UK – Law Firms

Purchase Of Unlisted UK Companies – Equity Incentive Issues

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U.S. purchasers and sellers of UK private or other unlisted companies should familiarize themselves with important differences in approach between the UK and the U.S. to dealing with employer equity incentive arrangements in corporate transactions. Often, U.S. plans will provide that outstanding equity rights are either assumed by a purchaser or are "cashed out" (eg. stock options would be cancelled in return for a cash payment equal to the deal consideration minus the exercise price). In U.S. corporate transactions, these plan provisions often mean that a cash out is the preferred method for dealing with outstanding equity rights. UK equity plans, on the other hand, often permit employees to exercise rights for a set period after closing, which would be somewhat unusual in a U.S. transaction, and this can give rise to various issues that should be addressed in the transaction agreements.

Warranty And Indemnity Cover In The UK

A purchaser of a private or other unlisted UK company or a UK business will normally expect the seller to give warranties in relation to the assets being sold. Where a majority of a company's stock or substantially all of its assets are sold, the transaction agreement will normally contain a full set of warranties which are designed to protect the purchaser against unforeseen liabilities in the target company.

The warranties will generally inform the purchaser because the seller will disclose against them by providing information about the company/business. The disclosure also provides the seller with quasi-insurance protection, because the seller cannot be held to account for liabilities of which the purchaser has been made aware. Breach of a warranty gives rise to a potential claim in damages, meaning that the purchaser is required to prove that financial loss has been suffered. UK case law has established a duty to mitigate any losses, which when coupled with the usual disclosure against warranties, means that warranty claims are quite unusual. In common with U.S. transactions, acquisition agreements for UK private companies include seller warranties in respect of the type of equity incentive plans operated by the company, whether income tax and national insurance contributions ("NICs" – UK social security withholding obligations) have been complied with and whether any shareholders have shares that are "employment related securities" that have been acquired outside of formal equity incentive plans and which may attract income tax/NICs liabilities.

A special form of tax indemnities, called a "tax deed" is often used where a company's shares are purchased in the UK. This might be unfamiliar to U.S. purchasers and sellers, who are more familiar with warranties (and carve-outs thereto) being set forth in the acquisition agreement. The tax deed is either a separate agreement or is contained in a schedule to the stock purchase agreement and contains a set of indemnities regarding general tax and NICs liabilities. It is not normal to permit disclosure against the indemnities in a tax deed and claims under the deed may well have lower financial limits than warranty claims (i.e., payments under the tax deed may be triggered by relatively small claims). Also, tax deeds normally include specific indemnities in respect of sensitive issues, which may restrict the ability of the seller to place limitations on claims in comparison to other indemnity claims under the tax deed. Breach of the indemnities in a tax deed gives rise to a potential debt claim and, as there is no duty to mitigate losses in respect of such a claim, the purchaser would seek to recover losses on a pound for pound – or dollar for dollar – basis.

Indemnity Cover For Equity Incentives

As far as equity incentive plans are concerned, a tax deed will normally contain general indemnities that income tax and NICs have been withheld and accounted for to HM Revenue & Customs ("HMRC") as required by the Pay As You Earn ("PAYE") income tax/NICs withholding regulations. This indemnity should relate to any income tax/NICs charges that arise up to and including closing in order to include charges relating to the exercise or vesting of incentive rights at closing. In contrast, a U.S. corporate transaction agreement will typically include only a broad representation that all tax and federal withholding requirements (such as FICA, FUTA, etc.) have been met; it is somewhat unusual for a U.S. corporate transaction agreement to specifically identify withholding treatment in option or other equity arrangements for a specific representation, warranty or indemnity obligation.

Specific Indemnities For UK Equity Incentives

Broadly, income tax/NICs charges arise in respect of UK equity incentives in ways that are similar to U.S. non-qualified stock options or restricted stock. Ignoring any plans that are approved by HMRC (the UK equivalent of the IRS) to permit tax relief on option exercise/vesting of rights, tax charges arise on the exercise of share options, the vesting of share rights or the acquisition of shares for less than market value. However, there are a number of differences that can provide potentially expensive traps.

The main risk area relates to failure to identify income tax/NICs withholding obligations. Where income tax/NICs charges arise on the exercise/vesting of equity incentive rights, the employing company is liable for employer's NICs at 12.8% of the amount that is subject to tax unless the liability has been transferred to the employee under specific legislative provisions which permit this. Employer's NICs liabilities are, therefore, likely to be considerably higher than social security charges that might arise in the U.S. Also, where income tax/NICs withholding obligations arise, the responsibility for withholding and accounting to HMRC falls on the UK employing company. Any failure to operate income tax/NICs withholding means that the target company becomes primarily liable to HMRC for the tax/NICs due and is obliged to recover it directly from the employees if it is not withheld. Also, the employing company may become liable for interest and penalties in respect of any unpaid income tax/NICs. Interest is charged on a daily basis at 6.5% of the amount of tax/NICs outstanding. Like the U.S. penalties for failure to withhold, penalties are charged at up to 100% of the unpaid tax (although this is mitigable). Also, if the employees do not reimburse the company with the tax due on option exercise within 90 days of the tax charge arising, they are deemed to have been paid an amount equal to the outstanding tax, meaning that further tax/NICs charges arise. (This is a double whammy U.S. employers should hope the IRS never learns from HMRC.) While under the UK tax legislation this "deemed benefit" charge falls on the employees, they may seek to recover the costs from the target company, claiming that they should be able to rely on the company to be responsible for tax withholding. If the employer meets a "deemed benefit" tax charge on behalf of the employees, the payment of tax will itself be a taxable benefit for the employees and the payment by the employer will need to be grossed-up to make the employees whole.

A tax deed may contain specific indemnities to provide protection for a purchaser in respect of the following issues in relation to equity incentive plans:

Founder Shares

Founder shareholders will normally expect to sell their shares without any income tax/NICs charges. Where an individual has subscribed for shares on formation of a company and developed the business within that company, this tax treatment should be available. However, where shares have been acquired by individuals working in the business after formation of the company, the shares may well be "restricted securities" for UK tax purposes and income tax/NICs charges may arise on sale of the shares. A purchaser may seek indemnity cover in respect of these potential charges.

Employee Shares

There are numerous planning techniques that have been used over the years to try to gain more generous capital gains tax (rather than income tax/NICs) treatment on the sale of company shares, such as deferred shares or "flowering shares." A purchaser should normally seek specific indemnities in respect of the potential costs, interest and penalties arising from a failure to withhold income tax/NICs in respect of these arrangements or seek a price adjustment or retention of purchase consideration in order to avoid effectively underwriting the seller's tax planning.

Enterprise Management Incentive ("EMI") Plan Options

Where the target has granted share options under an EMI Plan (an option plan that offers income tax/NICs relief on option exercise, subject to various HMRC qualifying conditions), the seller is likely to expect the options to be exercised on the sale of the company with no income tax/NICs charges arising. However, the target will self-assess whether the options qualified under the EMI legislation at the time of grant and whether any disqualifying events have occurred during the period the options have been held. If tax relief is not available on option exercise, potentially significant liabilities could arise in relation to the spread. Again, unless a purchaser is confident that the EMI Plan qualifies for tax relief, it should seek indemnity cover in order to avoid underwriting the seller's tax planning.

Purchase of Subsidiary Company

On the purchase of a subsidiary company, income tax/NICs withholding obligations in relation to equity incentives remain with the subsidiary company after it has become part of the purchasers' group. However, the subsidiary's employees may well retain rights to acquire the seller's shares after closing. When these rights are exercised, they will be exercised directly with the seller, meaning that the employing subsidiary (which has the tax withholding obligation) will not be aware that the income tax/NICs liability has arisen. A purchaser should, therefore, seek to require the seller to notify it of any share acquisitions by the subsidiary's employees. The purchaser may also seek indemnities in respect of any costs, interests and penalties that may arise as a result of any failure by the seller to notify.

Purchase of a Business

Where an operating business is acquired rather than a company's shares, UK employees often retain a right to acquire the seller's shares after closing. In this instance, the income tax withholding and reporting obligations in relation to equity incentives remain with the seller, but the NICs withholding and reporting obligations transfer to the purchaser. Again, a purchaser should seek to require the seller to notify it of any share acquisitions so that it can meet its PAYE obligations. The purchaser may also seek indemnities in respect of any costs, interest and penalties that may arise as a result of any failure to notify. The purchaser may also seek a price adjustment in respect of any employer's NICs falling on the purchasing company as a result of options exercised by employees of the business.

Conclusion

While the incidence of tax charges on the exercise/vesting of equity incentive rights is broadly similar in the UK and the U.S., potentially expensive consequences can arise as a result of any failure to operate PAYE withholding according to the regulations. UK sellers often have expectations with respect to the tax treatment of equity arrangements that create potential risks for a purchaser. Also, UK employees are often able to exercise equity rights after closing of a transaction, which carries further tax risks. A U.S. purchaser should consider managing the risks created by the tax withholding obligations that may fall on its group of companies by seeking indemnity cover in the acquisition documents and possibly price adjustments or retention of part of the purchase consideration where such liabilities and obligations arise.

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