SQUIRE SANDERS

UK BUDGET 2013

WHAT'S IN IT FOR PRIVATE EQUITY?

Introduction

The recent announcement of Budget 2013 provides a good opportunity to overview the key tax issues facing the private equity community. This alert covers the key tax issues for private equity backed companies and their management teams.

Private Equity Backed Companies

Rates

Budget 2013 contains good news for private equity backed companies. The corporation tax rate is to be cut to 23% from 1 April 2013 and again to 21% from 1 April 2014. This is to be followed by a further cut to 20% from 1 April 2015. However, the flip-side is that private equity backed companies need to plan carefully how they use their tax reliefs (capital allowances, interest costs, trading losses etc.). Tax paying private equity backed companies are likely to enjoy a better post tax position if the use of such reliefs is maximised in 1 April 2013 (rather than in 1 April 2014 or 1 April 2015).

Research and Development

Certain private equity backed companies may engage in research and development activity. Currently the government incentivises research and development activity by giving the relevant company enhanced tax deductions. Budget 2013 changes this. From 1 April 2016 incentives for research and development activity will be given as grants. Further, for research and development expenditure incurred between 1 April 2013 and 1 April 2016, the relevant company will be able to elect to treat the research incentive as a grant. The key advantage of this is the pricing. After consultation with the professional bodies, it appears that the grants will be treated as "earnings" for accounting purposes. Clearly every company is bespoke. However companies which are valued on an EBITDA basis may derive valuation benefits from treating the research incentives as earnings rather than as deductions against their corporation tax bills.

Patent Box

Budget 2013 is a good time for remembering that the phased implementation of the patent box begins in the fiscal year 1 April 2013 and is part of a process which concludes on 1 April 2017. Broadly speaking, the patent box cuts the effective tax rate from income derived from patents from 14% in the fiscal year beginning 1 April 2013 down to 10% in the fiscal year beginning 1 April 2017. The rules are generous and they benefit income derived from patented manufacturing processes and from the sale of items which contain any patented components. Private equity backed companies should review carefully their asset portfolios to see whether they can benefit from these rules.

Incentivising the Management Team

"Shares for Rights"

Budget 2013 provides more content to the "shares for rights" announcement which the Chancellor made on 8 October 2012, the change is expected to take effect this autumn. In return for waiving certain employment rights individual shareholders will be exempted from capital gains tax on gains on shareholdings which were valued at between £2,000 and £50,000 as at their acquisition date. Clearly a reform of this type will raise some complicated employment issues. However, the absolute exemption from capital gains tax may make this reform attractive for certain senior members of management teams who may want to enjoy a lower tax rate than the 10% currently provided by entrepreneurs' relief.

EMI Options

Budget 2013 contains some favourable relaxations on the rules on EMI share options which may benefit private equity backed companies. In summary, shares derived from the exercise of EMI options, will qualify for the 10% entrepreneurs' relief rate as long as (1) the holding period for the shares when aggregated with the holding period for the options is at least 1 year in duration and (2) the option holder/shareholder has been an officer or an employee for at least one year. Helpfully, this reform drops the requirement for there to be a 5% minimum shareholding to qualify for entrepreneurs' relief. This reform may assist members of management teams who are not able to meet the 5% shareholding necessary to qualify for entrepreneurs' relief. However the reform is not a panacea. This is because not every private equity backed company will qualify for EMI status. For example, the investor's control rights, the size of the investee company's balance sheet and the size of its workforce might block EMI status. Nonetheless, this could be an effective planning tool given the right circumstances.

As the Chancellor mentioned in his statement, the Finance Bill 2014 will introduce a new capital gains tax relief on the sale of a controlling interest of a business into an employee ownership structure. No further details were provided in the Budget documentation, making this an interesting proposal that is certainly worth monitoring.

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