Memorandum of Understanding between the BVCA and Inland Revenue on the income tax treatment of managers' equity investments in venture capital and private equity backed companies

25 July 2003

1. Introduction

1.1 This memorandum of understanding deals with certain tax issues for managers of a company that is financed by a venture capital/private equity provider ("VC"). In this context "managers" means people who acquire shares or an interest in shares ("Managers' Shares") in the company in which the VC invests, where those shares or the interest in them are "employment-related securities" within the meaning of section 421B Income Tax (Earnings and Pensions) Act 2003 (ITEPA 2003).

1.2 This memorandum sets out the approach that is accepted by the Inland Revenue in determining whether the price paid for the Managers' Shares is:

(a) initial unrestricted market value ("IUMV" as defined in section 428 ITEPA 2003), where the Managers' Shares are "restricted" securities as defined in section 423 ITEPA 2003;
(b) market value, where they are not restricted securities.

1.3 The approach set out in this memorandum is a "safe harbour". It does not affect the right of any taxpayer to argue that a different interpretation should apply to such a taxpayer's specific circumstances.

1.4 The Inland Revenue will not be bound by this memorandum:

(a) if the main purpose, or a significant purpose, of the arrangements is avoidance of liability to tax or national insurance, or
(b) to the extent there are material deviations from the structure described below.

In these circumstances, the Inland Revenue reserves the right to consider the application of all provisions relating to tax and national insurance, including Chapters 1 to 5 Part 7 ITEPA 2003.

2. Definitions and References

2.1 References to ITEPA are to the Income Tax (Employments and Pensions) Act 2003 as amended by Finance Act 2003 unless otherwise stated.

2.2 "Ordinary Capital" means ordinary shares leveraged by all other capital of the company including senior debt, junior debt such as mezzanine, and Preferred Capital invested by the VC such as preference shares or subordinated debt.

2.3 "Preferred Capital" is capital, whether debt or equity, which in a winding-up would rank ahead of the Ordinary Capital.

2.4 A “tag-along” right is one that gives managers the right to sell their shares if the VC or someone else agrees to sell their shares.

2.5 A “drag-along” right is one that requires the managers to sell their shares if other parties (particularly the VC) arrange to sell their shares.

2.6 An “equity kicker” is a feature of a loan (typically a mezzanine loan) whereby, as consideration for advancing the loan, the lender is issued a warrant to subscribe for ordinary shares of a borrower group company, in addition to receiving an ordinary interest coupon.

2.7 “IUMV” has the meaning given in section 428 ITEPA 2003.

3. The Approach

3.1 Where no ratchet arrangements (as described in Section 6 below) apply, provided all the conditions in paragraph 4.1 below are satisfied, the Inland Revenue accepts that the price paid for the Managers’ Shares is:

(a) equal to their IUMV, where they are restricted securities, and
(b) equal to their market value, where they are not restricted.

3.2 Where ratchet arrangements (as described in Section 6 below) apply, provided all the conditions in paragraph 4.1 below apart from 4.1(c) and 4.1(e) are satisfied, and the further conditions in paragraph 6.2 below are also satisfied, the Inland Revenue similarly accepts that the price paid for the Managers’ Shares is equal to their IUMV or market value as the case may be.

3.3 Accordingly,

(a) no taxable income taking the form of general earnings (as defined in section 7(3) ITEPA 2003) in respect of the acquisition of these shares will arise under Part 2 ITEPA 2003 whether or not an election under Chapter 2 of Part 7 ITEPA 2003 is made, and
(b) no subsequent liability can arise on application of the formula in section 428(1) ITEPA 2003 whether or not an election has been made under Chapter 2 of Part 7 ITEPA 2003.

4. The Conditions

4.1 The conditions mentioned in paragraph 3.1 above are as follows:

(a) Managers’ Shares are Ordinary Capital
(b) Where leverage is provided by holders of Ordinary Capital, particularly the VC, in the form of Preferred Capital, this is on commercial terms. It will be taken to be on commercial terms if the coupon or expected rate of return on it is not less than the coupon on the most expensive financing provided to the company by investors (including lenders) who do not hold Ordinary Capital (provided such investors are unconnected with the managers)

(c) The price paid by the managers for their Managers' Shares is not less than the price the VC pays for its Ordinary Capital shares, being shares of the same class as the Managers' Shares, or shares of another class but having substantially the same economic rights as the Managers' Shares.
(d) The managers acquire their Managers' Shares at the same time as the VC acquires its Ordinary Capital.
(e) The Managers' Shares have no features that give them, or allow them to acquire rights not available to other holders of Ordinary Capital.
(f) The managers are fully remunerated via salary and bonuses (where appropriate) through a separate employment contract.

4.2 The test in paragraph 4.1(b) shall be applied as follows.

(a) Where debt is lent on terms that include an equity kicker, it is accepted that such equity kickers with uncertain outcome will be ignored for the purposes of the second coupon referred to in paragraph 4.1(b) above.
(b) The second coupon referred to in paragraph 4.1(b) above shall be taken to be what it is at the time the Managers' Shares are acquired by the managers, so if it is a floating rate coupon then changes to it caused by subsequent changes in market interest rates shall not be taken into account in determining whether the condition in paragraph 4.1(b) is satisfied.
(c) The coupons or rates of return required to be compared under paragraph 4.1 (b) shall be adjusted according to whether they are in principle tax deductible or not. For example, if the coupon on Preferred Capital invested in the form of *preference shares* by holders of Ordinary Capital were at least 7% p.a., and the second coupon referred to in paragraph 4.1(b) above were 10% p.a. on capital in the form of *debt*, and the corporation tax rate were 30%, then the condition in 4.1(b) would be taken to be satisfied.
(d) In paragraph 4.1(b) the expression "rate of return" means the overall return expressed as an annualised percentage rate, typically a so-called "internal rate of return" or "IRR". In the case of, for example, an investment that includes a rolling-up coupon, a cumulating coupon or a redemption premium, it therefore means the return including these elements, not just the currently cash paid return.

4.3 Where Managers' Shares have "restrictions" of the type in section 423(2) ITEPA 2003 which require managers to transfer their shares, possibly for less than their then market value, in the event their employment ends, then provided the "same price" condition in paragraph 4.1(c) above is satisfied (or, in a case where there are ratchet arrangements, the condition in paragraph 6(c) is satisfied), the managers will be accepted as paying a price that is not discounted on account of these restrictions, and therefore these restrictions will be accepted as not creating any difference between the price paid for the shares and their IUMV.

4.4 Where Managers' Shares are subject to restrictions within section 423(3)(a) ITEPA 2003, being "tag-along" and "drag-along" rights, it will be accepted that these restrictions do not depress the value of the shares.

5. Worked Example

5.1 The following hypothetical example sets out how the above approach may be applied to a typical management buyout.

(a) A company is available to be purchased for £40m. The senior managers of the company obtain the backing of a VC to buy it in a management buyout. A new company ("Newco") is formed as the vehicle to acquire it. Newco is to be funded by the management team, the VC and banks.

(b) The managers and VC determine that the company needs £8m of expansion capital to develop its business, and that transaction costs (loan arrangement fees, professional fees, stamp duty, etc) will be £2m. Total funding of £50m is therefore needed.

(c) A bank offers to lend £25m as a senior secured loan, with an interest cost of 7%.

(d) A mezzanine lender (or possibly the mezzanine division of the same bank) offers a £5m mezzanine loan, unsecured but ranking ahead of the VC's and management team's capital. The mezzanine interest rate is 10%, and the mezzanine lender is granted warrants to subscribe at par value for 3% of Newco's ordinary share capital.

(e) The remaining £20m needs to be invested by the VC and the management team.

(f) The £20m capital is structured as £10m preference shares and £8m subordinated debt, all invested by the VC, and £2m ordinary shares subscribed 85% by the VC and 15% by the managers. The preference shares have a cumulating dividend of 8% p.a. and the subordinated debt has a coupon of 11% p.a. The managers invest (between them) £300,000 of their own money for 15% of the ordinary shares and the VC invests £1.7m for the other 85%. There are no ratchet arrangements.

(g) Customary leaver provisions are included in the relevant contracts whereby managers are required to sell their shares – possibly for less than full market value – to the other investors (including other managers) if they cease to be employed in the business. These leaver provisions do not apply to the shares held by the VC. Customary drag-along and tag-along provisions are also included.

5.2 The shares held by the managers are therefore "restricted securities", and are also "employment-related securities", within ITEPA 2003.

5.3 The IUMV of the Managers' Shares is determined as follows, applying Section 3 above:

(a) the coupon (11% p.a. on the debt, and after adjusting for tax as provided in paragraph 4.2(c) above, 11.4% p.a. on the preference shares) on the VC's Preferred Capital that is leveraging the ordinary shares is not less than the coupon on the most expensive third party debt (being the 10% on the mezzanine loan); and

(b) the managers paid the same price per share ("DA", for the purposes of section 428 ITEPA 2003) for their ordinary shares as did the VC.

(c) For the purposes of section 428 ITEPA 2003, IUP is computed as

$$\frac{IUMV - DA}{IUMV} = \frac{300{,}000 - 300{,}000}{300{,}000} = 0$$

(d) Therefore, in applying the section 428(1) formula,
UMV x (IUP – PCP – OP) – CE must always equal zero.

5.4 In this example borrowings from an unconnected bank were used to fund the investment and the coupon on these formed the benchmark "most expensive financing" mentioned in paragraph 4.1(b) above. If there were no other finance provided by an unconnected investor, so that all finance was provided by parties who hold Ordinary Capital, (which is a somewhat common feature of venture or development capital investments) then there would be no benchmark rate. In such a case, in order for the tax treatment in Section 3 to apply, the question of whether the condition in the first sentence of paragraph 4.1(b) is satisfied would need to be determined some other way. This might be done by comparing the expected rate of return on the Preferred Capital with the returns on similar investments in the market, or by comparing the capital structure with the structures in similar transactions, or by some other commercial analysis or comparison.

6. Ratchets

6.1 If the Managers' Shares are subject to "ratchet arrangements" which conform to 6.2(a) below, the Inland Revenue accepts that the ratchet arrangements should be dealt with by being taken into account in determining the unrestricted market value (assuming the shares are restricted, otherwise market value) of the Managers' Shares when they are acquired by the managers, and either Part 2 (general earnings) or Chapter 2 Part 7 ITEPA 2003 will apply if that value exceeds the amount paid for the shares. However, if the ratchet arrangements conform to all the conditions in 6.2 below, the Inland Revenue accepts that the ratchet arrangements will not of themselves result in any charge under Chapters 1 to 5 Part 7 ITEPA 2003 and accordingly, if all the conditions in paragraph 4.1 (apart from 4.1(c) and 4.1(e), which are replaced by the conditions in 6.2 below) are also satisfied then the Inland Revenue accepts that the price paid by the managers to acquire their Managers' Shares will not be less than IUMV.

6.2 The conditions referred to in 6.1 above are:

(a) The ratchet arrangements are arrangements under which the participation of different holders of Ordinary Capital in the profits and assets of the company might vary according to the performance of the company or the VC's return on its investment in the company (but not according to the personal individual performance of any particular holder).

(b) The ratchet arrangements are in existence at the time the VC acquires its Ordinary Capital.

(c) The managers pay a price for their shares in the Ordinary Capital that, at the time of acquisition, reflects their maximum economic entitlement. (This condition is to be interpreted in a manner consistent with the principles outlined in paragraphs 6.3 to 6.5 below.)

6.3 Where the managers pay a price per share that is equal to (but not more than) the price paid by the VC for its Ordinary Capital Shares, the condition in paragraph 6.2(c) will be satisfied where the ratchet arrangements are structured so that they can only have a negative or dilutive effect on the Managers' Shares. By way of illustration, arrangements comparable to those in the following Examples (i) and (ii) would be taken as satisfying this condition, whereas arrangements comparable to those in Example (iii) would not. In all these (hypothetical) examples the overall transaction structure is that a company is established into which a team of managers and a VC invest. The Ordinary Capital of the company is to be £1,000,000. The commercial terms agreed are that the managers will have a basic entitlement to 12% of the Ordinary Capital, but if the VC realises a return of at least 25% IRR on its (the VC's) investment at the time the investment is sold or realised, the managers will then become entitled to 15% of the Ordinary Capital. The A shares and B shares in these examples all count as Ordinary Capital as defined above, and each A share participates in the same proportion of the company's assets and profits as each B share.

Example (i)
Managers subscribe £150,000 for 150,000 A ordinary shares, VC subscribes £850,000 for 850,000 B ordinary shares. A term in the share rights requires that 34,091 of the A shares automatically convert (at the time when the investment is realised, in the future) into worthless deferred shares in the event the VC's investment returns less than 25% IRR. After this conversion, the division of the Ordinary Shares will be 115,909 A shares:850,000 B shares, which is 12:88.

Example (ii)
Managers subscribe £150,000 for 150,000 A ordinary shares, VC subscribes £850,000 for 850,000 B ordinary shares. The terms of the B shares give the holders the right to subscribe at nominal value for a further 250,000 A shares (or additional rights equivalent to a further 250,000 A shares) in the future, in the event the VC's investment returns less than 25% IRR. On the operation of the ratchet, the division of the Ordinary Shares will be 150,000 A shares:1,100,000 B shares, which is 12:88.

Example (iii)
Managers subscribe £120,000 for 120,000 A ordinary shares, VC subscribes £880,000 for 880,000 B ordinary shares. A term in the share rights requires that 200,000 of the B shares automatically convert into worthless deferred shares in the future, in the event the VC's investment returns more than 25% IRR. After this conversion, the division of the Ordinary Shares will be 120,000 A shares: 680,000 B shares, which is 15:85.

6.4. The distinction here is that in Examples (i) and (ii) the managers have paid the price for their A shares that they would have paid if the condition in paragraph 4.1(c) above were being observed and if hypothetically it were known at the start that the contingencies upon which the ratchet depends (in this case, the 25% IRR for

the VC) were going to be satisfied. In contrast, in Example (iii) under the same hypothesis, the managers have not paid as much as the VC for their relative holding of Ordinary Shares. Thus, Examples (i) and (ii) would be taken to comply with the condition in paragraph 6.2(c) above but Example (iii) would not.

6.5. Based upon this distinction:

(a) The condition in paragraph 6.2(c) above will also be taken to be satisfied if, in a case where the ratchet arrangements are structured so that they have a negative or dilutive effect on the Ordinary Shares other than the Managers' Shares, the managers subscribe for or acquire their Managers' Shares at a price which includes a premium (relative to the price paid by other investors for the other Ordinary Shares) attributable to the fact that the Managers' Shares cannot suffer dilution under the ratchet whereas the other Ordinary Shares can. The Revenue will accept that this premium has been paid if the principles illustrated in the following further Example (iv) are applied. This further example is based on the same assumed facts as the examples above.

Example (iv)
Managers subscribe £150,000 for 120,000 A ordinary shares, VC subscribes £850,000 for 880,000 B ordinary shares. A term in the share rights requires that 200,000 of the B shares automatically convert into worthless deferred shares in the event the VC's investment returns more than 25% IRR. After this conversion, the division of the Ordinary Shares will be 120,000 A shares: 680,000 B shares, which is 15:85. This is the same structure as in Example (iii) above, except the managers pay a further premium for their A shares of £30,000. The effect of this is that the managers have paid in 15% of the total money subscribed for Ordinary Capital, not 12% as in Example (iii).

(b) In the event the ratchet arrangements are structured so that they have a negative or dilutive effect on the Ordinary Shares other than the Managers' Shares, but no premium as mentioned in paragraph 6.5(a) above is paid, the Revenue considers that the Managers' Shares may have been acquired for a price lower than their IUMV. In such a case, and assuming the other relevant conditions in paragraphs 4.1 and 6.2 above are met, the Revenue accepts that the maximum difference between the price paid by the managers for their Managers' Shares and the IUMV of those shares will be an amount corresponding to the £30,000 premium calculated in Example (v) above. This will be the maximum "IUMV-DA" for the purposes of section 428 ITEPA 2003. It will be the *maximum* IUMV-DA because it will generally be appropriate to discount this maximum by reference to the likelihood of the ratchet being triggered or not. The actual IUMV-DA in these cases will thus be a matter for the taxpayers concerned to determine and agree with Inland Revenue as appropriate, and the only confirmation given in this memorandum is that the answer is somewhere in the range zero to whatever figure corresponds to the £30,000 premium in the above Example (iv).