicle with debt, equity or a hybrid instrument that combines the characteristics of both. The principles underlying these approaches are discussed below.

Debt

The principal advantage of debt is the potential tax-deductibility of interest (see deductibility of interest), because the payment of a dividend does not give rise to a tax deduction. Another potential advantage of debt is the deductibility of expenses, such as guarantee fees or bank fees in computing trading profits for tax purposes. By contrast, the costs of a share issue are not deductible.

Where it is decided to use debt, it then must be decided which company should borrow and how the acquisition should be structured. To minimize the cost of debt, there must be sufficient taxable profits against which interest payments can be offset. The following comments assume that the purchaser wishes to offset the interest payments against the UK target's taxable profits. Consideration should be given to whether relief would be available at a higher rate in another jurisdiction.

Typically, a UK company is used as the acquisition vehicle, funding the purchase with debt either from a related party (a debt pushdown) or directly from a bank. Provided at least 75 percent of the target's ordinary share capital is acquired (which, broadly, also entitles the holder to 75 percent economic ownership of the target), it should be possible to offset interest paid against UK taxable profits arising in the target group over the same period. Where interest cannot be offset immediately (i.e. there are insufficient taxable profits), the resulting losses can only be carried forward and offset against future profits of the UK borrower; they cannot be surrendered as group relief in subsequent periods.

Depending on the existing structures of the purchaser and target groups, it may also be possible to introduce debt into the UK after (rather than at the time of) the acquisition. Generally, this involves the acquisition by a debt-funded UK holding company of the newly acquired target's UK subsidiaries for cash consideration. The analysis of a post-acquisition debt pushdown can be complex. Specific anti-avoidance provisions may apply, such as the unallowable purpose rule, and local advice should be sought.

Deductibility of interest

Generally, a company's accounting treatment of interest is followed for tax purposes as long as it fairly represents all profits, gains and losses and all interest and expenses of the company's loan relationships. An accruals basis or mark-to-market basis is generally appropriate, and International Financial Reporting Standards (IFRS) and UK generally accepted accounting principles (GAAP) should meet these criteria. Where a company follows an accounting policy that does not satisfy these criteria, it is taxed on a basis that does meet these requirements.

Late-paid interest

An exception to the accruals treatment is that interest not paid within 12 months of the accounting period in which it accrues is deductible only when paid where the borrower is a 'close' company, the lender participates in the borrower or in a second company that controls the borrower, and the lender is resident in a territory with which the UK does not have a tax treaty that includes a non-discrimination clause.

Transfer pricing

UK transfer pricing legislation can restrict interest deductibility where the level of funding exceeds that which the company could have borrowed from an unrelated third party or where the interest rate charged is higher than an arm's length rate.

The UK transfer pricing rules apply when the parties to a transaction are under common control (or one of them controls the other). For financing arrangements, the scope of the rules is significantly wider, following changes introduced in 2005 to catch certain private equity structures. The rules have applied to transactions between UK companies since April 2004. In principle, small and medium-sized enterprises are exempt (although the UK tax authorities may issue a direction to a medium-sized enterprise requiring it to apply the rules).

Transactions caught by the rules are required to meet the arm's length standard. Thus, payments of interest to an overseas (or UK) parent or overseas (or UK) affiliated company that represent an amount that would not have been payable in the absence of the relationship are not deductible for UK tax purposes. Where both parties to the transaction are subject to UK tax, it is normally possible for the party whose profits have been increased to claim a compensating adjustment, so that there is usually no impact on the cash tax payable by the group (although losses can become trapped in certain situations).

No specific debt-to-equity ratio or other test is included to assist in deciding whether the legislation applies. The tax authorities focus on the fundamentals of the business, including its position within the industry, and the commercial feasibility of the capital structure. Their guidance suggests that

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ratios of debt-to-earnings before interest, taxes, depreciation and amortization and interest cover are suitable measures of a company's arm's length capitalization.

Worldwide debt cap

The worldwide debt cap rules seek to ensure that interest deducted by the UK members of a multinational group does not exceed the group's total consolidated external finance costs. The rules operate in addition to other provisions that can restrict interest deductibility (including the UK's transfer pricing rules discussed above). Therefore, the rules provide an additional hurdle to surmount for interest to be tax-deductible.

The mechanism used by the rules is quite complex. Very broadly, it works by comparing the tested amount to the available amount. The 'tested amount' is intended to represent the intragroup financing expenses of each UK company. The 'available amount' represents the net non-UK external finance expense of the group (which is restricted to nil where the group has net finance income). Where the tested amount exceeds the available amount, the excess is disallowed.

To the extent that UK companies have financing income from related companies (both UK and non-UK) and there is a group disallowance by application of the debt cap, such interest income may be tax-free. A specific exemption applies to banking and insurance groups, and the rules allow debt from some private equity funds to count as external debt.

The provisions contain wide-ranging anti-avoidance rules, for example, to prevent companies from turning intragroup financing arrangements into external borrowings.

The impact of the rules on M&A transactions is two-fold:

1. In many cases, it is now more difficult to introduce leverage into the UK (particularly when the funding is pushed down from related parties).
2. The company that is deemed for tax purposes to pay or receive interest may be different from the company that actually pays or receives it, possibly resulting in a reallocation of deductions between group companies and/or trapped tax losses.

Other debt-related issues

A number of other anti-avoidance provisions may also restrict interest deductibility. For example, interest may be re-characterized as a distribution where the return on the securities depends on the results of the company's business. Anti-avoidance legislation also combats certain structures that use hybrid entities and/or hybrid instruments to generate tax benefits (e.g. by creating a double dip).

Withholding tax on debt and methods to reduce or eliminate it

Payments of annual interest by a UK company to a non-resident are subject to WHT at 20 percent. The rate of WHT may be reduced or eliminated under a double tax treaty or, where the recipient is a company resident in another EU member state, under the EU Interest and Royalties Directive.

In most cases, the terms of a tax treaty or the directive make it clear whether UK WHT would apply to payments of interest to companies in other EU member states.

The prior approval of the UK tax authorities must be obtained before the reduced rate can be applied. There is an exemption for payments to UK banks and UK branches of overseas banks. Where the lender would not qualify for an exemption from or a reduced rate of WHT, an intermediate company resident in a more favorable treaty territory may be preferred, or other structures or loan instruments that do not attract WHT may be considered.

Debt may be structured as either quoted Eurobonds or deep discount securities, which eliminates the obligation to WHT on interest.

Checklist for debt funding

- The use of bank debt may avoid thin capitalization and transfer pricing problems, and should obviate the requirement to withhold tax from interest payments where debt is borrowed from UK banks.
- UK group relief operates on a current-year basis only. If interest cannot be offset immediately, it can only be carried forward for offset against the future profits of the UK borrower.
- Consider whether the level of profits would enable tax relief for interest payments to be effective.
- It is possible that a tax deduction may be available at higher rates in other territories.
- WHT of 20 percent applies on interest payments to non-UK entities unless either a lower rate applies under the relevant tax treaty/EU directive and advance approval is obtained, or the debt is structured as a quoted Eurobond or deep discount security.

Equity

A purchaser may use equity to fund its acquisition, possibly by issuing shares to the seller in satisfaction of the consideration or by raising funds through a seller placing. Further, the purchaser may wish to capitalize the target post-acquisition.

The UK does not have any capital duty, and neither stamp duty nor SDRT generally applies to new share issues. Under domestic law, there is no WHT on dividends paid by a UK company. Dividends are not deductible for UK tax purposes. Although equity offers less flexibility should the parent later wish to recover the funds it has injected, the use of equity may be more appropriate than debt in certain circumstances:

- Where the target is loss-making, it may not be possible to obtain immediate tax relief for interest payments.
- A number of restrictions on obtaining UK tax relief for interest may eliminate the principle advantage of using debt.

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— Where the company is thinly capitalized, it would be disadvantageous to increase borrowings without also injecting fresh equity. A tax-efficient structure normally requires an appropriate mix of debt and equity.

— There may be non-tax grounds for preferring equity. For example, in certain circumstances, it may be desirable for a company to have a low debt-to-equity ratio. This factor is among those that may encourage the use of hybrid funding instruments (as discussed later in this report).

Tax-free reorganizations

Where an acquisition is effected by the purchase of shares in exchange for the issue to the seller of shares or loan stock in the purchaser, the gain may be rolled over into the new shares or loan stock, thus enabling the seller to defer the UK capital gains tax liability. It is possible to obtain clearance in advance from the UK tax authorities that they will not deny the tax-free rollover under the relevant anti-avoidance provisions.

Hybrids

Consideration may be given to hybrid financing — instruments treated as equity for accounts purposes by one party and as debt (giving rise to tax-deductible interest) by the other. Various hybrid instruments and structures were devised to achieve an interest deduction for the borrower with no income pick-up for the lender. However, legislative changes made in 2005 (the so-called 'arbitrage rules') sought to deny the tax-effectiveness of hybrid financing structures. Some hybrid structures are still tax-effective but may cease to be so as of 1 January 2017 when legislation closely based on the recommendations in the OECD BEPS Action 2 report begins to apply.

Discounted securities

The tax treatment of securities issued at a discount to third parties normally follows the accounting treatment. As a result, the issuer should obtain a tax deduction for the discount accruing over the life of the security. However, where the borrower is a 'close' company, the lender participates in the borrower or in a second company that controls the borrower, and the lender is resident in a territory with which the UK does not have a tax treaty that includes a non-discrimination clause, a deduction for the discount accruing may be deferred until redemption. An advantage of discounted securities is that the discount does not give rise to WHT.

Deferred settlement

An acquisition often involves an element of deferred consideration, the amount of which can only be determined at a later date on the basis of the business' post-acquisition performance. The right to receive an unknown future amount is regarded as an asset that must be valued for UK tax purposes. This has potentially damaging consequences for a seller. The UK tax legislation that usually enables the seller in a paper-for-paper exchange to defer any capital gain until the subsequent disposal of the new shares does not apply to the right to an unknown future amount unless, when received, that amount will take the form of shares or loan stock. For corporate sellers, the receipt of such deferred consideration may be taxable.

Other considerations

Concerns of the seller

The tax position of the seller can be expected to significantly influence any transaction. In certain circumstances, the seller may prefer to realize part of the value of their investment as income by means of a pre-sale dividend. The rationale here is that the dividend may be subject to no or only a low effective rate of UK tax but reduces the proceeds of sale and thus the gain on the sale, which may be subject to a higher rate of tax. The position is not straightforward, however, because UK individuals are subject to a highest rate of tax on capital gains of 28 percent (with effect from 6 April 2016, the highest marginal rate of tax on dividends received by individuals is 39.1 percent). To defer capital gains charges, the seller may wish to receive share or loan note consideration. Each case must be examined on its facts.

The UK does not tax gains of non-residents (except certain disposals by non-resident companies with a permanent establishment in the UK).

Company law and accounting

The Companies Act 2006 prescribes how UK companies may be formed, operated, reorganized and dissolved. In some respects, UK company law allows considerable flexibility: the courts have a high degree of latitude, for example, in determining how companies may be reorganized. In other respects, the rules are relatively restrictive: corporate identity must be preserved so that, for example, the flexibility of reorganizations does not extend to allowing domestic mergers, although cross-border mergers with companies resident in other EU member states are permitted.

As for M&A, a business combination (which IFRS defines as the bringing together of separate entities or businesses into one reporting entity) may be categorized as either a merger or an acquisition. In essence, a combination is regarded as a merger where it effects a pooling of business interests (i.e. where one company's equity is exchanged for equity in another company) or shares in a newly incorporated company are issued to the merging companies' shareholders in exchange for the equity, with both sides receiving little or no consideration in the form of cash or other assets.

Company law and accounting standards predominantly determine the accounting treatment of a business combination. Generally, most combinations are accounted for as acquisitions, and merger accounting is only applied in limited circumstances. Merger accounting is not allowed under IFRS; all business combinations must be accounted for as acquisitions. The relevant UK accounting standards and company law restrict merger accounting to (and make it obligatory for) a very small number of genuine mergers and group reorganizations not involving minority interests.

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Genuine mergers are those in which the shareholders come together in a partnership for the mutual sharing of the risks and rewards of the combined entity and in which no party to the combination in substance obtains control over any other or is otherwise seen to be dominant in any way. Numerous detailed conditions must be met.

One of the main practical distinctions between acquisition accounting and merger accounting is that acquisition accounting may give rise to goodwill. The net assets acquired are brought onto the consolidated balance sheet at their fair values, and goodwill arises to the extent that the consideration given exceeds the aggregate of these values. As long as IFRS is not adopted or incorporated into UK GAAP, the goodwill is then amortized through the profit and loss account over its useful economic life. Acquisition accounting principles also apply to purchases of trade and assets and to any goodwill and fair value adjustments appearing on the acquirer's own balance sheet. In merger accounting, goodwill does not arise, as the acquirer and the seller are treated as though they had operated in combination since incorporation. Adjustments are made to the value of the acquired net assets only to the extent necessary to bring accounting policies into line.

Another important feature of UK company law concerns the ability to pay dividends. Distributions of profit may be made only out of a company's distributable reserves. For groups, this means the reserves retained by the holding company (or its subsidiaries) rather than those of the group at the consolidated level. Regardless of whether acquisition or merger accounting is adopted in the group accounts, the ability to distribute the pre-acquisition profits of the acquired company may be restricted. In certain types of business combination, legal provisions referred to as merger relief (not to be confused with merger accounting) may apply, which allow shares received as consideration to be recorded at their nominal amounts. These provisions may remove or decrease the restrictions on the ability to make distributions. IFRS does not allow merger relief because it requires the cost of acquisition to be recorded at fair value.

Finally, a common issue on transaction structuring arises from the provisions concerning financial assistance. Broadly, these make it unlawful for a public company (or one of its private subsidiaries) to give financial assistance, directly or indirectly, for the purpose of acquiring the public company's shares.

It is also unlawful for a public company that is a subsidiary of a private company to give financial assistance, directly or indirectly, for the purpose of acquiring that private company's shares. Financial assistance is broadly defined. Unlawful financial assistance is a criminal offence and renders the transaction involved unenforceable.

Group relief/consolidation

Where the purchaser owns other UK companies, the target company is included in a UK tax group so that UK profits and losses can be effectively consolidated for tax purposes. Where the purchaser does not wish to acquire the entire share capital of the target, group relief should still be available, provided the purchaser owns at least 75 percent of the ordinary share capital, which generally also entitles it to 75 percent economic ownership of the target.

Transfer pricing

Where an intercompany balance arises between the purchaser and the target following the acquisition, failure to charge interest on the balance may create transfer pricing problems in the relevant jurisdiction. For example, where the balance is owed to the target, the UK tax authorities could impute interest on the balance where an arm's length interest rate is not charged.

Dual residency

There are few advantages in establishing a dual resident company. The losses of a dual resident investing company cannot be offset against profits of other UK companies.

Foreign investments of a local target company

A new CFC regime applies as of 1 January 2013.

The profits of a CFC escape UK tax altogether where it is resident and carrying on business in certain excluded territories, pays tax on its profits equivalent to at least 75 percent of the corresponding UK tax, has only come under control of a UK resident company within the last 12 months, or has profits of less than GBP50,000 or a profit margin of less than 10 percent.

Where none of these conditions are met, only those profits of the CFC that pass through the CFC 'gateway' are subject to UK tax. These include profits attributable to UK activities, non-trading finance profits (with partial or full exemption available for group finance companies), trading finance profits and profits from captive insurance business. In each case, particular rules apply to determine whether and how much of the profits concerned pass through the 'gateway'. Specialist advice should be sought.

The new controlled foreign company (CFC) rules include a partial exemption regime for finance companies. Only 25 percent of such a company's chargeable profits is subject to UK tax, for an effective rate of 5 percent as of 1 April 2015.

Although they are referred to as a finance company regime, the new rules apply to both pure finance companies and mixed companies. There is no debt-to-equity ratio requirement, and the substance requirement is limited to the maintenance of premises in the company's territory of residence. The exemption is, however, limited to income from loan relationships excluding upstream loans to the UK.

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Comparison of asset and share purchases

Advantages of asset purchases

- The purchase price (or a proportion) can be depreciated or amortized for tax purposes (excluding goodwill).
- A step-up in the cost base of assets for capital gains purposes is obtained.
- A deduction is gained for trading stock purchased.
- No previous liabilities of the company are inherited.
- No acquisition of a tax liability on retained earnings.
- Possible to acquire only part of a business.
- Possible for the seller to rollover gains into the cost of acquiring other assets.

Disadvantages of asset purchases

- May need to renegotiate supply, employment and technology agreements, etc.
- Higher capital outlay is usually involved (unless debts of the business are also assumed).
- May be unattractive to the seller, especially where a share sale would be exempt, thereby increasing the price.
- Higher transfer duties usually arise.
- Accounting profits may be affected by the creation of acquisition goodwill.
- Benefit of any losses incurred by the target company remains with the seller (or may be lost altogether).

Advantages of share purchases

- There is usually a lower capital outlay (purchase of net assets only).
- Likely to be more attractive to the seller, both commercially and from a tax perspective (because the disposal may be exempt), so the price may be lower.
- Buyer may benefit from tax losses of the target company.
- Purchaser may gain the benefit of existing supply and technology contracts.
- Lower transfer duties are usually payable.

Disadvantages of share purchases

- Buyer acquires unrealized tax liability for depreciation recovery on the difference between accounting and tax book value of assets.
- Buyer effectively becomes liable for any claims or previous liabilities of the entity (including tax).
- No deduction is available for the purchase price.
- Buyer acquires any tax liability on retained earnings that are ultimately distributed to shareholders.
- Possibly more difficult to finance tax-efficiently.

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