

DE-RISK AND CARRY ON - CREATING A CAPITAL RETURN THROUGH MANAGEMENT SUCCESSION

The JDC Practical Solutions series



JDC Corporate Finance



HELLO



ISSUE OPPORTUNITY SOLUTION

JON DODGE FCA CF - FOUNDER

TONY LONGMAN CTA - DIRECTOR OF TAX

About JDC Corporate Finance

JDC is a leading independent corporate finance and advisory firm, with an impressive reputation as experts in our field, providing transaction and related corporate advisory and tax planning services to owner managed businesses.

Our team combines a wealth of corporate finance, corporate advisory and taxation experience, offering our clients a range of services to suit their needs and the needs of their company at all stages of its evolution and development.

We are instructed as advisers for both sell-side and buy-side clients in corporate transactions, including outright and partial disposals to trade and private equity purchasers; acquisition mandates to achieve growth objectives; MBOs/MBIs and minority shareholder exits.

We are also specialist advisers in succession solutions and related planning matters and by offering a tailored approach and working with clients for the long term, we remain the retained advisers of choice to many growing and enterprising businesses.

Our specialist skills, experience and ability to deliver integrated advice in a clear, concise, hands-on and cost-effective manner are the primary differentiators that set us apart from the competition.

About the Practical Solutions series

In this series of guides, Jon Dodge and Tony Longman have reflected on the tax aspects of certain key issues that they have, in their combined professional experience of over 50 years, encountered again and again and know to be of particular concern to owner managers.

This series (by reference to tax legislation current at May 2016) focuses on capital value extraction (with or without a 'third party' sale) from a privately owned business; key planning considerations in securing Entrepreneurs' Relief; issues that might arise on the departure from a business of a retiring or dissenting shareholder; the attraction, retention and reward of key people in a tax effective way and inheritance tax planning in relation to the value of a privately owned company.

We hope that the series will be of value to you and would be delighted to discuss any of the issues raised with you in more detail, on an entirely confidential and no obligation basis.

For many business owners, when the time comes to realise the capital value of their years of hard work a trade sale is often the first choice. But what about those situations where a trade sale is either not achievable or not appropriate or where the desire of the owner to continue in business remains as strong as ever?

Capital value can often still be released in such cases using a structured succession plan engineered through and with the assistance of a management team, offering a very attractive solution for all stakeholders.

In our experience many business owners have never had explained to them the various mechanisms that can be employed to achieve a full or partial exit from their business for a capital sum, an ongoing annuity and a continuing equity participation whilst also securing significant tax advantages, in particular accessing capital gains tax rates of 10% in respect of the funds that they extract.

For many owners, the concept of 'de-risking' their investment, retaining future 'upside' opportunities, securing a meaningful succession plan and retaining a strong element of influence over the business is a very attractive option.

JDC Corporate Finance is a specialist East Anglian based corporate advisory and transaction practice with particular expertise in designing and implementing tax effective strategic plans for businesses and balancing these plans with the personal objectives of the shareholders.

In this guide we have summarised some of the typical characteristics of a tax effective management succession structure and would be delighted to discuss these with you in more detail if the circumstances we have described have engaged your interest.

CREATING A CAPITAL RETURN THROUGH MANAGEMENT SUCCESSION: THE TECHNICAL ANALYSIS

The Potential Structure

A controlling shareholder's interest in their company ("Tradeco") is sold to a new company ("Newco") which is majority owned by the management team.

Newco can effectively borrow money secured on the assets of Tradeco and/or use any surplus cash in Tradeco to fund the purchase of shares. In addition, the purchase consideration can include deferred consideration, either fixed at the time of sale or based on future trading profits - an "earn out".

The consideration can include an issue of Newco shares to the controlling shareholders of Tradeco to enable a continuing interest to be held (the maximum Newco holding is likely to be dictated by tax considerations).

The structure is flexible as to whether value is left in Newco or the full value of Tradeco is extracted.

It is usual for the management shareholders to pay something for their Newco shares to incentivise and motivate them. If funds are not available from management, it is possible to issue shares with an 'unpaid call', or make a company loan to management, which creates a legally enforceable debt owed to Newco.

Future Control

Most controlling shareholders worry about the loss of control, but significant protections are available.

Deferred consideration can be structured as "loan notes" to give enhanced protection such that if Newco fails to pay any deferred consideration when it falls due, penalty provisions can apply to give back control.

A shareholders agreement can provide various continuing protections including:

- a provision that if Newco is subsequently sold all deferred consideration is payable in full at that time.*
- a list of excepted matters that require agreement by the former Tradeco shareholders, typically including a block on dividend payments until all deferred consideration is paid out, a cap on salary and benefits paid to the new management team and a block on significant items of company expenditure.*
- "Drag and tag" rights to protect shareholders in the event of a sale of shares in Newco.*
- Pre-emption rights to ensure control over the transfer or sale of any Newco shares.*

The Tax Analysis

The existing controlling shareholder(s) in Tradeco must lose control of Newco.

The deferred consideration is payable in the form of a particular type of "loan note". Tax is not payable until the loan note is redeemed.

The existing Tradeco shareholders must have a continuing shareholding in Newco to qualify for Entrepreneurs' Relief on any deferred consideration (the tax legislation imposes a minimum 5% test for voting rights and nominal value but no requirements as to economic value so there is a great deal of flexibility).

Statutory tax clearances are available to give a high level of certainty as to the tax treatment but there is some unpredictability as to whether clearance will be given where the controlling shareholders wish to retain a shareholding in Newco above 40%. There is usually no difficulty in obtaining tax clearance where the shareholding falls below 40%.

The Tax Result

Providing the existing Tradeco shareholding qualifies for Entrepreneurs' Relief it is possible to achieve a 10% tax rate on both the upfront consideration and any deferred consideration.

In addition, the Newco shares issued to the existing business owners are not treated as taxable consideration and should also qualify for Entrepreneurs' Relief on any future sale of Newco.

With the appropriate structure no tax charges fall on the management shareholders at the time of the transaction.

It is possible to ensure that any future sale of Newco shares by the management shareholders will qualify for Entrepreneurs' Relief to achieve a 10% tax rate on a subsequent sale.

Stamp duty of 0.5% is payable on the value of Tradeco although there are planning opportunities to mitigate this liability.

Interested? Please call or email us to find out more.

OUR SPECIALIST SERVICES

Acquisitions

Whether a first time purchaser, a serial acquirer or an MBO/MBI team, we have the knowledge and experience to assist in all aspects of the acquisition process including:

target searches • target appraisal • valuations • funding • due diligence • negotiation • deal structuring • integration strategy.

Business Growth

Through our business growth services we provide external advice or hands-on interim management support to a wide range of clients. Our services include:

business plans • financial projections • refinancing • tailored MI • non-exec services • cash flow management • development strategy • turnaround.

Disposals

We specialise in advising on full, partial or structured exits, retirement sales, divestments and equity release. Our services include:

pre-sale advice and preparation • information memoranda • contacting targets • negotiating and structuring the deal • advising on post deal issues • accelerated M&A.

Reorganisations

The restructuring of a company or a group of companies involves financial, structural, strategic and tax based considerations. We are specialists in:

financial restructuring and refinancing • de-mergers • divestments • succession planning • capital extraction including company purchase of own shares.

Private Equity

We are very well connected to many private equity and venture capital funds and focus on matching the best placed investor to the right deal. We can help with:

pre-investment preparation • deliverable deal structures and IRR models • investor profiling • business plans and sensitised financial models • leading management presentations • negotiating the deal • project management • advising on post deal issues.

Specialist Tax

Understanding the tax planning opportunities and avoiding tax traps and pitfalls is at the core of all our planning work. We are specialists in:

all aspects of transaction tax • corporate reconstruction • share option arrangements • investment and reinvestment relief • tax effective income extraction • tax effective capital extraction • inheritance tax planning • specialist tax clearances.

CONTACT US

Talk directly with any of our senior team:



Jon Dodge FCA CF MEWI
m: 07775 696809
e: jd@jdc-corpfin.co.uk



Tony Longman CTA
m: 07342 887680
e: tl@jdc-corpfin.co.uk



Dave Howes ACA MBA
m: 07500 858143
e: dh@jdc-corpfin.co.uk



Chris Adlam FCCA
m: 07786 166927
e: ca@jdc-corpfin.co.uk



Main Office

Dencora Court
2 Meridian Way
Norwich
NR7 0TA

Also at

3 Gray's Inn Square
London
WC1R 5AH

Contact

T: 01603 703177
E: info@jdc-corpfin.co.uk
www.jdccorporatefinance.co.uk