

UK TAX POINTS WORTH CONSIDERING NOW

In this difficult market, plans for corporate and business sales and the realisation of investments may be on a go-slow.

This is the time though that owner managers and private equity houses should be giving some thought to how well placed they and their businesses are to maximise the returns on offer once things start moving.

How can they ensure their management teams and employees stay incentivised in the meantime? Can their businesses attract the additional investment needed to see them through? How well placed will they be to realise their investment in the most tax efficient manner when the time comes?

In this alert we will look at some of the ways that proper and timely tax planning can help in addressing these issues.

In any given situation, much will depend on the particular facts and advice should always be sought on what is the best plan of action in the circumstances. However, the following should provide some food for thought.

Rewarding Management

The economic slump means that the value of the shares that management teams hold in their employer companies may have reduced significantly. Also, any options they hold may be “under water”.

Set out below are some of the possibilities for re-incentivising management and employees – without incurring significant tax charges.

Grant Options to Management

Options can be attractive to management as no money has to be paid on grant and no immediate tax charges should arise. The most tax efficient options also offer the ability for management to exercise the options and acquire shares without any employment related income tax charges and with only capital gains tax to pay on any growth in value.¹

■ *Grant EMI Options*

Enterprise Management Incentive (“EMI”) options can be hugely tax efficient for management. Provided the option is to acquire shares at their market value as at the date of grant, no tax charges should arise on exercise (regardless of any interim increase in value of the shares). Additionally, on a later sale of the shares, any profit made on increase in value above the exercise price paid should be taxable as capital gain (up to 18%) rather than employment related income (at 40% plus with national insurance charges).

Various conditions need to be met for a company to be able to grant valid EMI options to employees. These include that the company needs to be “independent” (not under the control of another company), carrying on a qualifying trading activity, have gross assets of less than £30 million and have less than 250 full time employees.

Conditions also apply as regards the employee receiving the grant of the options, including a working time requirement and a limit of £120,000 of unexercised options to be held at any time.

■ *Re-grant EMI Options*

If employees already hold EMI options that are currently “under water”, consider replacing these with new options. It may be possible to agree a lower market value for the shares (and hence lower exercise price) with HM Revenue & Customs (“HMRC”) than was approved at the time of the original grant.

Award Shares to Management

Currently low equity values may mean that employees can be given the opportunity to buy shares in their employing company or can be awarded shares as a bonus without exposing them to significant income tax charges.²

Transfer Loan Notes to Management

Where there is concern that equity values may not increase enough to provide management with any real incentive, many private equity houses have been considering transferring to management a stake in their loan note holdings. As these loan notes will likely have been structured as “qualifying corporate

bonds”, any capital gain arising to management on a later disposal of these loan notes may be exempt from capital gains tax. (Care needs to be taken, however, in determining the value of the notes transferred because, as with shares, employees will be liable to income tax charges to the extent the market value of the notes received can be said to exceed the price paid).

Attracting Investment

There are a number of tax incentives that can be available to UK investors injecting capital into small trading companies. If you are looking to raise funds to expand or maintain your business, it is worth considering whether the availability of these reliefs is something you should be highlighting.

Below is a short summary of the incentives that can be offered and who they would apply to. Note that, in all cases, there are a number of stringent conditions that need to be met, in particular in relation to the size and activities of the investee company. A company can obtain advance clearance from HMRC, however, that it meets the requisite conditions for investors in its shares to qualify. It should also be borne in mind that tax reliefs can be lost if conditions cease to be met or if the investors dispose of their shares within set time periods.

Further details on these various incentives can be provided on request.

Enterprise Investment Scheme (“EIS”)

The EIS is a package of tax reliefs available to UK individual investors subscribing cash for ordinary shares in small UK trading companies, up to a current limit of £500,000 of investment in any tax year.

The benefits available to investors include income tax relief on the amount subscribed at the rate of 20% and a capital gains tax exemption on any gains made on a later disposal of the shares.

Venture Capital Trusts (“VCTs”)

VCTs offer the ability for investors to participate in a range of small UK companies whilst offering similar (and sometimes better) tax benefits to EIS, up to a current limit of £200,000 of investment in any tax year.

VCTs can only invest in companies that meet set criteria.

Corporate Venturing Scheme (“CVS”)

The CVS provides tax incentives for corporate equity investment in the same type of UK trading companies that are qualifying for the EIS and VCT scheme.

Tax benefits for corporate investors include 20% relief from corporation tax on the amount subscribed and a chargeable gains deferral.

Entrepreneurs' Relief

Entrepreneurs' relief replaced business asset taper relief in April 2008 as the means of affording owner-managers a reduced rate of capital gains tax on the sale of their businesses. The conditions for entrepreneurs' relief are more restrictive than they were for business asset taper relief though and shareholders considering selling once the market picks up should give some thought now to whether they will be able to benefit.

If the conditions are met, entrepreneurs' relief can deliver an effective rate of capital gains tax of 10% for an individual on a lifetime limit of up to £1m of gains. It can apply to sales of businesses, shares and other securities.

Conditions for business sales

Entrepreneurs' relief can be claimed by an individual on capital gains arising on the sale of the whole or part of a business provided that he has owned the business for at least 1 year prior to the sale (or date of contract for sale if earlier).

Conditions to be met on sales of shares and securities

On share sales, the relevant conditions need to be met throughout the period of 12 months prior to the disposal (or date of contract for disposal). Accordingly advance thought should be given to whether the conditions will apply and whether any changes need to be made to ensure that key individuals can benefit from this relief.

Specific advice should be sought on whether the relief will apply to any particular set of circumstances. Generally though, the conditions include:

- *Shares or securities in a trading company or group* – that the shares or securities are in a trading company or holding company or a trading group.
- *Qualifying holding* – that the individual making the disposal has held a stake of at least 5% of the ordinary share capital in the relevant company and that holding confers at least 5% of the voting rights over the company.
- *Officer or employee* – that the individual making the disposal has been an officer or employee of the company or a company in its group.

Note that, if the necessary conditions are met as regards an individual and his interest in a trading company, entrepreneurs' relief can be claimed in respect of any gains arising on the sale of any shares or securities in that company regardless of whether they have been held for the full 12 months and also on any gains from earlier disposals held over into loan notes issued by the company (which crystallise when the loan notes are sold or redeemed).

New York

Seven Times Square
New York, NY 10036
+1.212.209.4800
+1.212.209.4801 [fax]

Boston

One Financial Center
Boston, MA 02111
+1.617.856.8200
+1.617.856.8201 [fax]

Washington, DC

601 Thirteenth Street NW,
Suite 600
Washington, DC 20005
+1.202.347.2222
+1.202.347.4242 [fax]

Hartford

City Place I
185 Asylum Street
Hartford, CT 06103
+1.860.509.6500
+1.860.509.6501 [fax]

Providence

121 South Main Street
Providence, RI 02903
+1.401.276.2600
+1.401.276.2601 [fax]

London

8 Clifford Street
London, W1S 2LQ
United Kingdom
+44.20.7851.6000
+44.20.7851.6100 [fax]

Dublin

Alexandra House
The Sweepstakes
Ballsbridge, Dublin 4
Ireland
+353.1.664.1738
+353.1.664.1838 [fax]

www.brownrudnick.com

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Traps for the unwary

Whilst the conditions for entrepreneurs' relief to apply are relatively straightforward, the requirements are strict and it is easy to fall, unwittingly, outside the conditions.

- *The meaning of 5% of share capital* – shares held by the claimant must form 5% of the total nominal value of the issued ordinary share capital of a company. In companies with different classes of shares, 5% of total shares by number or economic interest may not equate to 5% of the nominal value.
- *The issue for MBOs* – on buy-out transactions, it is common for management to sell shares they own in a company and for capital gains to be "rolled" into new shares and loan notes issued by the acquisition group. Prior to April 2008, management might have ended up receiving shares in a top company and loan notes in a subsidiary of that company. In these cases, entrepreneurs' relief may not apply to gains rolled into the loan notes as they are not issued by the company in which the "qualifying holding" of 5% ordinary share capital is held.

¹UK individuals are subject to income tax on employment related benefits at the rate of up to 40% and, as of April 2010, up to 50%. Employer and employee national insurance contributions may also be payable. Capital gains tax is payable at the rate of 18% (or 10% to the extent entrepreneurs relief applies). Thus capital gains tax treatment is by far preferable.

²Whenever employees or directors acquire or are awarded shares, an income tax charge and potentially national insurance charges can arise to the extent that the market value of what they receive is greater than the price being paid.

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Tracy Fisher
+44.20.7851.6015
tfisher@brownrudnick.com

Patrick Cox
212.209.4949
pcox@brownrudnick.com