Tax and M&A: Supporting Recovery

Mary Nyhan *Nyhan Tax Advisers*

Introduction

Corporate mergers and acquisitions (M&A) activity has shown signs of recovery in 2013. However, the activity that we are now seeing gives rise to significantly different tax issues than would be associated with boom-time transactions. In addition, we are continuing to see the types of corporate restructurings and reorganisations that are normally associated with less buoyant economies. This article addresses some of the tax issues relevant to this area.

Buy Now and Pay Later: Deferred Consideration

The percentage of the consideration that is deferred has now increased significantly, as business models are more uncertain, and the co-operation of the vendor post-sale is key, to avoid any unnecessary post-sale disruptions. The deferral is also a function of facilitating a buyer with limited financial backing. In many cases, up to one-third of the total proceeds could be reflected in a deferral and a conditional element, via either targets to achieve milestones or adjustments to working capital.

General principles

Section 563 Taxes Consolidation Act 1997 (TCA 1997) provides that the full amount of the consideration be taken into account in computing the capital gains tax (CGT) payable, regardless of the extent to which the receipt is uncertain or postponed.

Based on a 33% deferral, this increases the effective tax rate on the current funds received from 33% to 49.5% if the full amount of the sales proceeds is taxable now. If any of the amounts are subsequently not received, an adjustment takes place and a refund is due, albeit with interest unlikely to be claimed.

Marren v Ingles [1980] 54 TC 76 and *Marson v Marriage* [1980] 54 TC 59 remain the two key UK cases addressing the tax principles of deferred consideration. Both cases concerned agreements for the sale of assets in which the vendor received a quantified amount of money, plus a conditional and unquantifiable further amount payable at an unascertained future date. The point in dispute in both cases was the timing of any chargeable gain on the further amount to be received.

In *Marson v Marriage* Fox J held that s48 of the Taxation of Chargeable Gains Act 1992 applies when the sum to be brought into account represents ascertainable consideration, even when the right to it is contingent. It does not apply when the amount is unascertainable.

In *Marren v Ingles* it was held that the right to receive future unascertainable payments is a "chose in action". This is a separate asset in itself, which is chargeable for CGT purposes.

The Irish Revenue, in contrast, includes in the current computation the maximum amount of consideration where there is a cap involved. Given that milestone targets are becoming complex and can be scaled with no maximum, it is likely to become more difficult to value the right to receive the related sales proceeds at the time of contract signing.

Payment of tax: instalments?

In the current environment, where "buy now and pay later" is becoming more prevalent, it is more likely that the provisions of s981 of TCA 1997 will be looked at in more detail.

This section provides for payment of CGT on a sale by instalment where part of the consideration is payable by instalments over a period exceeding 18 months. The provisions apply if the vendor satisfies Revenue that full payment of the tax at the outset would result in undue hardship. The maximum instalment period is five years, with the last tax instalment due not later than the time of payment of the final sales proceeds.

Each case needs to be agreed with Revenue on an individual basis. To date, our understanding is that successful application of the provisions has been limited to cases where banking obligations have resulted in a cash-flow impossibility of full payment at the outset. However, we would urge Revenue to consider broadening the scope of these provisions to support the current M&A environment.

Stamp duty

The stamp duty analysis in relation to deferred consideration (in the form of either earn-outs to achieve milestones or working-capital adjustments) varies from the CGT analysis. Unlike the principle in *Marren v Ingles*, there is a requirement under s44 of the Stamp Duty Consolidation Act 1999 (SDCA 1999) for the asset being acquired to be valued, rather than the contingent element, and for stamp duty to be paid on this basis.

In relation to working-capital adjustments, the final numbers may not be available within 30 days, leaving the purchaser with the alternatives of paying stamp duty based on estimates, deferring payment (not recommended due to interest/penalty costs) or paying based on the amount paid, with refund difficulties potentially arising.

Holding back shares and share exchanges

The holding back of shares to represent the deferred consideration is likely to have practical application in the future. In the past, this was a mere talking point, due to a lower CGT rate. It achieves tax objectives by deferring the CGT on the value of the related shares. From a non-tax perspective, the vendor's position is strengthened by retaining rights in the target. Practically, and to avoid a downside for the vendor, this alternative is viable only if the milestones relate to the future value of the target company rather than specific individual performance measures. Purchasers are likely to require call options to guarantee the position, with the vendor taking a put option.

If the last instalment is due in two or more years, this also gives some scope in relation to succession planning by current share gifting and availing of the offset of CGT against the resultant gift tax liabilities. However, in this case, the succession-planning benefits replace the benefit of CGT timings.

The vendor may, alternatively, take shares in the acquiring company and avail of the simpler deferral provisions of s586 TCA 1997. While this is simpler tax-wise, it may not be feasible due to increased commercial risk, as the milestones are unlikely to be linked to the value of the acquiring company.

Share for Undertaking: Three-party Swaps

The tax provisions for separating existing trades into stand-alone companies remain unchanged, via ss587 and 615 TCA 1997 and s80 SDCA 1999, so that the ultimate sales proceeds revert directly to the individual shareholders at CGT rates.

However, in the current environment, where a share-for-undertaking three-party swap is involved, the key concern is whether the transfer can take place in accordance with the provisions of the Companies Acts. Accumulated trading losses may result in insufficient "profits available for distribution", which are required to facilitate the share-for-undertaking three-party swap.

Due to this restriction, we are likely to see more of a transfer of the **remaining** business, along with its liabilities, from the existing company to the new company. Provided that this part of the business has nominal value due to the effect of the liabilities, the reserve requirements will be satisfied. The existing company, with the valuable business, is then sold to the third party.

However, this approach results in greater complications for the due diligence process, with issues relating to the transfer of creditors/banking. In addition, to qualify for the tax reliefs, only assets and liabilities of the business being transferred can move to the new company. Hence, there may be a difficulty identifying sufficient liabilities linked to the business being transferred where liabilities relate to both businesses.

To avoid the complexities of transferring liabilities in this manner, the operation at the outset of distinct businesses as separate subsidiaries of a single holding company is always recommended. The net book value of each subsidiary will be nominal. The swap would involve a transfer of the subsidiary to a new company in exchange for the issue of shares in the shareholders in the holding company. In practice, Revenue accepts that a 100% shareholding in a trading subsidiary can represent an undertaking for this purpose. We are also relying on the decision of *Aveling Barford* [1989] BCLC 626, which held that reserves equal to the net book value of the asset to be transferred are sufficient. However, a more careful view is that reserves equal to the market value of the subsidiary are required. Given that "profits available for distribution" is an accounting term, the accounting treatment is key in determining the matter, and agreement with the relevant legal advisers is required to avoid any post-completion difficulties. The introduction in Finance Act 2008 of an exemption for dividends from the close company surcharge allows for greater comfort by the payment of a dividend, up to the market value of the business if possible, by the subsidiary to its parent before any transfer.

However, a more careful view is that reserves equal to the market value of the subsidiary are required. Given that "profits available for distribution" is an accounting term, the accounting treatment is key in determining the matter, and agreement with the relevant legal advisers is required to avoid any post-completion difficulties.

However, in both scenarios, the position is made more complex if there are creditors, banking and cross-guarantee issues, as is often the case.

Return of Trade Sales

Trade sales are also likely to be more common in the initial recovery stage where only one of the distinct businesses is being sold. This may also suit banking parties, as funds are received directly into the company to discharge any liabilities. Also, given historical risks, trade sales fit with purchasers who require the comfort of identifying only specific assets and liabilities for acquisition. This is helped, of course, by the current 2% stamp duty rate, the possible lack of a double taxation charge due to existing debt in the vendor company, and tax relief for intellectual property (IP).

A share-for-undertaking two-party swap where the transferor receives shares in the acquiring company allows the purchaser to acquire shares rather than a trade. Also, reserve issues should not arise. However, clawback provisions apply where there is an immediate subsequent sale, and hence, we are not likely to see this as a viable alternative.

Shareholders: Parting Ways

Unfortunately, shareholder disputes tend to be more prevalent in times of falling wealth, resulting in shareholders going their separate ways. As tax legislation does not specifically provide for business partitions, we are reliant on valuations and Revenue concession.

Revenue concession

By way of reminder, Revenue concession, as outlined in *Tax Briefing*, Issue 44 (June 2001), allows for a business to be partitioned in the following manner:

- The existing shares are reorganised into separate classes. The separate classes are linked to each particular trade, with each shareholder group owning the shares linked to a particular trade. The trade to be segregated can also be a 100% shareholding interest in trading subsidiaries.
- New companies are formed to take over the separate trades allocated to the different classes of shares.
- Each company is now owned by the shareholder linked to that trade.

For the provisions of ss587 and 615 to apply, the following conditions must be satisfied:

- No shift in value can apply.
- A 100% family company within the meaning of s598 TCA 1997 must be involved. Family for this purpose is spouse, sibling, ancestor or lineal descendant.
- No exchange of money can be involved.
- The underlying assets and shares must retain their original value.
- Advance approval from Revenue is required.
- Stamp duty relief is not available, but this is a lesser issue at the 2% rate. In the current environment, where legal certainty is required, stamp duty deferral is a thing of the past.
- The transaction must be undertaken for bone fide purposes and not for tax avoidance.
- All parties must be Irish-tax-resident.

Case law and practice

The well-known Irish case of *Patrick W. Keane & Co. Ltd v Revenue Commissioners* [2007] IEHC 466 and the UK case of *Fallon v Fellows* [2001] STC 1409 are further indications that a partition is not accepted as a reconstruction for tax purposes where there is a change in the ownership of the underlying trades. In these cases, shortly before the relevant partitions, specific trade value was allocated to each specific shareholder by the reorganisation of share classes.

In the UK from April 2002, partitions may fall within the relieving provisions for reconstructions. Such change would be welcomed in Ireland. Unfortunately, until it is introduced, shareholder disputes may continue to be resolved with an exit of one party for cash (seeking to avail of CGT, if the conditions of Part 6, Chapter 9, TCA 1997, are satisfied), with no opportunity to contribute to future growth of either business and related negative economic consequences. At a minimum, the definition of family for the purpose of the above concession could be broadened to other relatives so as to assist the transition of second and third family businesses.

At a minimum, the definition of family for the purpose of the above concession could be broadened to other relatives so as to assist the transition of second and third family businesses.

Executive Share Remuneration

The impact of Finance Act 2013 on executive share remuneration, along with recent developments, was addressed in detail by Cormac Brown and Keavy Ryan in the previous issue of *Irish Tax Review*, 26/1.

In relation to M&A, the following is a brief indication of some of the relevant points:

- After sale, the issue of shares is likely to be more prevalent in the future to retain key executives in the target. The cash exposure for the acquirer is reduced, and the executives are incentivised to drive future growth.
- Before or on sale, payments made to executives in the form of cash and, more often, shares would not qualify for a corporation tax deduction if the payment is made only, and dependent, on the sale taking place. UK case law supports this analysis.
- In relation to the sale of existing shares, quantification of any tax clawbacks in accordance with s128D TCA 1997 is required for executive shares that availed of the "share clog" provisions.
- The release of existing share options for value will give rise to an income tax charge under s128 TCA 1997. Under s128(8), existing share options can be exchanged for share options in the acquiring company so that a deferral arises.

International Aspects

Acquisition by non-Irish tax residents will clearly be prevalent due to both the value in the Irish market and the global focus of Irish fast-growth companies. The attractiveness of the 12.5% rate of corporation tax may not be sufficient for the target business to remain in Ireland, although the State will clearly wish to provide other incentives to retain the business here.

The CGT exit charge on a change of residence and the automatic tax residence of Irish-incorporated companies are two potential pitfalls associated with moving businesses outside Ireland.

Change of residence

Consideration will need to be given to the change-of-residence provisions affecting the target and the related implications for IP and goodwill held in Ireland.

The provisions for exit charges on a change of residence are contained in s627 TCA 1997. In summary, exceptions to the charge arise where the assets continue to be used for the purpose of a branch in Ireland, so a charge should not arise where activity remains in Ireland.

Significantly, an exit charge does not apply where the acquiring company remains an "excluded company". A company is an excluded company if it is at least 90% controlled by a foreign company. A foreign company is a company that is resident in a country with which Ireland has a taxation agreement but is not Irish-tax-resident or Irish-controlled. This gives flexibility in relation to, say, UK acquirers who wish to migrate back to the UK after the acquisition of an Irish target. In contrast, transfers to tax havens give rise to a potential charge where the assets do not remain in an Irish branch.

Irish incorporation

The provisions of s23A TCA 1997, where Irish-incorporated companies are deemed to be resident in Ireland regardless of place of management and control, will require ongoing consideration. Even if the previously outlined exit charges do not apply, these provisions may restrict international companies taking the capital appreciation of the Irish target outside the Irish tax net.

The exceptions to the application of the provisions are that the company is:

› a "relevant company" (broadly, under the control of a tax treaty country) and carrying on a trade in Ireland or

› regarded as not Irish-tax-resident by virtue a tax treaty; for example, care is required in cases such as the US, where there are no tax-residence tie-breaker provisions other than by mutual agreement.

Example

X Ltd, a Cayman company, acquires an Irish technology company. X Ltd is owned by Cayman investors.

Its assets are mainly IP and the related goodwill.

The company is acquired on the assumption that its residence will be transferred from Ireland to Cayman. Also, the IP will cease to be used in Ireland, and there will no longer be a base in Ireland.

In this case, s23A applies, so the company remains Irish-tax-resident, with its IP within the Irish tax net.

UK tax reliefs

There are a number of interesting UK measures seeking to support entrepreneurial growth and subsequent M&A activity that are worthy of note. The measures include the Entrepreneurial Scheme (providing a lower rate of CGT for the sale of companies by entrepreneurs) and the Enterprise Management Incentive (allowing for no income tax on share options where employees own less than 30% of the company). Hopefully, it is a case of "watch this space", and the Irish Revenue will look at similar provisions here.

Conclusion

In summary, the tax aspects of M&A activity are unlikely to be the key driver of transactions in the recovery stage. However, as importantly, if not more so, tax will link closely to achieving the business objectives of the various parties involved, for example:

› the purchaser seeking to defer full payment until the transition of the business has taken place and to tie in key executives through appropriate share-based remuneration, such as "share clogs";

› the vendor requiring commercial certainty of payment, ensuring that deferrals are linked to aspects that he or she can control and matching tax payments to receipts;

› banking and creditors seeking to collect payment from sales proceeds and not be adversely affected by sales;

› State agencies seeking that tax will act as a further incentive for the business to remain in Ireland after completion; and

› executives seeking to be rewarded for retaining value after completion.