SLAUGHTER AND MAY

Taxing joint ventures

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Joint ventures are an increasingly popular means of achieving commercial goals: they are used, for example, to pool businesses' technology (e.g. the Galvani Bioelectronics JV between Alphabet and GSK), as a means of creating scale and synergies while giving both parties an ongoing stake in the upside (e.g., EE before its sale to BT), or simply to create a consortium of investors to purchase an asset.

Whilst JVs can take many forms (including partnerships and contractual collaborations), corporate JVs, often the preferred structure for long-term JVs, are the focus of this article. Their tax issues can be split between JV formation, operation and termination.

Formation

When establishing a JV, groups normally pool resources but receive no cash in return. Achieving tax neutrality is thus important to ensure a JV partner does not face a tax liability with no cash to settle the bill - but this can be difficult when ownership thresholds for tax-neutral intra-group transfers are, typically, set at a level which means they cannot be used to form JVs.

Corporation tax

The relief for "mergers" in TCGA 1992, s. 181 ("s. 181") and the intangibles equivalent (CTA 2009, s.789) can, however, help JV partners to achieve a CT neutral contribution of capital assets and intangibles held by UK companies.

A typical structure relying on s. 181 could involve:

- first, identifying a UK company (the "assembly company") in the same group as the existing UK owners that can be contributed to the JV;
- secondly, transferring the relevant assets from the existing UK owners into the assembly company on a no gain, no loss basis under TCGA 1992, s. 171; and
- thirdly, transferring the assembly company to the JV company in return for the issue of shares.

By using this structure, degrouping charges under TCGA 1992, s. 179 can be switched off, provided that:

- the degrouping occurs as part of a "merger" (see below); and
- the merger is carried out for bona fide commercial reasons and avoidance of liability to tax is not a main purpose.

Broadly speaking, the formation of a JV between two groups will constitute a "merger" for a JV shareholder if the value that shareholder *receives* (in the form of a share in the other JV partner's business) is the same as the value that shareholder *gives up* (to the other JV partner) in the business it contributes to the JV; and, subject to a de minimis rule, the only value that that shareholder receives is its shareholding (of ordinary share capital) in the JV company.

In a scenario where the JV is negotiated between independent third parties (and neither party receives any benefit from the transaction other than its JV stake), the "same value" requirement should not be problematic. In this scenario, it is not necessary to get a third party valuation to support this; the commercially negotiated result

between third parties should serve as evidence that the same value requirement is met.

Section 181 does, however, have several traps to watch out for:

1. No equivalent to s. 181 for loan relationships or derivative contracts.

2. Assets must be transferred to the assembly company whilst it is still a member of the same chargeable gains group as the transferors. Any transfers after the agreement to form the JV has become unconditional are unlikely to qualify.

3. Exit rights for a JV partner should be carefully scrutinised to ensure each shareholder is acquiring its interest in the JV "other than with a view to their disposal".

4. Cash contributed to the JV as a "dowry" to meet short term working capital requirements of the JV will probably not breach the conditions in s. 181. Cash contributed to the JV for distribution to a shareholder is, however, generally problematic (see paragraph CG45464 of HMRC's Capital Gains Manual).

Whilst, historically, the default position was to seek clearance from HMRC that s.181 applies, HMRC have recently changed their practice such that clearances will now only be given in cases where there is "genuine uncertainty" as to the position.

Transfer taxes

There is no specific relief from SDLT or stamp duty for forming a JV.

In many cases where land is transferred to the assembly company, clawback of any resulting SDLT group relief will simply be a cost of forming the JV. Where the value of land is significant, one solution could be to put the landowning company into the JV, after hiving out non-JV assets - so that there is no SDLT group relief to claw back.

Stamp duty on contributing a UK incorporated assembly company can similarly be an inevitable cost of doing the deal, although there are three options that might help:

- "swamping" (i.e., transferring the assembly company shares themselves in return for a small proportion of the JV's ordinary share capital), but this can be perceived as aggressive.

- relief under FA 1986, s. 77, but take care to satisfy the mirror register requirement and fall within the "relevant merger arrangements" exclusion to FA 1986, s. 77A (broadly, a tougher version of the s. 181 conditions discussed above).

- relief under FA 1930, s. 42, but this is useful only if just one party to the JV needs to contribute UK shares, that party can incorporate the JV vehicle within its group, and the agreement to form the JV is subject to an outstanding genuine third party condition when the UK shares are transferred to the JV vehicle.

Operation

Most of the tax issues that can arise during the life of the JV will be the same as those that arise for other businesses. Tax issues relating to the relationship with the JV shareholders will, however, generally need to be addressed upfront in the shareholders' agreement between the JV partners (the "SHA").

1. *Consortium relief* - Where none of the JV shareholders has a 75% interest in the JV, the shareholders will want to ensure that the JV structure permits the surrender of consortium relief into (and out of) the JV. One critical point to watch out for here is that the JV company itself must be a trading company or a holding company. A company qualifies as a holding company only if its business consists wholly or mainly in holding shares in (direct) 90% subsidiaries which are themselves trading companies. This means that, to protect the consortium relief position, the JV group structure must be flat underneath the JV company. Intermediate holding companies can potentially (and unjustifiably) block such surrenders.

The SHA typically governs the basis on which the JV will pay (or be paid) for surrenders of consortium relief – and the price paid will, of course, be a commercial matter (reflecting, in particular, the usefulness of the losses if they are not surrendered into/out of the JV).

2. *Transfer pricing* - Although transactions between the JV and its shareholders are generally on arm's length terms for commercial reasons, most SHAs include a clause setting out what happens if there is a transfer pricing adjustment. This usually requires the party which pays more tax as a result of the non-arm's length provision to claim any available compensating adjustments and, broadly speaking, to pay to the other party the amount of any resulting tax benefit. Businesses establishing JVs should also note that HMRC will seek to use pricing with the JV as a comparable for similar activities which remain intra-group. Where JV pricing differs from a group's normal TP policy, the group's TP team will obviously want to explore any functional differences which could explain the apparent disparity.

3. *Tax planning by the JV* – Non-controlling JV shareholders will often want to limit the JV's power to carry out tax planning. Should, for instance, the JV shareholders agree a JV tax strategy, deviation from which requires unanimous consent?

4. *Hybrid mismatches* - The hybrid mismatch legislation in TIOPA 2010, Part 6A has created additional tax issues to consider upfront. As this legislation is new, no market-standard approach for JVs has yet developed.

If there is a hybrid disallowance on shareholder debt into the JV because of the characteristics of the lender, should the SHA shift the tax cost onto the relevant shareholder? What protection (if any) should be given to the JV by the shareholders to provide assurance that the JV is not importing a hybrid mismatch into the UK through shareholder debt?

5. *Corporate interest restriction* - We would expect to see protection in the SHA to ensure the JV company is compensated if it (or a subsidiary) is allocated or otherwise suffers an interest disallowance as a result of being a subsidiary of one of the JV shareholders. Where, however, a JV is not part of any JV partner's "worldwide group", it will want to consider whether to file a group ratio (blended) election to piggyback off the JV investors' group interest: EBITDA ratios. Similarly, non-controlling JV shareholders may wish to file an interest allowance (non-consolidated investment) election, which broadly allows them to "look through" the investment to their share of the JV's underlying activities in calculating EBITDA and interest expenses.

Termination

Typically, exit mechanisms for one, or both, JV partners are determined at the outset and documented in the SHA. Commercial circumstances will, of course, dictate those exit mechanisms, but tax advisers must ensure that they can be undertaken efficiently.

Buy out or redemption?

Where the exit mechanism relies on one shareholder buying the other out, the resulting stamp duty charge can often be mitigated if the exiting partner's shareholding is redeemed by the JV company, rather than purchased by the remaining shareholder. Redemptions come with complications, however. In particular, a (future) stamp duty saving on termination can come at a (current) consortium relief cost, as pre-agreed exit mechanisms can result in disqualifying "arrangements" existing which prevent the surrender of consortium relief. And, although exit mechanisms involving the "transfer" of shares in the JV company generally come within the safe harbour rules in CTA 2010, s. 155A, these do not apply to an exit mechanism which envisages redemption.

Demerger of the JV company

If a demerger of the JV is envisaged, consideration should be given to the mechanics needed to ensure this can take place as an exempt distribution demerger within CTA 2010, Part 23, Chapter 5: can the JV temporarily become a 75% subsidiary of the demerging JV partner, for instance?

The "arrangements" problem

Finally, the "arrangements" provisions (which deny consortium relief where arrangements exist under which the JV company could become a member of a group relief group) can create unjustified difficulties if there is a gap between the agreement to unwind and completion of that unwind. This can clearly be seen in The Felixstowe Dock and Railway Company Limited v HMRC [2011] UKFTT 838. In that case, the JV shareholder buying out the other partners was able to claim/surrender consortium relief before agreeing the buyout. After completion, it could of course benefit from group relief. In the interim period, however, it could benefit from neither. It is unfortunate that this has not yet been rectified through legislation; until it is fixed, partners should obviously aim to complete any JV unwind as quickly as possible.

Conclusions

Whilst many of the tax issues discussed above will not arise until the JV is in operation or unwound, they should often be addressed in the SHA when putting the JV together. As ever, prior planning (hopefully!) prevents poor performance.

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