HERBERT SMITH FREEHILLS

Destination United Kingdom

Why the UK is a popular destination for inverting US companies – and what US companies need to know.

The UK remains the leading destination for in-bound European M&A and has seen significant levels of M&A activity over the last two years, being a regime open to foreign investment and attractive as a destination for multinational companies for a combination of tax and other reasons (see chart opposite).

This last factor has been decisive in making the UK a key destination for US companies seeking to invert, regardless of the jurisdiction of incorporation of the target. An analysis of inversion transactions completed in 2015 or currently pending reveals the UK to be the destination of choice in more inversion transactions than any other nation, and approximately half of all inversion transactions, including some transactions in which neither party was originally UK incorporated or tax resident. Prominent recent examples of proposed inversions that would result in a UK tax resident topco include the Steris/Synergy Health merger and Monsanto's approach to Syngenta.

This article explores the benefits of inverting into a UK company and/or incorporating a UK Topco as the parent for the merged group, and notes some UK-specific considerations that are relevant to the structuring of any inversion transaction.

BENEFITS OF UK TAX RESIDENCY

"The benefits derived from the UK tax regime... can result in significant tax synergies for the merged group"

The principal benefits of using a UK Topco are derived from the UK tax regime, and these can result in significant tax synergies for the merged group. A UK-incorporated company will be UK tax resident unless it is deemed to be resident in another state with which the UK has a double tax treaty which affords taxing rights to that other state (which in many cases may occur if the company is managed and controlled from that other state as opposed to the UK). Alternatively, a non-UK incorporated company may be, which it can be irrespective of where it is incorporated. In order to be tax resident in the UK, if a company must have its place of central management and control is exercised in the UK. The concept of "central management and control" is not further defined in legislation and is instead governed by caselaw, but merging companies would therefore be well advised to ensure that, in particular where a non-UK incorporated company is to be used, at the very minimum, a majority of Topco's board meetings are held in the UK and that board meetings are not regularly held, nor board business regularly transacted, in any other country. In addition, other factors that may be helpful would in establishing UK tax residency include maintaining a headquarters in the UK (not merely a nameplate) and carrying out certain administrative functions e.g. company secretarial and board administration activities, in the UK to the extent possible. (Some other concerns regarding the place of incorporation are addressed later in this article.)

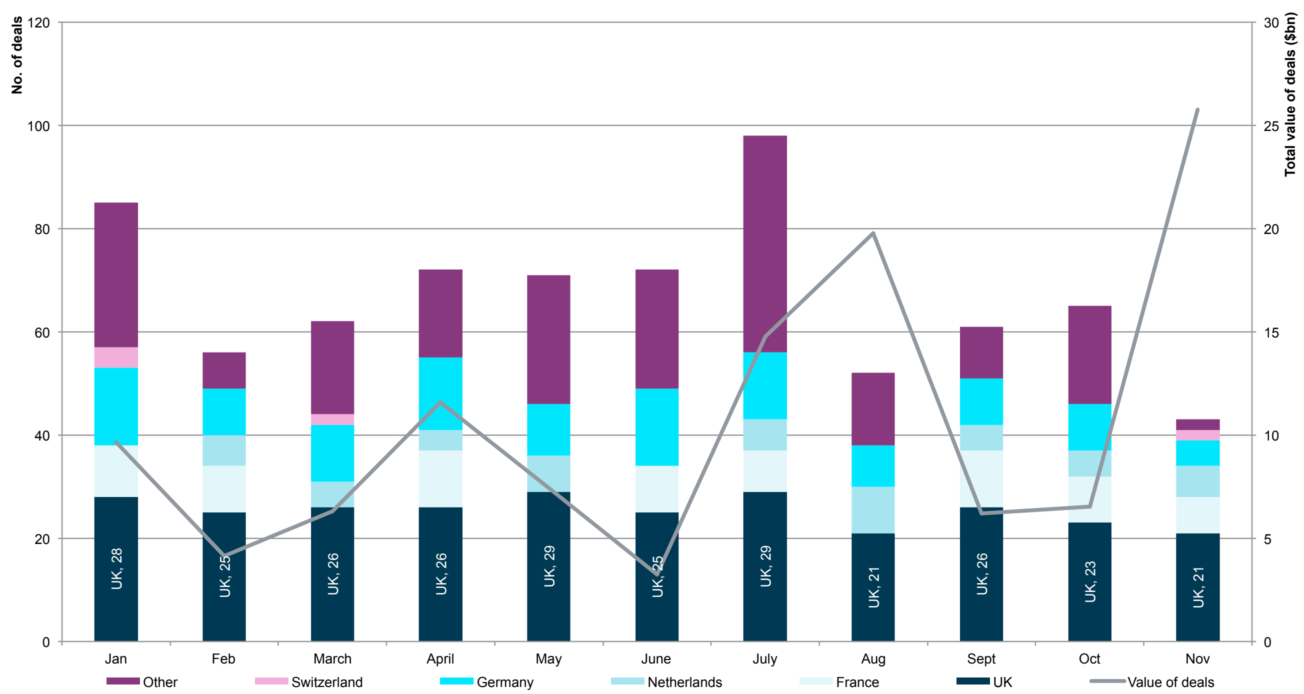
The benefits of UK tax residence include a comparatively low level of corporation tax (currently 20%, and scheduled to reduce to 18% by 2017, compared to 35% in the United States of America), no withholding tax on distributions (whether made intra-group or to shareholders), a controlled foreign company regime that is much more benign than the US regime, and an exemption for dividends which allows the repatriation of profits in overseas subsidiaries without further taxation, as well as a wide range of tax treaties with other jurisdictions. These benefits are particularly attractive to companies with significant international operations.

The US Government has taken a number of steps to seek to reduce the tax benefits from inversions and to deter US companies from seeking to invert. Most recently, in November 2015, the US Treasury issued a notice to the effect that stock of the foreign parent issued to foreign target shareholders will be treated as "disqualified stock" if the foreign parent is located in a third country (i.e., a country other than the country of foreign target). This will have the effect of limiting the circumstances in which the parties to an inversion will be able to elect to have a UK tax resident holdco. However, this rule will not affect inversion transactions which result in shareholders in the foreign parent holding more than 40% of the stock in the merged group, or in transactions that do not involve the creation of a new holdco in a jurisdiction other than that in which the "target" is based; so it would not, for example, impact an inversion executed by way of a takeover by a UK company of a US company, or a transaction between a UK and a US company which involves the imposition of a new UK topco.

OTHER UK CONSIDERATIONS

The extent to which UK law and regulation is relevant to the transaction will depend on a number of factors, including principally whether the transaction involves an acquisition of company to which the UK Takeover Code applies. This will not necessarily be the case; it is possible for the tax benefits of an inversion to be obtained by a UK target acquiring a US company (typically by way of a US law governed merger of the US company into a US mergersub owned by the UK company). Such

US M&A DEALS TARGETING EUROPE – 1 JAN – 30 NOV 2015, BY TARGET COUNTRY



Data based on US acquirer and European target

Source: Thomson Reuters, Dec 2015

a transaction would fall outside the UK Takeover Code. However, if a new Topco is introduced into the structure and an existing UK incorporated/UK listed company (or certain other companies to which the UK Takeover Code applies) is acquired, the transaction will be governed by the UK Takeover Code.

This has a number of significant consequences, including:

- any leak of the transaction or announcement by either party of a possible offer will trigger a 28 day "put up or shut up" period, by the end of which the parties must either announce a firm intention to proceed with the transaction or that they intend not to so proceed, which then then prohibits a further proposal, or significant further steps towards making another proposal, for six months, subject to certain exceptions. This 28-day period can be extended with the consent of the Takeover Panel, at the request of the UK company;
- the Takeover Code prohibits most forms of deal protection, including those very common in US mergers, such as break fees, matching rights, and non-solicitation clauses. This makes it much harder for the parties to lock in a transaction;
- any information shared by the UK company with the US company in diligence, and any access granted to the UK company's management, must also be shared with or granted to any other bona fide potential offeror;
- any profit forecasts or quantified merger benefits statements (e.g. synergies statements) are subject to specific disclosure and reporting requirements; usually a report from independent accountants is required. The interaction between these disclosure rules and US disclosure requirements is complex and requires very careful navigation; and
- depending on the transaction structure used in the UK, it may be necessary to pre-agree with the UK Takeover Panel any regulatory pre-conditions to the launch of the transaction.

Depending on the structure adopted, other UK regulations including the Listing Rules and the Prospectus Rules may be relevant to the transaction. For example, if the UK company is to acquire the US company, then the transaction may be a "class 1 acquisition" or a "reverse takeover" for the purposes of the UK Listing Rules. Such a transaction requires shareholder approval and the publication of shareholder circular conforming to certain disclosure requirements. If the transaction is a reverse takeover and there is a desire to retain the existing UK listing a prospectus will be required, again conforming to certain disclosure requirements. In addition, any leak or announcement of a possible reverse takeover can trigger the suspension of the UK company's shares, unless certain conditions are met.

In addition to these transaction-specific issues, the choice of a UK incorporated Topco has ongoing consequences that should be considered as part of transaction structuring. Of particular interest to US companies is the application of UK "say on pay" rules, which, being a matter principally of company law, apply to UK incorporated companies with shares traded on a broad range of international capital markets, including NYSE and Nasdaq. These rules require such companies to submit a remuneration policy to a binding vote of shareholders at least every three years, and not to make any payments or provide other benefits to directors except in accordance with the relevant policy.

A UK incorporated Topco will also be required to report in IFRS, irrespective of any other reporting requirements in the jurisdictions in which it is listed; this may result in a requirement to produce both IFRS and US GAAP accounts.

The location of incorporation of the Topco may also be relevant to eligibility for index inclusion in different markets. For example, for FTSE index inclusion the eligibly requirements are more relaxed for UK incorporated companies (e.g. a 25% free float requirement, as opposed to 50% for foreign issuers), whereas having a UK incorporated Topco may make it more challenging to meet the requirements for eligibility as a "US company" for the purposes of the S&P 500, though there are three UK companies that have succeeded in doing so.

It should also be noted that transactions in the shares of UK companies attract a SDRT charge of 0.5%, although in practice US holders often escape that charge by virtue of holding their interest through ADRs or through the DTC system. However, careful planning is required to avoid a 1.5% so-called "season ticket" charge on depositing shares into such depositary arrangements.

Finally, the English company law regime is not as permissive as certain other company law regimes, including in particular Jersey.

If these issues are thought to be significant in any particular case, one option would be to incorporate the Topco outside the UK whilst retaining UK tax residency. This could, for example, involve the establishment of a Jersey-, Swiss- or Dutch- incorporated, UK tax resident Topco to acquire both the US company and foreign counterpart. As noted above, the recent US Treasury notice will restrict the availability of such a structure in some, but not all circumstances. Clearly, any decision to split the jurisdiction of incorporation from the tax residency requires a very careful weighing of the relative benefits and disadvantages.

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LOOKING AHEAD

The raft of inversions of US companies into merged groups headed by a UK Topco is part of a broader trend of corporate redomiciliations, often influenced by perceived tax advantages, including companies migrating to the UK ahead of listing English shares directly on NYSE or Nasdaq. It remains to be seen the extent to which US Government attempts to stem the flow of US companies to Europe, and the UK in particular, through tightened regulation will be successful, or indeed whether multilateral efforts such as the BEPS project reduce the incentives for companies to migrate more generally. It should be noted that only days after the US Treasury published its most recent notice, Pfizer announced a proposed merger with Irish pharmaceutical company Allergan, in what would be the largest inversion by value to date. That transaction is proposed to be structured as an acquisition by Allergan of Pfizer, resulting in an Irish Topco; a structure that is not affected by the recent Treasury notice.

The UK looks likely to remain an attractive market for corporate activity for the foreseeable future. Crucially, there appear to be no imminent plans to broaden the range of circumstances in which the Government may intervene to block a proposed merger. Since the Enterprise Act 2002 was introduced the Government's power to veto deals has been largely limited to circumstances in which there are anti-trust concerns and certain other very limited grounds e.g. national security. Despite calls for the introduction of a new "national interest" test in the wake of the controversial Kraft/Cadbury takeover and support from senior politicians, including the former Secretary of State for Business from 2010-2015, there is no sign of such a law being implemented in the near-term, nor is the any evidence of significant protectionist sentiment amongst shareholders; the UK remains open for business. ■

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