



MERGERS AND ACQUISITIONS

United Kingdom

Taxation of Cross-Border
Mergers and Acquisitions

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TAX

United Kingdom

Introduction

The United Kingdom (U.K.) tax environment for mergers and acquisitions (M&A) has changed fundamentally in recent years, and continues to change, in response to a worsening fiscal climate, perceived competitive pressures from other European Union (EU) countries and challenges to existing U.K. legislation under EU non-discrimination principles. This chapter begins by explaining how these changes are likely to affect the approach to transactions.

The chapter proceeds by addressing three fundamental decisions which 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?

Tax is, of course, only one piece of the transaction structuring jigsaw. Company law governs the legal form of a transaction and accounting issues are also highly relevant when selecting the optimal structure. These areas are outside the scope of this book, but some of the key points that arise when planning the steps in a transaction plan are summarized below.

Recent Developments

The following summary of U.K. tax considerations is based on current tax legislation up to and including the Finance Act 2009. It also refers to anticipated developments as at the end of June 2009.

The last edition of this book commented on the consultative document issued on the taxation of foreign profits in the summer of 2007. At the time of writing, significant amendments to the existing legislation have been enacted in the Finance Act 2009 and Corporation Tax Act 2009, which are likely to have a considerable impact on U.K. acquisition structuring. In particular, the new legislation includes:

- the introduction of an exemption for foreign dividends due to commence from 1 July 2009;
- additional restrictions on interest deductibility (the worldwide debt cap) due to come into effect for accounting periods beginning after 1 January 2010;
- the late paid interest rules have been relaxed, effective for accounting periods beginning on or after 1 April 2009;
- the existing Treasury consent regime (whereby certain transactions involving a foreign body corporate may be unlawful without prior consent) is replaced with a reporting requirement for large transactions from 1 July 2009; and
- some relatively minor changes have been made to the U.K. controlled foreign company (CFC) rules from 1 July 2009 over a two-year transitional period.

The changes to the taxation of dividends, the worldwide debt cap and the relaxation of the late paid interest rules are summarized below. This is a fast-moving area and the full impact of the changes is uncertain at present. Local advice should, therefore, be sought when developing a structure, particularly when debt is introduced into the U.K. as part of the transaction.

Taxation of Foreign Dividends

Whilst the changes to the taxation of foreign profits have been described as the introduction of an exemption for foreign dividends, readers should note at the outset that the mechanism proposed is to tax all dividends, including those from U.K. tax-resident companies, and then exempt certain dividends. Broadly, dividends are exempted if they fall into one of the following five classes (unless they form part of a proscribed type of tax avoidance scheme with a main purpose of achieving a tax advantage, in which case they remain taxable):

- Dividends from companies regarded as controlled by the recipient for the purposes of the CFC rules.
- Distributions in respect of non-redeemable ordinary shares. To qualify, shares must not in substance be redeemable and must not carry preferential rights to dividends or assets on a winding-up.

- Distributions from portfolio holdings (broadly meaning no more than 10 percent of issued share capital, with an entitlement to no more than 10 percent economic ownership of the company).
- Dividends in respect of which a commercial motive test is met (that is, that no reduction in U.K. tax is achieved, or that any reduction achieved is minimal and was not one of the main purposes of the transaction).
- Dividends on shares accounted for as a liability under generally accepted accounting practices (GAAP).

Worldwide Debt Cap

The worldwide debt cap rules seek to ensure that interest deducted by the U.K. members of a multinational group does not exceed the group's total consolidated external finance costs. The new rules operate in addition to other existing provisions which can restrict interest deductibility (including the U.K.'s transfer pricing rules, see below). The new rules, therefore, provide an additional hurdle which must be passed for interest to be deductible for tax purposes. The rules come into force for accounting periods beginning on or after 1 January 2010.

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 intra-group financing expenses of each U.K. company, while the available amount represents the net non-U.K. external finance expense of the group (which is restricted to nil if the group has net finance income). If the tested amount exceeds the available amount the excess will be disallowed. To the extent that U.K. companies have financing income from related companies (both U.K. and non-U.K.) and there is a group disallowance by application of the debt cap, such interest income may be tax-free. There are a number of anti-avoidance rules, such as to prevent companies turning intra-group financing arrangements into external borrowings. A specific exemption has been proposed for the financial services industry and the current rules appear to allow debt from some private equity funds to count as external debt. The provisions contain wide-ranging anti-avoidance rules.

The impact of the rules on M&A transactions is likely to be three-fold:

- First, it will in many cases be more difficult to introduce leverage into the U.K. (particularly when the funding is pushed down from related parties).

- Secondly, the rules may mean that existing financing arrangements cease to be tax-efficient.
- Thirdly, 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. This may result in a reallocation of deductions between group companies and/or cause tax losses to become trapped.

This is a fast-moving area and local advice should be sought concerning potential tax-efficient financing structures.

Late-Paid Interest Rules

The new rules relax the existing rule, which denies a tax deduction on interest paid late (that is, more than 12 months after the end of the accounting period in which it accrues) to overseas connected parties until it is paid. For accounting periods beginning on or after 1 April 2009, interest paid to overseas connected parties became deductible on an accruals basis unless the recipient of the interest is in a territory with which the U.K. does not have a tax treaty containing a non-discrimination provision. Specific anti-avoidance rules also apply.

Asset Purchase or Share Purchase

An acquisition in the U.K. more usually takes the form of a purchase of the shares of a company, as opposed to 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. However, the benefits of asset acquisitions for the purchaser should not be ignored, particularly given that purchased goodwill now attracts a tax deduction. Some of the tax considerations relevant to each method are discussed later. The relative advantages are summarized at the end of the chapter.

Purchase of Assets

A purchase of assets will usually result 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 in the hands of the seller. In addition, historical tax liabilities generally remain with the company and are not transferred with the assets. Of course, defective practices or compliance procedures may still be adopted by the purchaser; thus, a purchaser may wish to carry out some tax due diligence to identify and address such weaknesses.

Purchase Price

For tax purposes, it will be necessary to apportion the total consideration among the assets acquired. It is generally advisable for the purchase agreement to specify the allocation, which will normally be acceptable for tax purposes provided it is commercially justifiable. However, there are two statutory rules that 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 his/her own trade. The second requires that the purchaser's cost of acquisition and the seller's disposal proceeds for capital allowance purposes be arrived at by a just apportionment of total consideration.

Goodwill

The tax treatment of intellectual property, goodwill, and other intangible assets has been aligned with their accounting treatment. Goodwill purchased from a third party on or after 1 April 2002 is deductible as it is amortized in the accounts (typically over 20 years). Under international financial reporting standards (IFRS), goodwill is not subject to annual amortization; instead it is subject to an impairment test. It is possible, however, to elect for an annual 4-percent writing-down allowance.

Depreciation

Depreciation of other assets charged in the accounts is ignored for tax purposes. U.K. 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 with respect to certain tangible assets (for example, plant and machinery, and industrial and agricultural buildings) and certain intangible assets (for example, patents and know-how, except that intangible assets created or purchased on or after 1 April 2002 will usually fall within the regime described above).

The U.K. capital allowances regime has been subject to significant amendment in recent years. Allowances for industrial and agricultural buildings are to be phased out by 2010/2011. The annual rate of tax write-off for such buildings, which was formerly 4 percent on a straight-line basis, is to reduce in the years leading up to this cut-off. 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 was reduced in 2008 from 25 percent to 20 percent (on a reducing balance basis). At the same time, a new regime with a lower annual rate

of 10 percent (on a reducing balance) is to be introduced for certain assets (such as integral features of a building) that previously attracted plant and machinery allowances.

There are special rules for cars and certain other assets, and for small and medium-sized companies. Accelerated allowances and tax credits are also available for research and development expenditure. Allowances may be recaptured when 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. However, if 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. Provided, broadly, 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 subsequently used in Newco (subject to potential restrictions if there is a major change in the nature or conduct of that trade, as discussed under Purchase of Shares). This route would, however, crystallize any chargeable gains inherent in the underlying assets transferred and generally is of practical use only when such gains are small or can be offset.

Value-Added Tax (VAT)

VAT is levied at the rate of 17.5 percent (up from the temporary 15-percent rate from 1 January 2010) on a large number of goods and services, although goods exported from the U.K. are not charged with VAT. The transfer of a business as a going concern, however, 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. A sale of assets is, therefore, not in itself the transfer of a business as a going concern. Professional advice should be sought if land or buildings are being sold, because complications arise if the transferor has previously made an election to bring them within the scope of VAT.

Transfer Taxes

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

Transfers of U.K. land and buildings are subject to stamp duty land tax (SDLT). The rates of SDLT on commercial purchases, lease premiums, and other non-rent payments range from 1 percent, if the value transferred exceeds GBP 150,000, to 4 percent, if the value exceeds GBP 500,000. Lease rents are taxable at 1 percent on the net present value of the rent payments if the GBP 150,000 threshold is exceeded. There is a relief for leases when property has been sold and leased back to the seller.

Certain transfers within groups or on company reorganizations are exempt from stamp duty, SDRT or SDLT, or bear 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; 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. The purchaser will, therefore, normally require more extensive indemnities and warranties than in the case of an asset acquisition. An alternative approach is for the seller's business to be dropped down into a newly-formed subsidiary with a view to the purchaser taking a clean company. However, for tax purposes this may crystallize any gains inherent in the underlying assets (note that this tax charge would crystallize in the subsidiary to which the assets had been transferred when it is acquired by the purchaser).

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) normally applies, and where warranties and indemnities would not be given. These situations typically would include the acquisition of a U.K.-quoted company, a purchase from a receiver or liquidator, and sometimes an acquisition of shares owned by individuals not involved in the management of the target.

Tax Losses

Carried-forward U.K. tax losses generated by the target company will, in principle, transfer along with the company. A company's brought-forward income-type

losses (such as trading losses) cannot be offset against the profits of other companies through group relief, but may, in principle, be set 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 against future chargeable gains on assets held before the change in ownership, or acquired for use in the trade from third parties after the transaction.

Where a U.K. 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 not been a major change in the nature or conduct of its trade in the period three years before to three years after the date of acquisition. If the purchaser intends to undertake a major rationalization of the trade or, alternatively, wishes to inject elements of its own trade into the target, it may be advisable to wait until at least three years have passed from the date of acquisition.

If the target is an investment or holding company, there is an additional condition to satisfy on a change of ownership if certain non-trading losses are to be preserved. The use of brought-forward losses (such as financial losses and management expenses) for these companies is also restricted if there is a significant increase in the company's capital within the three years after the acquisition. For this purpose, capital includes both debt (including accrued interest) and equity, and a significant increase is usually GBP 1 million or more.

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 will need to be clarified. For group relief purposes, a loss arising in the accounting period in which the acquisition takes place is usually apportioned on a time basis between the pre-acquisition element (available, subject to possible restrictions, to the seller) and the post-acquisition element (available to the purchaser). If the seller does not or cannot claim group relief with respect to pre-acquisition losses, they will be carried forward in the target company. The indemnities and warranties in the sale and purchase agreement will normally make reference 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 six

years by other U.K. companies within the seller's group, because the sale of the target company causes gains inherent in those assets at the time of transfer to crystallize in the target. It is usual for the purchaser 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 his/her 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 U.K. 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 U.K. 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 is complex and time-consuming, however, so it tends to be used only in larger transactions. Alternatively, it may be possible to reduce the liability if the target has issued debt that will be repaid on the transaction.

Choice of Acquisition Vehicle

There are several potential acquisition vehicles available to a foreign purchaser and tax factors will often influence the choice. There is no capital duty on the introduction of new capital to a U.K. company or branch (or to a U.K.-registered *Societas Europaea*).

Local Holding Company

A U.K. 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 *Funding*) or taxable profits of other U.K. companies (or the U.K. permanent establishments of non-U.K. companies) already owned by the purchaser.

The ability to group-relieve losses (and, in the case of a share acquisition, thereby offset tax-deductible interest in the acquisition vehicle against U.K. 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 U.K.-resident company or a 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 will not necessarily cause any tax problems, because the U.K. does not tax the gains of non-residents disposing of U.K. shares (unless held for the purpose of a trade carried on through a U.K. branch) and does not levy withholding tax (WHT) on dividends. However, the U.K. does charge WHT on interest (certain exceptions apply, notably where the debt is structured as a quoted Eurobond or deep discount security). So, if 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

If 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 U.K. However, the purchaser should be aware that certain U.K. treaties contain 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 U.K. branch. The U.K. does not impose additional taxes on branch profits remitted to an overseas head office. The branch will be subject to U.K. tax at the normal corporate rate, currently 28 percent. If the U.K. 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, there could be a timing benefit arising out of the ability to consolidate losses with the profits of the head office.

Unlike the disposal of a U.K. subsidiary by a non-resident, a disposal of a U.K. branch to a third party will trigger a tax liability on any capital gains. However, there are provisions which, subject to certain conditions, should enable a transfer of the branch's trade and assets to a U.K. group subsidiary to take place without an immediate U.K. tax cost being incurred.

Joint Ventures

Joint ventures can be either corporate (with the joint venture partners holding shares in a U.K. company) or unincorporated (usually a U.K. partnership). Partnerships

are generally considered to provide greater flexibility from a tax viewpoint. For example, where it is seen that the joint venture will make initial losses, the partners should be able to use their shares of those losses against the profits of their existing U.K. trades. By contrast, unless one of the joint venture partners has a 75-percent interest, the losses of a joint venture company would be available only to its owners if the conditions for U.K. consortium relief were met. Broadly, this relief enables a corporate shareholder holding 5 percent or more of a loss-making U.K. company to use its share of the losses against the profits of any U.K. 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.

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 fairly common structure involves the parties establishing a jointly-owned U.K. company that borrows to acquire the U.K. target. Interest paid can offset the target's profits, while relief for any excess interest may be available to U.K. partners (or, in some circumstances, other 75 percent-owned U.K. subsidiaries of non-U.K. partners) by means of a consortium relief claim.

Choice of Acquisition Funding

A purchaser using a U.K. acquisition vehicle to carry out an acquisition for cash will need to decide whether to fund the vehicle with debt or equity, or even a hybrid instrument which combines the characteristics of debt and equity. 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. The costs of a share issue, by contrast, are not deductible.

If it is decided to use debt, a further decision must be made as to 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 set. The following

comments assume that the purchaser wishes to set the interest payments against the U.K. target's taxable profits. However, consideration should be given to whether relief would be available at a higher rate in another jurisdiction.

Typically, a U.K. company is used as the acquisition vehicle, funding the purchase with debt either from a related party (a debt push-down) 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 for interest paid to be offset against U.K. taxable profits arising in the target group over the same period. If interest cannot be offset immediately (that is, there are insufficient taxable profits), the resulting losses can only be carried forward and set against future profits of the U.K. 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 U.K. after (rather than at the time of) the acquisition. In broad terms, this would involve the acquisition by a debt-funded U.K. holding company of the newly-acquired target's U.K. subsidiaries for cash consideration. The analysis of a post-acquisition debt push-down can be complex. Specific anti-avoidance provisions, such as the unallowable purpose rule, may apply and local advice should be sought.

Deductibility of Interest

Broadly, a company's accounting treatment of interest will be 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. Generally, an accruals basis or a marked to market basis will be appropriate and IFRS and U.K. GAAP should meet these criteria. Where a company follows an accounting policy that does not satisfy these criteria it will be taxed on a basis that does meet these requirements.

An important 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 parties are connected and the recipient is not subject to U.K. tax on that interest (non-U.K. residents are not generally so subject). This exception has been relaxed for accounting periods beginning on or after 1 April 2009 (see earlier in the chapter).

There are a number of situations in which a tax deduction for interest payments can be denied under

increasingly complex anti-avoidance legislation. In particular, U.K. 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 impact of the new worldwide debt cap is also likely to require consideration, particularly for multi-national groups, when debt is introduced to the U.K. subgroup from related parties (see earlier in the chapter).

The U.K. 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 U.K. companies since April 2004. Small and medium-sized enterprises are, in principle, exempt (although the U.K. 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 U.K.) parent or overseas (or U.K.) affiliated company that represent an amount that would not have been payable in the absence of the relationship will, under the transfer pricing provisions, not be deductible for U.K. tax purposes. When both parties to the transaction are subject to U.K. 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 in certain situations losses can become trapped).

No specific debt-to-equity ratio or other test is included to assist in deciding whether the legislation applies. Traditionally, however, for non-financial companies the U.K. tax authorities have used a debt-to-equity ratio of 1:1 and interest cover of 3:1 as benchmarks, which are then negotiated according to the particular circumstances of each case. While this remains a reasonable rule of thumb, the U.K. tax authorities are now more likely to consider the criteria by which third parties, such as banks, measure the ability to borrow. Free cash flows are likely to be more important in assessing ability to borrow.

A number of other anti-avoidance provisions may also restrict interest deductibility. For example, interest may be re-characterized as a distribution when the return on the securities depends on the results of the company's

business. Anti-avoidance legislation was also introduced in 2005 to combat certain structures that use hybrid entities and/or hybrid instruments to generate tax benefits (such as by creating a double dip).

Withholding Tax on Debt and Methods to Reduce or Eliminate

Payments of yearly interest by a U.K. 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 convention or, if the recipient is a company resident in another EU Member State, under the EU Interest and Royalties Directive. In most cases it will be clear, either because of the provisions of a relevant double-tax treaty (DTT) or because of the EU directive, which U.K. WHT will not apply to payments of interest to companies in other EU Member States. Payments to companies in other EU Member States which are not clearly exempt from U.K. WHT may fall foul of the EU anti-discriminatory provisions since, in general, the U.K. does not levy WHT on interest paid to resident companies. Specialist advice should be obtained in such cases.

The prior approval of the U.K. tax authorities must be obtained before the reduced rate can be applied. There is also an exemption for payments to U.K. banks and U.K. branches of overseas banks. If 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 a WHT liability 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.
- U.K. group relief operates on a current-year basis only. So if interest cannot be offset immediately, it can only be carried forward for offset against the future profits of the U.K. 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 will apply on interest payments to non-U.K. entities unless a lower rate applies under the relevant DTT/EU directive and advance approval is obtained, or if structured as 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 U.K. does not have any capital duty, and neither stamp duty nor stamp duty reserve tax generally applies to new share issues. As a matter of domestic law, there is no WHT on dividends paid by a U.K. company. Dividends are not deductible for U.K. tax purposes.

The use of equity, although offering less flexibility should the parent subsequently wish to recover the funds it has injected, may be more appropriate than debt in certain circumstances, such as:

- Where the target is loss-making, it may not be possible to obtain immediate tax relief for interest payments.
- There are a number of restrictions on obtaining U.K. tax relief for interest. These may eliminate the principal advantage of using debt.
- If the company is thinly capitalized, it would be disadvantageous to increase borrowings without also obtaining an injection of fresh equity. A tax-efficient structure normally requires an appropriate mix of debt and equity, so that debt-to-equity and interest cover are adequate for U.K. tax purposes.
- 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 have encouraged the use of hybrid funding instruments (see later in the chapter).

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 U.K. capital gains tax liability. It is possible to obtain clearance in advance from the U.K. tax authority that it will not deny the tax-free rollover under the relevant anti-avoidance provisions.

Hybrids

Consideration may be given to hybrid financing – that is, instruments treated as equity for accounts purposes in the hands of one party and as debt (giving rise to tax-deductible interest) in 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 the position is ever-changing and specialist advice should be obtained if such financing techniques are contemplated or already in place.

Discounted Securities

The tax treatment of securities issued at a discount to third parties normally follows the accounting treatment, with the result that the issuer should be able to obtain a tax deduction for the discount accruing over the life of the security. However, if the lender and borrower are connected companies, a deduction for the discount accruing may be deferred until redemption. This deferral applies if the owner of the security is not taxed in the U.K. on the discount accruing. An advantage of discounted securities is that discount, unlike interest, 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 U.K. tax purposes. This has potentially damaging consequences for a seller, because the U.K. 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. It should be noted that, 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 have a significant influence on any transaction. In certain circumstances the seller may prefer to realize part of the value of his/her 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 U.K. 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 U.K. individuals are subject to a flat rate on capital gains of 18 percent from April 2008 (the highest marginal rate for income tax is 50 percent from April 2009). The seller may wish to receive share or loan note consideration, to defer capital gains charges. Each case must therefore be examined on its facts.

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

Company Law and Accounting

The Companies Act 2006 prescribes how U.K. companies may be formed, operated, re-organized, and dissolved. In some respects, U.K. company law allows considerable flexibility: the courts have a high degree of latitude, for instance, in determining how companies may be re-organized. But in other respects the rules are relatively restrictive: corporate identity must be preserved so that, for example, the flexibility surrounding reorganizations does not extend to allowing companies to merge.

As for M&A, a business combination (which under IFRS is defined 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 when it effects a pooling of business interests (that is, 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. In general, most combinations are accounted for as acquisitions, merger accounting only being applied in limited circumstances. Merger accounting is not allowed under IFRS; all business combinations must be accounted for as acquisitions. The relevant U.K. 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. 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 U.K. generally accepted accounting principles (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 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 that this is necessary to bring accounting policies into line.

Another important feature of U.K. 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 amount. These provisions may remove or decrease the restrictions on the ability to make distributions. IFRS, however, 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 is the provisions concerning financial assistance. Broadly, these say that it is illegal for a public company (or one of its private subsidiaries) to give financial assistance, directly or indirectly, for the purpose of the acquisition of that company's shares. The scope of the prohibition was previously much wider, and prior to October 2008 it applied to acquisitions of private companies unless a whitewash procedure was carried out, which required the directors to make statutory declarations as to the

solvency of the company. This latter requirement was removed by the Companies Act 2006.

Group Relief/Consolidation

If the purchaser owns other U.K. companies, the target company would be included in a U.K. tax group so that U.K. profits and losses can, effectively, be 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, broadly, also entitles it to 75 percent economic ownership of the target.

Transfer Pricing

If, following acquisition, an inter-company balance arises between the purchaser and the target, failure to charge interest on the balance may give rise to transfer pricing problems in the relevant jurisdiction. For example, where the balance is owed to the target, the U.K. tax authorities could impute interest on the balance if an arm's-length interest rate is not charged.

Dual Residency

There are few advantages in seeking to establish a dual resident company. The losses of a dual resident investing company cannot be offset against profits of other U.K. companies.

Foreign Investments of a Local Target Company

The U.K.'s controlled foreign companies (CFC) legislation is designed to prevent U.K. companies from accumulating profits offshore in low-tax countries. Unless the offshore subsidiary is carrying on certain acceptable activities or meets other specified conditions, its profits will be apportioned to its U.K. parent and subjected to tax. Previous editions of this book referred to an acceptable distribution policy (ADP) test, whereby a CFC could broadly be exempted from apportionment by distributing at least 90 percent of its net chargeable profits within 18 months of the end of the accounting period. This exemption, together with the exemption for certain holding companies, has been repealed with the passing of Finance Act 2009. A 24-month transitional period applies to existing holding companies to allow groups time to restructure. Further consultation regarding the CFC regime is to take place, although it is unlikely that a significant overhaul will occur before 2010/2011.

Comparison of Asset and Share Purchases

Advantages of Asset Purchases

- The purchase price (or a proportion) can be depreciated or amortized for tax purposes (including 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.
- There is no acquisition of a tax liability on retained earnings.
- It is possible to acquire only part of a business.
- It may be possible for the seller to roll over gains into the cost of acquiring other assets.

Disadvantages of Asset Purchases

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

Advantages of Share Purchases

- There is usually a lower capital outlay (purchase of net assets only).
- It is 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.
- The buyer may benefit from tax losses of the target company.
- The purchaser may gain the benefit of existing supply and technology contracts.

- Lower transfer duties will usually be payable.

Disadvantages of Share Purchases

- The buyer acquires unrealized tax liability for depreciation recovery on the difference between accounting and tax book value of assets.
- The buyer effectively becomes liable for any claims or previous liabilities of the entity (including tax).

- No deduction is available for the purchase price.
- The buyer acquires any tax liability on retained earnings that are ultimately distributed to shareholders.
- It may be more difficult to finance tax-efficiently.

Withholding Tax Rate Chart

The rate information and footnotes contained in this table are from the 2009 IBFD/KPMG Global Corporate Tax Handbook.

Country	Interest ¹ (%)	Royalties (%)
Antigua and Barbuda	- ²	0
Argentina	12	3/5/10/15 ³
Australia	0/10 ⁴	5
Austria	0	0/10 ⁵
Azerbaijan	10	5/10 ⁶
Bangladesh	7.5/10 ⁴	10
Barbados	15	0/15 ⁷
Belarus ⁸	0	0
Belgium	15	0
Belize	- ²	0
Bolivia	15	15
Bosnia and Herzegovina ⁹	10	10
Botswana	10	10
Brunei	- ²	0
Bulgaria	0	0
Canada	10	0/10 ¹⁰
Chile	5/15 ¹¹	5/10 ¹²
China (People's Rep.)	10	7/10 ¹²
Croatia ⁹	10	10
Cyprus	10	0/15 ⁷
Czech Republic	0	0
Denmark	0	0
Egypt	15	15
Estonia	10	5/10 ¹²
Falkland Islands	0	0
Fiji	10	0/15 ¹³
Finland	0	0
France	0	0
Gambia	15	12.5
Georgia	0	0
Germany	0	0
Ghana	12.5	12.5
Greece	0	0
Grenada	- ²	0
Guernsey	- ²	- ²
Guyana	15	10
Hungary	0	0
Iceland	0	0
India	10/15 ⁴	10/15 ¹²
Indonesia	10	10/15 ¹²
Ireland	0	0
Isle of Man	- ²	- ²
Israel	15	0/15 ⁷
Italy	10	8

United Kingdom

Country	Interest ¹ (%)	Royalties (%)
Ivory Coast	15	10
Jamaica	12.5	10
Japan	0/10 ⁴	0
Jersey	- ²	- ²
Jordan	10	10
Kazakhstan	10	10
Kenya	15	15
Kiribati	- ²	0
Korea (Rep.)	10	2/10 ¹²
Kuwait	0	10
Latvia	10	5/10 ¹²
Lesotho	10	10
Lithuania	0/10 ¹⁴	5/10 ¹²
Luxembourg	0	5
Macedonia	0/10 ¹⁵	0
Malawi	0/- ¹⁶	0/- ¹⁶
Malaysia	10	8
Malta	10	10
Mauritius	0/- ¹⁷	15
Mexico	0/5/10/15 ¹⁸	10
Moldova ²⁴	0/5 ¹⁹	5
Mongolia	7/10 ⁴	5
Montenegro ⁹	10	10
Montserrat	- ²	0
Morocco	10	10
Myanmar (Burma)	- ²	0
Namibia	- ²	0/5 ¹³
Netherlands	0	0
New Zealand	10	10
Nigeria	12.5	12.5
Norway	0	0
Oman	0	0
Pakistan	15	12.5
Papua New Guinea	10	10
Philippines	10/15 ²⁰	15/25 ²¹
Poland	0/5 ⁴	5
Portugal	10	5
Romania	10	10/15 ⁶
Russia	0	0
St. Kitts and Nevis	- ²	0
Saudi Arabia ²⁵	0	5/8 ¹²
Serbia ⁹	10	10
Sierra Leone	- ²	0
Singapore	10	0/10 ⁶
Slovak Republic	0	0
Slovenia ⁹	10	10
New treaty ²⁴	0/5 ²²	5
Solomon Islands	- ²	0
South Africa	0	0
Spain	12	10
Sri Lanka	0/10 ⁴	0/10 ⁶
Sudan	15	10
Swaziland	- ²	0
Sweden	0	0
Switzerland	0	0
Taiwan	10	10
Tajikistan ⁸	0	0
Thailand	0/25 ⁴	5/15 ⁶

Country	Interest ¹ (%)	Royalties (%)
Trinidad and Tobago	10	0/10 ¹³
Tunisia	10/12 ⁴	15
Turkey	15	10
Turkmenistan ⁸	0	0
Tuvalu	- ²	0
Uganda	15	15
Ukraine	0	0
United States	0	0
Uzbekistan	5	5
Venezuela	0/5 ⁴	5/7 ²³
Vietnam	10	10
Zambia	10	10
Zimbabwe	10	10

Notes

- Many treaties provide for an exemption for certain types of interest, such as interest paid to the state, local authorities, the central bank, export credit institutions, or in relation to sales on credit. Such exemptions are not considered in this column.
- The domestic rate applies; there is no reduction under the treaty.
- The 3-percent rate applies to royalties paid for news; the 5-percent rate applies to copyright royalties (other than films, etc.); the 10-percent rate applies to industrial royalties.
- The lower rate applies to interest paid to financial institutions (as defined).
- The higher rate applies if the Austrian company controls more than 50 percent of the voting stock of the U.K. company.
- The lower rate applies to copyright royalties.
- The higher rate applies to films, etc.
- The treaty concluded between the U.K. and the former USSR.
- The treaty concluded between the U.K. and the former Yugoslavia.
- The lower rate applies to copyright royalties (excluding films), computer software, patents, and know-how.
- The lower rate applies to interest on loans granted by banks and insurance companies, bonds or securities that are regularly and substantially traded on a recognized securities market, and a sale on credit of machinery and equipment.
- The lower rate applies to equipment rentals.
- The lower rate applies to copyright royalties (excluding films, etc.).
- The lower rate applies to interest paid by a public body.
- The lower rate applies to interest paid on a loan by one enterprise to another.
- The domestic rate applies if the Malawi company controls more than 50 percent of the voting power of the U.K. company.
- The zero rate applies to interest paid to banks; the domestic rate applies in other cases (no reduction under the treaty).
- The zero rate applies to interest paid by a public body; the 5-percent rate applies to interest paid to banks and insurance companies and to interest on bonds and securities regularly and substantially traded on a recognized securities market; the 10-percent rate applies to interest paid by a bank or by a purchaser of machinery and equipment in connection with a sale on credit.
- The lower rate applies to interest paid by a public body and to interest on a sale on credit of machinery and equipment.
- The lower rate applies to interest paid by a company in respect of the public issue of bonds, etc.
- The lower rate applies to films, etc.
- The lower rate applies to interest paid by public bodies. It also applies where the payer and the recipient are both companies and either company owns directly at least 20 percent of the capital of the other company, or a third company, being a resident of a contracting state, holds directly at least 20 percent of the capital of both the paying company and the recipient company.
- The lower rate applies to royalties for patents and know-how.
- Effective from 1 January 2009 in Moldova/Slovenia and from 1 April/6 April 2009 in the U.K.
- Effective from 1 January 2010 in Saudi Arabia and from 1 April/6 April 2010 in the U.K.

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