Tax aspects of break fees

Madeline Gowlett
Travers Smith
Madeline Gowlett is a senior associate at Travers Smith LLP. She specialises in advising large and mid size corporates on tax structuring, M&A and ongoing tax advisory work. Email: madeline.gowlett@traverssmith.com; tel: 020 7295 3411.

When are break fees appropriate in the context of M&A transactions? And what are the tax consequences of such fees for both parties?

When UK private companies are bought and sold, it is common for buyers and sellers to enter into exclusivity agreements at a stage in the process when an outline commercial agreement has been reached. These agreements will typically prevent the sellers from engaging with alternative buyers for a given period of time (and may impose financial penalties such as break fees if they are breached), such that the buyer can incur the material costs associated with bringing a deal to a close without fear of being gazumped.

This approach is not possible in the context of a UK public company takeover, where even after a target's board has decided in principle to recommend a bid to shareholders, the buyer remains vulnerable to a higher bid from another party. In particular, the selling shareholders are not involved in the discussions with the potential buyer, nor are they a party to any contractual relationships in relation to the potential sale. In this scenario, the buyer is effectively negotiating with the target's board, not the selling shareholders, and all parties are constrained by the rules of the Takeover Code.

In the context of a UK public company takeover ... it is common for a buyer to seek a break fee arrangement with its target

A sale and purchase agreement will not be negotiated, or even possible to create, in a public company bid scenario, as compared to a private sale; however, a buyer with which the target is cooperating will still expect to incur very significant costs in the bid process, particularly in relation to due diligence on the target. It is therefore common for a buyer to seek a break fee arrangement with its target (as it has no contractual relationship with the sellers). This will typically provide for the target to make a payment to the buyer in the event that the buyer is outbid, or if the target board fail to recommend the buyer's bid to shareholders for any other reason.

In the public company context, all parties will need to consider the criminal prohibition on companies giving financial assistance in the acquisition of their own shares. Generally, it is possible to form the view that break fees of the type described above do not contravene the financial assistance rules, but this point should always be considered where one is proposed. These rules only apply to assistance given by PLCs, and so they will usually not be in point on a private company sale.

In the event that break fees are paid, there are both direct and indirect tax consequences for the parties.

VAT

The key question in relation to the VAT treatment of a break fee is whether it is consideration for a supply of services by the failed buyer; for example, the supply of engaging in discussions in relation to the possible takeover of the UK target. In a public company context, the corporate law advisers may be keen to steer the drafting of the break fee agreement in this direction, as the financial assistance analysis is eased if it can be shown that the target is paying for something when it settles its obligation to pay the break fee. However, if that is the analysis, the break fee will attract VAT (whether in the usual way or via the reverse charge mechanism if the failed buyer is offshore).

If VAT arises on the fee, the issue of recoverability by the target inevitably follows. Where the break fee is being paid by the selling shareholders of a private company, it should be assumed that it will be irrecoverable. Notwithstanding the developing European case law on the VAT treatment of the holdings of shares, one would expect HMRC's position to be that the fee was directly attributable to the (exempt) sale of shares to the new buyer, and hence irrecoverable.

The key question in relation to the VAT treatment of a break fee is whether it is consideration for a supply of services by the failed buyer

If the break fee is being paid by the target, then in the public company context it might be possible to argue that the fee can be treated as a general expense of the company's business, and so recoverable to the extent that business comprises the making of taxable supplies. The argument would be that the company obtained its listing to better access the capital markets and so benefit its business; and that amongst the consequences of listing is the need to deal with takeover approaches as the board sees fit. Accordingly, the fee is attributable to the business.

I would, however, expect HMRC to resist this argument strongly, on the basis that the fee is in reality a cost incurred for the benefit of the shareholders (in that undertaking the contingent obligation to pay it facilitated the making of a bid) with insufficient connection to the target's business to found the entitlement to recover. It is hard to see the fee as truly part of the company's cost base in the carrying on of its business of making taxable supplies.

Happily, the question of recoverability does not generally arise. In most cases, it is possible to conclude that the fee does not attract VAT in the first place, on the basis that it is in the nature of a compensation payment and so is outside the scope of VAT. The absence of clarity on the point is unsatisfactory though, and it would be helpful if HMRC were to express a view (although perhaps not if its view was that break fees attract VAT which is irrecoverable). To reflect this uncertainty, language is commonly included in public company break fee agreements which has the effect that if the agreed fee turns out to be subject to VAT, the total cost to the target is not increased but the total cost to the bidder is also mitigated. For

example, if the break fee was expected to be £100k on the assumption that no VAT was payable, and it transpires that VAT is payable, then the wording will ensure that the amount of the payment is adjusted such that the target pays an amount which, net of any recoverable VAT, is also £100k.

Direct tax

Where the target company pays the break fee, it should be assumed to be non-deductible for corporation tax purposes. This is for two reasons. Firstly, it is rather likelier to be seen as capital expenditure than a revenue cost, in which case it is hard to see how the target could be regarded as having any asset of which the fee could form part of the base cost. Secondly, assuming one can clear the considerable analytical hurdle of the first point, establishing that the break fee was wholly and exclusively incurred for the purposes of the target's trade (or business of making and managing investments) is likely to be impossible. Accordingly, no relief of any kind would arise in respect of its payment.

> Where the target company pays the break fee, it should be assumed to be non-deductible

Where the fee is paid by selling shareholders, and where it is incurred following a completed sale to a different buyer, it may be possible for them to argue that it is expenditure incidental to the costs of that disposal, such that it may form part of their base cost in the shares being sold under TCGA 1992 s 38(1)(c). My view is that such an argument would have a reasonable chance of success (and that the selling shareholders would generally have a filing position on this basis). However, there is no authority on the specific point, probably because it is in practice exceptionally unusual for such a fee ever to be paid in the private company context.

If the recipient of the fee is UK resident, it is likely to be taxed on it. Even where it is expressed to be compensatory, the principle in *Zim Properties* [1985] STC 90 ought to apply such that the payment is treated as consideration for the disposal of a capital asset, namely the contingent right to payment. ■

Recent highlights from Ask an expert


Offshore gains: Jonathan Shankland and Celia Speller (RadcliffesLeBrasseur) consider the impact of the new rules.

Cost sharing and the public sector: Rowena Clifton (RSM) explains whether it's worth setting up a VAT cost sharing group for public bodies that wish to share services amongst themselves.

Trade associations and mutual trades: Jackie Wheaton (Moore Stephens) explains tax differences.

Short term business visitors: Karen McGrory (BDO) answers a query on the tax issues facing large multinationals when its employees travel internationally within the group.

VAT and TOGCs: Kevin Hall (Gabelle) answers whether VAT is chargeable on the sale of assets in a business held among several companies within a large group.

Gender pay gap reporting: Liz Hunter (Mazars) explains the impact on share plan awards.


Hybrids and disregarded UK subsidiaries: Nick Thornton and Will Gay (Fried, Frank, Harris, Shriver & Jacobson) consider a question relating to the new hybrid mismatch regime.

'Ta Taar': How to exit shareholders of a property company in a tax-efficient manner, by Anthony Newgrosh (BKL).


Value chains: When is a value chain analysis worth doing, and how to do it, by Paul Daly and Malcolm Joy (BDO).

When can HMRC withhold VAT repayments? Ian Brown (RSM UK) explains whether HMRC can withhold part-payment of a repayment VAT return.

Waiver of inter-company debt between group companies: Peter Rayney (Peter Rayney Tax Consulting) provides practical advice.

The taxation of profits on cryptocurrencies: Robert Langston (Saffery Champness) explains.

Rebasing and unmixing: Matthew Shayle (Burges Salmon) provides guidance on how a non-domiciled UK resident can use the new rules to bring offshore funds into the UK.

SDLT: Solicitor Ann L Humphrey answers a query on the rate of stamp duty payable on various linked property transactions.

To view the above and more, see ***taxjournal.com/askanexpert.***