**Private equity funds and tax issues**

This section will focus on the tax issues that typically arise on a private equity backed IBO where the management team is retained

**Introduction**

The usual tax issues that arise on a standard share or asset purchase will also arise, where relevant, when the transaction is an IBO where the management team is being retained.

For example, since Bidco is borrowing from the Bank to fund the acquisition of the target, it will be important to ensure that corporation tax relief for the interest payable on the bank debt will be available under the loan relationship rules.

In addition to these there are some further issues specifically relevant due to the nature of the retention of the management team as follows:

* **interest relief** on borrowings made by the management; and
* potential **income tax and national insurance liability** arising as a result of the acquisition of shares by the management.

Further, the application of the **transfer pricing rules** to interest deductions claimed by Topco, Bidco or the target in relation to any loan notes held by the fund (**'Fund'**).

Due to the complexity of the tax issues involved in a private equity backed transaction, tax specialists should always be consulted.

**Interest relief on borrowings made by the management**

You have already seen that the amount of money which the management are required to invest in Topco might be large in proportion to their personal wealth and that therefore they are likely to have borrowed money in order to finance their investment. They will wish to ensure that they can **set off** the interest they pay on this borrowing against their income, for income tax purposes. The tax rules permit this provided the conditions on the next slide are met.

**Interest relief on borrowings made by the management – conditions for set off**

1. there must be a loan to an individual which is applied in acquiring shares. These shares must be **ordinary shares** within the meaning of s.160 of the Corporation Tax Act 2010;
2. at the time the shares are acquired, the company in which they buy the shares (in this case, Topco) must be a **close company.** This means, broadly, that Topco must be controlled by five or fewer participators or by shareholders all of whom must be directors of the company. It does not matter if it ceases to be a close company soon after the investment;
3. throughout the accounting period in which the investment is made by the management and subsequently in all periods in which the interest is paid on the loan, the company must exist for the purpose of carrying on a **commercial trade** or holding shares in or securities of or making loans to subsidiaries that exist wholly or mainly for the purposes of carrying on a commercial trade; and
4. throughout the period between the loan being made and the interest being paid, the individual must:
   * either have owned shares in the company and worked for the greater part of their time in the **actual management or conduct of the company** (or an associated company);
   * or **hold a material interest** (broadly 5 per cent or more) in the company.

In the case of management, the former condition is most likely to be satisfied.

**Interest relief on borrowings made by the management**

The requirement that Topco is a close company when the investment is made is generally satisfied by ensuring that when Topco is set up or taken off the shelf, the management invest nominal sums in proportion to their intended equity investment (the Fund will not hold any shares in Topco at this time). Provided that more than 50% of the shares in Topco are held by five or fewer managers or held by management who have been appointed directors of Topco, this will ensure that Topco qualifies as a close company.

The managers then borrow the necessary amounts and subscribe for the vast majority of their investment at completion, in return for a new issue of ordinary shares in Topco.

Immediately afterwards, the Fund subscribes for its shares in Topco. At this point Topco may cease to be a close company but this should not affect the availability of interest relief for the management.

**Potential income tax and national insurance liability in connection with shares acquired by management**

The management will want to minimise their liability to income tax charges in relation to their shares in Topco. Since the management are acquiring their Topco shares by reason of employment, if they pay less than full market value for their shares, they may be subject to income tax on the difference between the market value and the amount they pay. If income tax becomes chargeable in relation to these shares, there may also be a corresponding liability for Topco to pay employer’s national insurance contributions. **Therefore, it is important that the management pay full market value for their Topco shares**.

Furthermore, if the management’s shares are subject to any restrictions on the management’s ability to deal with them, including restrictions which are quite normal in an MBO/MBI such as good leaver/bad leaver provisions, the shares will be ‘**restricted securities’**.

**In this case, there is a risk that the management will either be required to pay more income tax on acquisition of the shares or will suffer a further charge to income tax at a later date, for example on a sale of the management’s shares or if the restrictions on their shares are lifted or varied.**

**Safe harbour provisions**

A Memorandum of Understanding between the British Venture Capital Association and HMRC (commonly referred to as ‘**the MOU’**) deals with the income tax treatment of managers’ equity investments in venture capital and private equity backed companies. The MOU contains the provisions of a ‘**safe harbou**r’. It sets out a number of tests to be applied in a buy-out situation.

If all of the tests are satisfied, then HMRC will accept that the management have paid full market value for their Topco shares and that no income tax charges will arise in relation to the management’s shares, either on acquisition or at a later date.

The tests which must be satisfied vary depending on **whether the shares are subject to ratchet arrangements or not.** The purpose of these tests is to ensure, so far as possible, that the only financial benefit the management obtain through holding their shares in Topco is the capital gain genuinely arising as a result of the increase in value of the target over the period of the investment and to ensure that the reward the management receive in consideration for their work for the company is only provided in the form of salary and bonuses, which will be paid under the PAYE system and thus chargeable to income tax and national insurance contributions.

**Where the shares are not subject to ratchet arrangements**

The following conditions must be satisfied:

1. the management’s shares must be **ordinary share capital;**
2. where leverage is provided (for example by way of preference shares or loan notes) by any other holder of ordinary share capital (generally the Fund), this must be on **commercial terms;**
3. the management must acquire their shares at the **same time** as the Fund. You have already seen that the management subscribe for their shares just before the Fund to ensure that the management can claim interest relief on the amounts they have borrowed to fund their investment. **This satisfies the ‘same time’ test for the purposes of the MOU;**
4. the management must be **fully remunerated** for the work they do by salary and bonuses through a separate employment contract;
5. the **price** paid by the management for their ordinary shares must not be less than the price paid by the Fund for its ordinary shares; and
6. the **management’s shares** must not have any features that give them rights not available to other holders of ordinary share capital.

**Where the shares are subject to ratchet arrangements**

Conditions 1 (ordinary shares), 2 (leverage on commercial terms), 3 (simultaneous acquisition of shares) and 4 (remuneration through salary and bonuses) on the previous slide must still be satisfied **and in addition**:

1. the ratchet arrangements must vary according to the **performance of the company** and not of the individual shareholder (in other words they must not operate as a quasi bonus scheme dependent on individual performance);
2. the ratchet arrangements must **exist at the time** the Fund acquires its ordinary shares; and
3. the management must pay a price for their shares that reflects the **maximum economic** entitlement they could achieve under the ratchet.

This last requirement means that the management will have to begin with their maximum potential proportion of the equity, which will then be reduced through the ratchet if at the time of the exit, the target has not achieved the relevant performance targets.

**Transfer pricing rules**

As you have already seen, once it has been decided what proportion of the ordinary shares in the MBO structure will be held by management and what proportion will be held by the Fund, the Fund will then take the balance of its investment in either convertible preference shares (issued by Topco) or convertible loan notes (which may be issued by Bidco).

You will recall from Business Law & Practice, that one advantage of debt finance over equity finance is that, for the company invested in, interest paid on debt finance is **tax deductible**, whereas dividends paid on equity finance are not tax deductible. Based on this, it would seem that every MBO structure would use loan notes, rather than preference shares, because this is more tax-efficient (because following acquisition of the target group it would be possible to set off the interest payable to the Fund against the taxable profits of the target group for corporation tax purposes).

However, in certain circumstances, a company’s ability to deduct interest payments against taxable profits is restricted under the **transfer pricing rules** (they are also referred to as the ‘**thin capitalisation’ rules or ‘thin cap’ rules**).

Under the transfer pricing rules, to the extent that the company issuing the loan notes (Newco) agrees to pay more interest to the Fund than it would have paid to an unconnected third party acting on arms’ length terms (e.g. a bank), the Newco may not be permitted to deduct the ‘**excess**’ interest against its taxable profits for corporation tax purposes. This means that, for example, if the **rate of interest** Newco has agreed to pay on the loan notes held by the Fund is **higher** than it would have agreed to pay to a bank, HMRC may disallow the difference between the two interest rates as a tax deduction. Alternatively, if the Fund has agreed to lend an amount of money to Newco (at a high rate of interest) in circumstances where a bank would not be willing to lend at all (for example because Newco is already too highly geared), then all of the interest payable by Newco on the loan from the Fund may be disallowed from the deduction.

The practical consequences of the transfer pricing rules are that loan notes may not be such a tax-efficient form of MBO financing as one might think and that, to the extent that loan notes are used in MBO structures, the tax advisers on the deal should obtain evidence that similar debt finance would have been available from an unconnected third party (e.g., an offer letter from a bank), at a **similar rate of interest.**

**Summary**

* Management are permitted to **set off** the interest they pay on their borrowings against their income for income tax purposes provided certain conditions are met including the requirement that the shares are ordinary shares and Topco is a close company.
* Management should ensure that they pay **full market value** for their Topco shares to minimise their income tax liability. However, if the shares are subject to restrictions, then there is a risk of further income tax liability.
* The **safe harbour provisions** in MOU provide that no income tax charges will arise in relation to management’s shares provided certain tests are satisfied.
* The **transfer pricing rules** means that a company’s ability to deduct interest payment against taxable profits is restricted.