Surprise, surprise

Employment Tax



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Tom Klouda and *Neil Graves* consider the potential employment- related securities issues on a fictitious due diligence exercise

Key Points

What is the issue?

Even simple corporate acquisitions can present a range of employment-related securities matters

What does it mean to me?

Care should be taken when advising clients who are looking to acquire a company with management shareholders

What can I take away?

If share-based transactions involving management in privately held companies take place without s 431 elections, these can give rise to material tax exposures in a target group. Wider consideration should be given to restrictions attached to employee shares and the value at which individuals have acquired their securities

On a due diligence exercise, it is common for the purchaser to request joint ITEPA 2003 s 431 elections from the target for reassurance that employee shareholders have acquired any restricted securities for their unrestricted market value (UMV) under the employment related securities provisions (ERS). (Legislative references are to ITEPA 2003 unless otherwise states.) If this is the case, prima facie, no employment tax exposures should arise on disposal of the shares. This is relevant for Targetco (see below). If less than the UMV is paid and there is no valid s 431 election – having determined that the shares are readily convertible assets (RCAs) – there may be a payroll obligation and employer's NIC due. All individuals are resident and domiciled for UK tax purposes.

Background

Our client, a private equity house (PE), is looking to acquire the target company, Targetco, for £50 million. Tim will fully exit at this point.

Example – Targetco

Tim founded Targetco in 2004 with £100 ordinary share capital (OSC). It has two classes of ordinary shares, A and restricted B. Tim holds all the A shares, representing 80% of OSC. He did not make a s 431 election.

Lisa, who is Tim’s daughter, holds half of the Targetco B shares, representing 10% of the company’s OSC. She subscribed for her shares at par value (which was under market value) two years ago and later became a director. Lisa did not make a s 431 election.

Rob is also a director. Two years ago he subscribed for B shares at par value (which was below the actual market value (AMV) which takes into account restrictions) representing 10% of the OSC. Rob did not make a valid s 431 election. Lisa and Rob will be permitted to cash out 50% of their respective interests and be required to roll over the other 50% up the acquisition structure through loan notes to invest alongside PE in Topco shares.

Tim’s acquisition

There is no exemption from the ERS provisions for founder shareholders (ERSM20240). However, because Tim incorporated a new company and subscribed for 100 x £1 shares, it is likely that he would have subscribed for them at their UMV (the shares are not restricted).

This plus the fact the time limits for a PAYE enquiry under TMA 1970 ss 34 and 36 have passed, should mitigate any risk to PE.

Recommendation: no further due diligence required.

Lisa’s acquisition

The definition of ERS is broad: s 421B(1) expresses them as ‘securities, acquired by a person where the right or opportunity to acquire the securities or interest is available by reason of an employment’. On the face of it, Lisa may be subject to the rules. But s 421B(3) has an exemption whereby shares are not deemed to have been acquired by reason of employment if that right or opportunity was made available in the normal course of the domestic, family or personal relationships of that person.

Recommendation: even though the shares were acquired at undervalue and Lisa later became a director, it is likely that the exemption would apply based on the facts (ERSM20220). No further due diligence required.

Rob’s acquisition

Say the shares were considered to be RCAs and the AMV of the shares was greater than par. Targetco should have operated PAYE and employee's and employer's NIC on the difference between AMV and price paid on a 'best estimate' basis (s 698). Rob did not sign a s 431 election and therefore did not opt to be taxed based on the UMV of the shares at acquisition.

Recommendation: the Targetco shares are not under the control of another company, nor did any 'trading arrangements' exist at the time Rob subscribed for the shares (s 702(1)(c)). Therefore, the shares should not have been considered RCAs and any tax due would have been Rob's personal liability, not Targetco's. No further due diligence required.

Tim's disposal

On the basis that Tim's shares are not restricted and that he paid UMV on acquisition, there should be no further employment tax implications for the Targetco group.

Recommendation: the disposal is a personal tax matter for Tim. No further due diligence required.

Lisa's cash out

Because Lisa's shares fall outside the ERS provisions, no tax implications should arise on Targetco as a result. This is therefore a personal tax matter for Lisa.

Recommendation: no further due diligence required.

Rob's cash out

On sale, an element of the proceeds – that is the cash received – representing the proportionate value of the restrictions will be subject to income tax via PAYE and NIC at his marginal rates of tax and employer's NIC of 13.8%.

Recommendation: a valuation of the restrictions is undertaken to determine the proportion of the proceeds subject to employment taxes. This is a cost to Targetco, so a reduction in the price should be negotiated to reflect the employer's NIC.

Rob's rollover

Unless the transaction is compliant with the memorandum of understanding (MoU) between the British Venture Capital Association (BVCA) and HMRC, a valuation of the Topco shares received is recommended to ensure that their UMV is not greater than the value of the loans rolled up the structure. This should help demonstrate that the Topco shares are not acquired at undervalue and to confirm that s 430A applies so that the rollover is not subject to income tax (s 430A(5)) because the consideration for the Targetco shares exchanged as part of the roll up is 'wholly' securities (s 430A(3)(b)).

Because s 430A(6) prevents a valid s 431 election being made over the shares in Topco and no election was made at the time of acquisition of Targetco shares, there is a risk that a future disposal of Topco shares generates an employment tax charge based on the value of the restrictions. To reduce the likelihood of this a s 430 election should be considered if there is a chargeable event (defined in s 427) before the shares are sold. A s 430 election deems for tax purposes the lifting of all remaining restrictions and, based on their value, imposes employment tax charges. These would be income tax and employee NIC at rates up to 47% withheld through PAYE and employer's NIC of 3.8%.

This approach should ensure all future growth of Topco shares is subject to capital gains tax, protecting the group from future PAYE obligations and employer's NIC charges.

Recommendation: to the extent the transaction is not MoU compliant, undertake a valuation of the Topco shares at acquisition to ensure that their UMV does not exceed the rolled loans. In addition, a valuation of the restrictions should be sought to determine the employment tax charge at the time of making the s 430 election. The employer's NIC charge should be included as a net-debt item in the sale and purchase agreement (SPA).

Lisa's rollover

Lisa's shares are outside the ERS provisions. The roll-up through loan notes into Topco shares should therefore not generate a tax charge on the group so long as the market value of the loan notes rolled is equivalent to the UMV of the shares acquired in Topco; that is, Topco shares are not acquired at undervalue. It is anticipated that Lisa's roll-up will be tax-neutral from a capital gains tax perspective under TCGA 1992 s 135.

Because s 430A would not apply, the receipt of the shares is in effect considered a new acquisition of an ERS on the basis that they are received as a result of her employment in the group.

Recommendation: to the extent the transaction is not MoU-compliant, undertake a valuation to ensure that the UMV has been paid for the shares. Lisa and the group should make a valid s 431 election to decrease the likelihood that any future proceeds on the disposal of Topco shares would in part be subject to employment taxes.

Conclusion

PE has realised that the management of the tax issues are more complex than it first thought, even on the acquisition of a simple private business.