Tax Planning in Pre-packaged Administrations

Michael Jones*

Pre-packaged administrations,[1] or "pre-packs" as they are commonly known, are a phenomenon on the rise. Their prevalence has been well documented,[2] but what has yet to be considered is whether they present any restrictions on, or opportunities for, tax planning in and around corporate insolvency. This note focuses on one important aspect of such planning, namely the use of tax losses, which is a subject that highlights the way in which pre-packs can impact on taxation in insolvency.

Background

Broadly speaking, a pre-pack works as follows. The troubled company, X Ltd, recognises that either it is, or will presently be, insolvent. It has a valuable business, or at least valuable assets, for which a prospective purchaser has been found. At this point a licensed insolvency practitioner, the administrator-in-waiting, is brought in to advise on the whether the terms of any proposed sale would be acceptable to him in his capacity as administrator of X Ltd. Against this background the purchaser and the company negotiate, but do not execute, an agreement for sale. The contract will usually contain only very limited warranties from the prospective administrator,[3] who will be the one executing the sale once the company is in administration.

After the terms of the sale have been agreed by the parties the company is placed into administration, usually using the "out of court" appointment procedure.[4] Once in office the insolvency practitioner, now acting as administrator, will execute the sale as agent for X Ltd. The advantage of having the sale executed in administration is that it provides an element of cover for the management of X Ltd, particularly where they are the ones buying the business from the administrator. Were the management themselves to execute a quick sale of X Ltd's business at a price less than market they would run a high risk of being challenged on the basis of being in breach of their fiduciary duties, especially where that sale was to themselves. By having the sale blessed and then executed by the administrator, however, the risk of challenge is lower. Another benefit of the pre-pack is that the time during which the company is subject to a formal insolvency procedure is kept to a minimum. This is particularly important where the main asset of the business is goodwill or where it is crucial to the survival of the business that disruption to its employees and clients is minimised.

After the sale is completed the administrator will wind down the company, making what distributions he can.

Tax Planning and Accumulated Losses

By the time a company reaches the stage where it might need to consider a pre-pack sale it will very often have already accumulated a considerable amount of trading losses. If it carries on trading after that point then it may well amass more. From a tax perspective there is value to be extracted from these losses and this can be done in one of two ways. First, the company might utilise them directly against its own tax liabilities; alternatively, the company could transfer its trade, together with the associated losses, to another company in return for consideration. Both options are discussed in more detail below.

On a more general note, it will be seen from what follows that the rules governing the use of losses in this context are relatively restrictive. This leads one to question whether tax law hinders the aims of insolvency law in this area, particularly in light of the Enterprise Act 2002 reforms and the focus on rescue.[5]

Direct Use of Losses

If or insolvent company, X Ltd, has any trading losses it can use them itself. The asset sale by the administrator may give rise to corporation tax on any chargeable gains, against which may the accumulated losses might be set. However, the company's entry into administration triggers a new corporation tax accounting period (s.10(1)(i), Corporation Tax Act 2009 (formerly s.12(7ZA) ICTA 1988)), with the result that the range of losses that can be used for such a purpose is substantially reduced. Under section 393A trading losses can only be set-off against chargeable gains in the same accounting period in which the losses arose or an earlier one. Once that period expires, trading losses can only be carried forward against future profits of the same trade.

So, if trading losses have been accumulated in the accounting period prior to the company's entry into administration then, purely from a tax-planning point of view, it would be better to complete the asset sale before the company enters administration because losses will be available to set-off against any gains. After entry into administration the trading losses can only be used if the company continues to trade,[6] but, of course, if the administrator has sold the business assets within days of entry into administration there will not be any future profits of the trade arising to the company. The losses will, therefore, go unused.

This problem is not exclusive to pre-packs, it is a feature of all administrations, but it is perhaps most pronounced where pre-packs are involved because the sale is negotiated at a point when losses would potentially be available but it is executed perhaps only days later at a point when those losses can no longer be used. What is more, had the sale been executed outside of administration any resulting tax would have ranked as an unsecured claim; once inside the administration procedure, however, any corporation tax on chargeable gains will rank as an expense of the administration[7] to the benefit of HMRC and to the prejudice of the other creditors.

Using Losses Directly in a Pre-packaged Insolvency

One option to get around these restrictions would be to have the pre-pack effected by an administrative receiver rather than an administrator, if that option is open to the charge holder.[8] The appointment of an administrative receiver does not cause a change in accounting period of the company and so the pre-negotiated sale can be executed and trading losses used against any resulting gain without the same restrictions.

Another option, subject to obtaining the necessary insolvency/company law advice, would be to have the company execute the sale of any assets standing at a capital gain before it enters administration. This would have the effect that the chargeable gain would arise in the accounting period during which trading losses are available for set-off.

A third option would be for the administrator to effect a hive down and then a sale to a third party. Alternatively, where the ownership of the transferor and the transferee companies will be the same there will be the possibility of using section 343 ICTA 1988 to pass the trading losses of the transferor to the transferee company for use in the carrying on of the trade. Hive downs and section 343 are discussed in the next part.

Indirect Use - Hive Downs

As just mentioned, one way around the restrictions on the direct use of trading losses is to make indirect use of them by transferring them to someone who is able to use of them going forward. This can be achieved by the administrator effecting a transfer, or hive down, of the trade and the assets into a "clean" subsidiary, which can then be sold to a purchaser.

This form of indirect asset-sale allows for the administrator to cherry-pick the valuable and profitable assets of the company, leaving behind any onerous or valueless assets. A further benefit that a hive down has over a straight assets sale is that the potentially valuable tax losses and capital allowances can be transferred to the subsidiary by virtue of section 343 ICTA 1988, which, in fact, began life as an anti-avoidance section.

Section 343 applies where one company ceases to carry on a trade, and another company begins to carry it on and, on or at any time within two years after that change, the trade, or at least a 75% interest in it, belongs to the same person as it did at some point within a year before the change. There is a further requirement that within the two year time frame the successor company carries on the trade within the charge to corporation tax. If these conditions are met then the successor company is entitled to the capital allowances and the unclaimed trading losses available for carry forward relief under section 393 ICTA 1988.

Looking at those requirements in turn, first, it is crucial that, on or within two years after the transfer, the trade or at least a 75% interest in it must be owned by the same person as it belonged to at some time within a year before the transfer. Under section 344(2), a trade or an interest in a trade belonging to a company can be treated as belonging to the persons owning the ordinary share capital of the company and as belonging to those persons in proportion to the amount of their holding of that capital. Alternatively, where it is a subsidiary company that carries on the trade, it can be treated as belonging to its parent or to those persons that own the share capital of the parent, and again, in proportion to the size of their respective holdings. For these purposes, as is common in taxing statutes, ownership means beneficial ownership. In essence, therefore, this provision ensures that the focus is upon economic, rather than pure legal, ownership of the trade.

To put this into the context of a hive down in an administration, it means that, within two years of the hive down, X Ltd, our insolvent company, must beneficially own, directly or indirectly, at least three-quarters of the share capital of the subsidiary in order to meet the first condition in section 343. Care must be taken to ensure that beneficial ownership of those shares has not been lost, for example, as a result of the administrator having contracted to sell the shares in the subsidiary to a third party purchaser before the requirement has been met.

Secondly, the section does not stipulate any minimum period during which the common ownership condition must be fulfilled; all that is required is that the requirement is met on or at any time within two years after the point of transfer. On a literal reading the section is brought into play where the condition is met for only a *scintilla temporis* on or after transfer. Ideally, however, in order to give the reconstruction some substance, it is suggested that X Ltd should beneficially own the shares for at least a week, during which Newco can carry on the trade, before any subsequent sale. It may be possible to trim down this period, and we will return to this point later, but the risk of HMRC attack is likely to be increased as a result. This is particularly the case in a pre-pack, where a prospective purchaser has already been lined up and is waiting in the wings. The further question of the impact of the *Ramsay* line of jurisprudence on pre-arranged hive downs is also considered below.

The timing of the commencement of trading is key. The successor subsidiary must begin to carry on the trade before X Ltd loses beneficial ownership of its subsidiary. If commencement by the subsidiary takes place after the share sale then section 343 will not apply.[9]

Thirdly, there is an important restriction on the use of losses where the transferor is insolvent, i.e. it has an excess of liabilities over assets and the successor company fails to take over all the liabilities. Broadly speaking, section 343(4) provides that a successor company is only entitled to the carry-forward trading losses to the extent that the amount of unrelieved losses exceeds the level of the transferor's insolvency.

The restriction operates by reference to "relevant assets" and "relevant liabilities". "Relevant assets" are defined in section 344(5) as the assets vested in the predecessor company immediately before cessation which were not transferred to the successor company and which were not apportioned to a successor company on any previous application of section 343. Also included is the consideration given to the predecessor company by the successor in respect of the transfer, although the assumption of the predecessor's liabilities by the successor is not treated as consideration. "Relevant liabilities" are liabilities which were outstanding and vested in the predecessor immediately before it ceased to trade, which were not transferred to the successor company and which were not apportioned to a trade carried on by a successor company on any previous application of section 343. "Relevant liability" does not include any liability representing the predecessor's share capital, share premium account, reserves or relevant loan stock.

The way in which this restriction works is best demonstrated by way of an example:

> Suppose X Ltd is in financial difficulty but it still has a valuable business. At this stage X Ltd has accumulated trading losses of £1m. It sets up a subsidiary,

> Newco, and transfers to Newco its lease, plant, machinery, stock, goodwill and employees. The sale consideration of £400k is left outstanding. Newco trades for a week before its shares are sold to Purchaser Ltd for £1. Purchaser Ltd ensures that Newco satisfies the £400k debt it owes to X Ltd. X Ltd has "relevant assets" of £800k and "relevant liabilities" of £1.5m:
>
> | | |
> |---|---|
> | Relevant liabilities: | £1,500,000 |
> | Less Relevant assets: | £ 800,000 |
> | Less Consideration: | £ 400,000 |
> | | £ 300,000 |
>
> For the purposes of section 343 ICTA 1988 X Ltd is insolvent to the tune of £300,000. Accordingly, there are £700,000 (£1,000,000 minus £300,000) worth of losses for use by Newco.

For this reason, where the company is heavily insolvent there may be no tax benefit in effecting a hive down.

The final restriction is on the way in which the trade is carried on within three years of the change of ownership of the trade. If, within three years of the transfer there is a major change in the nature or conduct of its trade then any relief will be lost.[10] Simply trading more efficiently should not be considered to be a major change in the conduct of the trade.

When the subsidiary is sold a tax degrouping charge will arise on the assets hived down to the extent that any chargeable gains would have arisen if the trade and assets had been transferred to a third party at that time;[11] however, under section 179A TCGA 1992 it is possible to re-allocate the charge to another member of the disposing group.[12]

There is a potential VAT charge on the transfer of assets from the seller to a buyer unless the sale is a transfer of a business as a going concern or both companies selling and buying are in the same VAT group.

One disadvantage of a hive down is that there is likely to be an SDLT or Stamp Duty on the transfer of some types of asset into Newco and accordingly such assets are commonly left out of the transfer.[13]

Hive Downs and Pre-packs

The next question is whether hive downs can be used in conjunction with pre-packaged administration. As explained, one of the defining features of a pre-pack is speed, and this factor may preclude the use of hive-down after entry into administration. With the appropriate planning and advice in place, however, it may be possible to arrange a hive down before the predecessor company enters administration. If that were done, and all of the necessary requirements satisfied, then the sale of the subsidiary could be pre-packed and executed once the predecessor company goes into administration. The difficulty is that this planning would require a transfer of the insolvent's company's assets into Newco prior to entry into administration, which is arguably inconsistent with one of the main purposes of pre-packing, namely protection of the management of the insolvent company. Since the transfer of the business will take place in the twilight period before administration, the management might be left more exposed to creditor redress and the sale itself may be open to challenge, for example, as being at an undervalue. Appropriate insolvency and company law advice would, therefore, be required.

An alternative method of employing a hive down would be for both the transfer to Newco and the sale of Newco to take place once X Ltd has gone into administration. The downside of this approach is that Newco would, ideally, carry on the trade for at least a week before being sold on whereas pre-packed sales tend to be executed more quickly than that. As noted above, however, there is no period stipulated in the legislation during which Newco must carry on the trade within the same ownership. It is, therefore, open to argue (with caution) that provided it can be shown that Newco has in fact carried on the trade, by completing sales, for example, then it should not matter that the sale of Newco takes place within a week of the hive down. The nature of the trade transferred will obviously be important in determining how strong that argument is.[14]

If it was decided to effect a hive down during the administration, there is an interesting question as to the degree of risk of a *Ramsay*-type attack from HMRC. As happens in a pre-pack, a purchaser for Newco will be lined up before the predecessor company enters administration, and, most probably, before the hive down is complete. In the absence of any form of enforceable agreement, however, it is not considered that this will lead to the conclusion that beneficial ownership has passed before the hive down takes place. Whilst it can be said that, as a matter of fact, it is highly likely that the prospective purchaser will assume beneficial ownership of the subsidiary very soon after the predecessor company enters administration, that fact is not enough to alter the legal rights of the respective parties; the point at which the beneficial ownership passes remains a question of law. Indeed, in paragraph 06210 of their Company Taxation Manual, HMRC, referring to the pre-*MacNiven* interpretation of the *Ramsay* line of cases, state that they would not expect *Ramsay* to be relevant where an entire trade, or part trade, together with its related assets and liabilities, are hived down with a view to its being carried on in other hands. Notwithstanding that, generally speaking, liabilities of the trade will be left behind in the transferor company, it is considered that in the absence of any unusual circumstances, for example the entry into an informal sale agreement before the hive down is complete, the risk of a *Ramsay*-type attack, whilst present, is small.

The conclusion is that pre-packaged administrations are not inherently consistent with the tax-efficient use of losses. This is partly as a result of the fact that the essential structure of a pre-pack does not lend itself easily to tax planning using losses or hive-downs, and partly as a result of the absence of specific tax rules designed with insolvency policy in mind. However, value can be extracted from tax losses in these circumstances, although the structure of the transactions involved will need to be adjusted slightly in order to accommodate the planning.

[*] Gray's Inn Tax Chambers will be hosting a seminar on the subject of taxation in insolvency in the autumn. If you would be interested in attending them please email st@taxbar.com for further information.

[1] Sometimes also termed "pre-packaged sales" or "execution-only administrations".

[2] See, for example, the excellent research produced for R3 by Dr Sandra Frisby, available at http://www.r3.org.uk/uploads/documents/preliminary%20analysis%20of%20pre-packed%20administrations.pdf

[3] The limited warranties will often push the purchase price down; this will also happen if the purchaser is willing to take on some of the company's creditors.

[4] Effected either by the holder of a qualifying floating charge under para. 14 of Schedule B1 of the Insolvency Act 1986, or by the company or its directors under para.22 of the same.

[5] This is a problem frequently encountered in the field of taxation of insolvents and one which probably results from the fact that there are very few provisions of the tax code aimed exclusively at situations involving insolvency. Whereas our insolvency laws are specifically designed to deal with the problems that arise where a person's liabilities exceed his or her assets, our general tax laws are, understandably, not drafted with that purpose in mind. Accordingly, an application of those general provisions to the very specific situation of an insolvent taxpayer can give rise to tax consequences that are inconsistent with the aims of insolvency law; by and large the upshot will be that HMRC end up better off than the taxpayer's other unsecured creditors. This is the case when one is looking at loss use in administration. Given, however, that the Crown Preference was abolished as part of the Enterprise Act reforms it might be thought that a result that has the indirect effect of preferring HMRC is contrary to current insolvency policy.

[6] And can only be used against income profits, not chargeable gains.

[7] See Insolvency Rule 2.67(1)(j).

[8] It is understood that the pre-packs were first used in the context of administrative receivership before the Enterprise Act changes, after which administrative receivership was largely abolished and it became possible to appoint administrators out of court. However, in addition to certain limited exceptions, it remains open to charge-holders with debentures entered into before 15 September 2003 to appoint an administrative receiver.

[9] See HMRC's Company Taxation Manual para.06210

[10] See sections 768 and 769 ICTA 1988.

[11] There is an equivalent for intangible assets in FA 2002, Sch 29 para 58.

[12] Again there is an equivalent for intangible assets FA 2002, Sch 29 para 66.

[13] It is considered that group relief would not be available in the context of a pre-pack because, by definition, there will be arrangements in place, albeit informal, for a purchaser to acquire control of Newco but not of X Ltd.

[14] The recent case of *Barkers of Malton Ltd v Revenue and Customs Commissioners* [2008] STC (SCD) 884 is instructive in this respect. It was held by the Special Commissioners that that a company which acquired a trade from its parent company did not "carry on" the trade (car dealing and repairing) during the 90 minutes before the transferee company sold the trade on to the appellant. Mere ownership of the trade was clearly not enough, and there was no evidence that the transferee undertook any trading activity during the 90 minutes that it owned the business. It incurred no expenditure and obtained no receipts, nor did it enter into any transactions during the period. These factors, coupled with the short duration of ownership of the trade and the fact that there was a "sense of inevitability" about the sale to the appellant, led to the conclusion that, for the purposes of section 343, the transferee did not carry on the business during the 90 minute period.