

BARNES ROFFE CORPORATE FINANCE

BUSINESS ACQUISITIONS SEMINAR

DUE DILIGENCE AND TAXATION

The following notes follow the format of the slides presented by Mario Ciantanni BSc ACA.

The notes give further detail and background to the slide presentation, but are not intended to be a full summary or a word for word substitute for the presentation itself. Hopefully, however, readers of these notes will be able to glean further information and statutory references, where necessary, to some of the technical issues discussed in the presentation.

Due Diligence

What is due diligence?

Due Diligence is the term that is now commonly used to describe the financial, commercial and legal processes carried out by any purchaser prior to an acquisition, whether it be an acquisition of shares or of assets. The term itself is an “Americanism” coming now to replace what was traditionally called “an investigation” by UK accountants.

The objective of a due diligence exercise is to provide comfort on the financial position of the target/subject company and to identify the key financial and commercial risks that may be involved with any transaction.

Inevitably, an element of due diligence work will be carried out by every purchaser in respect of virtually every transaction. Sometimes the process may not be a formal one, or consciously thought out, but it would indeed be rare for any purchaser to acquire a business (shares or assets) without some form of forethought as to what he is purchasing.

In a formal due diligence exercise, a host of areas will be covered, from commercial due diligence through to financial, legal, environmental, employment and other matters.

Is Due Diligence Necessary?

Unfortunately for purchasers, the UK legal system provides no statutory protection in respect of the acquisition of a business. The general rule is “caveat emptor” i.e. “let the buyer beware”. Certainly for any unquoted acquisition there is no statutory protection provided within UK legislation in relation to what may or may not be said by a vendor of any business to a potential purchaser.

Most purchasers are familiar with the concept of warranties and indemnities, and will realise the need to obtain from vendors whatever warranties are available relating to the assets or shares being sold. However, the existence of warranties and indemnities in themselves does not negate the requirement for due diligence since the courts have for a long time now left the onus on purchasers to nevertheless carry out their own pre transaction investigation to verify the facts and figures available with regard to any business being considered for acquisition.

The advice is therefore relatively straightforward. If a purchaser wishes to proceed with any potential transaction he should firstly take some of his own time (and costs) to more closely investigate the target and to verify some of the financial and other information available in respect thereof. He should not seek to rely on vendors warranties alone to protect him should matters come to light, post the transaction, which might otherwise have affected his view of value and price. Furthermore, to successfully pursue any form of warranty claim, post completion, the purchaser will also have to prove he carried out his own pre transaction assessment with the necessary care and attention required.

When is Due Diligence Carried Out

Generally, due diligence arises at two levels:-

- (a) Prior to signing Heads of Terms the purchaser will have carried out some level of commercial due diligence himself. This may comprise of an informal review of the business, perhaps even some meetings with the potential vendor and other persons involved, and a review of whatever publicly available information might be open to him.
- (b) After signing Heads of Terms, a more formal review will be generally carried out, involving accountants, lawyers, and other consultants. Most of today's discussion is concerned with this latter exercise.

Who Carries Out Due Diligence

The ideal form of a due diligence review will comprise of a blend of personnel, between external and internal advisors, each concentrating on his own knowledge base and area of expertise. The external advisors will generally comprise accountants and lawyers, who deal with the facts, figures, legal issues, premises, and certain system matters. Nowadays, environmental consultants and surveyors will also form an important part of such a team, reporting on issues in these areas which may have future impact on the viability of the business.

It is important also to involve internal team members to concentrate on those areas, in particular, where an intimate knowledge of the business is required and which cannot be given by the external advisors. Therefore, areas such as marketing, personnel and systems will be more appropriately handled by certain internal team members, generally key management personnel and others with regard to whom confidentiality relating to the transaction at hand can be assured.

Needless to say, it is absolutely vital that everybody on the team is briefed as to the precise scope and timing of their services, and that the team works coherently as a unit in bringing the process to a successful conclusion.

Common Misconceptions

We find clients have a number of misconceptions, often about the nature of the due diligence exercise.

It must be emphasised that due diligence is not an audit. We are not reporting under the provisions of auditing standards, nor by reference to any legislative format. We are generally not forming a view on a balance sheet or set of financial statements, nor auditing the same. Likewise, due diligence does not involve a verification of an audit which may have been undertaken previously on a target company. We may review auditors' files to verify that they have conducted their audit in compliance with auditing standards etc., but we will not be verifying the efficacy of the audit itself.

Likewise, the aim of the due diligence exercise is not to produce a certificate of value, or an endorsement that the price being paid for the target business is correct. Finally, due diligence, as noted above, cannot be utilised as a substitute for warranties, since the onus is on the purchaser to undertake his own investigations prior to the transaction.

Being more positive about the due diligence process, it can be said that due diligence is definitely time critical. There is no concept that a due diligence exercise can be carried out post completion, nor indeed even on the eve of signing documents. Due diligence needs to be completed fairly early on in the negotiating process since due diligence itself is critical in assessing the most ideal type of structure for the deal. As noted, due diligence is also necessary if a purchaser is going to be able to rely on warranties then given by the vendor should he wish to sue on the same.

Due diligence is much wider ranging than an audit (normally) since the aim will be to review a host of processes and transactions and structures involved with any business. Whilst the accountant/lawyer is not forming any type of audit opinion, he will however be looking at a much wider range of issues than will be reviewed by an accountant performing an audit on a balance sheet. The type of verifications also undertaken throughout this process will vary depending upon the purchasers requirements and scope of the exercise.

Key Questions Posed by Due Diligence

As part of the objectives, the main/key questions which the due diligence exercise aims to answer are as follows:-

- (a) Is the target the strategic fit which the purchaser thought it would be?
- (b) Does the target business require fundamental investment or re-engineering to make the deal work?
- (c) Is the purchaser now aware of any downsides (or perhaps even upsides) which might affect his view of valuation?
- (d) What further specific warranties or clauses might the purchaser now require in the purchase agreement to deal with issues uncovered by the due diligence exercise?

Commencing the Exercise

Planning is vital, so as to ensure the correct scope of the exercise and logistical issues such as access and staff availability. One of the key problems with such an exercise is obtaining adequate access to the target's personnel, who will very often be unaware of the potential transaction. Vendors are notoriously coy about allowing access to premises, records and staff, and very often the accountants/lawyer will have to work under a suitable guise or alias in order to carry out necessary on site work. From the perspective of the purchaser, of course, attendance on site, during working hours, is absolutely vital. Often a lot more can be gleaned and assessed (from both within and outside the scope of the exercise) by just watching the target in operation!

The initial information questionnaire is also a vital component of the exercise and needs to be handled with appropriate skill and expertise. However, a good due diligence questionnaire (and response) can assist in cutting down significantly the work which may otherwise have to be completed by lawyers.

Scope

The scope of the assignment will be governed by a number of factors, to include purchaser's requirements, likely costs, time available, risk involved with the transaction, knowledge of the target etc. Additionally, the type of asset being acquired (i.e. shares or assets) will affect the scope of any necessary due diligence exercise.

As with the planning, identifying the scope of the exercise is an absolutely vital prerequisite to a successful conclusion.

The handout pack includes a proforma/skeleton due diligence report. We have included this in our information pack as it covers most of the issues which will be commonly dealt with as part of a due diligence exercise. The speaker will utilise the time available to highlight some of the more common aspects which are dwelt upon within a typical due diligence report, and to bring out some of the salient concepts involved.

Taxation

General Principles

As one might expect, the issue of taxation is generally more close to the heart of the vendor than it is to the purchaser in most transactions! Generally speaking, there are normally few opportunities for a purchaser to avoid or reduce taxation payable as a result of any acquisition. Furthermore, there is a traditional tension between purchasers and vendors with regard to this issue (i.e. for a vendor to structure a transaction to save tax will often involve a tax cost for a purchaser!).

As a result of certain measures in the 2002 Finance Act, this gulf is likely to widen.

The general principle is that purchasers will normally wish to purchase certain types of asset or stock, whereas vendors will generally wish to sell shares. Recent legislative changes have increased the benefits to vendors who have shares to sell. The main reasons for the dichotomy of interest are:-

- (a) For an incorporated business, there is generally a double charge to taxation arising from an asset sale, first on the company profit on sale of assets, and then on the shareholders' extraction of the profits from the company.
- (b) More generous CGT rules relating to UK individuals selling unquoted/trading company shares have been recently introduced to reduce the longer term rate of CGT down to a maximum 10%.
- (c) Within the corporate realm, there is now corporation tax relief for acquisition of goodwill (as opposed to shares). Broadly speaking, tax relief will be given on the amortisation charged in the accounts annually.

Corporate Vs Personal Purchaser – Post 2002

As noted above, the 2002 Finance Act has introduced a measure of corporation tax relief for the acquisition of goodwill. This relief is only available within the corporate realm, but will tend to push corporate purchasers further toward asset acquisitions as opposed to share acquisitions if possible.

Corporations (and indeed individuals) receive no tax relief for acquiring shares. This applies equally to both companies and personal acquirers. However, following further changes in the 2002 Finance Act, corporate vendors can now sell substantial shareholdings entirely free of tax. Individuals (unincorporated entities) will however now have the benefit of the enhanced taper relief provisions, thus reducing the CGT payable on long term gains to a maximum 10%. Overall, recent changes therefore tend to drive vendors towards wishing to sell shares, as opposed to assets. They tend to drive purchasers, however, further toward acquiring assets rather than shares! Having said that, for incorporated companies, we now have a beneficial regime whereby shares can be sold (in unincorporated trading companies) entirely tax free.

Acquisition of Shares

As noted, there is no income tax or corporation tax relief granted to the purchaser for an acquisition of shares. He will however pay stamp duty at one half of a per cent. There is also the possibility of capital gains crystallising within companies acquired from a group, under Section 179 TCGA '92. This charge is often the subject of additional negotiation between vendor and purchaser. It should also be noted that any tax losses are preserved and remain available for use by the purchasers against future profits of the acquired company although there is complex anti avoidance legislation to prevent shell companies with historic losses being acquired as vehicles for future profitable ventures.

Acquisition of Assets

By contrast, a purchaser can stand to receive some significant tax breaks by acquiring assets instead of shares. The type of tax relief available, and its timing, will depend upon generally the type of asset acquired.

- (a) ***Fixed assets*** – Plant and machinery, motor vehicles etc., will generally attract a capital allowance of up to 25% on a reducing balance basis. Small and medium sized acquirers remain eligible for 40% first year allowances.

Computer equipment, acquired by “small” entities (corporate or otherwise) attract a 100% allowance in the year of acquisition. This relief continues for a further year under the provision of the Finance Bill 2003.

The acquisition of land and buildings will often acquire no measure of tax relief, albeit industrial buildings allowances (IBAs) may be available in certain circumstances.

- (b) **Stock** – The acquisition of stock or work in progress will attract corporation tax or income tax relief on normal commercial principles, i.e. 100% relief against subsequent sale proceeds.
- (c) **Goodwill** – Following the Finance Act 2002, there is now Corporation Tax relief for corporate purchasers of goodwill, but no income tax relief to personal purchasers. Having said this, individuals who sell goodwill are able to claim the more generous taper relief provisions for CGT purposes.
- (d) **Intellectual property** – No income tax relief is given for the acquisition of intellectual property.
- (e) **Debtors, cash, other assets** – No implications.

Capital Gains Tax

For corporate purchasers, there may be some capital gains tax advantages to be obtained from the acquisition of certain types of asset. This arises where there is a previous capital gain which needs to be “rolled over”.

Notwithstanding the roll over provisions, certain types of asset acquired by either a corporate or individual purchaser will attract no corporation tax or income tax relief, but will constitute qualifying costs for capital gains purposes. In other words, the cost of such assets can be offset against future sale proceeds in computing any eventual capital gains made from those assets. The assets concerned here are generally:-

- (a) Freehold property/land and buildings.
- (b) Goodwill, intellectual property and other intangibles – remember the cost of intangibles can now be relieved, as amortised, against corporation tax profits by companies (but not individuals).
- (c) Shares – In the corporate realm now exempt CGT (for substantial holdings), but the original cost, for individuals, is carried forward for relief against subsequent disposals. Any gains may be subject to CGT of no more than 10% if qualifying as business assets. (Unlisted trading companies or trading companies where held by an officer/employee or holder of 5% or more of the equity.)
- (d) Leaseholds – One tip for purchasers, beware of short leaseholds. A short leasehold is defined as leasehold land and buildings which have a lower than 50 year term to run. The cost of acquiring such leasehold property is “amortised” for capital gains purposes per Schedule 8 TCGA 1992. Thus, if such property is sold, the original cost may not be fully allowable for CGT purposes.

Stamp Duty

Stamp duty is by convention a purchaser's tax charge, although, interestingly, there is no statute which dictates that the purchaser, rather than the vendor, is liable. Furthermore, it can be a charge of up to 4%, depending upon the type of asset acquired, and whether or not that asset is capable of transfer by delivery.

On a share purchase, however, the rate of stamp duty is one half a per cent. Anti-Avoidance measures now prevent use of Shell Companies to transfer land interests and extend period where HMT can claim back Stamp Duty relief previously given to group companies to three years.

The trick in asset purchases, of course, is to ensure that all such assets acquired are capable of transfer by delivery and that an appropriate certificate of value is given as part of the sale agreement. Recent legislative changes have created a more beneficial regime for goodwill and intellectual property, both of which are now exempt stamp duty. From 1st of December 2003 only Property (land and buildings), Partnership Interests and Shares will remain dutiable.

The normal stamp duty issues therefore tend to revolve around freehold and leasehold property as well as the transfer of debtors in an asset sale. Transferring ownership of debtors can be a relatively torturous legal task, and most asset purchase arrangements involve the purchaser in simply collecting outstanding debtors on behalf of the vendor, acting as his agent. This avoids the need to formally transfer such debtors, thus also avoiding the raising of a formal document which would otherwise be stamped/liable to stamp duty.

As regards freehold property, a whole tax planning industry has evolved around the avoidance of stamp duty in this regard! The values involved can be extremely large, but many avoidance measures are seeing progressive attack now from the Revenue. In particular, values in excess of £10million left "resting on contract" are now brought into charge. In addition leases attract stamp duty relating both to the premium paid, if any, the rent and the duration of the lease. It is generally the case that costs under £60,000 do not attract stamp duty. This nil band does not apply to lease premiums! From 1st of December 2003 Lease duty on rent is calculated as 1% x NPV of rent due per annum. Discount factor is 3.5%. Residential values up to £60k will be exempt and non residential values up to £150k are to be exempt. The duty regime for premiums is unaffected.

VAT

VAT implications on business acquisitions are relatively straightforward. The acquisition of shares gives rise to no VAT consequences.

The acquisition of assets, on the other hand, can give rise to VAT, but certain rules exist to ameliorate the effect of this, known as the transfer of going concern provisions. Generally speaking, provided both vendor and purchaser are VAT registered at the time

of the transaction, and provided the business is transferred as a going concern, no VAT has to be levied on the transaction. Fine tuning is often required to ensure that buildings are similarly exempted. Generally, if both vendor and acquirer have waived their exemption (if applicable) from VAT re any building, VAT need not be charged.

Deferred Mechanisms and Earn Outs

As noted, the tax issues on business sales generally excite more interest among vendors. This certainly arises in situations where part of the value of the transaction is put on deferred terms, or linked to an “earn out”.

Common mechanisms which have been utilised to provide for such deferred consideration involve “loan notes”. The main concern for purchasers has been to ensure that no immediate tax charge arises as a result of a deferred element to a deal which, of course, may or may not be payable. The precise status of loan notes also has been subject to exceptional scrutiny by vendors in recent years with changing (generally falling) rates of capital gains tax, and a desire to see their deferred consideration from a deal taxed in a later tax year rather than an earlier one.

For purchasers, these mechanisms are generally of little consequence, particularly in the context of a share purchase.

However, in the context of earn outs, there are opportunities often for purchasers to save some taxation as a result of the earn out mechanism. In particular, if the earn out mechanism can be sufficiently divorced from the initial share or asset purchase, it may be possible for the purchaser to obtain some ongoing corporation tax relief out of the earn out payments. Particular mechanisms which we see utilised involve either royalty payments, commissions or consultancy fees. Great care has to be taken to ensure that the earn out proceeds cannot be linked to the original business acquisition, and in particular there has to be an element of variation or risk involved to the vendor in the earn out mechanism to be able to argue that the two tranches of sale proceeds are separate. However, with a little care and planning, it is generally possible to utilise such arrangements (particularly agency commissions and consultancy fees) to engineer a level of additional corporation or income tax relief for the purchaser, whilst at the same time leaving the vendors with sufficient incentive to undertake the transaction.

From the vendor’s perspective, to the extent that loan notes are received for shares, no capital gains tax is due until the loan notes are encashed.

Usually, if the loan notes are of fixed face value they are known as “qualifying corporate bonds” and any gain on disposal of the original shares is frozen at disposal and charged to tax pro-rata at realisation of the loan notes. Any additional gain based on an increase in the value of the company, and hence the loan note, is exempt from capital gains tax.

The position is different if the value of the loan notes is contingent on the company’s performance. The original gain is still not charged until realisation but further gains are subject to capital gains tax and all the gains would be subject to subsequent changes in the tax regime. In addition there is a small risk that business asset taper relief could be jeopardised, but only if the company obtains a listing.

Inheritance Tax

If succession planning is an issue it should be borne in mind that, in most circumstances, shares in unquoted trading companies qualify for 100% business property relief whereas assets held personally, used in a business, or controlling interests in quoted trading companies only attract 50% relief. However, disposals of entire interests in an unincorporated business would qualify for 100% relief.