

M&A Tax Fundamentals 2009

Sample excerpt United Kingdom

1. Mergers

1.1. Direct taxes

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1.1.1. Tax rate

The corporate income tax rate is 28%. A small company's rate of 21% may apply if the taxable profits do not exceed specified limits.

1.1.2. Tax base

Companies resident in the United Kingdom (wherever incorporated) are charged corporation tax at a single rate or a small-company's rate on their total worldwide profits - income and capital gains - for each accounting period, whether or not the profits are distributed and whether or not they are remitted to the United Kingdom. Under CFC legislation resident companies may also be assessed on the undistributed profits of certain UK-controlled but non-resident companies which are resident in low-tax territories and in which the resident company has a prescribed level of interest. The existing CFC legislation is currently under review and significant changes are expected to be brought into effect from July 2009, in conjunction with the introduction of a tax exemption on overseas dividends received.

A merger transaction will potentially involve a disposal of assets for tax purposes by the transferor companies and a corresponding acquisition of assets by the transferee company, subject to particular merger reliefs.

The taxation of assets transferred will vary depending on the particular category of asset. For example, capital assets (such as land and buildings) transferred would give rise to capital gains or losses.

1.1.3. Merger relief

Two of the most important merger reliefs in the United Kingdom are (1) a deferral of the taxation of gains on capital and certain other assets where they are transferred between companies in the same group which are within the charge to UK corporation tax and (2) a relief for capital gains arising on the transfer of assets in a reconstruction involving the transfer of the business of a company in consideration for an issue of shares to the shareholders of the transferor company.

Also the substantial shareholding exemption may be available if shares are transferred (see 4.1.3).

1.1.4. Group treatment

In addition to the reliefs for the transfer of assets within a group referred to at 1.1.3., there are also provisions whereby companies within the same group which are within the charge to UK corporation tax may elect to surrender certain

tax losses to other group companies to offset against their UK taxable profits of the corresponding period.

1.1.5. Preservation of tax-exempt reserves

There is no concept of tax-exempt reserves in the United Kingdom.

The only broad equivalent to a tax-exempt reserve are the provisions whereby if a company disposes of certain capital assets (usually those used in a trade), the capital gain arising on the disposal may be “rolled over” into other capital assets acquired by the company, or another member of the same group, within the period from 1 year before to 3 years after the date of disposal of the first asset. If on a merger the transferor company owned a capital asset into which a gain on an asset previously disposed of had been “rolled over”, and on the merger capital gains are not realized by virtue of the reliefs for intergroup transfers or reconstructions, the “rolled over” gain would also carry over to the transferee company. Otherwise such a “rolled over” gain may fall into charge to tax on the merger.

1.1.6. Preservation of tax losses

In considering whether tax losses may be preserved on a merger, it must first be noted that tax losses of a company available for carry-over generally fall into four different categories:

- trading losses;
- excess management expenses of companies with investment business;
- non-trading loan relationship deficits; and
- capital losses.

There are different provisions for each category of losses. With respect to trading losses, where a trade or part of a trade is transferred between companies under 75% or more common ownership and remains within the charge to UK corporation tax, the losses may carry over to the transferee company if all of the liabilities of the business are also transferred. The other categories of losses cannot be carried over between companies in a merger.

On a merger, usually one company that acquires assets of the other company issues shares, therefore in such a case the change of control rules may apply here (see 4.1.2).

1.2. Indirect taxes

1.2.1. VAT

Where assets are transferred from one company to another, this will normally be a supply for the purposes of VAT unless the transfer qualifies as a VAT free transfer of a business as a going concern. If the transfer is not considered a transfer of a business as a going concern for VAT purposes the transferor company will therefore have to charge VAT on the value of the assets transferred unless they represent assets which are zero rated or exempt for VAT purposes.

1.2.2. Capital duty

There is no capital duty on new share issues in the United Kingdom.

1.2.3. Other taxes

Stamp duty, stamp duty reserve tax or stamp duty land tax may apply in the United Kingdom at a rate of 0.5% on the transfer of shares and securities and at rates of up to 4% on the transfer of any UK land interest. Three principal exemptions from these taxes which may apply in merger transactions relate to transfers of assets within the same 75% or more owned group, reconstructions involving the transfer of the business of a company in consideration for an issue of shares to the shareholders of the transferor company and on certain share-for-share exchanges.

1.3. Anti-avoidance

1.3.1. Thin capitalization

Thin capitalization legislation in the United Kingdom is part of the transfer pricing law and may disallow a deduction for finance costs where a company's borrowings are in excess of what would be borrowed in an arm's length situation. The arm's length principle is applied to thin capitalization on a case by case basis, with due reference to the specific facts and circumstances of the borrower. There are no UK thin capitalization safe harbours, although the UK tax authorities have published guidance suggesting that a company's borrowing position is likely to be accepted as arm's length if its debt-to-equity ratio does not exceed 1:1 and its profits before interest and taxation are at least three times its total interest expense. However, it is accepted that there are often good business reasons why a company may borrow beyond this position.

1.3.2. Proposed worldwide debt cap rules

With effect for accounting periods beginning on or after 1 January 2010, the UK tax authorities propose to introduce legislation that could impose a further restriction on the tax deductibility of UK interest costs. Broadly, this debt cap will apply where a group's aggregate UK interest expense exceeds the worldwide group's consolidated interest expense, with tax deductions for the UK being limited with reference to the worldwide amount.

1.3.3. CFC

CFC legislation may tax a UK resident company on its appropriate share of the income of UK-controlled foreign companies which are resident in low-tax territories. This is, however, subject to various exemptions, such as where a company is resident in and derives most of its income from countries on an "excluded list", carries on certain genuine trading activities in the foreign country with sufficient local substance, distributes an acceptable level of profits to its UK shareholders each year or can demonstrate the absence of a tax avoidance motive. As set out in section 1.1.2., significant changes to the existing CFC legislation are expected to be brought into effect from July 2009, in conjunction with the introduction of a tax exemption on overseas dividends received.

1.3.4. Transfer pricing

Arm's length transfer pricing rules may apply to transactions between connected companies where they are either cross-border or between UK entities. The determination of arm's length prices follows the OECD transfer pricing

guidelines. The UK transfer pricing regime can adjust profits upwards only. As such, if a UK company's profits would be considered to be understated with reference to the OECD principles, upwards adjustments in the self-assessment tax returns are required to reflect arm's length pricing.

2. Divisions

2.1. Direct taxes

2.1.1. Tax base

A division is defined as a transaction whereby a company transfers all of its assets and liabilities to two or more existing or new companies. In the absence of special relieving provisions, a division will be potentially subject to similar corporate and capital gains tax liabilities as a merger.

2.1.2. Relief for division

Reliefs are available for divisions under both reconstruction provisions (see 1.1.3.) and under special provisions providing certain reliefs for demerger distributions.

2.1.3. Group treatment

See 1.1.4.

2.1.4. Preservation of tax-exempt reserves

There is no concept of tax-exempt reserves under UK law. The only broadly similar provision is the "rollover" relief whereby, in certain circumstances, capital gains arising on the disposal of specified assets may be "rolled over" into the acquisition of further assets. See 1.1.5.

2.1.5. Preservation of tax losses

There are no special provisions which allow for the carry-over of tax losses on a demerger. The only provisions whereby tax losses may be carried over from one company to another are those described at 1.1.6.

2.2. Indirect taxes

2.2.1. VAT

The VAT position relating to businesses and assets transferred in a division will be similar to that in a merger (see 1.2.1.).

Relief from VAT may be available if the transfer meets the specific criteria to be considered as a VAT free transfer of a going concern.

2.2.2. Capital duty

There is no capital duty on new share issues in the United Kingdom.

2.2.3. Other taxes

The position with respect to stamp duties is similar to that on mergers (see further 1.2.3.).

See 4.2. of the IBFD's online database Mergers & Acquisitions.

7. Cross-border mergers

7.1. Direct taxes

7.1.1. Foreign absorbing company, domestic absorbed company

Where a cross-border merger proceeds by a UK resident company or companies transferring its assets to a foreign resident absorbing company, the UK company will be treated as having disposed of the assets transferred in the merger. If the companies are connected or the transaction is not a bargain at arm's length, assets will be deemed to have been disposed of at their market value.

7.1.2. Domestic absorbing company, foreign absorbed company

Where a foreign resident company transfers its business to a UK resident company in a merger, there would not normally be any immediate UK taxation liabilities on the transfer unless the foreign company was already carrying on a trade in the United Kingdom. The UK company would acquire the assets transferred to it at the consideration given in the merger transaction, unless it was not a bargain at arm's length or a transaction between connected persons, when capital assets would normally be acquired at their market value at the date of transfer.

7.2. Indirect taxes

7.2.1. VAT

UK VAT would apply to a cross-border merger transaction in the same way as to a domestic merger, although assets situated outside the United Kingdom will normally be outside the scope of UK VAT.

The relief available from VAT on the transfer of a business as a going concern may be available for a cross-border merger, however there are varying requirements in different jurisdictions which would need to be considered in relation to treating the transfer as a VAT free transfer of a going concern (see 1.2.1.).

UK stamp duty and stamp duty land tax will apply to the transfer of assets on a cross-border merger in the same way as is described at 1.2.3. The relief available for transfers within a 75% group is available regardless of the residence or place of incorporation of the companies concerned and could therefore be utilized on a cross-border merger.

The stamp duty and stamp duty land tax group relief, acquisition relief and reconstruction reliefs apply regardless of the place of registration of any of the companies which is a party to the transaction.

See 4.8. of the IBFD's online database Mergers & Acquisitions.

8. Transnational divisions

8.1. Direct taxes

8.1.1. Domestic dividing company, foreign beneficiary companies

Where a division involves a UK resident company transferring its businesses to companies which include a foreign resident company, the tax position for UK corporation tax purposes would be exactly the same as for a cross-border merger (see 7.1.1.).

8.1.2. Foreign dividing company, domestic beneficiary

The corporation tax consequences where a division involves a foreign dividing company transferring its businesses to at least one UK resident company would be exactly the same as for a cross-border merger involving a UK absorbing company (see 7.1.2.).

8.2. Indirect taxes

8.2.1. VAT

The VAT position in the United Kingdom on transnational division is the same as for transnational mergers (see 7.2.1.).

8.2.2. Other taxes

The UK stamp duty and stamp duty reserve tax position on transnational divisions is the same as for transnational mergers (see 7.2.2.).