Analysis

Tax themes in acquisition financing

Speed read

This article considers developments in how some of the UK tax issues on lending into UK acquisition finance structures can be dealt with in practice. Where funding has been provided by non-treaty eligible debt funds, advisers should weigh the pros and cons of alternative methods for mitigating UK withholding tax, and ensure that the risk (including change of law risk) is appropriately allocated. Groups which have implemented the commonly seen 'Finco LLC' borrowing structure will be aware of the tensions in the UK source analysis on that structure, and may also wish to consider options for restructuring in light of the potential impact of the recent hybrid mismatch rules.

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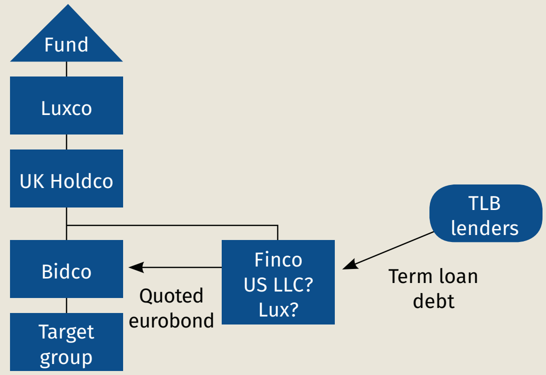
It will have been the experience of many readers that 2017 was another busy year for private equity M&A transactions. The role played by debt finance – including where provided by alternative, non-bank lenders – is obviously integral to these deals. This article points out a few developments which the authors have found of interest in working on the tax aspects of financing in a PE context over the past year or so.

The diagram (above right) sets out a typical structure that might be established for a private equity acquisition of a UK target group. Bidco will be financed in part with an appropriate combination of equity and shareholder debt advanced from the fund, and in part by third party debt from banks or other lenders.

Withholding tax

A key consideration will be the withholding tax position on the interest expense of the UK company set up to acquire the target group (Bidco). Very often this will be unproblematic, with senior debt coming either from UK banks or non-UK treaty-qualified lenders, and shareholder funding perhaps being provided in the form of a quoted eurobond listed on a suitable exchange.

Example structure



Obstacles can arise, however, when the borrower's marketing effort encompasses other categories of lender: the debt funds, hedge funds, insurers and collateralised loan obligation (CLO) issuers often referred to as 'term loan B' (TLB) lenders (a reference to the yield and covenant features of their products that distinguish them from customary bank loans). A typical TLB lender might be organised as a Cayman Islands partnership and will not therefore be eligible for the exemptions relied on above.

Tax advisers might have a ready list of options to deal with this scenario. An immediate question, given the straightforward conditions of the quoted eurobond exemption, is: 'Can the TLB debt be listed?' (Note that relying on the relatively recent exemption for unlisted 'qualifying private placements' at ITA 2007 s 888A will not assist, given the requirement under the associated regulations that creditors are, in essence, resident in a treaty jurisdiction.) Listing the debt is certainly an option that is used, but is not without its difficulties. For a start, lenders will be expecting to sign up to a familiar set of leveraged facility agreement papers and may be surprised to be told that they will in fact be subscribing for a note listed on a stock exchange. Listing fees and expenses of advisers in the listing venue will also be incurred (though these may be manageable). Grafting the substance of a leveraged loan agreement on to the skeleton of the terms and conditions of a bond will require considerable drafting efforts of the finance lawyers, and the result can be an instrument that looks somewhat idiosyncratic, with whatever consequences for future marketability that might hold.

At a more technical level, this option also throws up the nice lawyer's question as to whether the TLB debt dressed in such garb constitutes a 'security' – a requirement of the quoted eurobond exemption. The term is not defined and there is little learning on it in this context, though guidance can be drawn from the well-known capital gains case law on the meaning of 'debt on a security'. Importantly, a security must be 'marketable', or designed to be sold (including in part) for a possible profit. Restrictions on assignment, including borrower consent rights or narrow definitions of 'eligible assignees', which would be unknown for general debt capital markets instruments, will need to be carefully evaluated. That said, other features of the debt – a meaningful term, a commercial return, make-whole payments applicable on early prepayment, a noteholder's register, and so on – will be strongly indicative of the TLB debt being a 'security' (though whether or not the notes benefit from proprietary security is not determinative); and, once the debt is successfully listed on the chosen exchange, this is a point HMRC would presumably be unlikely to take in practice.

Often, however, the solution is found by incorporating a non-UK finance company (Finco) as a sibling to Bidco (see the figure). This might be a Delaware LLC or a Luxembourg company, which will borrow from the TLB lenders and on-lend the proceeds (for an appropriate return) to Bidco by way of quoted eurobond. Bidco clearly will not have a UK withholding obligation, but does Finco? That will turn, of course, on whether Finco is considered to be paying 'UK source' interest.

That will involve the adviser in attempting to apply case law principles to the documents and surrounding circumstances of the transaction. An interesting point here is that often the vast preponderance of quantitative factors – the 'residence' of the Finco debtor, the governing law and jurisdiction clauses of the loan, and the nature of the security and guarantee package (which may relate to a global group of subsidiaries) – will point to a non-UK source, as against perhaps a single factor (the substantive funding of Finco's interest obligation by Bidco's payments on the eurobond) which points to the UK. The cases give little guidance on how the multi-factorial test should be applied in such circumstances (and whether the relevant principles will be elucidated when *Ardmore* [2015] UKUT 633 comes to the Court of Appeal in March is perhaps doubtful, given the taxpayer's position in that appeal).

The analysis is obviously facts specific and a spectrum of views is clearly possible even on a given fact pattern. However, for what it's worth, the authors have noticed that a number of advisers in the market have become somewhat more cautious on this analysis in recent months. Creditors on this structure should ensure they are protected with an unqualified gross-up for UK withholding tax in the credit agreement. For the borrower group, there are practical points to bear in mind around the substance required to adopt such a structure, managing the controlled foreign companies (CFC) rules and transfer pricing position, and any implications for its tax strategy that are presented by a proposal to utilise a new entity that may (among other matters) facilitate a tax efficient structure.

A final point to watch out for during 2018 and beyond is, of course, the survival of the quoted eurobond exemption in its current form. While Finance Bill 2018 will relax the exemption to cover multilateral trading facilities, its use in the context of intra-group arrangements where there is no regular trading of the instrument has been on HMRC's radar for years. A Labour party policy document in 2014 floated the idea of restricting the exemption where bonds have been issued to connected parties. More recently, Labour's *Tax transparency and enforcement programme*, published alongside the 2017 manifesto, continued to denounce the 'eurobond loophole' for securities listed in the Channel Islands. Advisers should weigh how the risk of a change in tax law on this point is borne between the parties. There will perhaps be further debates to be had around allocating change in tax law risks in these documents as clarity begins to emerge around the UK's amendments to its treaties under the multilateral instrument, and more generally around Brexit.

Hybrid mismatch rules

During 2017, structures such as that in the figure on the previous page have had to contend with the hybrid mismatch rules. On the face of it, Bidco's payment to an LLC (a hybrid payee) may well fall foul of these rules – assuming the interest income is not included in ordinary income either by the LLC or its parent – and lead to a disallowance of Bidco's deduction. Delaware LPs have been suggested as alternatives to LLCs to address this point. (Of course, the precise hybrids analysis will inevitably become more complex in practice. The tax analysis for UK Holdco of a conversion of an LCC to a LP will also not be entirely straightforward.

The hybrid mismatch rules are impacting other areas of PE acquisition structuring, as well. The sustainability of a deduction for shareholder debt issued by a UK top holding company to the fund may be difficult to support if clarity cannot be obtained as to how and when the limited partners will recognise that income. This, and the fact that shareholder debt can broadly no longer be used to take an interest deduction above 30% of UK EBITDA under the interest restriction rules in any event, is leading in recent experience towards a general shift towards preference share funding for UK headed structures. (Preference shares may also be more attractive than loan notes for taxable US investors in the fund, on the basis that the former should generally avoid a dry tax charge for such investors.)

Similarly, on a Luxembourg top holding company structure, a UK deduction for shareholder debt ultimately funded by preferred equity certificates (PECs) or convertible preferred equity certificates (CPECs) will look doubtful under the imported mismatch rules. For deals structured as a sale of Luxembourg shares and PECs/CPECs, a UK buyer will want to think about unwinding such arrangements post-acquisition.

Care should be taken here that redeeming such instruments does not (counterintuitively) trigger a taxable income distribution on the full value of the amount redeemed. The point here is that, at least as a starting point, the 'principal secured' on the PECs/CPECs for the purposes of CTA 2010 s 1008 may well be nil, raising the prospect of a taxable receipt for a UK corporate holder notwithstanding that no accounting profit may be expected on such a redemption under the loan relationship rules. Any residual technical concerns here, however, can often largely be managed.

Readers will also have seen how the anti-hybrid rules cannot be ignored even where Bidco is negotiating plain vanilla borrowing direct with third party lenders, in case that borrowing imports an offshore mismatch within the lender's structure under a 'series of arrangements' (see 'How ordinary loans become surprise hybrids' (Dan Neidle & Jemma Dick) *Tax Journal*, 29 September 2017). This can be particularly sensitive if a borrower funded by a financial institution's private equity arm is looking to a syndicate of lenders (in an arm's length process) which might include that institution's banking division, but can be relevant (depending on Bidco's level of gearing) more generally.

Fortunately, the most recent version of HMRC's guidance (*International Manual* at INTM559230) now gives some practical comfort to borrowers in this scenario (although concerns remain over the legal reliability of such guidance should push come to shove). Absent this guidance, reconciling the borrower's obligations to diligence the hybrid rules with the lender's reluctance to disclose details of its internal funding structure was causing some angst in negotiations, which would often come as something of a surprise to principals.

Further evidence that HMRC has been in listening mode can be seen in the amendments to the hybrid rules in Finance Bill 2018. The change at Sch 7 para 11, in particular, appears to be responsive to concerns raised by the BVCA that a fund partnership which is a hybrid entity as regards a particular limited partner investor should not cause a counteraction with respect to other tax exempt partners for whom that hybridity makes no difference to the tax result. No doubt further amendments to these over-ambitious rules, including those with retrospective effect, in response to glitches pointed out by taxpayers struggling to apply them in the real world, will be a feature of Finance Acts for years to come. ■

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- How ordinary loans become surprise hybrids' (D Neidle & J Dick, 18.19.17)
- Quoted eurobond 'loophole' shocker! (Helen Buchanan, 11.7.14)