Private Equity

Part 1: Tax issues for managers

The private equity sector has rarely been more buoyant. According to the FSA, in the first half of 2006 UK-based private equity fund managers raised £11.2 billion of capital. During the same period, the total value of UK mergers and acquisitions was 40% higher than a year earlier, with the rest of 2006 continuing at a similar pace.

In the light of this, a two-part, back-to-basics article on the main tax issues for managers, the private equity house and lenders in a typical private-equity-backed management buy-out seems timely. This first part deals with the tax issues for management and draws on the issues that regularly arise in the deals on which we advise.

BACKGROUND
While it is common to see two or three acquisition vehicles used in a structure for a management buy-out (predominantly to facilitate the seniority of borrowing), for this article we have assumed that a simple structure is employed, involving just one newly incorporated company (Newco) to acquire the target company (Target). The management team will be expected to invest in Newco and will typically subscribe for ordinary shares. The private equity fund (VC) will invest in Newco by way of a subscription for shares and loan stock. Banks generally provide senior debt, with Newco giving security for the borrowing.

TAX ISSUES FOR MANAGEMENT
The rights attaching to the Newco shares for which the management team subscribe will invariably include restrictions and often a ratchet arrangement. It is also common for the management team to hold shares in Target acquired on or before the buy-out. Management’s objective will be to minimise any income tax on the acquisition and pay capital gains tax (CGT) on the disposal of their shares in Target (and, ultimately, in Newco).

The statutory framework
As the management team will be employed by Target and, going forward, Newco, the shares in Target and/or Newco will be employment-related securities within the scope of Part 7 of ITEPA (we have assumed that the managers are resident and ordinarily resident in the UK).

Part 7 of ITEPA was enacted as a response to the Government’s concerns that companies were manipulating share values to minimise income tax and National Insurance contributions (NICs) on acquisition. The advent of the taper relief regime only exacerbated the issue. Taper relief reduces the amount of chargeable gain that is subject to CGT. It is particularly valuable if assets are business assets, in which case a higher-rate taxpayer has an effective CGT rate of 10% after holding shares for only two years.

Part 7 is a special income tax regime that applies to employment-related securities and the income tax charge that applies will depend on the circumstances of the acquisition of the shares:

- the gift or purchase of shares at an undervalue will be taxable as ‘earnings’ (s 62);
- the acquisition, retention and disposal of shares whose value is reduced because of restrictions will be taxable as ‘restricted securities’ (Part 7, Chapter 2);
- the acquisition, retention and disposal of shares whose rights entitle the holder to convert them into securities ‘of a different description’ will be taxable as ‘convertible securities’ (Part 7, Chapter 3);
- there are other categories dealing with shares with an artificially enhanced or reduced value (Part 7, Chapters 3A and 3B);
- the acquisition of shares on deferred payment terms will be taxable under the ‘notional loan’ provisions (Part 7, Chapter 3C);
- where post-acquisition ‘benefits’ are received, Part 7, Chapter 4 can apply; and
- the acquisition of shares pursuant to the exercise of an option will be taxable under the ‘securities option’ rules (Part 7, Chapter 5).

TAX CONSEQUENCES OF SUBSCRIBING FOR SHARES IN NEWCO
Restricted securities
The articles of association of private limited companies invariably contain restrictions (shareholder and investment agreements also contain restrictions). The most common is the compulsory transfer provision – that is, in the event a shareholder manager ceases employment, the manager must transfer his shares. The circumstances surrounding cessation usually determine the transfer price. For example, if employment ceases for good reasons (for example, ill health, or death), the transfer price is usually the greater of the subscription price and market value; for bad reasons, it is the lower of those two values.

If the shares acquired by management contain such restrictions, Chapter 2 applies.

If the manager pays the full, unrestricted market value (UMV) for the shares (that is, the market value ignoring any restrictions that depress market value), no Chapter 2 income tax charge will arise. However, if the manager does not, and the provision for transfer falls away within five years, Chapter 2 provides that there is no tax charge on acquisition of the shares. Rather, on a subsequent chargeable event (for example, the lifting or variation of a restriction or the disposal of the shares), the proportion of the gain attributable to the undervalue (the untaxed proportion) is subject to income tax. As the share value increases, so too will the untaxed proportion, leading to much higher levels of income tax and, if the shares are readily convertible assets, NICs.

Continuing our series of basic informative articles, in the first of two articles on private equity, Michael Bell and Vicki Carr, Tax Practice, Osborne Clarke, look at the tax issues for managers.
Alternatively, if the manager does not pay UMV on acquisition, he can enter into a joint election with his employer and elect to be taxed on acquisition by reference to the UMV of the shares (s 431). This effectively ensures that no further restricted security charge will arise on a subsequent chargeable event – most particularly the disposal of the shares.

**Ratchet arrangements**

Broadly, a ratchet is a mechanism to increase or decrease management’s shareholding to reflect the economic performance of the business, typically on an exit.

Ratchets may be drafted so that they have a negative or positive impact on management’s shares. For example, management shareholders start with X% of the share capital, which reduces to Y% if performance targets are not met. More usually, however, the ratchet is drafted such that if performance targets are satisfied, a percentage of the VC’s shares convert into worthless deferred shares (thereby increasing the value of the managers’ shares). Tax practitioners and HMRC disagree on the tax treatment of such ratchet arrangements. Tax advisers generally argue that while the ‘hope value’ of the ratchet should be taken into account when valuing the shares on acquisition, as nothing happens to management’s shares on exit (or, at most, there is merely the fruition of an inherent right), the entire value received on the exit event should be assessed to CGT. HMRC, on the other hand, maintained until recently, that the resulting increase in value of managers’ shares was a ‘post-acquisition benefit’ and taxable under Chapter 4 of Part 7 on the basis that the value management receives is disproportionate to the capital invested.

Because of the uncertainty surrounding the tax treatment of management shares in private-equity-backed transactions (including the above point), in July 2003 the BVCA and HMRC agreed a ‘memorandum of understanding’. Following legal advice, HMRC published further guidance on 21 August 2006. Together, they confirm that, provided the following conditions are met, there will be no income tax charge on acquisition or when the ratchet takes effect. Rather, the sale proceeds received on an exit will be subject to CGT.

The conditions are:
- shares are ordinary share capital;
- leverage by the VC is on commercial terms (in other words the VC lending must be on the same terms as the most expensive unconnected lending);
- managers acquire their shares at the same time as the VC;
- managers are fully remunerated by way of salary;
- the ratchet performance targets are corporate targets and are not personal performance targets; and
- the ratchet arrangements are in existence at the time of subscription.

However, as discussed above, the shares are inevitably restricted securities (ignoring the ratchet). In this respect HMRC’s guidance is less clear. The suggestion is that the manager will only be taken to have paid UMV for his shares if he pays a price that represents his maximum economic entitlement (discounted to take account of the likelihood of the ratchet not being triggered). If he does not, the risk is that HMRC will impose a post-acquisition income tax charge on any ‘untaxed’ element. Accordingly, it is prudent for managers to sign a s 431 election as a protective measure. Then, should HMRC dispute that the price paid reflects the UMV of the shares, any income tax (and NICs, if any) would be levied on the difference between the price paid and the UMV at the time of acquisition. The manager will have certainty that only CGT will be payable on the gains arising when the ratchet is triggered.

**Shares in target**

If the managers own shares in Target, they will want to dispose of those shares in a tax-efficient manner. They may dispose of their shares for cash, shares and/or loan notes.

If the managers have held their shares for more than two years and Target was a trading company throughout the period of ownership, the managers should achieve full business asset taper relief and an effective CGT rate of 10% will apply on the gain.

A sale of the shares for cash will trigger an immediate CGT charge so, alternatively, the managers could defer the payment of tax by exchanging their shares for loan notes (or shares) in Newco. If the exchange is for loan notes, the type of loan note will determine the CGT treatment.

A loan note can be prepared as either a qualifying corporate bond (QCB) or a non-qualifying QCB (non-QCB).

A QCB is a sterling-denominated security that cannot be converted into or redeemed in a currency other than sterling and which is issued on normal commercial terms (TCGA 1992, s 117). QCBs are outside the CGT regime. Therefore a disposal of a QCB does not give rise to a chargeable gain or an allowable loss. A non-QCB is anything that is not a QCB.

The effect of receiving a QCB in exchange for shares is that any gain (taking account of taper relief) made on the sale of the shares is calculated at the date of sale. That gain is not taxed immediately but is frozen. When the QCB is redeemed or matures, the frozen gain becomes chargeable and CGT payable. Tax is therefore deferred.

If the loan note is a non-QCB (or if the exchange is for shares), then technically no disposal takes place; the loan notes (shares) are treated as the same asset as the original shares.

The decision to take QCBs or non-

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**BACK TO BASICS**

Direct tax and stamp duty topics already dealt with under Back to Basics are Plant & Machinery Allowances (Issues 857, 862, 869), New Pensions Regime (859, 860), Industrial Buildings Allowances (Issue 853), Employee Share Options (847), SDLT (839), The Taxation of Non-Domiciliaries (830); Taxation of Termination Payments (829), Interpreting Tax Statutes (822), Possession or Power (796), Special Commissioners (789), Charity Taxation (778), Mergers & Acquisitions (770), Partnership Law & Taxation (757), National Insurance Contributions (749), Tax & Human Rights (737), Appeals (728), Company Cars (709), Corporate Debt (685), Accounts for Tax (684), Trusts & Settlements (681), R&D Tax Credits (670), Transfer Pricing (667, 668), Employee Share Incentives (653), Stamp Duty for Real Estate, Stamp Duty on Corporate Transactions (648), Taxation of Lloyd’s Names (647), Business Compensation Receipts (628), Leases – Sums Paid To or By Lessees (621), Incorporation (618), Tax investigations (552, 555, 611), Enterprise Management Incentives (610), Civil Tax Appeals (607, 609), Withdrawal of cash basis (600), NI on share option gains – transferring the liability (598).

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QCBs (shares) depends on how much taper relief the manager has accrued.

As QCBs are outside the CGT regime, taper relief does not accrue on them. Therefore if the manager has accrued full business asset taper relief, the manager may prefer to receive QCBs to protect the 10% effective CGT rate. Conversely, if the manager has not reached the effective 10% CGT rate the manager may prefer to receive non-QCBs so that taper relief continues to accrue.

However, a potential problem with QCBs is the lack of tax relief if the issuer fails to pay out when the loan notes are redeemed. In the worst case, a manager could find himself with a tax bill but without having received any cash.

Care must be taken if the shares in Target were acquired on the exercise of an enterprise management incentive (EMI) option. The exchange of shares for non-QCBs will restart the taper clock, effectively losing the taper relief accrued from the date of grant of the EMI option (TCGA 1992, Sch 7D, Part 4, para 14(3)).

Tax clearance
To ensure that the exchange provisions of the CGT legislation apply and the anti-avoidance income tax provisions do not, HMRC clearance is very often sought to confirm that the transaction is being carried out for bona fide commercial reasons and not for the avoidance of tax (TCGA 1992, s 137 and ICTA 1988, s 707).

CONCLUSION
These are some of the broad tax issues currently arising on private equity transactions. However, the issues for management are often far wider and, as with most tax planning, advance consideration is critical.

Part 2 will look at current issues for private equity houses and lenders.