MoU refresher

Large Corporate OMB



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Tom Klouda and *Ashley Prior* provide a refresher guide to the memorandum of understanding between the BVCA and HMRC on the income tax treatment of managers' equity investments in venture capital and private equity backed companies from 2003

Key Points

What is the issue?

The MoU can provide a ‘safe harbour’ for HMRC to accept that unrestricted market value (UMV) has been paid when individuals acquire shares at the time of a private equity buyout.

What does it mean for me?

If UMV has been paid there should be no PAYE or NIC when the shares are issued. If the MoU applies, it eliminates the need for a tax valuation to be undertaken and it can mitigate the risk of unforeseen tax liabilities arising.

What can I take away?

If individuals invest in a ‘vanilla’ private equity structure at the same time and on the same terms as the investor while meeting the conditions of the MoU, UMV is deemed to have been paid, mitigating the risk of HMRC challenging the valuation.

This article looks at the memorandum of understanding (MoU) between the British Venture Capital Association (BVCA) and HMRC on the income tax treatment of managers’ equity investments in venture capital and private equity backed companies from 2003.

On acquisition of the shares by managers, there is a risk of an income tax charge on any discount if shares have been received at undervalue. If the MoU applies, the risk is eliminated because it sets out an approach accepted by HMRC to determine whether the price that managers pay for their shares is at least market value, where they are not restricted securities, or UMV where there are restrictions on them, such as on the ability to transfer them. This eliminates the need for a tax valuation to be performed on the equity investment, including the associated costs, and reduces the risk of a potential HMRC challenge to the valuation.

When restricted securities are subject to a chargeable event, if they were acquired for less than UMV the excess proportion between market value and UMV on any proceeds is chargeable to income tax rather than capital gains tax. Having restricted securities deemed to be acquired for UMV is therefore beneficial because, when a chargeable event occurs, for example when the securities are sold, the entirety of the proceeds will be subject to capital gains tax.

The approach set out by the MoU is a reflection of the law and represents a ‘safe harbour’ which HMRC will accept should the conditions be met. HMRC does not have to accept the MoU if a significant purpose of the arrangement is to avoid tax or there are material deviations from the conditions. Conversely the taxpayer may also argue that a different interpretation to the MoU applies in their situation.

The conditions for the MoU to apply

Six conditions must be met for the MoU to apply:

1. The shares that managers acquire must be ordinary capital.
2. Any leverage provided by holders of ordinary capital (for example, the private equity/venture capital investors) that is in the form of preferred capital is on commercial terms. (It will be deemed to be on commercial terms when the coupon is not less than that on the most expensive financing provided by third party lenders.)
3. The price paid by managers for their shares should not be less than that paid by the private equity investor for its ordinary capital shares. These must be either the same class as managers’ shares, or shares of another class that have substantially the same economic rights as the managers’ shares.
4. Managers must acquire their shares at the same time as the private equity investor.
5. The shares acquired by managers must have no additional features to give them or allow them to later acquire additional rights which are acquire additional rights that are not available to the other holders of ordinary capital.
6. Managers should be fully remunerated by salary and bonuses (where applicable) through an employment contract.

In relation to the above conditions, if managers’ shares have restrictions requiring them to possibly transfer their equity for less than their market value should their employment end (‘bad leaver conditions’) then, as long as condition 3 is met, the managers will be treated as not having paid a discounted price. In addition, tag-along and drag-along rights are treated as not depressing the value of the shares.

When managers’ shares are subject to ratchet arrangements

Where managers' shares are subject to ratchet arrangements HMRC accepts that these should be considered when determining the UMV. HMRC accepts that, if conditions 1, 2, 4 and 6 above as well as the conditions below are met, the price paid by the managers for their shares will be at least UMV.

The further conditions are:

- That the ratchets are arrangements whereby the participation in the profits of the company may be different depending on the company performance or the private equity investor's return on its investment.
- The ratchet arrangements exist at the time that the private equity investors acquire their share capital.
- The managers must pay a price for their investment in the ordinary capital on acquisition that reflects the maximum economic entitlement.

How the MoU would apply

Let us say that a private equity investor acquired a 95% interest in a company and a single manager acquired 5%.

For the above transaction to be MoU-compliant, the manager must have acquired their interest at the same time as the private equity investor and they must have acquired either the same shares or those with substantially the same economic rights as those acquired by the private equity investor. The shares acquired by the manager must also have the same rights as those acquired by the private equity investor, say one vote per share. This would mean that the manager would hold 5% of the votes while the private equity investor held 95% of the votes, in addition to the same income and capital rights.

In this example, as long as the manager holds their shares for at least a year then, on disposal, it is likely that they would also qualify for entrepreneurs' relief, subject to additional criteria.

When MoU may not apply

There are many situations in which the MoU may not apply. If, in the example above, the manager was unable to invest at the same time as the private equity investor, condition 4 would not be met and the MoU would not apply. When the MoU was

introduced, HMRC was fairly flexible about equity acquired shortly after the private equity investors. However, this is generally no longer the case. When managers acquire their shares at a different time from the private equity investor, our understanding is that HMRC's view is that the employee's share acquisition falls outside the MoU.

Award of shares under ESS

The MoU will not apply if managers' shares are awarded under employee shareholder share (ESS) rules. This is because condition 3 will not have been satisfied since the manager will not have paid anything for the shares that they were awarded. Although any shares within the ESS regime will not fall within the MoU, it is one instance where it is possible to submit a pre-transaction valuation to HMRC that can provide certainty to the value of the shares awarded.

Conclusion

In practice, deals do not always follow the prescriptive rules set out within the MoU and there are various factors that can cause a transaction to fall outside the qualifying conditions. It is therefore important to take care to ensure the conditions are met. If these are not met, it will be necessary in most cases to perform a tax valuation to mitigate the risk to the company and the employee.