Costs and Expenses

Tax Treatment of costs and expenses including break fees and inducement fees

Both the buyer and seller will inevitably incur significant costs and expenses during the course of an M&A transaction. Ensuring the optimal tax treatment is essential to minimise the impact of those costs and expenses. The position is likely to be even more stark, when for whatever reason the transaction does not complete. In these circumstances there may also be the added complication of considering the tax treatment of break fees or inducement fees paid by one party to the other.

The article looks at the issues relevant to the tax treatment of costs likely to be incurred by both parties to a share sale. The analysis usually turns on the particular facts of the transaction, so we have outlined the principles that normally apply.

Direct Tax Issues

Seller

For most sellers the disposal will be a capital transaction and the gains arising on the sale will be subject to capital gains tax or corporation tax on chargeable gains (subject to the availability of the substantial shareholding exemption (SSEs)). Costs which are directly attributable to the sale such as legal fees involved in the negotiation of the share sale agreement will be treated as incidental costs of disposal under TCGA 1992 s.38 and so will be taken into account in calculating any gain arising on the disposal.

Only costs wholly and exclusively attributable to the disposal will be allowable for the purposes of calculating the gain. A seller may well have incurred additional costs, for instance in taking more general strategic advice on the options open to a seller, or specific tax advice. For individual sellers, these costs are likely to be deductable. For corporate sellers they may be deductable as an expense of management or trading deduction if they are revenue not capital expenditure.

Buyer

Costs incurred by the buyer are likely to break down into a number of different categories. There will be costs directly attributable to the share purchase but there may also be costs attributable to the raising of debt finance, possibly costs attributable to the issue of new share capital (either to raise funds to finance the acquisition, or directly to the sellers) and costs attributable to more long term strategic advice.

Generally a corporate buyer will not get an immediate tax deduction for the costs directly attributable to the acquisition. However, they should be treated as incidental costs of making the acquisition and added to the base cost of the shares for the purposes of capital gains tax and taken into account on any future disposal of the shares.

Costs incurred in obtaining strategic advice will not generally be treated as incidental costs of acquiring the shares for the purposes of capital gains tax. However, provided that the costs are revenue in nature a company should get an immediate corporation tax deduction under ICTA 1988 s.75 as an expense of management, or possibly in some cases as a trading expense.

A deduction for the costs of obtaining debt finance will normally be available under the loan relationship rules in Finance Act 2006. However, it is likely the costs will be amortised over the
life of the loan in accordance with account rules. **One of the key questions is likely to involve the extent to which costs can properly be attributable to the debt finance.**

For instance, can the costs of carrying out due diligence which is addressed to and relied up by both the buyer and the bank be properly attributable to the loan finance if the due diligence was a condition of obtaining the loan finance? Provided that the costs were necessarily incurred for the purposes of obtaining the loan finance there is a good argument they are deductible even though there is a dual purpose.

The costs of issuing equity are likely to be capital in nature and therefore non-deductible, although unless there is a separate public offering costs attributable to the shares might be negligible.

It is worth adding that in general a party to a transaction is only going to be able to claim a deduction for its own costs but not for third-party costs it pays on behalf of someone else (although, depending on the circumstances, they may for instance be treated as an adjustment to the consideration paid for the assets. This is a common issue in deals within the private equity sector, where the buyer may agree to pay the management teams costs. The buyer will need to consider not only whether it can claim a deduction for these but also whether paying them gives rise to a taxable benefit for the management team.

**VAT**

Turning to the VAT treatment, the first question is whether the costs and expenses will be subject to VAT or will be VAT-exempt.

To the extent that fees relate to intermediary services in relation either to the share transaction or to the raising of debt or equity finance, they will fall within VATA 1994, Sch 9, Group 5, Item 6 and will be exempt for VAT purposes. Intermediary services are defined as the bringing together of the parties to a supply of financial services. Certain preparatory work is also included if the supply is one of debt finance.

On a typical M&A transaction the only fees which are likely to qualify for exemption are corporate finance fees and any debt arrangement fees.

The sale of shares is, of course, an exempt supply for VAT purposes. VAT on fees directly related to the sale of shares will not therefore be recoverable. However, this does not necessarily mean that a seller will not be able to recover any VAT on fees. Fees attributable to general strategic advice may be recoverable as a general overhead – assuming of course that the seller is registered for VAT.

The position of a buyer is more complicated. The acquisition of shares by a buyer is not a supply for VAT purposes so (subject to the comments below on the Securenta case) costs attributable to the acquisition will be treated as general overheads and VAT recovered according to the buyer's partial exemption method. Following the decision in *Kretztechnik AG v Finanzamt Linz* [2005] STC 1118 any costs attributable to share or debt issues should be treated in a similar way. In that case the ECJ held that a share or debt issue did not involve a supply by the issuer for VAT purposes, so that costs attributable to these elements are now dealt with in the same way as costs on the acquisition itself.

Following *Kretztechnik* it appeared that a buyer should be able to recover much of its VAT on the acquisition (assuming it was not carrying on a significant element of exempt business). However, the decision in another ECJ case, *Securenta Gottinger Immobilienanlagen under Vermogensmanagement AG v Finanzamt Göttingen* [2008] STC 3473, has thrown that into doubt. Although it was not directly addressed in the ECJ's decision, there was implicit acceptance therein of the Advocate General's statement that 'the acquisition, holding and sale of interests in other businesses is not an economic activity. If this case is followed it may cause VAY recovery problems for companies on the acquisition of shares.
Assuming that the business of the target is taxable, the position may be improved by hiving the business up immediately following the acquisition on the basis of the decision in CCE v UBAF Bank Ltd [1996] STC 372. In UBAF the buyer acquired companies carrying on a leasing activity and immediately hived up the businesses. It was held that the costs and expenses were attributable to the taxable leasing business.

If a special purpose vehicle (SPV) is being used for the purposes of making the acquisition it is important that the SPV is registered for VAT either as part of a group registration or possibly a sole registration, based on taxable supplies of management services it is proposing to make.

The final point to remember is that a company can only recover VAT on supplies made to it. Where a company pays a third party’s fees (for example, a bank’s legal fees) it will not be able to recover the VAT on those fees, as the supply is to the bank not the company. This can be an issue for SPVs, as they will need to be able to establish that relevant supplies such as the provision of due diligence is supplied to them and not to the investors in the SPV. The decision in Mono Global Ltd 18559 is helpful in this respect. This case concerned the VAT treatment of fees incurred in relation to an acquisition by a SPV which was set up for the purposes of an acquisition which was funded by 3i. A number of the invoices were addressed to 3i and not the SPV but the fees were paid by the SPV. It was held that the supplies were made to the SPV even though invoices were issued to 3i. Nevertheless it is important to ensure that as far as possible the engagement letter, the provision of the advice and the issue of invoices all support the fact that the supply is made to the SPV.

In addition to ensuring that invoices are addressed to the right person it is also important to ensure that where a different VAT treatment will apply to different elements of a global fee the fees are invoiced separately, or at least broken down into the different elements on the invoice. HMRC will find it much more difficult to challenge a properly considered apportionment.

Aborted Deals

The fact that an acquisition does not go ahead does not affect whether expenditure is treated as capital or revenue in nature. If the expenditure is revenue expenditure, it is still likely to be deductible for tax purposes, either as an expense of management or trading expense.

Capital expenses will not be deductible. There will be no acquisition or disposal of an asset, so they cannot qualify as incidental costs of acquisition or disposal for capital gains purposes.

Expenditure on attempting to bring a loan relationship into existence is deductible under the loan relationship rules and this will cover abortive expenditure, as long as the expense would have been allowable had the company raised the loan.

For VAT purposes, if input tax is attributable to a specific exempt or taxable supply the fact that the supply does not occur will not alter the attribution of that input tax. Therefore the fact that a deal does not proceed will not alter the VAT treatment of the fees.

Break and inducement fees

It is possible that either party to the transaction may require the other party to pay an agreed fee to it, or to cover a proportion of the costs in the event the other party pulls out from the transaction.

In the buoyant market of the last few years, where they have often been multiple potential buyers, we have seen fewer such arrangement, especially in the mid-market. The seller will be less worried about the deal falling through if there are multiple buyers in the background and the buyer has less bargaining power if it is one of many. However, it is quite possible that we will see more such arrangements in the future, since both parties will be more concerned about the possibility of the deal falling through.

For direct tax purposes it is difficult to see how either buyer or seller will be able to obtain a corporation tax deduction for a payment made to the other party in these circumstances. The
expenditure will almost certainly be capital in nature but there will be no related acquisition or disposal to which it can be attributed.

The VAT treatment is more complex. There is very little guidance or case law relating specifically to break fees or inducement fees payable on an M&A transaction. Therefore it is necessary to consider case law and guidance in other areas. The key question is whether the payment is consideration for any supply.

The definition of a supply for VAT purposes is very wide. VATA 1994. s 5(2) provides that 'anything which is not a supply of goods but is done for a consideration.…is a supply of services'. If the recipient of the payment has done anything or omitted to do anything in consequence of the payment, arguably the payment is consideration for a supply. This therefore will be subject to VAT. However, it is also possible to see how a payment could be structured in such a way that it is merely a compensation payment. If this is the case, then under the principles outlined in the Holiday Inn case this would be outside the scope of VAT.

Unfortunately, as the treatment will depend on the exact nature of what is being paid and for what, each case will need to be looked at on its own facts.

Summary

M&A transactions can be very costly and obtaining the optimal tax treatment of fees can help reduce that cost. This is a complex area and the treatment will depend on the exact nature of the fees and the circumstances. However, it is always important to consider the tax treatment at the time invoices are issued to ensure that fees are properly described and paid by the correct parties so as to optimise the tax treatment.

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