

Tax and Legal Considerations for Global Tender Offers

Private company tender offers and similar programs are becoming ever more prevalent in recent years as a means of providing liquidity to service providers for their equity awards and/or shares without the company entering the public markets.

This article is intended to serve as a high-level guide to help privately-held companies evaluate the variety of tax and legal considerations that apply when launching a global tender offer. In this article, the term “global tender offer” refers to an offer made by the issuing company itself or by a third party (but usually facilitated by the issuing company) to purchase shares held by current or former service providers both in the U.S. and outside the U.S. As such, this article addresses both U.S. and non-U.S. tax and legal issues that can arise for private companies during tender offers.

This article has been structured in a FAQ format, with brief questions and commentary to address the most prevalent issues we see when U.S. private companies launch global tender offers. This article does not address considerations applicable to tender offers by publicly-traded companies. Also, this article is intended only to help private companies identify issues that may apply to their circumstances and should not be read as a substitute for specific tax or legal advice.

QUESTION

What type of awards and/or shares are typically eligible under a global tender offer?

COMMENTARY

Previously Acquired Shares: In most cases, eligible holders are able to offer shares they have previously acquired pursuant to an equity award (typically upon exercise of an option) in the global tender offer. If transfer restrictions apply to the shares, the company will need to (temporarily) lift such restrictions to allow the shares to be sold in the tender offer.

Stock Options: Additionally, many companies allow holders of vested options to participate in the tender offer. Vested options can be included in a tender offer through two methods:

- 1. Contingent exercise:** the option holder indicates an intent to exercise the option (contingent on the closing of the tender offer) and to immediately tender all shares acquired at exercise, with the exercise price and applicable withholding taxes (and any fees) deducted from the sale proceeds.
- 2. Cancellation/cash-out:** the tendered options are cancelled (and the underlying shares returned to the company) in exchange for a cash payment (typically based on the difference between the value of the shares and the exercise price).

These two methods can result in different tax treatment because a contingent exercise results (at least for a theoretical moment) in the

issuance of shares subject to the option while a cancellation/cash-out does not. In the U.S., a contingent exercise can result in a modification and potentially also a disqualification of incentive stock options (ISOs), to the extent such an exercise method was not provided for under the original option terms (and even if a disqualification does not occur, a disqualifying disposition will occur). A cancellation/cash-out of ISOs will always result in a disqualification.

Outside the U.S., one example of different tax treatment between a contingent exercise and a cancellation/cash-out is that, in Italy, the contingent exercise will avoid social taxes being due on the option income, while social taxes are due in the case of a cancellation/cash-out.

Restricted Stock Units: More recently, some companies have chosen to allow holders of time-vested restricted stock units (RSUs) to participate in global tender offers. This raises many complex issues, especially for companies with RSU holders who are U.S. taxpayers.

Most U.S. private companies grant RSUs with “double-trigger” vesting conditions, meaning that the RSUs vest and settle only after both a service-based time-vesting condition has been satisfied and a liquidity event (e.g., an IPO or company sale event) has occurred. In order for RSU holders to participate in a tender offer, the liquidity event condition typically must be waived, in which case individuals who have satisfied the time-vesting condition fully vest in their RSUs and receive shares. These shares can then be offered for sale in the tender offer.

In some cases, companies may also consider cashing out time-vested RSUs directly in the tender offer, without first settling the RSUs, similar to the distinction for contingent exercise and cancelled/cashed-out options described above. For double-trigger RSUs, this still requires lifting the liquidity event condition to enable the cash-out.

Since lifting the liquidity event condition will result in the issuance of shares subject to the (now fully) vested RSUs (or in the case of a cash-out structure, in a cash payment), this approach triggers a taxable event for most RSU holders and, depending on the country, the employer will be required to withhold and/or report applicable taxes and social insurance contributions. Companies will need to consider how to satisfy such tax withholding obligations. Further, in countries in which no withholding obligation applies (or withholding does not cover all applicable taxes at settlement), it is highly advisable to educate RSU holders about the tax consequences of the RSU settlement, so they can make an informed decision whether or not to participate in the subsequent tender offer (to ensure they have enough funds on hand to pay applicable taxes).

From a U.S. tax perspective, significant considerations arise when companies allow holders of double-trigger RSUs to participate in a tender offer (through one of the methods described above). Waiving the liquidity event condition can raise concerns under Section 409A of the U.S. Internal Revenue Code for all outstanding double-trigger RSUs (even those not eligible to participate in the tender offer), as well as any such RSUs that may be granted in the future. Companies should carefully consider these issues for U.S. taxpayers given the magnitude of potential penalties in the event of a Section 409A violation.

Further, if a company waives the liquidity event condition only for RSU holders who elect to participate in the tender offer, U.S. taxpayer RSU holders who do not participate in the offer will still be taxed on the RSUs with respect to which they could have elected to receive a payment in the current year. Adverse U.S. tax consequences also are likely to arise under Section 409A if U.S. RSU holders are offered a choice as to the waiver of the liquidity condition. Therefore, for any U.S. RSU holders, any contemplated waiver of the liquidity event condition would need to be effected unilaterally for all or a portion of the RSUs that are time-vested prior to an offer.¹

What will be the purchase price for shares tendered in the offer?

In some cases, the purchase price will be equal to the current fair market value (FMV) of the shares (which is typically the company's current 409A valuation). However, it is not unusual for the purchase price to include a premium over the stock's current 409A valuation.

The tax consequences of participating in the offer may vary, depending on whether the purchase price is equal to or greater than the current 409A valuation of the shares.

If the purchase price is equal to the current 409A valuation of the shares, shares tendered in the offer typically will be subject to capital gains taxes on any difference between the purchase price and the individual's cost basis in the shares (typically, the FMV of the shares on the acquisition date). However, this treatment can vary by country.

If the purchase price is greater than the current 409A valuation of the shares, in some countries, the premium may be characterized as employment income that is subject to withholding/reporting by the employer, while any difference between the purchase price and the individual's cost basis in the shares may be treated as capital gains.

In the U.S., the characterization of a premium for tax purposes depends on whether the facts and circumstances of the tender offer demonstrate that the premium has a compensatory nature or instead should be treated as a payment for or with respect to the shares.

For RSUs that vest immediately prior to a tender offer (through waiver of the liquidity event condition, as described above) or for vested stock options, the taxable income at settlement (RSUs) and exercise/cash-out (options) generally will have to be determined by reference to the purchase price, not the current 409A valuation (if different). In this case, the subsequent/concurrent sale of the shares subject to RSUs and options in the tender offer generally does not result in any additional tax because the cost basis equals the purchase price.²

¹ By contrast, in many countries outside the U.S., it is possible to lift the liquidity event condition only for RSU holders electing to participate in the offer, and avoid taxation for the RSU holders who do not elect to participate.

² Exceptions to this rule apply in countries where the cost basis of shares is determined by reference to all of the shares the individual holds (e.g., Canada and United Kingdom).

Who will purchase the shares tendered in the offer: the issuing company or a third party?

In some tender offers, the issuing company will purchase its own shares from eligible individuals. In other tender offers, an outside investor or other third party will purchase the shares.

Tax consequences may vary depending on the purchaser of the shares. In particular, purchases of shares by the issuing company may trigger complex and sometimes onerous tax treatment under share buyback rules in certain countries such as Australia, Denmark and Japan. In these cases, all or a portion of the purchase price (not just the difference between the purchase price and the cost basis of the shares) may be treated as a deemed dividend which can result in unintended tax consequences, such as double taxation.

Issues under share buyback rules in some countries can be avoided if awards are cashed out, instead of first settled into shares that are then bought by the issuing company. However, this does not work for shares the participant acquired prior to the offer.

From a U.S. perspective, if the issuing company purchases the shares from its employees (and not an independent third party), this is usually a factor that points to any premium paid over the current 409A valuation of the shares as being treated as compensatory, rather than capital, in nature (as discussed above).

On the other hand, regulatory issues can arise in some countries if a third party is purchasing the shares, such as financial promotion and regulated activity rules in the United Kingdom. Offers to purchase shares from a company's own employees are often exempt from certain regulatory requirements under employee share plan exemptions. Such exemptions may not be available if a third party is purchasing the shares.

Who will be eligible to participate in the tender offer?³

Companies must decide what categories of equity holders may participate in the offer, which may include:

- Current employees of the issuing company or a subsidiary of the issuing company.
- Employees of third-party employers of record (EORs) providing services to the issuing company or a subsidiary of the issuing company.
- Other current non-employee service providers, such as independent contractors.
- Former employees/other service providers.
- Other award and shareholders.

Tax and regulatory issues for the offer will vary depending on the categories of individuals eligible to participate.

³ This section does not address a scenario in which outside investors or other shareholders are eligible to participate in the offer, as these scenarios are less common in our experience. Different considerations will apply if outside investors or other shareholders are eligible to participate.

The tax consequences of the offer may vary for each of the categories listed above. For example, where the employer is obligated to report the income and/or withhold taxes for a current employee, such obligations may not exist for an independent contractor or EOR employee. In some cases, an EOR is subject to a withholding obligation, which typically will require close coordination between the issuing company and the EOR. Finally, independent contractors and EOR employees may have been subject to unique tax treatment on the underlying stock options/RSUs from which their shares were acquired, which can impact the computation of these individuals' tax basis for capital gains tax purposes.

Discrete issues arise if former employees/service providers are eligible to participate in the offer. Apart from the practical challenge of delivering funds to such individuals and communicating with them, the former employer may remain obligated to withhold/report taxes for former employees, which can be difficult to accomplish if the individual has been off payroll for a significant period of time. If the tender offer also involves waiving the liquidity trigger on double-trigger RSUs, former employees/service providers are likely to be involved because these individuals typically can retain service-vested RSUs after termination (until the expiration date of the RSUs).

Further, the offer may be subject to securities, exchange control, or other legal/regulatory requirements. Complying with these requirements, or relying on exemptions from these requirements, may be more difficult if eligible individuals include EOR employees, independent contractors, and/or former employees. For example, if an exemption from a regulatory requirement is premised on an individual's status as an employee of the company group, the exemption may not apply to an EOR employee, independent contractor, and/or former employee.

How many shares will eligible individuals be permitted to sell in the offer?

Most companies will place a limit on the number of shares that eligible individuals will be able to tender in the offer. The limit is primarily driven by commercial considerations which will vary from one company to another, but this limit should be evaluated in advance because such a limit can be complex to calculate and administer. Also, as the limit increases on shares that can be tendered, so does the magnitude of the potential tax impact to employees who choose to participate.

Have the tax and regulatory implications of the tender offer been confirmed?

Regulatory requirements for the offer should be evaluated in advance so that any regulatory filing or other action items related to the offer can be addressed before the offer is made. For example:

- If the offer is made to U.S. residents or if the company is otherwise subject to U.S. securities laws, the company generally will need to satisfy certain requirements that apply to tender offers under the U.S. Securities Exchange Act of 1934, including keeping the offer open for at least 20 business

⁴ Whether or not the tender offer requirements apply to an offering is a fact-specific analysis that depends, among other things, on the number of offerees and the number of shares that can be tendered in relation to the company's total number of shares.

days and providing offerees a minimum level of disclosure about the company and the tender offer.⁴

- The offer also may be subject to prospectus, registration, or other approval requirements under applicable securities laws outside the U.S., unless an exemption is available. If a prospectus, registration or approval requirement applies and no exemption is available, it could be burdensome to launch the offer under local law.
- Exchange control requirements also can pose complications for tender offers outside the U.S., particularly in countries such as China and Vietnam. These requirements can limit the purchaser's ability to remit cash proceeds to participants in the offer, or may impose requirements on the participants to repatriate cash proceeds (if paid offshore) within certain periods of time.

Tax requirements for the offer also should be evaluated well in advance for a variety of reasons:

- Any countries with burdensome or disadvantageous tax treatment (e.g., deemed dividend) should be identified so that the company can explore workarounds or comply with the applicable tax requirements.
- As discussed above, the employer (or former employer) may be required to withhold and/or report applicable taxes in some cases (e.g., upon contingent exercise of stock options or waiver of the RSU liquidity event condition). These withholding/reporting requirements should be identified in advance so that the company can prepare to discharge these obligations where applicable.
- Finally, the tax consequences of participating in the offer should be communicated to employees, both for legal and practical reasons, as discussed below.

How will the parameters and consequences of the tender offer be communicated to eligible individuals?

Most companies will want to inform offerees (U.S. and non-U.S.) of the tax consequences of participating in the offer so that offerees can make an informed decision whether to participate. Moreover, offerees will need to know when it is their responsibility to report and pay applicable taxes that arise from participating in the offer (e.g., capital gains taxes), versus the company/employer (or former employer) withholding/reporting and remitting taxes to the applicable authorities on their behalf.

We have also seen some companies go beyond providing information about the tax consequences to current and former employees by delivering interactive training sessions (live or via webinar) for offerees to ask questions about the tax consequences of participating in a tender offer. Although companies cannot (and should not) give individual tax advice to offerees (whether current/former employees or other individuals), training sessions can provide offerees with valuable opportunities to gain a greater understanding of the general tax consequences of the offer so that the offerees can apply that knowledge to their personal circumstances.

Finally, communication/education for current and former employees can be particularly helpful if the RSU liquidity event condition is waived. In this situation, some countries may require the individual to report and pay applicable taxes that arise in connection with the vesting/settlement of the RSUs on their own. In addition, if the individual chooses to tender the resulting shares in the offer, additional capital gains tax liability may arise in connection with the sale of the shares if the sale proceeds exceed the cost basis in the shares. Thus, individuals in this position will need to plan ahead to ensure that they have sufficient cash flow/liquidity to pay the applicable taxes that will be due on their RSUs/shares.

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