



HERBERT
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TRANSACTIONS AND EQUITY INCENTIVES

TRICKY AND PRACTICAL TAX ISSUES

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PUBLIC M&A

Practical issues relating to share or cash-and-share offers

- Option exercise or share vesting generally arises either at sanction of scheme of arrangement or on offer becoming unconditional
- Taxation arises at the time of the delivery of target shares
- This generally occurs such that the shares become subject to the Scheme or offer
- Offer consideration payable within 14 days of change of control
- How to deal with the time differential?
 - May not be enough cash proceeds to cover tax liability arising
 - Share price movement may lead to increase (or decrease) in participant's "effective" rate of tax

PUBLIC M&A

Practical issues relating to share or cash-and-share offers

- Potential to cash-cancel a proportion of each option or award
 - Cancel proportion equal to tax rate?
 - Cancel only enough to allow for tax to be settled?
- Cash proceeds from offer plus cash cancellation proceeds
- *Plus* cash required for cashless exercise?
- Work with administrator to set up vesting spreadsheet
- Actual tax rate or highest effective tax rate in jurisdiction?
- Forms part of Rule 15 offer – participants have choice to fund own tax or cash cancel in part. Could also offer ability to sell once they receive shares.

BUSINESS SALES

Accounting for income tax and NIC

- Business sales may be structured as a share sale of subsidiary or asset sale
- With a subsidiary sale, the employer will generally not change
- A TUPE transfer of employment will ordinarily be triggered by an asset sale
- Business sales often constitute “good leaver” status in share plans; or normal terms may continue to apply
- Where exercise of options or vesting of share awards is a taxable event, who operates PAYE?

BUSINESS SALES

Accounting for income tax and NIC – Share Sale

- Employer (no longer part of the grantor's group) will continue to be liable to account for income tax and NIC
- Purchaser will expect SPA to include provisions:
 - requiring Seller to inform Purchaser/Employer of taxable event
 - requiring Seller to operate withholding provisions in share plan rules and transfer funds to Employer to settle PAYE
- Seller will expect Purchaser/Employer to provide sufficient information to Seller to operate withholding provisions accurately
- Should the Seller also reimburse the Employer for secondary NICs arising?

BUSINESS SALES

Accounting for income tax and NIC – Asset Sales

- Original employer (part of the grantor's group) will continue to be liable to account for income tax through PAYE (*s 712 ITEPA*)
- New employer becomes liable to account for NICs (both primary and secondary) (*para 28, Sch 4, SI 2001/1004*)
- Can the parties agree that the original employer will account for NICs?
 - agency provisions (*para 4, Sch 4, SI 2001/1004*)
 - can the original employer accurately account for NICs
 - Category A week 1 rates?
 - who makes annual NIC filings?

BUSINESS SALES

Accounting for income tax and NIC – Asset Sales

- If new employer to account for NICs, Purchaser will expect SPA to include provisions:
 - requiring Seller to inform Purchaser/Employer of taxable event
 - potentially requiring Seller to operate withholding provisions in share plan rules and transfer funds to Employer to settle NICs (but consider whether this can be dealt with through payroll)
- Depending on above, Seller will expect Purchaser/Employer to provide sufficient information to Seller to operate withholding provisions accurately
- Should the Seller cover or reimburse the new employer for secondary NICs arising?

BUSINESS SALES

Statutory corporation tax deduction

- Subsidiary sale – employing entity continues to benefit from statutory corporation tax deduction
 - Should new employer group keep the benefit?
 - Negotiation point, particularly in connection with NICs liability
- Asset sale – debate around whether statutory deduction lost
 - HMRC currently considering the position
 - HMRC previously accepted that new employer should be able to take advantage of the deduction as “business” for which the option was granted has transferred, but this does not sit neatly with statutory provisions
 - Same negotiating point above, but less clear as to benefit arising

PRIVATE COMPANY M&A

Earn-outs

- Common feature of private company acquisitions
- Initial upfront consideration with possibility of additional consideration payments based on future performance outcomes
- Taxation of employment related securities arises on “market value” of shares on exercise of option or transfer of restricted securities
- Market value includes:
 - initial upfront consideration, *plus*
 - value of right to receive potential future consideration
- Issue for participants that a tax charge arises upfront on a value which may never be realised

PRIVATE COMPANY M&A

Earn-outs - example

- Initial upfront consideration: £5
- Earn-out based on Year 1 revenue: potential £1 (valued at 25p)
- Earn-out based on customer numbers: potential £1 (valued at 50p)
 - Upfront tax/NI on £5.75 (i.e. $£5.75 \times 47\% = £2.70$)
 - If no earn-out consideration, effective tax rate of 54% with capital loss of 75p (£5 received, but tax of £2.70 paid)
 - If earn-out pays, effective tax rate could be as low as 38.6% (£7 received but potentially only £2.70 of tax paid)
 - Valuation will be key to determining whether level of risk is acceptable

PRIVATE COMPANY M&A

Earn-outs – dealing with risk

- Share split into three classes of share
 - A1 represents initial upfront consideration
 - A2 represents earn-out right (Year 1 revenue)
 - A3 represents earn-out right (customer numbers)
- Options: roll over option and exercise or cash-out at the time each amount of consideration due (or lapse if earn-out does not pay)
- Restricted securities: split securities continue to be restricted; extend the forfeiture conditions and add new forfeiture connected to earn-out
- Put and call option arrangements to be entered into between participant and purchaser

PRIVATE COMPANY M&A

Earn-outs – dealing with risk

- Beware of time limits on restricted securities – five year maximum
- Purchaser will own company with participants who hold rights to minority interests or who hold minority interests
- Possible additional considerations if (unusually) acquisition is governed by Takeover Code (as same terms provisions will apply)

EMI OPTIONS

Were they really EMI options?

- Problems with EMI options often surface in the context of M&A
- Purchaser will undertake due diligence on the options, and will be looking at key issues including:
 - Did the company qualify: gross assets, number of employees?
 - Are there option agreements in place? Are they signed and dated? Do they contain details of restrictions?
 - Were the options notified within 92 days?
 - Did the employee sign the working time declaration?
 - Was market value agreed with HMRC? Were the options granted within the agreed period for this market value to hold?

EMI OPTIONS

Were they really EMI options?

- HMRC consider that if any of the statutory conditions were not met then the options could not have been EMI options
- What about the 12 month period for an HMRC enquiry?
- Dealing with “unapproved” EMI options
 - what do the plan rules say?
 - secondary NICs: have they been passed or is this a cost?
 - gross up participants for tax leakage and reduce per share consideration?
 - offer one-off compensation payment to include vested and also rolled-over options?

Questions?

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