before starting on a data collection exercise. It is for this reason that we recommend that groups carry out a dry run of their CBC reporting process based on prior year data. This allows time for any wrinkles in the data definitions to be ironed out, and also gives group tax directors an opportunity to analyse the results.

In our experience, the analysis and review of data once collected is critical for two main purposes: to identify trends or outliers that need to be explained in the master file or local files; and to shape the key messages to be communicated to the board and other stakeholders. Given the potential for public CBC reporting in future, there could be a wide range of stakeholders.

In addition to tax authorities, pressure groups such as Publish What You Pay (PWYP) and the Tax Justice Network have been strong advocates of public reporting. Following the first publication of data by Shell earlier this year under the Reports on Payments to Governments Regulations (a transparency initiative aimed at the natural resource extractive industries), PWYP was quick to publish a list of follow up questions arising from its analysis. Many groups are preparing for this level of scrutiny by drafting Q&As for public relations or corporate affairs teams to explain the key issues highlighted by the CBC data, should this become public.

All of this may sound like another heavy burden for already stretched tax teams, but time invested upfront to work through the rules and requirements will ensure a smooth process in years to come. If one thing is certain, it is that greater tax transparency is here to stay. ■

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- The Finance Bill change for public CBCR (Tim Law, 13.9.16)
- Publishing corporate tax strategies (Maya Forstater, 4.8.12)
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- Tax transparency by multinationals: for whom and why? (Jane McCormick, 21.1.14)
- Implementing a common template for country by country reporting (Bill Dodwell & Alison Lobb, 22.11.13)

Analysis

# UK tax issues on US merger agreements


**Speed read**

**Despite the efforts of the US government to discourage inversion transactions through US tax changes announced earlier this year, the flow of such deals has not yet dried up. Given the UK's attractiveness as a holding company tax jurisdiction, UK tax advisers will often be called upon to advise on the 'merger agreement' documentation put in place to implement these transactions. Some of the UK tax issues that advisers will want to think about when reviewing such agreements include: ensuring UK tax residence; settlement mechanics and other stamp duty practicalities; the direct tax and VAT implications of termination fees; and the UK tax implications of any intra-group financing structures.**



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The trend for inversion transactions in recent years has seen a number of public transactions through which a US-headed group combines with a non-US group in order (amongst other objectives) to achieve a more favourable effective tax rate for the combined group. The new holding company chosen for the combined group will often be a UK tax resident (and, possibly, UK-incorporated) company ('Holdco'). The framework for the deal will usually be set out in a merger agreement, business combination agreement, transaction agreement or other similarly titled document entered into by the parties, generally governed by US law.

A typical structure might involve Holdco incorporating a US subsidiary, into which the US public company will merge, in exchange for an issue of shares to the US shareholders by Holdco. Holdco will simultaneously also acquire the shares or business of the non-US group – by, for example, a contractual offer, scheme of arrangement, or EU cross border merger – again for an issuance of shares. Further steps may be contemplated, for example, to capitalise any merger reserve, reduce share capital/share premium and create distributable reserves in Holdco.

Very often the merger agreement will have to be drafted and agreed in short order as the parties face timing pressures to announce the transaction. Accordingly, at signing, the parties may not have arrived at a finalised legal and tax steps plan for implementing the transaction at closing. There may also be third party stakeholders (registrars, depositaries, clearance services, not to mention tax authorities), which it may not be practicable to approach before signing the merger agreement. In such cases, the watchword for UK tax advisers at merger agreement stage will generally be 'flexibility': drafting the provisions of the merger agreement which deal with these structural and mechanical matters to allow for developments in the analysis post-signing. This also goes for the related SEC filings.

### Tax residence

Managing Holdco's UK tax residence can be something of a balancing exercise (particularly where Holdco is not incorporated in the UK). While the composition and governance protocols of the combined board will be a key commercial issue for the deal teams, and will generally be enshrined to a greater or lesser extent in the merger agreement, these arrangements also need to be viewed in light of the various technical (and highly fact sensitive) constraints necessary to preserve (sole) UK tax residence.

Generally speaking, the location, nature and frequency of board meetings will be the main focus, but there is also a range of views among advisers as to how much weight is to be placed on 'softer' factors, such as the personal residence of particular directors and the composition of board subcommittees.

Advice may also be needed on tricky practical questions, such as directors dialling in to board meetings, protocols for 'ad hoc' or 'emergency' board meetings, and procedures for taking decisions outside board meetings. Where the 'non-US' element of the transaction involves an EU cross-border merger, there may also be a further tension between demonstrating UK tax residence and the existence of a non-UK permanent establishment where this is required for tax neutral treatment under the rules of the other EU member state.

## The watchword for advisers at merger agreement stage will generally be 'flexibility'

As a process matter, there may be a desire to obtain HMRC comfort on the proposed governance arrangements (or to refresh existing comfort), which may not be forthcoming before the merger agreement is signed. Advisers may therefore seek to include in the merger agreement some commitment from the parties to ensure that the Holdco will be UK tax resident, and to build in flexibility to adjust the governance protocols to achieve this goal.

### Settlement mechanics

In the case of a UK-incorporated holding company, the provisions of the merger agreement concerning the settlement mechanics for the shares issued in consideration of the mergers are another area where flexibility in the drafting may prove useful. Assuming that Holdco will be listed on two (or more) exchanges, a number of questions need to be considered as to how exactly Holdco will satisfy the commitment in the merger agreement to deliver shares to investors. Will US holders receive American depositary shares, or hold shares in Holdco itself through the facilities of DTC (the clearance service for NYSE and NASDAQ)? Is provision needed (for example, via a specialist depositary receipt issuer) to house 'restricted' shares, or to interact with the relevant clearance systems to facilitate withdrawals and re-deposits of shares? (This feature has recently been customary on US listings of UK plcs.)

If participants in the non-US exchanges will hold through a different clearance service (such as Euroclear or Clearstream), how will these arrangements interact with trading via DTC? One model that appears to have been adopted on the recent Coca Cola European Partners plc combination is for DTC to act as a 'primary' clearance service, with investors on various European exchanges participating via accounts in DTC held on behalf of the European clearance services. Variant settlement structures could also be considered. Further special arrangements may be needed to facilitate trading on the London Stock Exchange via CREST (which is not, of course, a clearance service). The Cyberonics/Sorin transaction, which used 'domestic depositary interests' issued by a UK Computershare entity (which held the underlying shares through a Computershare account in DTC) and which trade with 0.5% SDRT, is an interesting example of this. (The SDRT technology on this point may have moved on since then.)

The financial advisers on the transaction will have views on these options, including from a liquidity, fees, and operational perspective; but there will also be a meaningful workstream for UK corporate and tax advisers to work through the proposals in light of the stamp duty and company law constraints particular to UK issuers. Just as importantly, the structure will need to be acceptable to DTC (and any other relevant settlement system), which may in practice require an HMRC clearance.

### Stamp tax on the mergers

As well as the stamp tax implications of the issuance and future trading of the merger consideration, the stamp tax treatment of the merger itself needs to be considered. The US side of the merger should generally be straightforward: SDRT should not be relevant; and even if it were considered that the merger involved a document theoretically within the scope of UK stamp duty (given it involves the issuance of shares by a UK company), in practice it is unlikely that such a document would need to be relied upon for official purposes in the UK. There may be a residual preference to execute the merger agreement outside the UK to mitigate against penalties (though this point may fall away if it is considered that executing in the UK has some marginal benefit to the residence analysis).

If the non-US side of the merger involves the acquisition by Holdco of a UK company (by contractual offer or transfer scheme or arrangement), the working assumption should be that stamp duty will be payable. In the context of a transfer scheme, advisers will need to bear in mind HMRC's guidance (helpfully revised in November 2015) on the logistics around this. Broadly, HMRC will accept that the court order itself is not subject to stamp duty where the scheme terms specifically require a separate instrument to be executed to transfer the shares, and will issue a letter accordingly in case this is required by Companies House for the purposes of Companies Act 2006 s 899(4).

## The tendency of the US government to shift the US tax goalposts to block inversions ... means that these clauses are of real commercial importance

In the context of an EU cross-border merger, the authors consider that the better view is that the transfer of assets is a transfer by operation of law rather than on sale, and not (where such assets are chargeable securities) an agreement to transfer for SDRT purposes (see also *Save & Prosper Securities Ltd v IRC* (2000) STC (SCD) 408). It is understood that Companies House and HMRC broadly accept this position, although there is not currently any publicly available guidance to this effect.

### Termination payments

It is not uncommon for merger agreements to provide for sizeable 'break fee' payments in case one party terminates the deal before closing. Quite apart from the vicissitudes of the market, the tendency of the US government to shift the US tax goalposts to block inversions (Pfizer/Allergan and Abbvie/Shire being two well-known examples) means that these clauses are of real commercial importance. However, in the atmosphere of signing up the merger agreement, clients may not always immediately focus on the tax implications of the deal falling over.

In terms of direct tax, the working assumption for a UK company should probably be that a break fee receipt is taxable as a capital sum, and a break fee payment non-deductible for the same reason. There are differing views on this, however, and advisers will want to look closely at the provisions pursuant to which the break fee is payable before dismissing an argument that the break fee is not taxable. There may be other planning options to consider in identifying a recipient for the break fee within the group. Is there an entity with expenses of management, non-trading loan relationship deficits or other losses available to shelter the gain? Would using a low-tax subsidiary be advantageous? There may, for a number of reasons, be little appetite however to engage in (somewhat uncertain) tax planning in this area.

The VAT analysis of termination payments is a difficult area. Where the break fee clause is included in the merger agreement itself, there should be good arguments that it is not consideration for a supply at all (see HMRC's guidance in its *VAT Supply and consideration Manual* at VATSC35400); or that otherwise, in the context of a receipt from a US counterparty, any such supply is not made in the UK.

As a matter of risk allocation, however, the starting point will often be that a US law governed merger agreement is silent on VAT. This is a position which in substance will leave VAT risk with the EU party both as recipient and payer of a break fee. While a straightforward VAT exclusive clause is unlikely to be an appropriate alternative, more nuanced drafting is often used to achieve a more reciprocal risk allocation (including a 'gross up' for VAT recoverable by the payor, and a 'gross-down' for irrecoverable reverse charge VAT). Conduct provisions should also be considered.

A gross-up for withholding taxes is also unlikely to be appropriate for termination payments. While UK withholding tax won't be relevant, a UK recipient should investigate its position as regards US withholding and whether it will need to provide forms and rely on the treaty to receive gross.

## Other points

There will, of course, be other points of detail for the UK tax adviser to consider. Is the implementation documentation consistent with Holdco having given consideration (the value of the shares issued) for the acquired group for base cost purposes? Are the Delaware law corporate mechanics of the merger consistent with rollover treatment for UK resident shareholders under TCGA 1992 s 136 (if such shareholders are a significant constituency)?

Looking beyond signing, the application of the CFC rules and the anti-hybrid rules will be important in assessing the efficiency of intra-group financing options (if any such structures survive beyond BEPS, the Anti-Tax Avoidance Directive, and the proposed regulations under section 385 of the US Internal Revenue Code…). Again, hardwiring pre-closing financing steps into the merger agreement in advance of a full tax analysis may be unwise.

In short, readers should be mindful of the scope for technical (though important) UK tax issues to have a direct bearing on the drafting of the merger agreement and related documents. Prudent advisers will look to air these issues with the commercial parties in good time, while giving themselves leeway for the analysis to develop within the four corners of the documentation agreed at signing. ■

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- ▶ Inversions of US corporations: the current state of play (Joseph Goldman & Anthony Whall, 23.6.16)
- ▶ US inversions through European mergers (Tim Sanders & Eric Sensenbrenner, 28.6.14)