Mergers and acquisitions: structuring the deal

Large Corporate OMB

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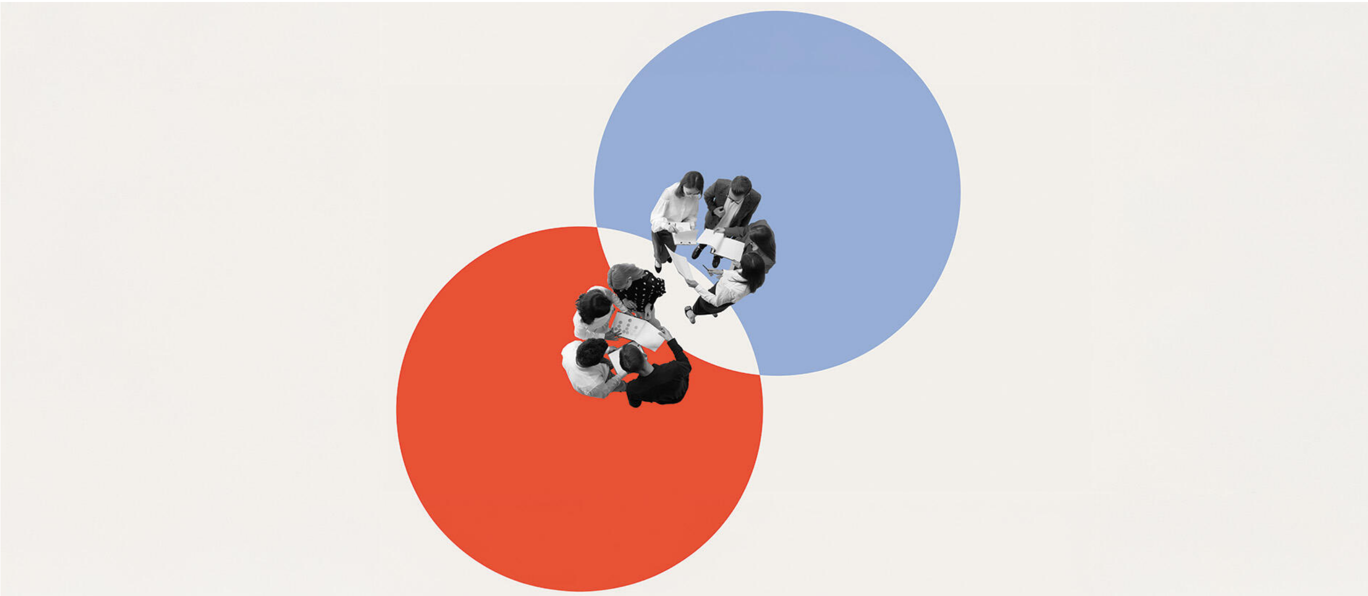

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Careful transaction structuring, consideration planning and early tax advice can improve commercial outcomes while reducing unexpected liabilities for buyers and sellers.

Key Points

What is the issue?
M&A transactions involve far more than choosing between a share sale and an asset sale. The way a transaction is structured can have significant tax consequences for both buyers and sellers.

What does it mean to me?
Advisers should consider the interaction of multiple taxes, the form of consideration

and available planning opportunities at an early stage to help maximise value and avoid unexpected liabilities.

What can I take away?
Early engagement allows advisers to shape the structure of a transaction before commercial terms are fixed, improving both the tax outcome and the likelihood of achieving the client's wider objectives.

Mergers and acquisitions (M&A) transactions are often introduced as a relatively straightforward choice between a share sale and an asset sale. For many advisers, the emphasis is initially on the tax consequences for the seller.

In practice, however, successful transactions require advisers to consider a much broader range of tax issues affecting both parties. Decisions made during the planning stages can influence the deal value, structure and post-transaction outcomes, while the tax implications often extend well beyond the initial disposal itself.

In the early stages of any deal, neither buyer nor seller is likely to be dwelling on the tax impacts of their proposals. Commercial motivations and practical considerations are usually the starting point for both buyers and sellers. A purchaser may be looking to expand its market share, acquire intellectual property or strengthen its supply chain, while a vendor may wish to realise value, streamline operations, dispose of a non-core business or prepare for retirement.

Tax is seldom the primary driver at this stage. Instead, the key questions are usually commercial rather than tax-driven: what is being sold, why is the transaction taking place and how can the best deal be achieved? Once advisers become involved, however, tax rapidly becomes a key consideration throughout the transaction.

Effective tax planning can enhance returns for both buyers and sellers, while poor planning can reduce deal value or create unexpected liabilities. This article focuses on the tax considerations involved in structuring an M&A transaction, from the choice between share and asset deals to the way consideration is structured and planning undertaken before completion.

A follow-up article will examine the tax due diligence process, the types of issues that commonly emerge during transactions, and the post-completion tax considerations that advisers should not overlook.

Share or asset acquisition?

One of the first tax decisions in any M&A transaction is whether the purchaser acquires the shares in the target company or its underlying assets. While this is often presented as a straightforward choice, each approach has different commercial and tax consequences for both buyer and seller.

Share deals are generally preferred by sellers because the disposal is usually subject to capital gains tax or corporation tax, and may qualify for reliefs such as business asset disposal relief or the substantial shareholding exemption. Buyers, however, inherit the company together with its historic tax liabilities and other risks.

Asset acquisitions are often more attractive to buyers because they allow the purchaser to cherry-pick the desired items, avoid many historic liabilities and potentially obtain tax relief through capital allowances. This is, however, an oversimplification and the distinction is often less clear-cut in practice, with many transactions involving elements of both share and asset acquisitions. It is not uncommon for an owner-managed business to operate from premises owned personally by the founder. This raises questions about whether the trade, the property or both should form part of the transaction.

Similarly, a trading group may comprise a holding company and several subsidiaries, each carrying on a particular product line or operating from a separate location. A buyer may wish to acquire only selected parts of the group, such as the shares in one or two subsidiaries together with valuable intellectual property held in another group company. The transaction may require a combination of share and asset acquisitions to achieve the desired commercial outcome.

These examples illustrate why share and asset deals should not be viewed as mutually exclusive. Advisers need to be prepared to consider the full implications of any deal.

One of the most useful disciplines when approaching an M&A transaction is to consider every tax that could potentially arise, rather than focusing solely on the immediate capital gains tax implications for the vendor. Depending on the structure, corporation tax or income tax may arise on the disposal of assets subject to capital allowances, including property. VAT implications need to be considered for both parties, together with the availability of transfer of a going concern (TOGC) treatment. The purchaser may also face stamp duty or stamp duty land tax liabilities.

Unlike many areas of advisory work, where a single tax is often the primary focus, M&A transactions require advisers to take a wider view from the outset. This can help to ensure that the chosen structure delivers the intended commercial and tax outcomes.

Consideration

Whatever the target of a transaction, the parties must first agree a value. This is rarely an exact science. Although it will draw on detailed financial analysis, there is often an element of commercial judgement that defies any simple formula.

While valuation is primarily a commercial matter, how that consideration is structured can lead to very different tax outcomes. Advisers therefore need to do more than simply understand the tax implications of any offer made by the other side. They should also consider whether the consideration package, or the method by which it is delivered, could be structured differently to achieve a better commercial and tax outcome for their client, while avoiding any nasty surprises along the way.

Forms of consideration

Consideration can come in many forms, although vendors will naturally prefer to receive as much cash upfront as they can. Buyers, however, may not wish to release the full value upfront. They may want to manage cash flows, be cautious about unknowns, or wish to make some amounts contingent on future performance – or may simply not have available the necessary amount.

Accordingly, under M&A agreements, consideration can be in cash, loan notes, deferred or instalment payments, or shares in the acquiring company. The amount agreed can also be dependent on future criteria being met, such as an increase in net profits, EBITDA, margins or share price.

Cash consideration will generally be taxable in the vendor’s hands, but that is often the easy part of the transaction.

Where consideration is paid in instalments or partly deferred, an individual may be eligible to pay capital gains tax in instalments. Broadly, there must be at least an 18-month period between the first and last payment, allowing 50% of each instalment to be paid to HMRC as it is received, rather than paying the full capital gains tax liability upfront. Importantly, this treatment is not automatic, and a claim is required under TGCA 1992 s 280, which could be easily forgotten.

Where consideration is received in loan notes or shares, the gain is generally rolled over into the new asset under the share-for-share exchange provisions in TCGA 1992 s 135. However, this treatment can be disapplied by election where advantageous. For example, although the vendor may qualify for business asset disposal relief on the initial disposal, they may not be eligible on the future disposal of the replacement shares. While making an election can create a dry tax charge, it may be highly beneficial to secure the lower capital gains tax rate available at the time of the original disposal.

Future consideration also requires careful analysis. Where the amount is ascertainable, that amount is generally taxable immediately. Where it is unascertainable, however, such as under an earn out arrangement, the principles established in *Marren v Ingles* [1980] 54 TC 76 will be applied. In these circumstances, the vendor is considered to have received not only the initial consideration but also a right to a future payment, which itself is an asset.

That asset must be valued as best it can be at completion and included in the initial capital gain. When the future payment is eventually determined, that right is treated as having been disposed of, and the value previously calculated will be deducted as the base cost against the future sum received. Any further capital gains tax is then payable accordingly.

Many transactions combine several of these forms of consideration, making it essential to consider how the different tax rules interact.

Tax versus commercial objectives

Even where a structure is most tax-efficient, it may not represent the best overall commercial outcome for your client. Advisers and taxpayers alike can sometimes fall into the trap of letting the tax tail wag the dog by seeking primarily to maximise tax efficiencies.

A vendor may be willing to accept a less optimised deal for tax if it benefited them in another way. They may, for example, accept a lower price in exchange for a faster completion, or a larger proportion of the consideration being paid upfront rather than through deferred payments or earn-outs.

Ultimately, the structure of the consideration package requires a negotiated balance between tax efficiency, commercial objectives and the allocation of risk.

Deal planning and transaction vehicles

Early engagement is one of the greatest advantages a tax adviser can offer. The sooner advisers become involved in a transaction, the greater the scope for effective planning.

Once commercial terms have been agreed, or a deal is close to completion, the opportunities to improve the tax position may be limited. Early engagement allows advisers to understand the taxpayer’s objectives and consider whether the proposed structure is the most appropriate way of achieving them.

Whether you are acting for a vendor or a purchaser, understanding your client’s end goal long in advance can create planning opportunities that might otherwise be missed. Many deals involve one or both parties wanting only part of a business, making it possible to reorganise a company or group before the transaction takes place to achieve a smoother deal.

Take, for example, a management team with a minority holding wishing to acquire the business from a retiring owner. They have negotiated a price with the owner, but are lacking funds to make an outright acquisition, and are cautious of taking on large personal loans. The company could undertake a purchase of own shares, utilising the company’s own funds to buy out the owner. However, this requires there to be distributable reserves and, under the Companies Act 2006, the purchase price must generally be made at completion, limiting its effectiveness in some transactions.

An alternative may be for the management team to establish a new holding company and use it as part of a scheme of reconstruction to acquire the shares in the trading company. The new holding company would owe the purchase consideration to the previous owner, and could subsequently repay that liability from future profits of the acquired trading company, paid up as a dividend. This overcomes both limitations and does not require the management team to take on significant personal liabilities.

Another common situation arises where a single company owns both its trading business and the property from which it operates; however, the purchaser wants to acquire only the trade, or the vendor wishes to retain the property as a source of future rental income. Instead of undertaking a trade and asset sale, the company could undertake a capital reduction demerger to separate each part into its own company, enabling the shares in the trading company alone to be sold.

Reorganisation requires sufficient time to implement, and advance clearance from HMRC should always be sought where appropriate. Although this will create additional professional costs, the tax and commercial benefits will often outweigh that additional expense.

In conclusion

The tax implications of an M&A transaction extend well beyond the headline question of whether a business is sold by way of shares or assets. Decisions made at the planning stage, from the structure of the transaction to the form of the consideration, can have a significant impact on both the commercial outcome and the after-tax position of the parties.

This first article has focused on the tax considerations involved in structuring a transaction before completion. In the second article, we will examine how tax due diligence helps identify historical liabilities and planning opportunities, before considering the warranties, indemnities and post-completion tax issues that advisers should have firmly on their radar.