Tax Update:
Developments affecting Private Equity Houses

12 May 2003

PRICEWATERHOUSECOOPERS

Agenda

- Introduction and welcome – Angela Crawford-Ingle
- Solutions for investee companies – Kevin Morris
- Post deal risk management – Robert Mellor
- Management team incentivisation – Claire Wesley
- Summary and Q&A

Less tax for investee companies – More cash for You!

Kevin Morris

PRICEWATERHOUSECOOPERS

Key changes impacting Investee Companies

- Budget 2003 – watch this space!
- Selling Shares – Tax free sales now available!
  – The new Substantial Shareholding Exemption (SSE)
- Buying Assets – The new tax relief for Intangibles
- Financing the Deal
- Releasing trapped interest losses
- R&D tax credits for all

Budget 2003

- Fundamental change on rolled up interest or discounts in PE backed structures – unexpected
- Exemption for limited partnerships which are Collective Investment Schemes or where lender is subject to UK corporation tax on the income – problem for management shareholders + other investors
- Need for "new thinking" in structures going forward – PwC discussing with the Revenue
- Applies from 9 April 2003 to need to review existing structures
- Does your PE structure fall within the CIS definition?
- Watch this space!

Selling shares tax free

- Capital Gains on substantial shareholdings exemption commenced on 1 April 2002
- Complete exemption on sale of shares
- 10% minimum shareholding
- 1 year holding period
- Selling company and company being sold must both be trading companies or holding companies of trading groups before AND after sale
- Potentially of great value and very simple

Selling shares tax free

- But life is never straight forward – The practical problems with SSE
  - Non-trading activities
  - Surplus cash
  - Investment properties
  - Cash arising from sale of subsidiary
  - Non-commercial loans can break 10% test

Selling shares tax free

- SSE should be used to maximum effect but some planning may be required to achieve this:
  - Restructure a non-qualifying group to create a qualifying sub-group
  - Review divisionalised structures – consider breaking up
  - Crystallise capital losses on falls in value without giving capital gains on increases in value
  - If vendor would fail to qualify immediately after sale ⇨ carry out transaction in a different way

Buying intangible assets – The new relief

- May be much more attractive than buying shares for Purchaser
- But, what is Vendor’s position?
- Consolidated goodwill is NOT deductible – have to buy assets
- Is it possible to get the “best of both worlds” on corporate transactions?

Buying intangible assets as a share deal

Purchaser

Purchaser buys

Target Shares

Vendor

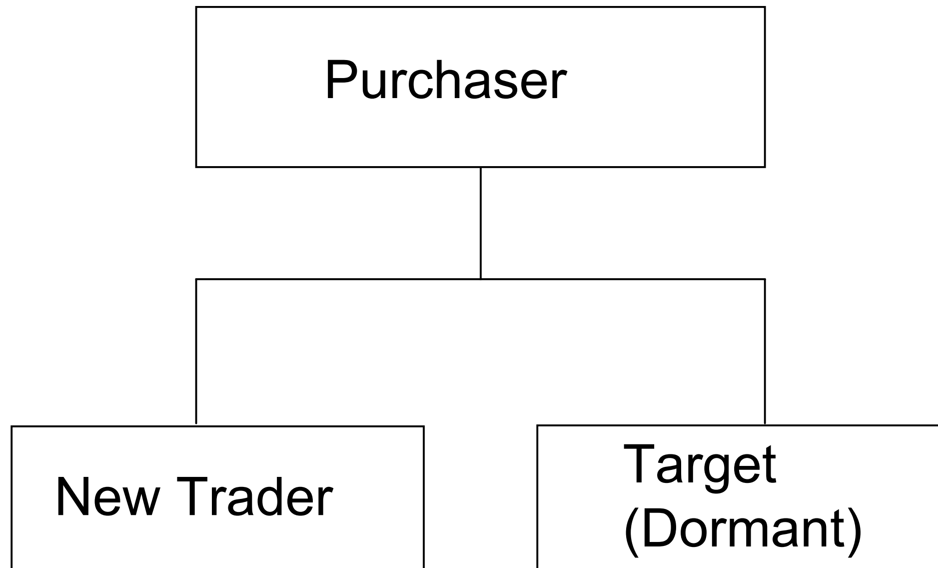
NewCo

Target

Target agrees to sell

Business with £100m to NewCo

Buying intangible assets as a share deal -Best of both worlds?



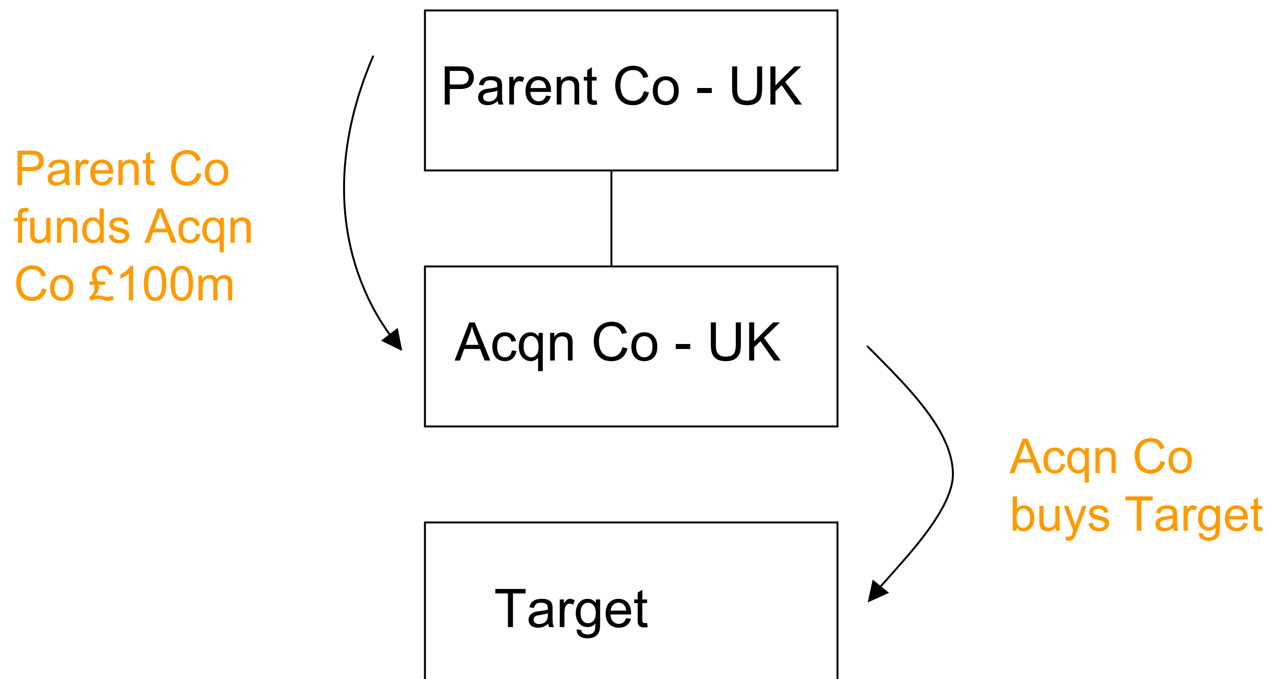
Vendor

Tax benefit = £100m x 4% @30% = <u>£1.2m pa</u>

- Vendor has tax free shares sale ⇨ Vendor happy
- New Trader claims tax relief for goodwill ⇨ Purchaser happy
- Intra-group reorganisations?

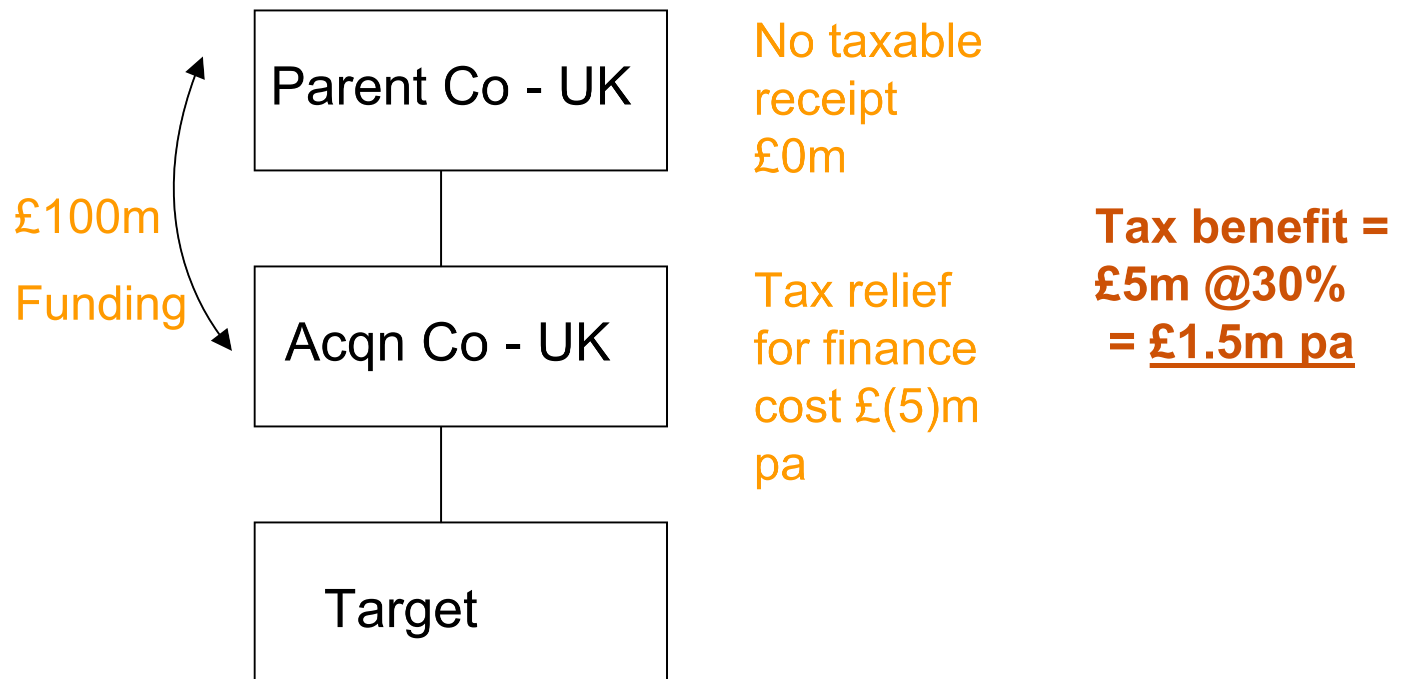
Financing the deal
- adding value with tax

- Planning opportunities exist wherever finance is required
- UK tax efficient financing – Current position



Financing the deal
- adding value with tax

- UK tax efficient financing



- International structures are also available

Releasing trapped interest losses

- Do you realise you can add value?
- Captive audience in fund

R&D tax credits for all

- Introduced for large companies from 1 April 2002
- 125% deduction for qualifying expenditure - £1.5m extra saving for every £20m spent (25% x £20m @ 30%)
- However determining what qualifies is not simple
- PwC working closely with the Revenue on current thinking and proposals

Conclusions

- Tax offers considerable opportunity to increase the value of investee companies
- But if you get it wrong, it will cost you dearly!
- Tax free share sales – will you/ can you qualify?
- Tax relief for intangible assets – can you get the best of both worlds?
- Financing structure – the benefits of the right planning may be substantial
- Can you "sell" your trapped interest losses?
- R&D tax credits – the great tax giveaway?

Post Deal Risk Management

Robert Mellor

PRICEWATERHOUSECOOPERS

Do you manage your Post Deal Risks

- Do you think you manage tax risk on your deals?
- Are all your deal structures robust?
- How much do you spend on due diligence, legal costs and M&A tax advice per deal?
- How much do you spend on monitoring that the deal structure continues to work?
- Have you ever had to re-structure a deal in advance of sale?
- Have you ever had to adjust on price because the vendor DD identifying tax exposures?

How typical is this scenario?

- May 12th 2003, Best-Deal-Ever closes at €900m.
- May 13th 2003 deal team responsible fly out to Italy to continue work on another deal.
- May 15th 2003 incomplete deal bible placed in cupboard.
- June 2004 deal exec responsible for deal leaves.
- Sept 2006 IR enquiry received querying deal structure.
- More importantly, what are the chances of this happening now ?

What are the risks?

- So what are the risks that our cupboard bound deal faces:
- Latent tax exposures may not be dealt with.
- Missed tax & VAT filings could lead to interest & penalties
- Structural integrity of deal could fail.
- Future sale price could be reduced because of tax exposures.
- Return produced suffers wht or is in a form which investors / carry execs not expecting

What have we seen in practice?

- Residency?
- Form and Substance?
- Withholding Tax exposure?

Market experience: Residency

- SCO Enquiry into Non-UK Holdco Residency
- Importance of:
  - the fact pattern
  - the time line
  - Commercial rationale for each step
  - Contemporaneous evidence.

Market experience: Residency

- Board Meetings
- Essential ingredient in getting central management and control right
- Key decisions of corporate need to be made in jurisdiction of tax choice / outside jurisdictions of tax risk.
- Real decision making – no rubber stamping!
- Delegated Authority ?

Market experience: Form and Substance

- Intrinsically linked to residency
- Common with EU directives / treaty applications– i.e. parent / subsidiary directive
- Local Substance over and above Board level Central Management and Control.

Market experience: Form and Substance

- Use of Effective control tests in some EU countries
- Management of German KG structures – equivalent of UK LP – have a German GP vehicle
- Used for German investors as a parallel feeder vehicle – to mitigate against draconian German anti-foreign fund legislation

Market experience: Withholding Tax Exposure

- UK managed PE Fund structured as a Scottish Limited Partnership investing into France.
- Investment stake over 25%.
- SLP treated by French authorities as having a legal personality under UK law so that UK / French DTA would not apply.
- Investment return bore CGT on disposal at 16% and wht on dividends at 25%
- Fund ended up compensating investors for WHT cost – cost

Market experience: Withholding Tax Exposure

- We are currently seeing many funds where underlying investments in the form of debt have been provided to UK investments.
- With exit opportunities being limited assets are being held longer.
- In some cases interest that was due to be accrued over the life of the investment is being paid out to the Fund.
- 20% wht exposure where Fund includes individuals or non-UK entities.

So what can you do?

- Communicate.
- Set up internal systems to transfer internal ownership of each deal.
- Communicate Again.

Types of pro-forma documents

- Does your deal team provide for each deal:
- Stage papers showing approval of deal investment, sale / purchase agreement with vendor.
- Minutes of all Board meetings held for all of the entities involved in the transaction.
- Deal Background documents prepared

Bible of documents – does it include?

- Copies of legal, tax and accounting advice received
- Copies of all contracts, warranties, side agreements
- Copies of deal structure papers, diagrams
- Copies of debt instruments / share certificates
- Articles of Association, shareholder agreements
- Management incentive arrangements / packages
- More importantly – agree a deadline when this will be provided.

Conclusions

- Deal structure needs to be maintained for it to work – doing nothing may be a very costly option!
- Need transfer of ownership of deal structure from deal team to infrastructure team
- Deal details and documents should be captured once.
- Need processes in place to maintain, review and adapt deals so that required exit can be secured.

Executive and Management Team Incentivisation

Claire Wesley

PRICEWATERHOUSECOOPERS

Incentive plan drivers

- The carrot approach- investors generally have first slice of the action !
- Sufficient incentive to change behaviour
- Any investment must be affordable to executives
- No "upfront tax" charge or at least manageable
- No withholding tax or social security charges
- Preferred return is capital with full taper relief

Current PE incentive plans

- Target company Management
  - Sweet equity
  - Equity ratchets
  - Growth or "flowering shares"
  - Share options
  - Bonus plans
- Co investment Schemes
- Carried Interest arrangements

Deals before the Finance Bill 2003

- Industry norm for senior management "sweet equity" structure with an equity ratchet.
- There were issues but well established "methodology"
  - Undervalue points
  - Some anti avoidance rules eg conditional/convertible shares and dependent subsidiaries
  - With care taper relief available
  - Private equity normally avoided "Readily Convertible Assets"

Post Finance Bill 2003 Additional tax at stake!

- Almost everything has changed !
- Finance Bill schedule 22 abolishes much of the existing legislation e.g dependent subsidiaries and conditional shares
- Overall some sensible ideas
  - More targeted charges
  - US style election regime
- Introduces amongst other items
  - Restricted stock rules
  - New convertible share rules
  - Enhanced or depressed value
  - Additional interest rules

Restricted Stock

- Securities where value potentially reduced due to
  - Forfeiture type provisions
  - Restriction on transfer
- Exceptions are very restricted- previous articles exemption for conditional shares abolished
- Calculate value of security on basis that there are no restrictions- CGT valuation
- US style election- within 14 days
- No election – proportion of proceeds liable to income tax

Restricted Stock
Deal issues arising

- Private equity transactions caught
- Valuation problems
  - Quantum
  - Timing
- Timing of election
- No cash tax charges if restrictions lifted etc

Artificially depressed value

- Very broad anti avoidance legislation
- “Things done” for non commercial reasons
- Tax avoidance (incl national insurance) is never a commercial purposes
- Thing done has to directly lead to the reduction in value
- within 7 years of acquisition and which reduce value by 10%
- Specifically catches transfers of conditional shares prior to 16 April 2003

Artificially enhanced value

- Very broad anti avoidance legislation
- Catches “Things done” for non commercial reasons
- Enhancement exceeds 10% within a fiscal year
- Charge calculated annually on growth in value - no cash tax charge
- Non arms length intra group transaction will never be a commercial purpose
  - Replaces dependent subsidiary rules
  - Innocent transactions caught
  - Capital structures

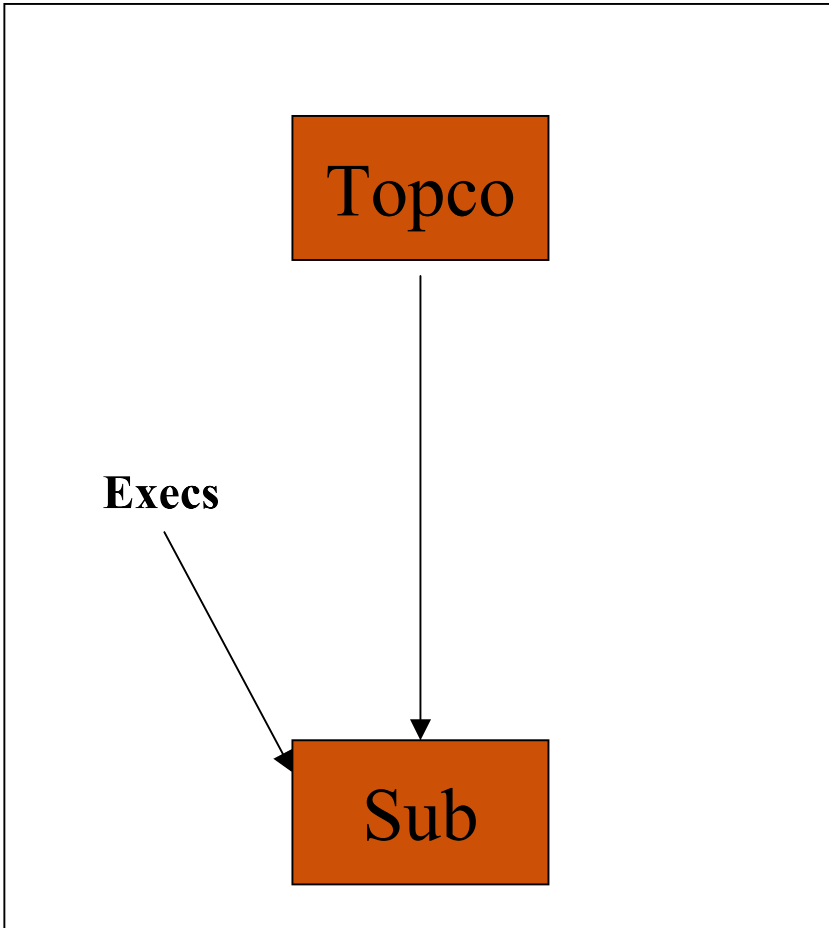
Convertible Securities

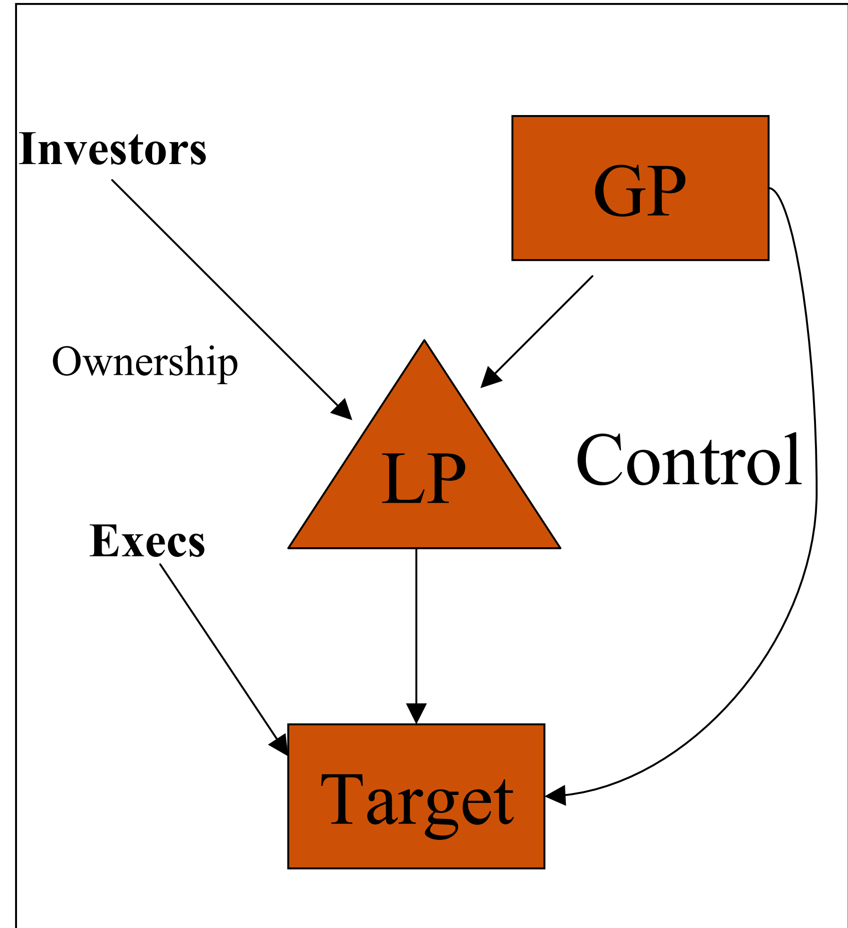
- Replaces the existing rules on convertible shares
  - Previous income tax charge- all or nothing
  - Only happened on actual conversion
- Charge now based on the value of the initial conversion right and growth arising from conversion
- Previously could avoid simply by removing conversion right- no longer effective

Additional Interest rules

- Employee has an interest in securities and additional interest arises
- No longer a requirement that it is a result of employment, simply that opportunity provided by employment
- Some indication that the Inland Revenue intended these provisions to apply to ratchets and flowering shares….. But……
- Potentially an exposure for carried interest as the mechanism does give an additional interest in securities….. But….

Share schemes – corporate deductions





National Insurance and PAYE

- No corporate deduction available for dilution costs of shares and options where company under control of another
- Affects most VCs which are not quoted entities
- Potential PAYE and NIC liability
- 90 days for employee to repay tax otherwise there is a gross up

Conclusions

- Period of great uncertainty where securities provided to employees
- Similar issues for co-investment and potentially carried interest arrangements
- Some sensible changes
- Concerns
  - Valuation
  - Elections- do you dare ?
  - Elections- timing now and in the future
  - PAYE and NIC

Don’t panic!

- We have teams working on this!
- Already some movement from the Inland Revenue

Discussion