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No 12

TAXATION AND MERGERS POLICY

John Chown

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John Chown is a tax specialist with "hands on" experience of mergers and reorganisations, both international and domestic. He originally trained as an economist and took "enforced competition in the United States 1870-1896" as his special topic in economic history.

INQUIRY INTO CORPORATE TAKEOVERS IN THE UNITED KINGDOM

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1990

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The David Hume Institute has been commissioned by The Joseph Rowntree Foundation to conduct an Inquiry into the issues raised by Corporate Takeovers in the U.K. This paper is the twelfth of a series presenting the results of research undertaken in the course of the Inquiry, and also submissions of opinion received from individuals and organisations which are thought to be of wide general interest. The Institute hopes in this way to keep the public informed of work in progress. The Final Report will appear in the late Spring of 1991.

A note on the Institute and a list of its publications appear on pp. 21-23.

The Institute has no collective views on any public policy question and is not committed to the views of any of its authors.

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I. GENERAL INTRODUCTION

The present British Government's strategy has, rightly, been to unleash the entrepreneur. The profit motive is a great engine of prosperity, but Adam Smith's "invisible hand" is not, unaided, always effective in channelling this urge to where it can benefit the consumer. We want the businessman to grow rich by offering better and cheaper goods and services in a competitive, unrigged market place with free entry to newcomers, including foreigners. Many have done so, and the new economic climate has helped them to prosper by helping others.

That is not the only way to make money. It is sometimes easier to create, join or perpetuate a cosy cartel, profit from insider trading or conflicts of interest, or to engage in what Professor Buchanan calls "rent seeking", manipulating political influence and dispensing or soliciting patronage. As we saw in the City after Big Bang, those who have led a sheltered and privileged life do not always adapt immediately to the chill winds of competition: one source of "just being there" profit disappears, but another takes its place.

As the Americans discovered in the late nineteenth century, mere laissez faire can all too easily result in the concentration of industrial and personal power, power which is then used to perpetuate privilege and eliminate competition. The present Government sometimes appears to pride itself on having no industrial policy and on leaving matters to market forces. It does have relevant interests, such as national security and defence, competition policy, investor protection (including takeover rules), employment, trade and Common Market infighting. A "hands off" policy is a disaster. Government actually needs to work very hard indeed to create and maintain a true free market economy.

As economists we have to distinguish clearly between genuine "competitive free market" proposals and some of the ideas put forward by "pro business" lobbies which can sometimes take an asymmetrical approach to government intervention. Tax policy is just one aspect of government intervention that can affect markets, often in perverse and unexpected ways.

The danger to free markets begins when along comes an industrialist seeking to extend his power and prestige (and perhaps, but only incidentally, the wealth of his shareholders). Seeing rich pickings from the public sector, he will choose that Minister whose departmental interests can be made to appear to coincide with his own. This Minister then puts his head above the parapet before there is time for any broader consideration of the impact of the proposals on other aspects of Government policy. At this stage, the Government sometimes seems remarkably out of touch with what is well known to the thinking members of the financial community, if not always to the ex officio "great and good". Weeks or months later, the scandal breaks, but the damage is done. There have been several examples, but "the task of filling in the names I'd rather leave to you".

Not all mergers take place for rational, financial reasons, and they do not necessarily lead to a better use of resources. In the 1950s the "take over bid" was a powerful device for extracting assets from inferior management. As a rule of thumb contested, "unwanted" bids, resisted and resented by management, were beneficial, and just what the economy needed: cosy "agreed" mergers, beloved of industrialists, perpetuated inefficiency, reduced competition, and seldom did much good to, and often harmed, the economy.

Nowadays it is seldom as simple as that. There is an accepted "bid premium" of about 20% over the value placed on assets by investors - and that in a sophisticated and buoyant market! It is not realistic to believe that every successful bidder can create superior performance on that scale. One suspects that

the main beneficiary is the ego of the chairman of the bidding company rather than the pockets of his shareholders. Cynics have even suggested that some bids have been conceived and promoted simply to generate profits for corporate finance professionals: this has certainly been true in the United States.

Acquisition or Merger?

An *acquisition* or *takeover* occurs when one company acquires control of another, smaller company. A *merger* is in normal UK usage a marriage between two companies, usually of roughly equal size, although it is quite common to use the word 'merger' to include acquisitions as well. The terms are indeed used interchangeably: in Continental Europe the term "merger" is confined to transactions where at least one company ceases to exist as a corporate entity, its assets vesting in the successor company. Unless different national usages are spelt out explicitly, discussion on tax harmonisation for instance, will often be at cross purposes.

A *demerger* is the reorganisation of a company into two or more component parts. Tax law and company law in the United Kingdom normally place no obstacles in the way of mergers between domestic companies. There are, and should be, restrictions imposed by the Monopolies and Mergers Commission, and the Take-Over Panel but if their requirements can be met there are generally no real tax obstacles.

At the shareholder level, shareholders receiving shares (or, unlike in the United States, debt securities) in exchange for existing shares in the course of a merger enjoy "roll-over" treatment. No capital gains tax is imposed on the exchange; tax is imposed on an eventual sale with reference to the original cost.

Similarly at the company level, a merger coming within reasonably flexible provisions has no adverse tax consequences. Capital assets are carried over into the successor company

without a "deemed realisation" precipitating a tax charge, and depreciation calculation are undisturbed. Tax losses can *generally* be carried over and used by the successor company. There is anti-avoidance legislation designed to prevent companies being purchased solely or mainly; for the benefit of losses: some of us would argue that this is too sweeping and does inhibit genuine commercial transactions. -

To be sure, there are technicalities, and differences of opinion on points of detail including that just mentioned. At the broad public policy level, though, the tax law on domestic mergers is generally satisfactory.

There are three main tax problem areas of which only the first two are discussed here.

1. There have been several periods in the past few years where specific aspects of tax policy have positively *encouraged* mergers for which there was no apparent long term industrial logic. The various forms are described in Section II and illustrated in the case studies in Section III. These anomalies have distorted industrial structure. Some still apply: the rest may have disappeared but have cast a long shadow and continue to affect today's industrial structure.
2. **Demergers**, although no longer impossible, are far less leniently treated. This makes it difficult to correct the distortions created. My own interest in the public policy aspects of demergers goes back at least to 1973.[1] A change of government put tax reformers back on the defensive but a Green Paper published in 1978 made a general case for demergers.[2] Its only relevant footnote reference was to my article in the Financial Times and in consequence my company was invited to submit evidence to an enquiry. In 1980 the newly elected government did introduce provisions designed to permit companies to "demerge" without tax penalty. These provisions, though they proved invaluable in

certain cases, were seriously flawed because of an over cautious Revenue approach.

The problem is therefore still with us. There is still no wholly satisfactory and generally available way in which unwieldy conglomerates, resulting from past merger frenzies, can, of their own initiative, break themselves up into more manageable component parts. The solution only too often has been acquisition by an even bigger group or an externally stimulated break up where most of the benefits go to financial intermediaries rather than to the original shareholders.

3. **Cross border mergers** within Europe are still very difficult, in spite of recent and belated adoption of the old 1969 Directive.[3] I have written elsewhere on this subject,[4] but briefly, the "ACT trap" and its equivalents in other countries put tax obstacles in the way of creating a company whose shareholders and activities are spread fairly widely over the European Community instead of being concentrated in one country.

II. TAX INDUCEMENTS FOR MERGERS

Tax law in the UK has long facilitated mergers but has put obstacles, now rather less serious than they were, in the way of demergers. This is a one way ratchet; it is easier for groups of companies to grow towards what appears (in the circumstances and fashions of the time) to be optimum size than to pull back if they h;ave overshot, or if circumstances, including tax rules, have changed.

There have at various times, been significant actual tax inducements, usually unintended, for companies to merge or otherwise expand by acquisition. Some of these did not last long, and some have not applied for many years, but because

of the "ratchet" effect we are still left with an industrial structure caused in part by a quarter century and more of serious fiscal and other distortions.

There are four main types of tax distortion. Of these : (l) and (2) were the main villains of the past, while (3) and (4) still persist today.

1. Bias against company distributions

The 1965 system of corporation tax and its earlier predecessor, the two-tier profits tax, put a serious tax penalty on dividend payments by companies, and encouraged them to retain profits, regardless of their cash needs. This inevitably led to what Ted Heath characterised as "the survival of the fattest". Companies with a cash flow in excess of reinvestment opportunities (what are now known as "cash cows") would, instead of returning money to shareholders, set out on the acquisition trail, regarding retained profits as cost free funds. As any first year economist knows, the optimum use of national resources would have been better achieved by distributing the cash to shareholders, who would then be free to reinvest in whatever company offered the best prospect of future returns.

With the introduction of the imputation system and the (later) reduction of the top rate of personal tax, the actual tax distortions are no longer so serious, but old habits die hard: company managements are still very reluctant to disgorge surplus cash for reinvestment by their shareholders.[5]

The effect was pervasive and distorted industrial decisions for a generation. To mention but two specific examples, in the late 1960's Imperial Tobacco diversified into the food and food packaging industries. A little later, British American Tobacco bought an insurance company (Eagle Star) followed by International Stores. In both cases, deals were driven by substantial fiscal advantages: the industrial logic was dubious, to say the least.

2. Bias against private companies

The first bias encouraged buyers: this one brought out the sellers. Together, they created a powerful urge to merge.

During the post war period, and until Geoffrey Howe's 1980 Budget, UK personal tax rates were confiscatory. In contrast *company* tax rates were quite reasonable (then) and internationally competitive, especially taking account of various forms of generous investment allowances and fast write-offs. Owners of private companies could see them grow, as profits accumulated at a moderate tax rate. They were rich on paper, but were hard pressed to find cash for school fees.

There was, inevitably, anti-avoidance legislation directed against the abuse of corporate money boxes, and in 1965 this grew into a frontal assault on "close companies" (those controlled by five or fewer families, unless 35% or more of the shares were held by "the public" as defined). The owners of such companies were penally taxed as long as "close" status continued, and the only light at the end of the tunnel was the possibility of a sale to a publicly quoted company or a public listing.

Independent listings were only for the largest and most successful. To meet the needs of the other cases, conglomerate holding companies were created specifically to exploit the fact that owners of private companies were keen to sell out at multiples of three or four times earnings (wealth beyond the dreams of avarice compared with the after tax value of annual dividends and directors' fees), while a public company might be rated at a ten times multiple or more. Several fortunes were created by financial intermediaries who took advantage of opportunities, artificially created by tax distortions, to buy in the private company market at one price, with paper valued in the public company market at a much higher price. Some of the fortunes were, alas, lost. The players became too greedy and more concerned with manipulating numbers than with

the management and strategy of the underlying industrial enterprises. The "asset stripper" is the traditional villain of that period: the real economic ills arose from the activities of the "multiple manufacturer", who built paper mountains reminiscent of 1720 and 1825.

This particular pressure to sell out is no longer so serious. Owners of private companies can turn company profits into spending money at a fairly modest tax penalty. Inheritance tax still makes it difficult, but it is no longer impossible, to pass a private business on to the next generation without outside financial help. "Corporation tax" apart, another 1965 change was a long term capital gains tax. This gave an inducement for shareholders to sell out for shares rather than for cash: this persists, in a modified form, and there is perhaps still a small overall tax bias forcing private companies onto the merger market. It is no longer particularly serious.

The main point, though, is that some of the past tax-driven conglomerates still exist as a rag bag of unrelated businesses. These need to be broken up into more manageable, stand-alone units. Institutional and tax factors continue to inhibit this economically desirable process.

3. Bias against foreign earnings

The 1972 corporation tax reform substantially reduced the bias against distribution and, at a domestic level, removed many of the illogicalities of the 1965 measures. It was designed to create a level playing field for dividends, but created some serious distortions of their own. The most important of these still persist, in spite of 17 years of sustained effort by tax professionals and occasional forays by committees of company chairmen. They are also, incidentally, the most important remaining obstacle to true Europe-wide mergers.[6]

This is the most technical but today the most important of the remaining distortions. The next few paragraphs need, and deserve, a lot of digestion.

The imputation system of taxing companies and shareholders introduced in 1972 gave shareholders a credit for part of the corporation tax on the profits underlying the dividend. At present rates, a company pays 35% on retained profits. Under the mis-called "classical" system (UK 1965-1972, and USA today) dividends would have suffered an extra level of tax. A 40% taxpayer would suffer 35% underlying tax, plus another 26% of original profits, being 40% on the balance of 65, making a total of 61%. In fact the UK today gives an "imputation credit" of one third of the net dividend in part compensation for the underlying company tax. On these figures there is nothing extra for the basic (25%) rate taxpayer to pay. A pension fund actually gets a refund of about two thirds of the UK corporation tax paid, while a 40% taxpayer needs to pay up the difference. Overall, the total effective tax rate on underlying profits is as shown in the following table.

	RATE	TOTAL NET BURDEN
Basic rate taxpayer	25%	35%
Top rate taxpayer	40%	48%
Pension fund	0	13.33%

The introduction of the imputation system in the UK, as in France and elsewhere, succeeded in reducing economic distortions at the *domestic* level, but actually increased or perpetuated them at the *international* level.

In 1972, the UK Revenue had naturally been concerned to protect itself from having to refund tax it had never collected in the first place: it was particularly concerned to collect at least something from the oil companies. Accordingly, at the time of payment of the dividend, the company must pay the Revenue "Advance Corporation Tax" (ACT) in an amount equal to the imputation credit. As its name implies this ACT is an *advance* payment which can be credited against the mainstream

tax eventually payable and is *normally* simply a prepayment of that tax if any is due.

The object of the exercise is "collect first, refund later" and ACT is a very real extra burden where there is no mainstream UK liability. This can happen when a company incurs losses and continues to pay dividends out of reserves, but for our purposes the serious economic problem arises when dividends are paid out of foreign source, rather than UK profits.

Where a UK company has profits arising in another country, prima facie both countries have a claim to tax. The UK, and most other countries, deal with the problem of double taxation by giving a credit for taxes paid by foreign branches or subsidiaries. Unfortunately, this relief does not flow through to shareholder level. A company can pay foreign tax *plus* unrelieved ACT. A company is only "prejudiced" in this way if it cannot meet its dividends out of *UK* taxed profits. A "prejudiced" company must earn half as much again as an "unprejudiced": company to meet the same level of dividends, and has a strong tax incentive to buy UK source profits regardless of any industrial logic. This "prejudice problem" remains the most widely criticised feature of the present UK company tax system.

Immediately following the 1972 tax reform there were several examples of companies with international earnings making acquisitions simply to acquire UK earnings and the distortion continues today. S Hoffnung, an overseas trader, acquired G & M Power Plant in 1974. In 1977 Thomas Borthwick acquired Matthews Holdings: in this case there was some commercial logic. Selection Trust, a mining finance group, acquired Cleveland Industrial, while Lonhro made a series of acquisitions with the same motive. Consolidated Gold Fields acquired Greenwoods and Amalgamated Roadstone. The case of British American Tobacco is considered in a little more detail below.

4. Tax losses and capital allowances

For many years, until 1984, capital investment incentives in the United Kingdom had taken the form of a very fast write-off: most recently in the extreme form of 100% first year allowances. Companies making heavy capital investments generally had more allowances than they could absorb, often had poor UK trading profits and were generally "fiscally starved". (This meant they paid no "mainstream" UK tax - many of them continued to pay dividends and accumulated "ACT mountains" as discussed above.)

Industry reacted to this problem in two ways. Tax driven financial leasing transactions were used to shift allowances from manufacturing companies to banks and others which had no natural tax shelter of their own. The other approach was for these fiscally starved companies to merge with profitable, but not capital intensive, industries such as retailing and financial services. There were also mergers based on the use of tax losses, or to take advantage of capital gains tax losses. Several examples, some old, and some new, are given in the next section.

III SOME CASE STUDIES

1. British American Tobacco

The name of this company seems to come up at every stage of the merger saga. As a result of its agreement with Imperial Tobacco (with whom it had cross shareholdings) its tobacco activities were almost entirely outside the United Kingdom. This made it, with the oil companies, one of the leading members of the "prejudice club" in 1972. It therefore set about acquiring UK earnings, buying successively International Stores and Eagle Star Insurance.

Also in 1972 the agreement with Imperial Tobacco was terminated, and BAT decided to sell its 26% holding in that

company, valued at £170 million. A straight disposal would have incurred a capital gains tax charge of £26 million. No demerger procedure was then available (and the rules since introduced would probably not have helped) but there were various ways in which the charge could have been mitigated by some variation on a Scheme of Arrangement. All would have involved a direct distribution of assets to shareholders, involving the reduction in the total size of BAT, (which did not appeal to the BAT management) or Imperial (ditto, mutatis mutandis). In the case of BAT, there was also the real problem of the substantial tax penalty of becoming a pure "foreign source income" company. Nothing was done at the time. Eventually in 1975 there was a straightforward taxable disposal, but by then the market had fallen and the tax (and profit) was lower.

BAT's preoccupation with retaining the size of its empire kept its management happy, although it was less successful in building value for shareholders. It became a classic example of a company whose component parts were worth more than the whole: a "demerger" candidate. The demerger rules do not remove all the tax liabilities of disposing of assets; the "ACT prejudice" problem remained, and management was still unenthusiastic about dismembering its empire. An outside stimulus was needed. In 1989 a vehicle company Hoylake, controlled by a syndicate led by Sir James Goldsmith, announced it was to make a bid for BAT. The bid did not go ahead for US regulatory reasons. It had some tax motives (explained in the next case study) but the main practical effect was to stimulate management into its own "demerger" plans.

2. Pembridge/DRG

In this case the "Hoylake" type proposals were actually implemented. In contrast to BAT, DRG was a relatively small group of companies, mainly UK based, which did not have a substantial ACT problem. There was no obvious case for unbundling. The share price of DRG was close to asset value and hardly moved in response to the bid.

The tax advantages of *external* intervention were the same and the scope for using the domestic demerger route was actually rather less. The bid was successful (just) for two reasons; first because the Stock Exchange was going through a jittery patch and second because the bid was more generous than could have been justified without a material tax advantage.

The bidder in this case, Pembridge, was also a Bermuda based "one purpose" company. There were two ways in which a tax advantage could be obtained by a third country bidder. The less important (in this case) was to juggle debt, so that debt interest is charged against profits in whichever country is the most appropriate.

The major angle was capital gains tax. It seemed to an observer that for Pembridge to pay £697 million for DRG would hardly be commercially worthwhile unless it could extract profits on the sale of the DRG operating subsidiaries tax free. Analysts estimated DRG to be worth a maximum of about £800 million but the £100 million gross profit that Pembridge presumably found attractive would have been eliminated by the potential capital gains tax charge.

Avoiding this tax was, therefore, the key. If a UK group of companies decides to sell off some of its operating subsidiaries to a third party, then the gain will arise on disposal: purchase price, based on current value of the assets of the subsidiary, including goodwill, will be subject to corporation tax at 35%. This is reinforced by an anti-avoidance provision which comes into play when a company leaves a group. Nevertheless there is a device by which a non-resident predator company can avoid the charge to tax on the capital gain. This involves setting up a series of directly owned new UK subsidiaries and utilising the group transfer provisions.

The art is to ensure that a *company* never leaves a UK *group* but that the *group* leaves a company. It is possible to re-arrange the structure of the UK group so that the original UK group

subsidiary which is to be sold off is transferred and isolated as the only subsidiary of what was the first new UK subsidiary (company A) formed by the predator company (and of necessity at one time the new UK holding company of the group). The predator company simply unbundles the original subsidiary, by disposing of its direct shareholding in A tax free (the UK does not levy capital gains tax on non-residents). It is possible to repeat the exercise over and over again until the unbundling of all the original subsidiaries so earmarked has-been achieved.

3. Trafalgar House/Cunard

At the beginning of the 1970's, Trafalgar House was earning profits before tax of £6 million and had a tax charge of £1 million. Being in the building industry, it had no obvious way of sheltering its profits. It therefore acquired Cunard in 1971 for £25 million in shares and unsecured loan stock, This compared with a theoretical net asset value of £41 million, taking its ships at book value of £75 million. This was not a realistic figure as a valuation: the ships were worth only a fraction of this. What *was* very real was the right to depreciate these ships from that figure and thereby generate tax deductible "free depreciation" (effectively tax losses, but without restrictions on their use) which could be offset against Trafalgar's profits. In the words of the offer document "the special taxation concessions available to shipping companies are only of real value where, overall, operations are profit earning to an adequate extent, a state of affairs which has not generally applied in the case of Cunard in recent years." In fact with this acquisition (and another) Trafalgar House ensured that it had no tax liabilities for many years. It also, unusually in stories of this type, did an excellent and constructive job of reorganising Cunard as a business.

4. P & O/Bovis

The P & O acquisition of Bovis was essentially the same transaction in reverse. In 1972 Bovis, the then profitable

building group, had made a similarly tax motivated bid for P&O. This was unsuccessful. A year or two later Bovis ran into trouble when its subsidiary, 20th Century banking, went down in the property-related secondary bank crash. In 1974, P&O turned the tables and made a successful bid for Bovis. P&O, with ships valued at £138 million, had £40 million unutilised tax allowances: these would never be used in the shipping business but enabled it to buy a flow of future profits and shelter these against tax.

5. Allied Breweries/J. Lyons

J Lyons was a classic case of a company that was nearly bankrupted by the "foreign debt" trap. (I had indeed calculated in 1976 that the company would become insolvent at an exchange rate of $1.45, which was never quite reached.) It had made the fatal error of borrowing "cheap" foreign currencies. At the time of the bid, debt was £218 million and rising: equity net worth was £59 million and falling: its value as a going concern was obviously low, and the risks were high.

Allied Breweries made a bid of £65 million in August 1978. Lyons was in fact making substantial profits (£33 million) *before* debt interest. There are provisions in the Taxes Acts by which past losses can only be carried forward against profits of the same trade. Allied could take advantage of the Lyons losses because of its ability to pay off debt. Losses could then be offset *against* Lyons profits, which gave Allied a means for using the Lyons tax losses without falling foul of the anti-avoidance legislation. It could borrow at "Allied" level (deducting interest against Allied profits), inject money into Lyons to pay off debt and use the carry forward against Lyons profit.

6. British Aerospace/Rover

The terms on which the Rover Group was sold to British Aerospace is, from our point of view, a more recent example of the "Lyons" transaction. Leaving aside other issues which

have had a good public airing, it does seem that the real tax benefits were considerably larger, and rather more subtle, than were generally apparent This may not have been a motive, and indeed it seems that, judging from their evidence to a Parliamentary Committee on 11 May 1988, that the company's directors were not aware of them at the time of the transaction.

The government injected £800 million into Rover before the sale which increased net worth, at book value, to £1,133 million. The purchase price of £150 million therefore represented a substantial discount on this, but, as with Cunard, this does not tell the whole story. The "fixed assets" of £700 million could be so much scrap metal, and "inventory" could prove to be unsaleable and of little value. There was an obligation to run the company, which had a volatile record and doubtful prospects, and there was risk of heavy closure expenses should the attempt fail. Given the risk of losing the whole cost and more, £150 million could well have been a fair price, *but for the tax factors.*

The Rover group had £1,600 million of carry forward tax losses but under the arrangement with the government "the trading tax losses of Rover group are to be limited to £500 million". Provided the company makes profits, the eventual value (but not the discounted present value) of this tax loss is about equal to the whole of the purchase consideration.

This, however, is not the end of the story, which is really a subtle variation on Cunard. Rover had fixed assets, inventory, etc, with a book value of £1,331 million. Assuming the "monetary assets" are collectable in full, the basis on which the company was sold would imply that these were in total only worth a quarter of this (£348 million). Commercially this may well be true, but to the extent to which these assets are eventually sold, or traded out in the course of trade, any difference between the *tax value* (which may not be the same as book value) at the time of the transfer and the proceeds would constitute a current year loss which, unlike the carry forward

loss referred to above, could be used anywhere within the group. Unless this point was specifically covered in the agreement with the government (information the European Commission was understood to be seeking) the potential tax loss available to the British Aerospace group may have been not just £500 million, but potentially as much as £1800 million. In practice it is likely to be considerably less for various reasons: many of the fixed assets will, for instance, already have enjoyed 100% first year allowances.

Stocks can certainly be traded out to generate a tax loss. Assuming the "real" asset value is indeed £150 million, that fixed assets are a write off but "related companies" and financial assets are worth book, it would follow that Rover is worth the £150 million paid, "stocks" should be worth £247 million, an overvaluation of £381 million. This figure is probably a conservative estimate of the extra loss available, assuming that Rover trades profitably. Adding the £500 million carry forward would give total potential losses of £881 million. If real losses are incurred after acquisition or if stocks prove to be worth even less than £247 million, the loss will be higher.

Taking these factors into account we can work out the value of the assets at the end of five years on different assumptions, e.g.

A. Rover makes £100 m p.a. for five years, in the course of which the existing assets are written down to the value implied by the purchase consideration.

B. Rover make £50 m p.a. (present implied level) on the same assumptions.

C. Rover loses £150 m over the five year period - ie BAe's investment is worth exactly zero before tax.

D. Rover goes bankrupt; non-financial assets at time of purchase prove entirely worthless, and B.Ae. must find £200 million to meet the excess of liabilities over monetary assets and £200m for closing down costs.

THEN

VALUE OF ROVER AFTER 5 YEARS

	£ MILLION			
	A	B	C	D
Ignore Tax	650	400	NIL	(400)
After Tax				
1. Rover tax losses "ring fenced"	475	312	NIL	(400)
2. Our assumptions	817	655	394	135

The last row assumes that all surplus losses can, one way or another, be used against otherwise taxable profits in the British Aerospace group, valuing these losses at 35%. The profits of success are enhanced, while a complete disaster (*before* tax) still leaves BAe's investment intact (*after* tax). Heads I win, tails the Revenue loses - a pleasant enough reversal of some of the tax traps of the past, but hardly sensible as an aim of public policy.

7. Cambrian & General

Cambrian & General Investment Trust was a UK vehicle for Ivan Boesky. As a listed UK investment trust, it was exempt from tax on its own capital gains: such tax was postponed until the shareholder sold his shares. No tax is imposed on a non-resident shareholder, although Mr Boesky would eventually have paid US tax on any gains he realised. Meanwhile he could use the trust as a tax efficient vehicle to "garage" shares in the (mainly US) companies he was stalking. As the company was a UK company, the double tax agreement gave him protection against the US legislation, intended to counter the use of offshore companies to postpone US tax.

Mr Boesky having had a little trouble with the US authorities, 20% of the shares in Cambrian became held in escrow on behalf of the US Treasury. Along comes a US company, Camacq, which made a bid for Cambrian. It received 70% acceptances,

but without 80%, and the right to "group", there would have been a US tax penalty of some £10 million. The Escrow Agent felt precluded by his US fiduciary duties from accepting the original terms.

The UK Takeover Panel would obviously not permit Camacq to make a special deal with this shareholder. A tax adviser appears to have thought he had a solution. If Cambrian declared a dividend on its actual shares, the Escrow Agent could invoke the "sovereign immunity" provisions and reclaim the whole of the imputation credit attaching to the dividend. This would have amounted to about $8 million.

Not surprisingly, the contract between Camacq and the US Treasury Escrow agent was conditional on Inland Revenue clearance for the full tax credit being applicable. On 8th June the Inland Revenue (Inspector of Foreign Dividends) authorised Cambrian to pay the dividend with the full amount of the tax credit. On 29th June the Revenue learned that Cambrian was proposing to send a circular to capital shareholders announcing the dividend and realised, just in time, that the dividend appeared to be being paid from pre-acquisition profits thereby falling foul of the anti-avoidance provision in the Taxes Acts. As the circular was being sent out the next day, they immediately revoked the authorisation of 8th June. The Court of Appeal held that the authority was properly revoked.

FOOTNOTES

1. See John Chown's paper to the Economic Section of the 1973 Annual Meeting of the British Association for the Advancement of Science, Proceeding published as "The New Mercantilism".

2. "A Review of Monopolies and Mergers Policy: A Consultative Document" Cmnd 7918, May 1978.

3. (90/434/EEC) O.J. No L 225 of 20 August 1990)

4. John Chown and William Hopper "Company Tax Harmonisation in the European Community" Intertax 1982/8.

   John Chown, "Company Tax Harmonisation in the European Community" Institute of Directors 1989.

   John Chown "The Mergers Directive - some broader issues" Intertax 1990/10. (The whole issue is devoted to the subject.)

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