CHARTA LEARNING · INTERVIEW PREPARATION

Transaction Tax and Tax Structuring

Interview preparation summary · AU track

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INT.TM.1.a · Deal structure and diligence

Compare a share deal with an asset deal from the buyer's and the seller's side, including the effect on tax cost, tax base and inherited liabilities.

In a share deal the buyer acquires the shares in the target company and so takes the company with its history: its assets and liabilities, including any unpaid tax, and its tax attributes such as losses. The seller, if an individual or a holding company, usually pays one layer of tax on the gain, and often a relief or exemption applies to a corporate seller's gain on shares. In an asset deal the buyer picks the assets and liabilities it wants and the target company is left with the seller. The buyer usually gets a new tax base equal to the price paid, which can mean higher depreciation and amortisation deductions, and it leaves behind the target's historic tax liabilities. The seller company is taxed on the gain on each asset, and if the proceeds are then paid out to its shareholders there can be a second layer of tax. Asset deals also bring transfer taxes on property, VAT or sales tax questions, and contract transfers. Sellers therefore usually prefer share deals and buyers often prefer assets, and the price negotiation settles the gap. Candidates often say one is better; say whose view and why.

WORKED EXAMPLE: A SHARE SALE AGAINST AN ASSET SALE

An individual, Mr Valen, owns all the shares in Targetco, an invented trading company. His base cost in the shares is 2.0m. A buyer offers 12.0m for the business. The business assets have a tax base of 4.0m. Compare the seller's net proceeds in a share deal and in an asset deal followed by liquidation of Targetco, and then the buyer's benefit of the asset deal. Illustrative rates: 20% tax on an individual's gain, 25% corporate tax, and amortisation of the stepped-up amount at the corporate rate. Check current rates and reliefs.

Answer: Share deal: the seller keeps 10.0m. Asset deal then liquidation: the seller keeps 8.4m. The buyer gains up to 2.0m of tax saving over time, about 1.34m in present value, less than the seller's loss of 1.6m, so a share deal usually wins, with protection for inherited tax.

> **Interview tip:** Say whose position you are taking, set out both layers of tax for the seller and the step-up for the buyer, and note that the buyer's saving comes over time.

INT.TM.1.b · Deal structure and diligence

Explain what tax due diligence reviews, rank findings by likelihood and amount, and say how findings affect price, protection and structure.

Tax due diligence is the buyer's review of the target's tax position before it commits. Advisers read tax returns and computations, correspondence and open enquiries with the tax authorities, and the target's accounting for tax. They look for three things. Exposures: unpaid or underpaid tax for open years, plus interest and penalties, in areas such as VAT, payroll and employment status, transfer pricing between group companies, withholding taxes and tax-driven structures. Tax attributes: losses, unused allowances and credits, and whether they survive a change of ownership. Historic compliance: whether returns were filed on time and whether the target has a record of disputes. Findings are usually ranked by likelihood, probable, possible or remote, and by amount. Probable items may lead to a price reduction, possible items to a specific indemnity or retention, and remote items to a note in the report. Findings also shape structure, for example by favouring an asset deal. Diligence has a scope, a timetable and a cost, so advisers agree materiality thresholds with the client. Candidates often list areas without ranking them. Rank by likelihood and amount.

WORKED EXAMPLE: RANKING DILIGENCE FINDINGS

An invented target has four findings in a tax review. VAT underpaid on mixed supplies of 0.30m is probable. Contractors treated as self-employed give an employment tax exposure of 0.45m, which is possible. A management charge between group companies may be challenged, giving an exposure of 0.60m, which is possible. A stamp duty omission of 0.05m is remote. The target also has trading losses of 3.0m, taxable at 25%. Rank the findings, size the exposures and say what you recommend for each. Figures are illustrative.

Answer: Probable 0.30m: price. Possible 1.05m: indemnity or retention. Remote 0.05m: report only. Gross exposure 1.40m. Losses nominally worth 0.75m should not be priced in until the restrictions are tested.

> **Interview tip:** Rank by likelihood and amount, then link each band to a different protection. Mention attributes as well as exposures.

INT.TM.1.c · Deal structure and diligence

Explain tax warranties and indemnities in a share purchase agreement, and apply limits such as a de minimis, a basket, a cap and a time limit to a set of claims.

A share purchase agreement allocates tax risk between buyer and seller. A tax warranty is a statement by the seller about the target's tax position, for example that returns have been filed and tax paid. If it proves untrue, the buyer can claim damages, but the seller may rely on matters disclosed against it. A tax indemnity, often called a tax covenant, is a promise by the seller to pay the buyer for tax liabilities that relate to the period before completion. It works pound for pound, whether or not the buyer knew of the issue, and usually has fewer limits than warranties. Typical limits are a de minimis, below which individual claims are ignored, a basket or threshold, a total claims level that must be passed, a cap on total liability, and time limits, which for tax are often longer because authorities can reopen several years. A basket can be tipping, so that once reached the whole amount counts, or a deductible, so that only the excess counts. Buyers worry about the seller's ability to pay, so the price may be partly retained, held in escrow, or backed by warranty and indemnity insurance, which usually excludes known issues. Candidates should say which limit applies to which instrument. All terms are negotiated.

WORKED EXAMPLE: APPLYING CLAIM LIMITS

Tax warranty claims of 12k, 65k, 80k and 160k are made after completion of an invented deal with a price of 20.0m. The agreement has a de minimis of 20k per claim, a basket of 100k and a cap equal to the price. Work out what the buyer can recover if the basket is tipping and if it is a deductible. Figures and terms are illustrative; they are negotiated in practice.

Answer: Tipping basket: 305k recoverable. Deductible basket: 205k. The 12k claim is lost in both. The cap is not reached.

> **Interview tip:** Say which instrument you are discussing, then walk through the limits in order. Mention that tax indemnities usually have fewer limits.

INT.TM.2.a · Structuring and reliefs

Explain why a buyer uses an acquisition holding company, compare debt with equity funding, and apply a cap on interest deductions to compute the tax cost of the cap.

A buyer often acquires through a new holding company, sometimes called Bidco, which holds the shares, raises the acquisition debt and sits above the target for a later exit. The funding choice matters for tax. Interest on debt is usually deductible, subject to limits; dividends on equity are not. Many countries therefore restrict interest deductions, for example by capping net interest at a percentage of tax-adjusted earnings before interest, tax, depreciation and amortisation, often with a de minimis amount and a group ratio option. The UK has a rule of this kind and a transfer pricing test on whether a lender would lend that amount at that rate. Interest that is not deductible is simply taxed as profit, and interest paid across borders can also bear withholding tax. A Bidco has no profits of its own, so the structure needs a group tax regime or a merger of Bidco with the target so that the interest offsets the target's profits. Shareholder loans from the seller or from an overseas investor are examined for arm's length terms. Candidates often say debt is cheaper without mentioning the cap. Give the cap, then the deductible amount, then the tax saving.

WORKED EXAMPLE: INTEREST DEDUCTION CAP

A buyer plans to acquire Targetco through Bidco for 80.0m. It can fund with 50.0m of bank debt and 30.0m of equity, or with 70.0m of debt and 10.0m of equity. Interest is 8% a year. Targetco's tax-adjusted EBITDA is 16.0m, interest deductions are capped at 30% of that, and the tax rate is 25%. Work out the interest, the deductible amount and the tax saving in each case. Figures are illustrative; check the current rules.

Answer: With 50.0m of debt the interest of 4.0m is fully deductible and saves 1.0m a year. With 70.0m of debt only 4.8m of 5.6m is deductible, saving 1.2m and leaving 0.2m of tax lost to the cap. The extra 20.0m of debt adds only 0.2m of saving for 1.6m of extra interest.

> **Interview tip:** Give the cap first, then the deductible amount, then the tax saving. Say that Bidco needs to be grouped with the target.

INT.TM.2.b · Structuring and reliefs

Describe reorganisation and exit reliefs in outline, and compute stamp or transfer taxes and the tax on a share exchange that includes cash.

Reliefs allow a restructuring without immediate tax on the gain, and they matter in deals. A share-for-share exchange lets a shareholder swap shares in the target for shares in the acquirer without a disposal for tax purposes, with the base cost carried over, so tax is deferred until the new shares are sold. If part of the price is cash, that part is treated as a part disposal and the gain on it is taxed. Group reorganisation relief lets assets or shares move within a tax group with no gain at the time, though there is a charge if the company leaves the group within a set period while still holding the asset. Exit reliefs may exempt a company's gain on selling a substantial shareholding, or give an individual selling a qualifying business a lower rate. Transfer taxes are a separate cost: many countries charge stamp duty on the price of shares, UK stamp duty on shares being about 0.5% for example, and land taxes at higher rates on property in an asset deal, while goodwill and plant are often not taxed. Rates and conditions change, so figures must be checked. Candidates often forget the clawback conditions and the buyer's transfer tax.

WORKED EXAMPLE: STAMP TAX AND A SHARE EXCHANGE WITH CASH

Mr Valen sells all his shares in Targetco for 12.0m. His base cost is 2.0m. In a share deal the buyer pays stamp duty of 0.5% on the price. In an alternative asset deal property worth 3.0m carries a land transfer tax of 5%. Separately, in a different offer Mr Valen would receive 7.2m of shares in Bidco and 4.8m of cash. Use an illustrative 20% rate on gains. Compute the transfer taxes in both structures, and the tax on the part-cash exchange.

Answer: Transfer tax is 60,000 on the shares and 150,000 on the property in the asset deal. In the part-cash exchange tax of 0.8m is due now on a gain of 4.0m, and 6.0m of gain is deferred.

> **Interview tip:** Say which reliefs apply and under what conditions, including clawback. Then give the transfer tax on each route separately.

INT.TM.2.c · Structuring and reliefs

Describe in outline how employee share incentives are taxed in a deal, compute the tax on options exercised on a sale, and explain how a tax adviser contributes to a deal timetable.

Employee share options usually vest or can be exercised on a change of control, so a sale triggers tax. If options are not in a tax-advantaged scheme, the gain on exercise is taxed as employment income and may attract social security from both employee and employer, and the employer's cost becomes a deal point: the buyer often asks the seller to bear it through a price adjustment or indemnity. Tax-advantaged schemes, such as the UK's enterprise management incentive scheme, may give capital gains treatment at lower rates, but have conditions that a sale or a restructuring can break, so these are checked early. Alternatively, options may be rolled over or replaced. The company may also get a deduction for the gain. A tax adviser contributes at each stage: scoping and a structure paper after heads of terms, diligence and a findings report before signing, tax provisions in the agreement and any tax deed, completion mechanics such as the payment of withholding and stamp taxes, and post-completion returns and clearances. Candidates often describe tax only as a risk; say also that the adviser helps the deal happen on time. Rates and rules should be checked.

WORKED EXAMPLE: OPTIONS ON A SALE

Management hold options over 100,000 shares in an invented target at an exercise price of 1.00 each. The buyer pays 6.00 per share. Assume unapproved options, taxed as employment income at 45% with employee social security of 2% and employer social security of 15%, and, alternatively, a tax-advantaged scheme taxing the gain at 10%. These rates are illustrative. Compute the gain, the tax in each case and the employer cost, and say what the buyer will ask for.

Answer: Gain 500,000. Unapproved: employees keep 265,000 and the employer pays 75,000 more. Tax-advantaged: employees keep 450,000. The buyer will want the sellers to carry the employer cost.

> **Interview tip:** Give the gain, the two treatments side by side and the deal point. Then say how you would use the timetable to deal with it early.

Summary of the Charta interview-preparation topic. Companies and figures in the examples are invented. Draft content, not yet expert reviewed.