activity which has an impact on the employer group. Employer-related events include a change to group structure, a change of control or partial change of control of an employer, a change to the employer in relation to the scheme (including replacing a participating employer or merging employers, business and asset sales and purchases). However, an employer-related event will only be a Type A event in any transaction where the scheme has a relevant deficit. The Clearance Guidance indicates that employers and trustees should compare the strength of the employer pre- and post-event, and consider any change or effect on the wider employer group's financial strength.

4.94 Scheme-related events are events impacting directly on the scheme, and are Type A events irrespective of the level of funding of the scheme. A scheme apportionment arrangement is likely to by a Type A event where certain circumstances apply (eg broadly that the apportionment increases the section 75 debt that is immediately payable by another employer who can afford the increased debt and there is no net reduction in the employer covenant). Withdrawal arrangements may also be Type A events if a transaction is detrimental to the ability of the scheme to meet its liabilities and the trustees will particularly be wary of the terms of any guarantees.

4.95 The issue of a clearance statement will be of considerable comfort to the parties involved, particularly in the case of contribution notices, which may be issued against individuals. The price for clearance from the Pensions Regulator may be a cash payment or other arrangement eliminating all or part of a deficit. However, the clearance process is voluntary and if the venturer does not think it likely that the Pensions Regulator will issue a contribution notice or an FSD it may not wish to involve the Pensions Regulator by applying for clearance.

4.96 It must be remembered that trustees have a significant role to play whether or not clearance is being sought. In this context it is important to ascertain what their powers are under the scheme documents. They are expected to assess the impact of an event and seek appropriate 'mitigation' for their agreement to any course of action. Where trustees become aware of a potential Type A event, they should discuss this with the employer. If no or inadequate mitigation is forthcoming they may consider contacting the Pensions Regulator themselves, although the Pensions Regulator will not have a formal role unless and until approached for clearance.

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Notification

4.97 There are separate obligations on both employers and trustees to notify the Pensions Regulator if certain prescribed events occur[15]. The employer obligation arises, among other things, when a controlling employer decides to relinquish control of a subsidiary, unless the scheme is both fully funded on an ongoing basis and in the last 12 months the trustees have not had a duty to report a failure to meet the contributions schedule that they believe is materially significant to the Pensions Regulator. When a withdrawal arrangement or approved withdrawal arrangement is in force there are certain further employer-related notifiable events under PA 2004, s 69 and regulations made thereunder[16].

Transfers of pensionable employees

4.98 Where the joint venture vehicle is to take over the employment of pensionable employees from more than one of its joint venturers, the benefits provided under their existing schemes are likely to differ, so the joint venture could end up with employees of similar status having different pension rights. The joint venture vehicle may, either immediately or at some later stage, recruit further employees to whom it may wish to offer pension benefits on other, different terms. Whilst it is not unusual to have different benefit structures for different groups of employees, it is generally perceived as undesirable from the point of view of employee relations. Harmonisation of benefits is, however, difficult and potentially expensive as it involves changing employees' pension rights and expectations – and not infrequently moving to the better benefits. It can usually be best achieved by the joint venture vehicle establishing its own pension scheme, although the administrative cost involved may be regarded as too high if there are only a small number of pensionable employees, and complete harmonisation may not be possible in any event if TUPE is applicable (see para 4.100).

4.99 If the shares in the company in which the employees are employed are being transferred to the joint venture, the creation of the joint venture will not result in any change in the identity of the employees' employer nor in the terms of their employment contracts. The scope for varying pension benefits in these circumstances is as discussed at para 4.120ff.

4.100 TUPE generally applies when there is a transfer of an undertaking or economic entity to the joint venture vehicle from one of the venturers. TUPE is intended to give effect to the European Acquired Rights Directive ('ARD') and, accordingly, is to be interpreted in line with the purposes of that

15 PA 2004, s 69.
16 Pensions Regulator (Notifiable Events) Regulations 2005 (SI 2005/900).

Directive so far as possible. Broadly, TUPE provides for the transfer, by operation of law, of existing employment contracts from the venturer to the joint venture vehicle. However, there is an important exemption under TUPE to the employment rights which transfer: any rights relating to old-age, invalidity or survivors' benefits under an occupational scheme are exempt from being automatically transferred, but are dealt with in PA 2004 (see para 4.107). The exemption applies only to occupational schemes – any contractual obligation to contribute to an individual or group personal pension scheme will transfer. Similarly, the right to life cover under a standalone life cover only scheme will transfer.

4.101 The European Court of Justice ('ECJ') has given guidance on the extent of the 'old-age, invalidity and survivors' benefits' exemption in the decisions in *Beckmann v Dynamco Whicheloe Macfarlane*[17] and *Martin v South Bank University*[18]. To the extent that any benefits under an occupational scheme are not old-age, invalidity or survivors' benefits they would, it seems, have to be provided in addition.

4.102 The key question in the *Beckmann* case was whether certain early retirement benefits payable under an occupational scheme on dismissal from employment by reason of redundancy qualified as old-age benefits. The ECJ held that it was only those benefits paid to an employee from the 'end of [his] normal working life' that could be classified as old-age benefits. Consequently, it held 'early retirement benefits and any benefits intended to enhance the conditions of such early retirement paid in the event of dismissal to employees who have reached a certain age' were not within the 'old-age' exemption, and the obligation to provide such benefits transferred to a transferee under TUPE. In the *Martin* case the ECJ considered whether contractual rights to a lump sum and pension either in the event of redundancy or premature early retirement by agreement with the employer were within the old-age exemption. The ECJ construed the exemption narrowly and held that any rights 'contingent on dismissal or the grant of early retirement by agreement with the employer' were not old-age benefits for the purposes of the ARD and so were not included within the exemption. Therefore, the obligation to provide any such benefit transfers to the transferee. The suggestion in the *Martin* case is that all early retirement benefit entitlements (other than those relating to invalidity or ill health) would transfer under TUPE (but see para 4.104). In this context, it will be important to see if any rights to early retirement and enhanced benefits on redundancy have previously been transferred into a scheme with employees who are to transfer under TUPE.

17 C-164/00 [2002] ECR I-4893, ECJ.
18 C-4/01 [2004] 1 CMLR 472, ECJ.

4.103 Early retirement rights which transfer under TUPE are payable under the same terms and conditions as applied under the original employer's scheme and any relevant contractual provisions or collective agreement. It would appear that where a benefit is discretionary it remains discretionary and, where it is subject to actuarial reduction, it may be reduced. It is not clear how powers and discretions exercisable by the trustees under the original arrangements are to be given effect to and what the effect of any funding conditions is. Also, discretions exercisable by the employer (such as a requirement for company consent for early retirement) will be subject to any restrictions arising from custom and practice which also transfer.

4.104 The *Beckmann* and *Martin* cases deal with benefits payable on redundancy or on retirement 'in the interests of efficiency' respectively and, despite some of the sweeping statements made by the ECJ in these decisions, arguably normal early retirement pensions payable to employees who opt for early retirement still come within the old-age exemption to TUPE and, therefore, do not transfer to the transferee. To reason otherwise would significantly undermine the old-age exemption. A possible argument may be that if an employee, without any prompting from the employer, decides to take early retirement, then, by doing so, he has chosen to end his normal working life and therefore any benefits to which he becomes entitled are, in fact, related to old-age, and as such fall within the TUPE exemption. Other possible interpretations of the ECJ's judgments include that it is only the pension payable before normal retirement date which is not an old-age benefit and so the rights which transfer would be to a pension between the date of early retirement and normal retirement date but not to a pension for life. Alternatively, it can be argued that it is only to the extent that the early retirement terms exceed the pension which would have been payable to the employee had he left service with a deferred pension payable from normal retirement date which transfers. Further guidance from the ECJ is required to clarify these issues. In the meantime, it can only be safely said that a pension payable on retirement at normal retirement date, incapacity pensions and survivors' benefits are within the TUPE exemption.

4.105 It is, however, fairly clear that the fact that the pension was not payable by the employer but rather by the pension scheme would be rejected by the ECJ as an objection to the transfer of the obligation to pay the pension, since it rejected that argument in the *Beckmann* case, which concerned the NHS Superannuation Scheme (albeit that that scheme is set up under statute and not under trust). It would therefore appear that the transferee has an obligation to pay the pension or procure its provision even though the transferor's obligation was limited to funding benefits in accordance with the provisions of the trust deed of its scheme and subject to the power of amendment and any rights to terminate contributions. However, since the *Beckmann* and *Martin* cases both concerned a statutory scheme, there are still arguments to be run on these issues.

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4.106 Sections 257 and 258 of the PA 2004 contain provisions which require the joint venture vehicle to provide certain specified minimum benefits following a TUPE transfer in the place of the old-age, invalidity and survivors' benefits which were provided for the employees under the venturer's occupational scheme.

4.107 The protection under the PA 2004 will apply only if:

(A) the employee is, or is eligible to be, an active member of the transferor's occupational scheme or would have become so eligible had they been employed for a longer period; and

(B) if the scheme provides money purchase benefits, the transferor is required, or if the employee had become an active member would have been required, to pay contributions (other than minimum payments for the purposes of contracting-out of the state second pension) in respect of him or, if the employee is an active member, the transferor, or any associate of the transferor, has paid any such contributions in the past.

These conditions will be regarded as having been satisfied in any case where they would be satisfied but for any action taken by the transferor by reason of the transfer (eg the transferor terminating the scheme prior to the transfer).

4.108 Section 258 and the regulations made thereunder[19] provide that following such a transfer (and save to the extent that the employee and the transferee otherwise agree at any time after the transfer has taken place) it will be a condition of the contract of employment with the transferee that one or other of the following are complied with:

(A) occupational pension scheme option – the employee becomes, or is eligible to become, a member of an occupational scheme and:

(1) if the transferee's scheme is a money purchase scheme, relevant contributions (see para 4.109) are payable by the transferee,

(2) if the transferee's scheme is a defined benefit scheme, either it satisfies the statutory reference scheme test for contracting-out purposes, or the value of the benefits provided are at least 6% of pensionable pay (as defined in the scheme) for each year of service (this is additional to the value of the benefits provided by the member's contributions. The member must not be required to contribute more than 6% of pensionable pay).

(B) stakeholder pension scheme option – the transferee makes relevant contributions to a stakeholder pension scheme (or has offered, and not withdrawn the offer, to do so).

19 Transfer of Employment (Pension Protection) Regulations 2005 (SI 2005/649).

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There is thus a degree of choice as to the form of benefits to be provided.

4.109 'Relevant contributions' are contributions which match the employee's contributions up to 6% of basic pay. This is so even where the transferor was not paying as much as 6%. In these circumstances, the transferee will be saddled with higher pension costs than the transferor. Conversely, the requirements provide limited protection for those employees for whom the transferor provided a good final salary scheme or was contributing at a higher rate to a money purchase scheme.

4.110 In the case of an employee who was only prospectively eligible for membership of the transferor's scheme, the transferee need only provide a scheme from when the employee would, apart from the transfer, have been able to join the transferor's scheme.

Joint venture vehicle participating in existing scheme

4.111 It may be possible for the joint venture vehicle to participate in one or more of the existing defined benefit schemes. Whether it can do so or not will turn on the scheme rules, which will need to be examined.

4.112 Where joint venture employees are to participate in an existing defined benefit scheme, the joint venture vehicle should obtain appropriate warranties as to the status and funding of the scheme. It will also be necessary to agree the rate of contributions which the joint venture vehicle will pay, and the position in relation to any surplus or deficiency which may now or in the future arise. Where there are two or more schemes available, consideration should be given as to which scheme or schemes should be used (and whether having employees in different schemes might lead to sex or age discrimination), and where new recruits will be placed.

4.113 There are various ways in which the question of contributions by the joint venture vehicle can be approached:

(A) The joint venture vehicle could pay the same contributions as the other employers participating in the scheme. This has the advantage of simplicity. Leaving aside any surplus or deficiency, the contribution rate will depend on such factors as average ages, salary increases and staff turnover, and so, unless the joint venture employees are typical of other employees participating in the scheme, the joint venture vehicle may be paying more or less than the true cost of funding their benefits. If the scheme is in surplus and this is being used to reduce the employer contribution rate, the joint venturer whose scheme it is may, in any event, object, as it would be providing a benefit to the joint venture without receiving any corresponding benefit from it. Similarly if, which is perhaps more likely, the scheme is in deficit, the other venturers are likely to object.

(B) The joint venture vehicle could pay a contribution rate calculated in relation to its own employees only, disregarding any surplus or deficiency in the scheme. This avoids some of the problems associated with the joint venture vehicle paying the same rate as the other participating employers. It does, however, mean that the joint venturer whose scheme it is will be assuming the risk as to the adequacy of the contribution rate.

(C) A notional fund could be established within the scheme for the joint venture vehicle. Contributions of the joint venture vehicle and any of its employees would be paid into this fund and benefits for the joint venture employees paid out, with the intent that the fund would be operated so far as possible as if it were entirely separate from the rest of the scheme.

Alternatively the scheme can effectively be segregated (see para 4.117).

4.114 When establishing the joint venture, the terms upon which the joint venture vehicle may withdraw from the scheme should be considered, even if it is proposed that it should participate in the scheme on a long-term basis. The importance of this cannot be over-emphasised. The general intention, in the normal course, should be that the joint venture vehicle's share of the funding of the scheme would be made available for transfer to a successor scheme so that the same level of pension benefits can continue to be provided for the employees at approximately the same cost. This may not happen under the normal operation of the scheme rules, which may provide employees with no more than the minimum leaving service benefits.

4.115 More importantly, the joint venture vehicle may be faced with having to make a substantial funding deficiency payment when it withdraws from the scheme (as discussed at para 4.58ff). As the initial calculation of liability will normally exceed the amount required on the scheme on-going funding basis by a significant margin, any excess payment will usually result in a reduction in the future contribution liability of the venturer who sponsors the scheme. How equitable this is as between the venturers is debatable, but it needs to be borne in mind that the venturer sponsoring the scheme will have ultimate liability for the funding of that scheme.

4.116 The doomsday scenario for any employer participating in another company's scheme is that the other company becomes insolvent and, as a result, the employer becomes liable for a disproportionate amount of any funding deficiency.

4.117 An alternative approach would be to set up a segregated section under the scheme for the joint venture vehicle employees. Broadly, if the assets and liabilities of the section are held completely separate from the other assets and liabilities of the scheme and there can be no cross subsidiary, the section will for funding purposes and for the purposes of s 75

of the PA 1995 be treated as if it were a separate scheme. The joint venture vehicle's liabilities would therefore be similar to those which it would have if it were to establish its own scheme.

Consultations

4.118 A change of scheme or benefits may give rise to an obligation to consult. If the change coincides with a TUPE transfer, the consultations will be under TUPE. In other cases the obligation may arise under the regulations made pursuant to ss 259 to 261 of the PA 2004. These regulations apply to employers with at least 50 employees (whether or not they are members of the pension scheme).

4.119 The regulations require the employers to consult 'affected members' or their representatives in advance of making any 'listed changes'. These changes include, in relation to occupational schemes, (i) increasing normal pension age, (ii) preventing existing employees from joining, (iii) preventing or reducing future benefit accrual and (iv) introducing or increasing member contributions and, in relation to personal pension schemes, reducing or stopping employer contributions or increasing member contributions[20]. Failure to comply with the regulations may result in action by the Pensions Regulator who can impose a fine (maximum £5,000 for individuals, or £50,000 for companies). Non-compliance will not, however, alter or affect the validity of a change.

Varying pension benefits

4.120 There is a strong trend nowadays to control costs and limit risks by converting final salary type benefits to money purchase benefits, and the opportunity of establishing new pension arrangements for the joint venture vehicle is sometimes seized on to effect such a conversion where employee relations and other considerations permit. (It should be noted that for any employee with enhanced protection under the FA 2004 such protection would be lost automatically if any contributions (employer or employee) are paid to provide money purchase benefits for them, other than minimum contributions for the purposes of contracting-out of the state second pension.)

4.121 Where such a switch is not being made, and costs considerations permit, the approach is likely to be to provide benefits at least as good as those available to the transferring employees under their existing schemes;

20 Occupational and Personal Pension Schemes (Consultation by Employer and Miscellaneous Amendment) Regulations 2006 (SI 2006/349).

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8.57 If the associate is loss-making, the investor must continue to account for its share of the losses. Where this results in an interest in net liabilities, FRS 9 requires this to be reflected in the balance sheet as a provision or liability.

8.58 Investors which do not prepare consolidated financial statements are required by FRS 9 to present the relevant amounts for associates by preparing a separate set of financial statements, or by showing the relevant amounts as additional information in their own financial statements. Investors that are exempt from preparing consolidated financial statements (under either CA 1985, s 228 or 248 (CA 2006, s 399 et seq)), or which would be exempt if they had subsidiaries, are exempt from this requirement.

8.59 The investor's share of the associate's exceptional items, interest payable and receivable, and tax are also included in the profit and loss account, with separate disclosure in the notes. Additionally, the share of turnover may be included with the joint venturer's turnover as a memorandum item on the face of the profit and loss account, but the investor's share of the associate's turnover has to be clearly distinguished from group turnover (ie that of the investor and its subsidiary undertakings).

Equity accounting – gross equity method

8.60 Where an investor prepares consolidated financial statements, investments in FRS 9 joint ventures are to be accounted for using what FRS 9 terms as the gross equity method.

8.61 The treatment is the same as the (net) equity method used for associates except that:

- in the consolidated profit and loss account, the investor's share of the joint venture turnover must be shown, but not as part of group turnover; and
- in the consolidated balance sheet the investor's share of the gross assets and liabilities underlying the (net) equity method must be shown in amplification of that net amount.

8.62 The accounting treatment for a loss-making joint venture is the same as that for a loss-making associate, except that the investor's share of gross assets and liabilities of the joint venture must still be shown (within the liabilities or provisions section of the balance sheet).

8.63 The requirement to show the gross assets and liabilities rather than netting them off can make a considerable difference to the appearance of the investor's accounts.

Consolidation and equity accounting compared

8.64 The crucial difference between the two methods is that consolidation always requires the whole amount of each item of the consolidated entity's assets and liabilities to appear on the consolidated balance sheet, even though the reporting entity does not own 100% of the subsidiary or subsidiary undertaking in which the assets and liabilities are recorded. The adjustment for the minority interests is made in a separate line of the balance sheet. Similarly, the whole amount of the profits and losses must appear in the consolidated profit and loss account, with subsequent adjustment for the minority interests. In contrast, equity accounting only records the group's share of the profits or losses and net assets or net liabilities (or, in the case of the gross equity method, the gross assets and gross liabilities), even though further sub-division and disclosure is made in the accounts.

8.65 Participants in a joint venture which has a particularly large amount of debt or other liabilities, or is making losses, may prefer to equity account rather than consolidate, if the venture can be structured in such a way that this is permitted. Although the difference is to some extent presentational, other differences are more significant. Consolidation can have the effect of some unpleasantly large negative numbers appearing in the consolidated accounts, to which the subsequent adjustment for minority interests is not directly referable on the face of the accounts. A majority shareholder who wishes to avoid consolidation might be tempted to put in place an arrangement with a friendly minority party such that the minority, although having various vetoes, will never exercise them in practice. Clearly such an arrangement is not a joint venture and should not be accounted for as such; it is substance, not form, which governs the correct method of accounting. The combination of FRS 2 and FRS 5 means consolidation will be needed wherever an investor controls another entity in terms of those standards. In any cases of doubt, directors and auditors will also be mindful that there is an accounts enforcement regime whereby a company could be reported to the Financial Reporting Review Panel if its accounts failed to comply with those standards.

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Accounting for the interest as an investment

8.66 Where an interest is to be accounted for as an investment, the treatment in the individual accounts is as set out in para 8.22. If the joint venturer also has subsidiary undertakings, and must therefore prepare consolidated accounts, the amounts shown in the individual accounts will be carried forward into the consolidation.

5 International Financial Reporting Standards

Introduction

8.67 Listed companies within the European Union are required to prepare their consolidated financial statements under International Financial Reporting Standards (IFRS).

8.68 Listed companies do not include those which are admitted to AIM, but the London Stock Exchange also requires such companies to prepare their consolidated financial statements under IFRS. Non-listed UK companies currently have the option of preparing their accounts either under UK GAAP or under IFRS.

8.69 However, following the International Accounting Standards Board's launch of the International Financial Reporting Standard for Small and Medium-sized Entities (the IFRS for SMEs), it appears likely that the Accounting Standards Board will adopt this as a replacement for UK GAAP in the future. IFRS for SMEs is a new IFRS based standard which is designed specifically for non-listed companies. The principles of accounting for subsidiaries, associates and joint ventures under IFRS for SMEs are not different to those in IFRS.

8.70 Since many participants in joint ventures are listed companies, they are currently required to account for their interests in them under IFRS, and in order to simplify this process they may require their joint venture companies to do so also. Quite apart from this, some joint venture companies will probably choose to do so, particularly those where the parties envisage that their exit will be achieved by means of a flotation, or where the joint venture company is very large and wishes to account under IFRS in order to maintain comparisons with its competitors.

8.71 Consolidation is dealt with under IFRS by International Accounting Standard IAS 27 'Consolidated and Separate Financial Statements' and associates by IAS 28 'Investments in Associates and Joint Ventures.

Consolidation of subsidiaries

8.72 Under IAS 27 a parent must prepare consolidated accounts in which it consolidates its investments in its subsidiaries. IAS 27 defines a subsidiary as 'an entity, including an unincorporated entity such as a partnership, that is controlled by another entity (known as the parent)'. Control is defined as 'the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities'.

8.73 Control is presumed to exist when the parent owns, directly or indirectly, more than half of the voting power of an entity unless, in

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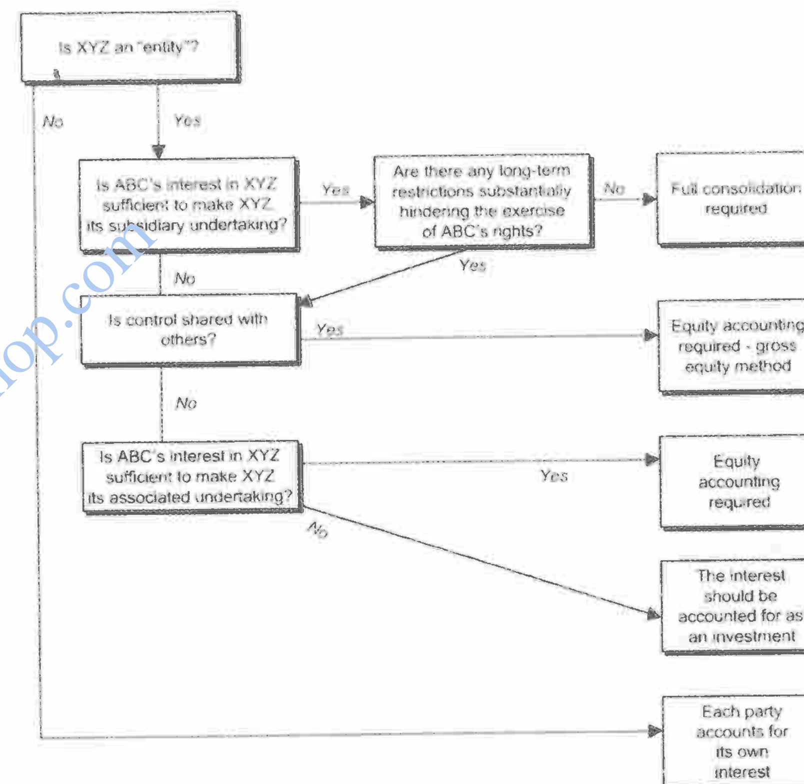
Flowchart 1

Joint venture accounting requirements under UK GAAP

This flowchart illustrates the considerations which govern how a joint venturer (ABC) should account for its interest in a joint venture (XYZ). This is somewhat simplified and is not intended to override the text; it is very difficult to illustrate the concepts diagramatically.



exceptional circumstances, it can be clearly demonstrated that such ownership does not constitute control. Control also exists where the parent owns half or less of the voting power of an entity when there is:

(a) power over more than half of the voting rights by virtue of an agreement with other investors;

(b) power to govern the financial and operating policies of the entity under a statute or an agreement;

(c) power to appoint or remove the majority of the members of the board

of directors or equivalent governing body, and control of the entity is by that board or body; or

(d) power to cast the majority of the votes at meetings of the board of directors or equivalent governing body, and control of the entity is by that board or body.

This approach is very similar to the UK approach. IAS 27 does not deal specifically with the situation where a parent has a participating interest in the enterprise with dominant influence or unified management, but where this is the case the enterprise is likely to be controlled by the parent. The principles of consolidation are very similar to those under FRS 2.

Associates

8.74 The requirements of IAS 28 are, in broad terms, similar to the requirements of FRS 9. The definition of an associate under IFRS, however, does not require that the investor actually exercises significant influence, merely that it is in a position to do so.

8.75 In addition, IAS 28 provides specifically that an associate should not be included in the financial statements using the equity method when the investment is acquired and held exclusively with a view to its disposal within 12 months from acquisition and management is actively seeking a buyer, in which case the investment should be classified as held for sale in accordance with IFRS 5 'Non-current assets held for sale and discontinued operations' and measured at the lower of its carrying amount at the date of its classification of held for sale and its fair value less cost to sell. If a buyer is not found within that 12 month period, however, the standard requires that the financial statements are restated to include that associate under the equity method from the date of its acquisition.

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Accounting for associates

8.76 FRS 9 is much more prescriptive than IFRS in terms of the presentation of associates in the financial statements, with IAS 28 requiring only that the investor's share of the profit or loss of the associate (post-tax) is recognised in the investor's income statement. The standard does not specify where in the income statement this should be included, nor does it include any of the requirements of FRS 9 with regard to operating profit and items below operating profit.

8.77 The requirements of IAS 28 apply to both consolidated and unconsolidated financial statements. A company which has no subsidiary undertakings, but which has associates, is therefore required to account for its associates

under the equity method in its own financial statements, as opposed to presenting an additional set of financial statements, or providing additional disclosures under FRS 9. IAS 28 also contains a further detailed exemption from the requirement to equity account when the investor is a subsidiary of another entity.

8.78 Under IAS 28, where an associate is loss-making, an investor accounts for its share of the losses only until its investment (including long-term interests such as debt or preference shares) is reduced to zero. Beyond this point, additional losses are provided for, and a liability recognised, only to the extent that the investor has assumed either a legal or constructive obligation on behalf of the associate.

Jointly controlled entities

8.79 The definition of a joint venture in FRS 9 is similar to that of a jointly controlled entity under IAS 31. However, the definition in IFRS specifically requires the formation of an entity (in the legal sense), otherwise the joint venture arrangement falls to be treated as a jointly controlled operation or jointly controlled assets.

8.80 The definition under IAS 31 does not require the formation of a separate legal entity as the IAS 31 definition of joint venture refers to the undertaking of an 'economic activity'. This can take many different forms, including jointly controlled operation, jointly controlled assets and jointly controlled entities (IAS 31.7). IAS 31 prescribes different accounting treatment for each form of joint venture. It is the FRS 9 definition of a joint venture which refers specifically to 'an entity'.

8.81 A JANE under UK GAAP which involves the formation of an entity (in the legal sense) will fall to be treated as a jointly controlled entity under IAS 31.

8.82 IAS 31 allows two accounting treatments for jointly controlled entities: proportional consolidation and equity accounting, both of which are discussed further below. However, it should be noted that the standard specifically states that the use of the equity method is not recommended. This is therefore a reversal of UK policy as discussed at para 8.50, although proportional consolidation is currently prohibited under UK law (see the proposed change below).

8.83 As for associates (see para 8.75), IAS 31 provides that a jointly controlled entity should not be accounted for by either proportional consolidation or equity accounting where it is acquired and held exclusively with a view to subsequent disposal within 12 months from acquisition, and management is actively seeking a buyer. Instead they should be classified as held for

the times that it has control. The disadvantages of this method are that the policy of the joint venture company may be subject to considerable fluctuation, and a particularly crucial decision might have to be made during one party's period of control, which is made in a way which the other party finds unable to accept. However, in view of possible 'retaliatory' action when the other party is in control, in practice the parties have an incentive to behave sensibly and reach decisions by consensus.

13.15 If the parties are not able to accept the complete discretion of the other party when it is in control, this can be addressed by providing that both parties must approve certain major transactions. These could be similar to the vetoes commonly afforded to a minority (see Chapter 15). However, this of course may mean that there is then a deadlock over one of the relevant transactions, but at least most other matters could be dealt with without the danger of an actual deadlock.

13.16 Another approach is to place the balance of power in the hands of an independent party. The chairman's casting vote at board meetings could be retained, and the parties would agree that the chairman shall be independent. However, it could be difficult to persuade someone to take on that role, and there is always the risk that he might resign at the very moment when the dispute between the shareholders becomes most heated and his services are most required: there may then be a dispute about the identity of his successor. A variation is to appoint an independent non-executive director, with the chairman having no casting vote.

13.17 A further similar approach, which is often suggested by the parties, is for the company itself to be deadlocked, but in the event of a deadlock arising, the dispute is to be referred to an independent expert, whose decision is to be final. One difficulty with this is that business decisions are not issues which are readily solved by an expert, being matters of business judgment. Another point is that it must be questioned whether there are many appropriately qualified people who would be prepared to take on such a role and whether, in actuality, the parties would always be happy to accept his binding decision. In practice, there are few businessmen who would allow a third party not involved in the business to make crucial decisions for them if the parties themselves cannot agree.

13.18 Chapter 23, on dispute resolution, considers the various means by which the parties can look outside the company to resolve disagreements. These include mediation (which does not necessarily lead to a binding determination), as well as expert determination, arbitration and litigation (which do produce a binding outcome, but on a legal or technical basis and not necessarily one which is commercially desirable).

13.19 A further approach, which is really an extension of the concept of submission to a third party, is for the parties to accept that although the

company is 50:50 owned, it is in fact inappropriate, and indeed may be stifling of corporate enterprise, for all decisions to be made by its founders alone, and that most decisions are best left to an independent board who can be expected to make their decisions in the best interests of the joint venture company, and ultimately of the joint venturers. Although the articles or shareholders' agreement may still provide for the appointment of a certain number of directors by each shareholder, there will also be scope for the appointment of a number of additional directors who will hold the balance of power. They will most likely have executive roles in the joint venture company, and will not be the 'yes men' of either party, and may indeed have been recruited from outside or, in time, to have grown up, in terms of experience, with the joint venture. This solution is particularly appropriate for a sizeable full-function joint venture which is intended to be long-term and, in time, to be operationally independent of its founders and it is suggested that this is often the most rational way of structuring such a venture.

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Termination on unresolved deadlock

13.20 Not all the above methods provide a certain way of resolving a deadlock should it arise. Except where the parties are prepared in every situation to bind themselves to accept the decision of the other party, or of another party who is brought in to resolve the dispute, the parties may still find themselves with a deadlock which cannot be resolved.

13.21 The normal remedy provided for in this event is termination of the shareholders' agreement. This is a solution which is likely to be so unpalatable to the parties that it is included more in the hope that the parties will try to avoid it by making every effort to negotiate a solution to the deadlock. In practice, termination will only be resorted to when the business relationship of the parties has completely broken down. With a view to ensuring that this is in fact the last resort, the documents will quite often provide that the right of termination can only be exercised after the parties have taken some defined steps to resolve the dispute. A clause might not allow a termination notice to be served until the following have occurred:

- there has been an equality of votes on a matter which has been raised at a board or general meeting;
- either party has served on the other a notice requesting the convening of a special board or general meeting to consider the issue again, and which states that if an equality of votes again results (or the other party's representatives absent themselves from the meeting so that there is no quorum) a deadlock will exist;
- at the special meeting there is again an equality of votes or there is no quorum;

has probably enabled many aggrieved minority holders to achieve a satisfactory settlement.

MINORITY SHAREHOLDERS' ACTIONS

14.11 The law does provide two alternatives to the rather unsatisfactory and limited remedy of winding up. Firstly, there is the possibility of the minority shareholder bringing what is known as a 'derivative claim' to redress wrongs inflicted upon the company by the controlling majority, which have prejudiced the shareholding of the minority. Secondly, there is the possibility of being able to petition under CA 2006, s 994 for 'unfair prejudice' (which has replaced CA 1985, s 459 but is virtually identical). A derivative claim is so called because, on the basis that it is only the company who can sue for wrongs done to it, the rights of the minority shareholder are 'derived' from those of the company. Both the minority holder or holders and the company itself are made the claimants in the action. The rule that the company is the only proper claimant for a wrong done against it, and that shareholders cannot complain of irregularities in the conduct of its internal affairs, was laid down in *Foss v Harbottle*[11], and to mount a derivative action the minority shareholder had to show that its case came within one of its exceptions, and leave of the court was required.

14.12 The common law rules in *Foss v Harbottle* have now been replaced (with effect from 1 October 2007) by a new statutory derivative claim in Part 11 of the CA 2006. A derivative claim can now only be brought under CA 2006, Part 11 or by order of the court in proceedings under CA 2006, s 994 (see below).

14.13 The new rules in Part 11 apply to all derivative claims brought on or after 1 October 2007. If, however, the act or omission in question occurred prior to that date, then the court should determine the outcome on the basis of the common law rules which applied at the time.

14.14 The circumstances in which a shareholder can bring a claim have been widened, but the CA 2006 also introduces additional procedural steps which have to be followed to avoid non-meritorious claims being brought.

14.15 Under the old common law a shareholder had to show that there had been a fraud on the minority (in that the director had committed a breach of duty) and that the directors concerned had control of the company and had used that control to prevent a claim being brought by the company itself.

14.16 Under the new statutory procedure, an action can be brought for any act or omission involving negligence, default, breach of duty or breach of

11 (1843) 2 Hare 461.

trust by a director – so that negligence will be sufficient. The director no longer has to have benefitted personally from the breach.

14.17 An action can be brought against a director or another third party. However, the Explanatory Notes to the CA 2006 state that an action should only be brought against a third party in very narrow circumstances, where the damage suffered arose from an act involving a breach of duty by a director.

14.18 The procedural steps under the CA 2006 are as follows:

- Step 1 – the shareholder brings the claim but he also has to make an application to the court for permission to continue the claim. The shareholder has to make a prima facie case at this stage, based on evidence from the shareholder alone. If no prima facie case is made, the court has to dismiss the application.
- Step 2 – if the action passes, then the court decides whether to grant permission to continue the claim based on evidence provided by both parties. Only if the court gives permission to continue at Step 2, will the action proceed to a full hearing.

UNFAIR PREJUDICE

14.19 The second alternative to winding up is a statutory remedy contained in CA 2006, s 994 (formerly CA 1985, s 459).

14.20 If the court is satisfied that a shareholder has suffered 'unfair prejudice', it may make such order as it thinks fit for giving relief in respect of the matters complained of, which may include, but is not limited to:

- regulating the conduct of the company's affairs in the future;
- requiring the company to refrain from doing or continuing to do an act complained of by the petitioner, or to do an act that the petitioner has complained it has omitted to do;
- authorising civil proceedings to be brought in the name and on behalf of the company by such person or persons and on such terms as the court may direct; or
- providing for the purchase of the shares of any member of the company by other members or by the company itself and, in the case of a purchase by the company itself, the reduction of the company's capital accordingly.

14.21 The last of these remedies is the one almost always ordered, since it is recognised that if the relationship between the shareholders has broken down, the best solution is usually to bring it to an end. In fact, the Court of Appeal has recently confirmed that a buy out should be the normal

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remedy[12]. Winding up cannot be ordered. Once unfair prejudice has been established, the court is given a wide discretion as to the relief to be granted – it is not limited merely to reversing or putting right the immediate conduct. The court is entitled to look at the reality and practicalities of the overall situation, past, present and future.

14.22 Any 'member' of the company may petition for an order on the ground that the company's affairs are being, or have been, conducted in a manner that is unfairly prejudicial to the interests of the company's members generally or of some part of its members (including at least the petitioner), or that an actual or proposed act or omission of the company (including an act or omission on its behalf) is or would be so prejudicial.

14.23 A 'member' includes not only an existing member but also a person to whom shares in the company have been transferred or transmitted by operation of law, so that a person who is refused registration as a member may apply.

14.24 A new provision introduced by the CA 2006 (s 994(1A)) is that the removal of a company's auditors from office on grounds of divergence of opinion on accounting treatments or audit procedures or any other improper grounds will be treated as unfair prejudice.

14.25 Cases on s 459 of the CA 1985 provide that an order can be made if the petitioner can show that the course of conduct complained of is unfair and as a result the value of his shareholding has been seriously diminished or at least seriously jeopardised[13]. The test of unfairness is objective, not subjective, and there is no need to show any bad faith or lack of probity or that the conduct complained of was unlawful. Such conduct need not be sufficient to justify a winding-up order. Unfortunately the decision in *O'Neill v Phillips*[14] appears to have considerably restricted the availability of the remedy by holding that a member will not ordinarily be able to complain of unfairness unless there has been a breach of the terms or understanding on which it has been agreed that the affairs of the company should be conducted, whether written or oral, and whether contractually binding or not, although equitable considerations may also enable the court to hold that those terms are being performed in a manner which equity regards as a breach of good faith. The decision in *O'Neill v Phillips* emphasises the need for the parties to commit all their understandings to writing, since although the existence of an oral understanding might be established by the evidence, this is obviously much more uncertain than producing a written agreement.

12 *Grace v Biagoli & Ors* [2005] EWCA Civ 1222.
13 Slade J in *Re Bovey Hotel Ventures Ltd*, unreported and approved by Norse J in *Re R A Noble Clothing Ltd* (1983) BCLC 273.
14 [1999] 1 WLR 1092.

14.26 It will be seen that although the law does provide for a certain amount of minority protection, its effectiveness and scope is limited and uncertain. The minority shareholder is obviously much better off if he is given some express rights under the articles of association or in a shareholders' agreement which can be acted upon if breached, rather than having to prove the terms of an oral understanding or to rely on vague concepts such as unfairness, which might be interpreted differently by different judges.

14.27 An interesting question which arose in relation to s 459 was whether a term in a shareholders' agreement excluding the operation of the section is enforceable. It may be thought that, after a long and hard negotiation to arrive at a shareholders' agreement, it would be inconvenient if a shareholder could have successfully petitioned under s 459 on the basis of some unfairness which was expressly permitted by, or at least was not a breach of, the terms of the agreement. Although it had been argued to the contrary, the better view would appear to be that such a provision is not effective, and was held to be so[15]. This would presumably also apply to CA 2006, s 994 although there is not as yet any authority on the point. In view of the approach taken in *O'Neill v Phillips*[16] the question may to a considerable extent be academic, in that the court's starting point will be to see whether the alleged unfairness is a breach of the shareholders' agreement and would be likely to refuse to grant any relief where it is not. The scope for arguments that there were informal understandings or implied terms not reflected in the shareholders' agreement must be very limited where it is very comprehensively drafted, especially if it contains an 'entire agreement' clause. The approach taken in *O'Neill v Phillips* was endorsed by the Company Law Steering Group.

2 Types of express minority protection

14.28 Minority protection can generally be divided into positive and negative rights and, typically, a minority shareholder will negotiate protection which is a combination of both.

Positive rights

RIGHT TO APPOINT DIRECTORS

14.29 One of the most important positive rights of a minority shareholder may be the ability to appoint one or more directors to the board of the

15 *Exeter City AFC Ltd v The Football Conference Ltd*, [2004] 1 WLR 2911.
16 [1999] 1 WLR 1092.

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company, albeit that such a right is of itself of limited value where the majority appoints a majority of the directors. This form of protection is dealt with in detail at para 16.1ff.

SHARE RIGHTS

14.30 The majority shareholder will, where its shares are ordinary voting shares, have the right to attend and vote at general meetings. The shareholders' agreement or the articles may provide that there is no quorum unless the minority shareholder is represented at a general meeting. However, in order to avoid a shareholder being able to block every resolution to which it is opposed by failing to attend or send a representative to the meeting at which the resolution is being proposed, there will usually be a provision to the effect that if there is no quorum the meeting is adjourned for a short period, say seven days, and if there is no quorum at the adjourned meeting the shareholders present will be a quorum, whether all shareholders (or classes of them) are represented or not. Sometimes the shareholder is given a further chance by means of a second adjournment and it is only on the third attempt to hold the meeting that the provisions for a reduced quorum come into operation. Apart from the elimination of casting votes, Table 3 (see Chapter 13, section 1) is equally relevant to companies which are not deadlocked. Where the minority holder holds a special class of shares, he may have other positive rights such as the right to a preferential fixed dividend or the right to priority on a return of capital on a winding up – such rights are referred to as 'class rights'.

DIVIDEND POLICY

14.31 A provision regarding the dividend policy of the company is often included in the shareholders' agreement. Commonly, this provides that it is the intention that the whole, or perhaps a percentage, of the profits earned and available for distribution in each financial year of the company will be paid out as dividends, except such part of them as the board reasonably believes should be retained to meet the future capital needs of the company. Such a provision (expressed only as an 'intention') suffers from the disadvantage that if the majority controls the board it could, by finding reasons to retain profits, deny dividends to the minority, or severely restrict their amount. If the minority has a right of veto in respect of the business plans of the company (see para 15.40), a better solution would be to require that dividend policy should be dealt with in each business plan, so giving the minority some control over it. If minority approval is required for capital expenditure (see para 15.28) this may be another way of indirectly controlling dividend policy, since if capital expenditure is restricted it will probably increase the amount of profits which could be distributed.

VISITATION RIGHTS AND PROVISION OF INFORMATION

14.32 Another positive right which is sometimes seen is the *visitation right* (an expression originating in the United States) under which the minority holder is given the right to visit the company's premises, inspect its books and records, and interview and obtain information from its directors and senior staff. This right adds little or nothing to those which are available to a director, but they could be useful to an investor without board representation and are quite often included in favour of a shareholder which is primarily providing finance, such as a venture capital investor. Visitation rights can be coupled with the right to receive information about the progress of the company at regular intervals, such as the right to receive monthly or quarterly internal management accounts, cashflow forecasts and sales figures which would ordinarily only be available to the directors. Those advising the company will wish to ensure that the information is provided under the protection of a confidentiality undertaking, and such provisions are usually contained in shareholders' agreements.

RIGHT TO APPOINT AN OBSERVER

14.33 A further positive right which is sometimes given is the ability to appoint an observer to attend board meetings. This will be included where the shareholder concerned either has been given no board representation, or is worried about using it because it is a passive investor whose representative will have only the knowledge gleaned from attending board meetings. If its representative was appointed a director he might incur personal liability if, unbeknown to him, the affairs of the company are unlawfully conducted, eg if it trades whilst insolvent. The observer may or may not be given the right to speak, but will not, of course, be entitled to vote.

RIGHT TO REQUIRE PROPER CONDUCT OF THE BUSINESS

14.34 Other positive rights which are sometimes included are those which are designed to ensure that the affairs of the company are properly conducted, and are to some extent statements of the obvious, or even statutory requirements. Those which are most often seen are that the company maintains proper insurance, prepares and maintains proper books of account and has them audited in accordance with the legal requirements, and that it conducts its business in accordance with all applicable laws. It is also common for there to be a time limit for the production and audit of the accounts for each year, and the identity of the auditors is sometimes a matter requiring minority approval. There may be issues of substance in the insurance provisions, since without an agreement there may be a dispute over the scope and amount of cover the company should obtain. Of particular relevance is product liability insurance, which is so expensive that it may be necessary to limit the cover as to amount or as to the jurisdictions

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to which it will apply. There are also sometimes provisions under which 'key man' insurance will be taken out in respect of certain executive directors or senior employees; this is often insisted upon by institutional providers of equity finance. In the case of a company which is to exploit an invention, there may be a positive obligation to pursue patent applications, either generally or in various agreed jurisdictions.

14.35 In addition to these provisions, there is often a provision in a shareholders' agreement under which each shareholder undertakes to the others to act with the utmost good faith (or some similar expression) towards the company, not to allow its own interests to conflict with the company and to join with the others in procuring that the business of the company is efficiently conducted and in accordance with best practice. Such vague statements of general principle may be difficult to enforce in practice, but they can be useful provisions for a minority shareholder to be able to highlight in a dispute. A point to watch is whether the good faith provisions can be effectively extended to other companies within a covenantor's group. The good faith provisions fall short of a positive obligation not to compete, so non-competition covenants should also be taken where appropriate (see para 10.50ff).

SHARE TRANSFERS

14.36 Other positive rights may be conferred in relation to share transfers, such as the right to transfer shares subject to any pre-emption provisions and the right to buy shares under such provisions (see Chapter 19). Various other share transfer rights may be granted, and are discussed at para 17.28ff (termination put and call options, Russian roulette, Texas shoot out and multi-choice realisation procedure) and para 21.13 ('tag along and drag along').

IMPOSITION OF TERMS IN EMPLOYMENT CONTRACTS

14.37 Minority shareholders will often be keen to ensure that all key employees enter into non-competition covenants, confidentiality agreements and, as far as the law allows, will wish to ensure that employment contracts provide that all intellectual property devised by employees belongs to the company. Positive obligations to this effect could be imposed in the shareholders' agreement but this may be of limited value unless the employees in question are contractually bound by it.

RIGHT TO ENFORCE ANCILLARY CONTRACTS

14.38 An important minority protection can be a right to enforce the company's rights under ancillary agreements which are made between the company and another shareholder, which would normally be entirely in the hands of the board. Methods of achieving this in relation to support

agreements are discussed at para 3.15ff. The same principles could be applied in relation to other ancillary contracts, eg the breach of a patent licence by withholding improvements from the company or the breach of a warranty contained in an agreement for the transfer of business assets to the company.

NON-COMPETITION

14.39 A minority shareholder will usually have the benefit of a restrictive covenant in the shareholders' agreement under which all the shareholders agree with each other not to compete with the company, and it may possibly require shareholders to channel any business opportunity within the scope of the company's activities to the company rather than exploit it themselves, or through another member of their group[17].

TAX

14.40 Another positive right which may be afforded to a minority shareholder in a company which is a consortium for tax purposes is the ability to avail itself of consortium relief by surrendering the appropriate proportion of its trading losses to the company and receiving payment for them. Consortium relief is discussed at para 7.35ff.

Negative rights

14.41 It is common for minority shareholders to be provided with a large number of vetoes, ie the ability to require that particular transactions are not carried out unless one or more minority shareholders approve them first. Where such rights are available to more than one minority shareholder, the approval of all, or of a defined majority, of them may be required. Minority vetoes are discussed in more detail in the next chapter, but where they should be placed in the documentation is discussed in paras 14.42–14.88.

3 Should the minority protection rights be conferred by a shareholders' agreement or the articles of association?

14.42 Every joint venture or arrangement between shareholders is likely to involve both the articles of association and a shareholders' agreement. A company must have articles of association and, although it is possible to adopt Model A in its entirety and include all minority protections in the

17 Non-competition covenants are discussed in more detail at para 10.50ff.

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the options are granted. It is likely that the HMRC will not be able to treat such an arrangement as a disposal, especially if material terms of the options, such as the exercise period or exercise price, are not exactly the same, but it is possible they may be able to do so where the purpose of the options is only to delay the date of the disposal, where the circumstances are such that the exercise of one or other of the options is very likely, or there is no good commercial reason for the grant of the options.

18.4 The possible difficulty involved in a listed company entering into an option under which it may be bound to buy or sell shares was discussed at para 11.30ff.

18.5 To be effective, an option must specify the price at which the shares the subject of it will be bought and sold upon its exercise. If the earliest exercise may be some years in the future, it is unlikely to be a fixed price. If it is a fixed price, it will need to be made adjustable to take into account subsequent share issues and reorganisations, as referred to in para 18.9, with such adjustment being subject to expert determination if there is a failure to agree the adjustment. A formula price based on the profits or net assets shown by the last audited accounts at the time of exercise might be used, but will have to be carefully worded and is best avoided lest the formula turns out to be inappropriate in the light of the circumstances at the time of exercise. Where it is intended the price shall be equal to market or fair value at the time of exercise, it is usual to provide that the price shall be determined by a valuation made by the auditors or an independent accountant. A provision that the parties will first try to agree the price, with a valuation provision if they should fail to do so, is quite often seen. Share valuation provisions are dealt with in detail in Chapter 22.

2 Structuring an option

Avoiding conflict with other provisions

18.6 Care needs to be taken to ensure that an option is not contrary to other provisions of the documents, such as pre-emption provisions or restrictions on transfer in the articles of association. It will usually be necessary to provide that it takes precedence over such other provisions and that any necessary action will be taken to give effect to an exercise of the option, such as granting pre-emption waivers or procuring the registration of a transfer. Parties other than those to the option may need to be involved in this to ensure these provisions are effective, and it will therefore usually be convenient to incorporate the option in the shareholders' agreement.

Time of exercise

18.7 The terms of the option should define the period during which the option is exercisable and state whether the option may only be exercised once in respect of all the shares subject to it, or whether there may be more than one partial exercise. A provision that a partial exercise must relate to a minimum number of shares is desirable to avoid the seller being left with only a small number of shares, possibly without any minority protection if this falls away when a holding becomes minimal[1]. If there is to be a long delay between the grant and the earliest date of exercise of the option, it may be appropriate to allow for earlier exercise in certain events such as a change of control, an offer for the whole issued share capital of the company or its listing; here the option should be exercisable immediately before the event in question, so that the option holder may benefit from the sale or listing, a point which is sometimes overlooked. Exercise may be subject to the satisfaction of conditions set out in the agreement, and there could be undertakings on the part of the parties to the option or other shareholders to endeavour to procure that they are satisfied. The exercise period will then normally commence on satisfaction of the conditions and continue for a short period afterwards. Alternatively, it may be better to make the completion of the sale and purchase consequent upon exercise of the option subject to the required conditions. This avoids the grantor being involved in time and effort in satisfying the conditions without its knowing whether the grantee will exercise the option should they be satisfied. The choice of route will depend on the nature of the conditions and whether they are a necessary objective for the company, or something special to the transaction with the purchaser. If the conditions could be satisfied on more than one occasion, it should be specified whether the option can only be exercised by reference to the first occasion, or whether to the extent not then exercised it may be exercised on a subsequent occasion.

The shares the subject of the option

18.8 There will need to be provisions identifying the shares which form the subject of the option, which will not necessarily be simply all the shares held by the seller at the date of grant. The seller may subsequently be issued with further shares, or the identity of its shares may change as a result of reorganisation of the share capital, or could even become shares in a different company, and it will need to be clear whether the extra or substituted shares are included in the option. Where additional shares are issued to the seller without any consideration, such as a bonus issue, no

1 See para 15.9.

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difficulty results in including these in the option. However, where the seller can only obtain the shares by subscribing for them, it needs to be agreed whether any such additional shares are included, and whether the seller is obliged to subscribe for them, which may be onerous. An alternative is for the seller to be obliged, if requested, to assign the right to subscribe for all such additional shares to the prospective purchaser, either altogether or to the extent that the seller does not take them up.

Adjustment of the consideration for the option shares

18.9 A related question is whether, assuming that the shares resulting from any such reorganisation are included in the option, the option price should be adjusted to reflect any such capital reorganisation. Where the price is to be fixed by valuation, no adjustment mechanism is necessary, since the valuer will simply value the shares which are the subject of the option at the time of exercise. Where, however, the initial price is fixed or is based on a formula, it may be necessary to adjust it to take account of subsequent reorganisations. The option agreement will usually leave such an adjustment to the expert determination of an independent accountant or the auditors, but this is not really adequate, and it would be preferable for the terms of the option to set out some guidelines for the valuer to follow. Where the number of shares changes due to a sub-division or consolidation, or there is a bonus issue of new shares or some other reorganisation not involving the introduction of new funds or the extraction of funds from the company, the overall consideration for the exercise of the option in full should not change, but the price per share will increase or reduce to reflect the lower or higher number of shares included in the option. Where the prospective seller has had to pay additional sums to secure additional shares, the overall price should normally be adjusted upwards to reflect the amount paid. On the other hand, if the prospective purchaser has received a capital sum from the company in respect of any of the shares or some of them have been purchased or redeemed, the overall price may be adjusted downwards to reflect the consequent outflow from the assets of the company.

Perpetuities

18.10 The rule against perpetuities may in theory apply to commercial contracts involving a contingent interest by the Perpetuities and Accumulations Act 1964, s 10, and this is most likely to arise in relation to options. However, given that the perpetuity period is a life or lives in being at the date of grant plus 21 years thereafter, it is extremely unlikely that the rule will have any practical relevance, since most options between shareholders have a life far shorter than 21 years, and in any case it is possible, under s 3 of the

above Act, to 'wait and see'; ie a disposition is not void for remoteness until such time as it becomes certain that the contingent interest cannot vest in the perpetuity period. Where there is any possibility that the rule might be infringed, the alternative 80-year limitation period permitted by the Act should be used.

Multi-party options

18.11 If the option extends over the shares held by more than one potential seller, or the shares are to be purchased by more than one party, provisions will need to be included for joint exercise and/or joint obligations as to the delivery of the shares. The proportions in which the shares are to be purchased will need to be specified, and a provision that neither the sellers nor the purchasers are obliged to complete unless all the shares are paid for and delivered at the same time will be desirable. It will need to be specified whether the exercise of the option is by agreement between the prospective purchasers (or sellers if it is a put option) or whether a majority may exercise it on behalf of all of them. If the latter is chosen, performance of the purchase obligation might be secured by the grant of power of attorney, possibly coupled with the right to recover from any parties who fail to provide their proportions of the purchase price in favour of those who provide such monies in their places.

Restrictions on disposal

18.12 The prospective purchaser will wish to include a restriction on the prospective seller from disposing of the shares the subject of the option to a third party at any time prior to the expiry of the exercise period, although such a term is implied anyway. This should not result in the immediate passing of beneficial ownership.

Voting rights and dividends

18.13 It will need to be agreed whether it is the prospective seller or the prospective purchaser who is to be entitled to exercise the voting rights and receive dividends and other distributions in respect of the shares the subject of the option down to the date of exercise or completion. Normally, the prospective seller will remain so entitled, since there is no reason why it should be deprived of its rights where it has not received the price of its shares or even a binding commitment for such purchase from the option holder; indeed if it is not so entitled it may indicate possible loss of the beneficial ownership of the shares and this could result in the disposal for

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capital gains purposes of the shares at the time the option is granted. Also, there may be a loss of 'grouping' status. For example, if the prospective seller owns 80% of the shares of a company, it will be entitled to 'group' it for tax purposes (see para 7.33ff), but if it then grants an option over a 10% stake, and agrees that the prospective purchaser shall be entitled to the dividends and votes on those shares, it will only receive dividends and votes on a 70% stake and may lose its ability to 'group'. Although the voting rights may be retained by the prospective seller, the prospective purchaser may wish to make the ability to vote in respect of certain transactions subject to its approval, although this is rare. This could enable the prospective purchaser to obtain some minority protection in respect of the stake it would be acquiring. This could be particularly important if it is not already a shareholder or its existing stake does not carry sufficient, or any, minority protection. Such an arrangement should not cause any loss of beneficial ownership or the ability to 'group'.

Completion

18.14 The option will need to include provisions relating to the completion of the sale and purchase of the shares following exercise, which will basically oblige the seller to hand over an executed transfer and the share certificates and the purchaser to pay the price of the shares. These will be similar to the provisions contained in a share sale and purchase agreement, but other points may need to be dealt with, such as an obligation upon the seller to remove its board appointee or to procure registration of the transfer. If the agreement is silent on the latter point, the seller is not obliged to procure registration.

Warranties

18.15 Warranties will be taken by the prospective purchaser as to the prospective seller's title to the option shares and the seller will generally be required to sell with full title guarantee. If the prospective purchaser is not already a shareholder, it may also desire warranties concerning the affairs of the company. This is problematical – any warranties taken at the time of grant are not likely to remain true at the time of exercise. The purchaser will want assurances about the situation at the date of exercise and the seller will not be willing to warrant the future. A possible solution to this difficulty is for the seller to undertake to disclose everything contrary to the warranties (which are worded to refer to the position at the date of exercise) with the purchaser having the right to withdraw if it does not like the position revealed by the disclosure letter, without prejudice to a subsequent exercise of the option subject to any general time limit on exercise. No liability would

fall on the seller if the option notice is withdrawn, but where the purchaser proceeds to completion the seller would be liable if it failed to make a true and complete disclosure so as to render any of the warranties untrue when read together with the disclosure letter. The timing would be that once the (conditional) notice exercising the option has been served, the seller would have an agreed period to prepare its disclosure letter and the purchaser would then have an agreed period to consider this and serve notice either affirming its exercise of the option or withdrawing. A difficulty may be that the seller does have access to sufficient information about the company to give the warranties, especially if it has no board representation. Warranties are discussed in more detail in Chapter 25.

Consideration for grant

18.16 To be enforceable, the grant of the option must be for consideration, or the option granted by deed. One pound is quite sufficient and there is not normally any reason for making it any higher. If the option is contained in a shareholders' agreement, other undertakings contained in it on the part of the grantee will normally provide sufficient consideration.

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Tax position

18.17 If the consideration for the grant of an option is a monetary amount greater than a nominal sum or represents less than the market value of the option, it becomes necessary to consider the special rules which apply for capital gains purposes to the grant and exercise of options under s 144 of the Taxation of Chargeable Gains Act 1992 (TCGA 1992).

18.18 Basically, an option is treated as a separate asset for capital gains purposes. When an option is granted it is treated as a disposal of the option by the grantor for the consideration received for the grant, even though there was no acquisition of the option by the grantor, from which it follows that no acquisition cost can be deducted from the consideration received from the grant, except the legal and other expenses relating to such grant. A capital gains liability can therefore arise as soon as the option is granted.

18.19 When the option is exercised, the grant or acquisition of the option is treated as the same transaction as its exercise. In the case of the grantor:

- if the option is a call option under which it can be required to sell shares, the consideration it received for the grant of the option is added to the sale proceeds of the shares, so that a gain is made on the difference between the base cost of the shares and the aggregate of the sums received on grant and exercise; and

- if the option is a put option under which it can be required to buy shares, the consideration it received for the grant of the option is deducted from its acquisition cost of the shares, so that when it comes to sell the shares acquired under the option, the gain will be the difference between the price then received minus the sum paid for the acquired shares after deducting the sum received for the grant of the option.

18.20 The position of the grantee is as follows:

- if the option is a call option under which it may call for shares to be sold to it, the sum it paid to the grantor for the option is added to the base cost of the shares acquired; and
- if the option is a put option, under which it may require the grantor to buy its shares, the sum it paid to the grantor for the option is treated as an expense of the sale, so reducing the capital gain.

18.21 As a consequence of the option being exercised, the grant of the option ceases to be an occasion of charge. Accordingly, any capital gains tax paid by the grantor on any gain arising on the grant should be set off or repaid by HMRC (HMRC Capital Gains Manual CG12317, and see http://www.hmrc.gov.uk/manuals/cgmanual/CG55400+.htm for HMRC Capital Gains Manual regarding share options).

18.22 In certain circumstances (eg where the parties are connected), the market value rule in s 17(1) of the TCGA 1992 may apply to the grant of the option, the acquisition of the option by the person exercising it or the transaction resulting from its exercise. This would result in the position of the parties being different from their economic position.

18.23 In the case of mutual put and call options, the consideration for the grant of each option is the value of the option received in exchange. This can result in tax being payable without funds being received out of which it may be paid.

18.24 Since an option is a chargeable asset, the assignment of an option and the cancellation of an option can both be disposals. Virtually all private company options will have a life of less than 50 years and are 'wasting assets', which has the effect that the acquisition cost of the asset is to be written down on a straight line daily basis over the option period. This means that the base cost of the option will decline over its life, so on a disposal for a fixed amount the gain will increase the later the disposal takes place, but on the other hand one might expect the consideration for the disposal to be less as the available period for exercising the option shortens. The same principles are applied in relation to the release of an option; this is a disposal of the option for the sum paid for the release[2].

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2 *Powlson v Welbeck Securities Ltd* [1987] STC 468.

18.25 If a share option is itself a marketable security (as defined for these purposes at s 122 of the Stamp Act 1891) the grant or transfer on sale of the option, if in writing, will be chargeable with stamp duty at the rate of 0.5% of the amount or value of the consideration. If the option is not itself a marketable security no stamp duty is payable on transfer or grant. If an option is listed, it will be a marketable security and a transfer in writing of such an option will be chargeable with stamp duty at 0.5%.

18.26 Whether or not they are marketable securities for stamp duty purposes, stamp duty reserve tax ('SDRT') is imposed at 0.5% on transfers of 'chargeable securities' which would include an agreement to transfer a call option. However, despite such a call option being a chargeable security for the purposes of SDRT, no SDRT will be due upon the grant of such an option, as the grant constitutes the creation of new rights rather than the transfer of existing rights.

18.27 Generally speaking, put options are not marketable securities for stamp duty purposes, nor are they chargeable securities for SDRT purposes, and, as such, no stamp duty or SDRT will be chargeable on their grant or transfer.

18.28 Where an option is granted to a director or employee, the tax considerations referred to in Chapter 26 will apply.

Dangers of put options

18.29 Put options which may be exercisable a long time after they have been granted can be dangerous for the grantor. When the grantee puts the shares on the grantor, the circumstances then existing may be completely different from those that were envisaged when the option was granted. Although, if the price is to be fixed by valuation, a deterioration in the financial position of the company could be expected to be reflected in the valuation (although if this is to be based on the last audited accounts, there is always the possibility of a deterioration since they were prepared), there may be circumstances in which the grantor is not prepared to purchase at any price, and the grantor may wish to specify that the happening of certain future events, such as the loss of an important licence or concession, or other events likely to seriously disrupt the business, will release the option. Such a suggestion will probably be bitterly resisted by the grantee, who is relying on the option to ensure its exit. Formula prices are obviously especially dangerous.

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partnership law, most of the rules pertaining to corporations may be applied to partnerships.

There are no rules of Dutch contract law that specifically govern joint venture agreements. The normal rules of contract law, predominately based on the principle of contractual freedom, apply. In general, joint venture agreements in the Netherlands bear a strong resemblance, in form and substance, to joint venture agreements in common law jurisdictions. A particular feature of Dutch law is the overriding applicability of the principles of reasonableness and fairness. Pursuant to those principles, a contractual arrangement or an arrangement provided in the articles of association, or even a law, may not apply or may be mitigated in court to the extent that full applicability would under the circumstances (a high threshold is applied) be unreasonable to one or more of the parties involved. These principles also apply between those parties and persons involved in corporate entities such as shareholders and directors.

Incorporated joint ventures

An incorporated joint venture entity can be a company limited by shares (naamloze vennootschap, or 'NV'), a private company with limited liability (besloten vennootschap met beperkte aansprakelijkheid, or 'BV') or a co-operative (coöperatie). These entities are incorporated by notarial deed executed in the presence of a Dutch civil law notary.

The NV

The NV is a company with a capital divided into shares held by one or more shareholders. The deed of incorporation also contains the first articles of association of the company. NVs can have either or both registered shares (*aandelen op naam*) and bearer shares (*aandelen aan toonder*). Various kinds of registered shares are possible, such as preference shares, which carry preferential profit rights, and priority shares, which carry special voting rights. If the articles of association do not specify otherwise, all similar shares carry equal rights. The company may not issue share certificates for the registered shares. Transfer and issue of shares and amendment of the articles can only take place by notarial deed executed in the presence of a Dutch civil law notary. In respect of the transfer of listed shares an exception applies, shares of a listed NV can be transferred without a notarial deed being required.

The minimum share capital of an NV is €45,000. In addition, there are several mandatory legal provisions that restrict a reduction of the share capital of the NV to an amount that is lower than the amount of its nominal share capital. The background of these rules is that the issued share capital is considered to serve as guaranteed capital for the company's creditors. The main rules put limitations on (i) the distribution of dividends and other reserves below the amount of the nominal share capital, (ii) the acquisition

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of own shares by the company, (iii) the cancellation of issued capital, (iv) financial assistance, (v) transactions between new companies and their incorporators (*nachgründung*) and (vi) the issuance of shares against contributions in kind.

The BV

The BV can be compared with the German GmbH, the French SARL and Italian Srl. In October 2012, the Dutch Civil Code was amended to modernise BV laws and make them more flexible, resulting in a new version of the regime governing the BV, generally referred to as the 'Flex BV'. A number of mandatory rules that were applicable to the BV prior to the amendment have been abolished with the introduction of the Flex BV rules, such as rules relating to capital requirements and restrictions on the transfer of shares. A BV can be incorporated without any capital being contributed. The main difference from an NV is that the BV is designed to have a limited number of shareholders and in principle its shares cannot be freely transferred or traded, provided that since the introduction of the Flex BV rules, the articles of association of a BV may deviate from this principle. The introduction of the Flex BV results overall in a wider gap between the legal rules applicable to the NV and the BV, with the latter providing more options to tailor the corporate documentation to the needs of the shareholders, accommodating for example joint venture partners. These and other main characteristics of the BV after the introduction of the Flex BV rules are listed below:

Capital & equity:

The BV can have one or more shareholders. It can only have registered shares. The requirement that a private company has a minimum capital of at least €18,000 has been abolished. The rules that distributions to shareholders, like dividends, have to be based on a test of distributable capital of the company have also been abolished. The general meeting of shareholders may, with the approval of the Board of Managing Directors (bestuur), decide to distribute profits to the extent that the equity capital exceeds the reserves prescribed by law or in the articles of association. If the Board of Managing Directors grants approval and afterwards it turns out that the company cannot satisfy its debts, both the Managing Directors and shareholders can be held liable for the shortfall if – in short – 'they should have known better'.

Furthermore, the restrictions on the repurchase and/or cancellation of shares in the capital of a BV have been abolished. As a result, a BV can now repurchase and subsequently hold or cancel its entire issued share capital minus one share (provided that voting rights are attached to this share). The test that the Board of Managing Directors has to apply to a proposed decision to repurchase and/or cancel shares is the same test as for a decision to approve a distribution to shareholders (see above). The prohibition for a BV to provide financial support to a person or entity in order to acquire shares in this BV has also been abolished.

Last, the Flex BV rules provide for the possibility to create shares that give no right to profit (dividend). A holder of non-profit shares must, however always be able to exercise voting rights.

Corporate governance – appointment & dismissal of Directors:

The Dutch Civil Code provides that the general meeting of shareholders is authorised to appoint and dismiss Managing Directors and/or Supervisory Directors (commissarissen). In the articles of association this right to appoint and dismiss can be granted to holders of shares of a certain class (or a certain series). The body authorised to appoint a Managing Director or a Supervisory Director is also competent to dismiss him or her. However, after the introduction of the Flex BV rules, it is possible that the articles of association grant the power to dismiss also to another body than the body authorised to appoint.

Voting rights:

The starting point of Dutch company law, including the Flex BV rules, is that the voting right is linked to the nominal value of a share. However, the Flex BV rules allow for deviation from this starting point in the articles of association, for example by allowing multiple voting rights to be attached to one share. Flex BV introduces non-voting shares, these non-voting shares must, however, give a right to profit.

Transfer restrictions:

Although under the new rules it is no longer mandatory to include share transfer restrictions in the articles of association of a BV, the majority of the articles of association of BV's still contain a clause restricting the transfer of its shares (the 'blocking clause'). To the extent the articles of association do not deviate from this principle, the Dutch Civil Code prescribes an offer clause, pursuant to which shares before being transferred must first be offered to the other shareholders. The other shareholders are in principle entitled to purchase shares pro rata to the entire nominal amount of the shares held by each of them. The articles of association can also exclude the transfer of shares for a specific period of time (a lock up period). The law does not determine any maximum period for such lock up period. A transfer in violation of a transfer restriction or lock up provision in the articles of association is void.

Additional obligations on shareholders:

The Flex BV rules offer the possibility to include the following provisions in the articles of association: (i) obligations on shareholders vis-à-vis the BV (eg to provide additional financing), vis-à-vis third parties or vis-à-vis co-shareholders (eg non-competition or obligation for transfer shares), (ii) certain requirements for being a shareholder and (iii) special circumstances that trigger an obligation to transfer shares (eg good leaver/bad leaver provisions with a mechanism for determining price and irrevocable power of attorney).

Rules applying similarly to NVs and BVs

The rules of corporate law, specified in Book 2 of the Dutch Civil Code, apply to some extent similarly to a NV and a BV. The most material features of Dutch corporate law, to the extent applicable to both NV and BV, are set out below. Shareholders are not personally liable for the debts of the company, unless they can be held liable on the basis of tort. There are only limited examples of shareholders being successfully held liable, mainly where they have acted fraudulently. This is often quoted as the main difference between the BV, NV and (under circumstances) the Cooperation on the one side and unincorporated partnerships on the other side.

Representation & decision-making

NVs and BVs are represented by their Board of Managing Directors. The authority of this Board to bind the company cannot be set aside by or be limited by the articles. The articles may prescribe that individual directors or two or more directors acting jointly can also bind the company. The Managing Directors may be persons or corporate entities and do not have to be resident in the Netherlands. The company may also have a Supervisory Board (raad van commissarissen), to advise the Board of Managing Directors and supervise its policy. Supervisory Directors cannot have executive powers. The Supervisory Directors and Managing Directors should take as their guideline the 'interests of the company and the enterprise connected with it'. Often the articles will specify that the Managing Directors require Supervisory Board approval for material resolutions. For NVs the law prescribes that certain material management resolutions require the prior approval of the general meeting of shareholders.

Large Company Regime

NVs and BVs that meet the criteria of the Large Companies Regime (structuurregime) are by law required to have a Supervisory Board. Under this regime, the Managing Directors are appointed and dismissed by the Supervisory Board and the law prescribes certain management resolutions that require Supervisory Board approval. The Supervisory Board members are appointed by the general meeting of shareholders, upon nomination by

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the Supervisory Board itself in accordance with a profile drawn up by this Board. One third of the members should be appointed upon the recommendations of the Works Council. The general meeting may at all times reject any nominations and may at all times dismiss the entire Supervisory Board. Currently the (cumulative) criteria for the applicability of the Large Companies Regime are: an equity that exceeds €16m, more than 100 employees in the Netherlands and an active Works Council. For other companies the Supervisory Board is optional and the above-mentioned features of the Large Companies Regime do not apply. Certain exemptions apply, for instance when the company is a subsidiary of a company which is itself subject to the Large Companies Regime. A mitigated and more flexible regime applies when the company is part of an international group, which has the majority of its employees outside of the Netherlands, or the shares are held by a joint venture of two or more of such international groups or by one or more (co-operating) natural persons.

One tier board

In January 2013 new legislation was introduced, providing for a legal basis for a one-tier board system for both NVs and BVs. In this system, the articles of association of a company with a one-tier system allocate specific management powers to executive directors (uitvoerende bestuurders) and non-executive directors (niet-uitvoerende bestuurders). Management powers that have not been allocated will vest in all executive and non-executive directors (the one-tier board). The task of supervising the performance of directors cannot, by such allocation, be withheld from non-executive directors. Powers that may not be allocated to executive directors are the chairmanship of the one-tier board, the nominations for the appointment of directors and the power to determine the remuneration of executive directors.

Employee representation

Companies that have more than 50 employees in the Netherlands are required to incorporate a Works Council (ondernemingsraad). Pursuant to the Dutch Works Council Act (Wet op de Ondernemingsraden), the Board of Managing Directors needs to seek the prior advice of the Works Council to certain material resolutions such as major investments or a sale of the company. In case law, it has been decided that this right also applies in the event of a sale of the majority of the shares in the company. If the Works Council's advice is not followed, the relevant decision needs to be postponed for one month, during which period the Works Council may appeal the decision.

Annual accounts

NVs and BVs are obliged to publish their annual accounts, which should comply with Dutch law. They should be adopted and published within 13 months of the end of the financial year.

Shareholders/voting agreements

Voting agreements are in principle allowed, even if the enforcement thereof leads to undesired results for the parties that have executed the voting agreement. However, voting agreements may not lead to the continued frustration of the law or the articles or conflict with the interest of the company. In addition, here again the overriding principles of reasonableness and fairness apply.

Buy-out procedure

A shareholder that holds at least 95% of the issued share capital has the power to enforce a buy-out of the other shareholders, through legal proceedings held before the Enterprise Chamber of the Court of Appeal of Amsterdam (*Ondernemingskamer*). The law allows minority shareholders only limited grounds to object to the buy-out. The Enterprise Chamber can order experts to determine the price for the shares.

Dispute resolution

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Dutch corporate law provides for a dispute resolution mechanism that allows one or more shareholders holding at least one third of the issued share capital to request the district court (rechtbank) to force share transactions between shareholders in the following two situations. Firstly, a shareholder whose behaviour damages the interests of the company may be forced to transfer his entire shareholding to the other shareholders. Secondly, a shareholder who considers his interests damaged by one or more of the other shareholders can require that his shares are taken over and transferred to those shareholders. The articles of association or the applicable shareholders' agreement may provide for an alternative dispute resolution mechanism overriding this legal dispute resolution, to the extent such alternative dispute resolution does not render a transfer of the shares onerous or impossible.

Dutch corporate law also contains a right of inquiry (*recht van enquête*) into the policies, business and affairs of a company. At the request of (amongst others) a shareholder having at least 10% of the issued share capital, the Enterprise Chamber can appoint one or more persons to investigate the company. The investigators are entitled to full access to the books and records of the company. The request is granted if there are reasonable grounds to doubt whether the company has adopted correct policies. This right applies in the event of suspected misconduct by the management, but also applies in the event shareholders are prejudiced by the company or by the other shareholders, or even in the event of a deadlock between the shareholders that threatens to damage the interests of the company. Apart from appointing investigators, the Enterprise Chamber can also take certain interim measures such as the appointment of a Managing Director or a Supervisory Director, the suspension of a Managing Director or Supervisory

Director, or the temporary transfer of the voting rights of one or more shareholders.

Depository receipts for shares

A peculiarity of Dutch law is the possibility to separate the legal ownership of the shares from the beneficial interest in the shares, through the issue of depository receipts for shares (certificaten, or 'DRs'). This procedure is often used to limit the decision-making rights of certain shareholders, without affecting their financial rights. Legal ownership of the shares is then held by an entity that administers the shares, usually a foundation (stichting, comparable to a trust). The rights of the holders of DRs are set out in the general rules covering the DRs, which may vary according to the circumstances. One such rule is customarily that the foundation pays to the holder of the DRs any dividends or other amounts received in connection with the shares. The law also provides some basic rights to the holders of DRs: for instance, they are allowed to be present at shareholders' meetings (but not to vote). The entity administering the shares exercises the voting rights, but requires the approval of the holders of the DRs for far-reaching actions such as a sale of the shares.

Dutch tax consequences for NVs and BVs

Dutch resident companies are subject to Dutch corporate income tax (*vennootschapsbelasting*, or 'CIT'). The main types of companies referred to in the CIT Act are NVs and BVs. An NV or BV is considered resident in the Netherlands for CIT purposes if it has been incorporated under Dutch law or if its place of management and control is situated in the Netherlands. A Dutch-resident NV or BV is subject to CIT in respect of its world-wide income. However, the taxing rights of the Netherlands may be limited on the basis of the double tax treaties concluded by the Netherlands. Non-resident companies are subject to CIT if they derive certain categories of income from the Netherlands. The corporate income tax rate on the first €200,000 of taxable profit is 20%. The rate on taxable profit in excess of €200,000 is 25%.

When the shares in an NV or BV are held by an offshore holding company located in a non-treaty jurisdiction (tax haven), special attention should be given to the provisions in the Dutch Corporate Income Tax Act regarding foreign tax payers (CIT Act, art 17/17a).

According to these provisions, a foreign entity will be subject to CIT in respect of its income received from the Dutch NV or BV if certain conditions are fulfilled. These conditions include the entitlement to the profit or the equity of an enterprise having its residence in the Netherlands or income from a receivable against a Dutch resident company, when the holder of that receivable holds a substantial shareholding in a Dutch company. A substantial shareholding is a shareholding of at least 5% of the shares in a company. These provisions do not apply if holding the substantial shareholding is not

aimed at avoiding income tax or dividend tax or if the substantial shareholding does not belong to the active business of the holder.

Dividend income received by an NV or BV from subsidiaries can be exempt from CIT if the participation exemption applies. The minimum requirement for the participation exemption to apply is that at least (i) 5% of the nominal paid up capital of a company with a capital divided into shares, (ii) 5% of the units in a mutual fund, (iii) a membership right in a cooperative society, (iv) a limited partnership interest in an 'open' limited partnership that gives a right to a share in such partnership's profit of at least 5%, or (v) 5% of the voting rights in an entity of another EU member state, if the applicable tax treaty provides for a reduction of dividend tax based on voting rights is held.

The participation exemption does, however, not apply if the participation is held as a portfolio investment, unless the participation is a qualifying portfolio investment participation. A portfolio investment participation is regarded as a qualifying portfolio investment participation in case the 'minimum tax test' or 'asset test' is met. The minimum tax test is met if the company is subject to at least 10% profit tax on a tax base to be calculated according to Dutch principles. The asset test is met if the assets of a participation – on a consolidated basis – do not consist of 50% or more of free portfolio investments.

Dividends paid by an NV or BV to its shareholders are in principle subject to a 15% Dutch withholding tax on dividends. However, the widespread Dutch tax treaty network and the EU Parent-Subsidiary Directive, or available domestic exemptions may reduce or eliminate the Dutch withholding tax. Furthermore the Netherlands does not levy withholding tax on interest and royalty payments.

The Netherlands does not apply general thin capitalisation rules. Deductibility of interest payments on loans from related and from unrelated companies can be limited due to anti-base erosion provisions. No capital tax or stamp duty is due on capital contributions made to an NV or BV.

Co-operative

For tax reasons (see below), many foreign entities investing in the Netherlands use a Co-operative. Originally intended for co-operating farmers, a Co-operative is an association which should have, at its incorporation, at least two members. The objects of the Co-operative must be to 'provide for certain material needs of its members through agreements with its members'. Profits may be distributed to its members. There are no minimum capital or funding requirements. The liability of the members for debts of the co-operative may be limited or fully excluded. As regards governance, the NV/BV rules on Boards of Managing Directors and Supervisory Boards apply more or less similarly to the Co-operative. Otherwise, co-operative law is more flexible than NV and, to some extent, BV law.

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Dutch tax consequences for a Co-operative

A Co-operative is subject to CIT. The computation of the taxable basis for CIT purposes of a Co-operative does not differ from that of an NV or BV except where distributions of profits to individuals are concerned: these can, subject to certain requirements and limits, be deductible for CIT purposes.

A Co-operative has membership interests instead of a capital divided in shares. Therefore the profits distributed on the membership interest are generally not subject to Dutch dividend withholding tax. A Co-operative is however subject to Dutch dividend withholding tax if (i) it holds equity interests with the main goal or one of the main goals to avoid foreign tax or Dutch dividend withholding tax of another party (an abusive structure), and (ii) a membership interest in the Co-operative cannot be attributed to the active business of the member of the Co-operative.

No capital tax or stamp duty is due on capital contributions made to a Co-operative.

Unincorporated joint ventures

A joint venture in the form of an unincorporated entity usually takes the form of a general partnership (vennootschap onder firma) or a limited partnership (commanditaire vennootschap). Partnerships are not separate legal entities, so that they cannot acquire legal title to goods. Nevertheless, the partnership is able to sue and to be sued in its own name. The assets contributed to and the proceeds generated by the partnership form a 'joint ownership' (gebonden gemeenschap) in which the partners each have an undivided share. All the partners in a general partnership are liable for its debts, but in limited partnerships limited partners are only liable up to the amount of the capital they have contributed, unless they intervene in management, in which case they are liable with the general partners for the partnership's debts.

The general or limited partnership is a contract governed by Dutch law by which two or more partners (vennoten) agree to practise a profession or to conduct a business for joint account under the obligation to bring together a common property. None of the partners needs to be Dutch or resident in the Netherlands, although a number of administrative requirements must be complied with in order to operate a joint venture in the form of a partnership in the Netherlands. Unless prescribed otherwise, the partners participate in the profits or losses pro rata to their contributions. A partner's participation in the losses may be limited or excluded. A partner cannot be totally excluded from profits.

Contributions by general partners may be in cash, kind, labour or goodwill, but in the case of a limited partnership the contribution by a limited partner must be in cash.

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The contract between the partners establishing the partnership is governed by specific provisions under Dutch law applicable to partnerships, but also by general principles of Dutch contract law. Partnership law is quite flexible and leaves the parties much room to agree the terms of the partnership.

Tax position – general partnerships

For Dutch tax purposes, a general partnership is considered transparent. At the level of the partnership, no CIT is due, but each of the partners will be taxed in accordance with the tax system applicable to them. If the partner is an NV or BV, it will be subject to CIT (see above). If the partner is an individual, the individual is subject to Dutch personal income tax (inkomstenbelasting, 'PIT'). If the partnership carries on an enterprise, a Dutch-resident individual is subject to PIT on its world-wide income at progressive rates, with a maximum rate of 52%. If the partnership does not carry on an enterprise, the individual will be taxed over a notional income based on the value of his share in the partnership if the wealth of the individual exceeds a certain threshold. In short, an effective 1.2% tax would be payable over the value of the wealth. Non-resident companies are subject to CIT and non-resident individuals are subject to PIT if they derive certain categories of income from the Netherlands. The foregoing is subject to the terms of any available tax treaty.

No Dutch capital tax or stamp duty is due on capital contributions and there is no withholding tax on distributions.

Tax position – limited partnerships

For the Dutch tax treatment of a limited partnership ('CV'), a distinction must be made between a so-called 'Closed CV' and an 'Open CV'. The main distinction is the transferability of the partnership interests. If the admission and replacement of limited partners or the transfer of interests between them is subject to the prior consent of all other partners (both limited and general partners), the CV is considered to be a Closed CV. Otherwise the CV is considered an Open CV.

An Open CV is treated as a taxable entity for Dutch tax purposes and its profits are subject to CIT to the extent that they are attributed to the limited partners. An Open CV can apply the participation exemption provided the relevant conditions are met. Upon distribution of profits to the limited partners, 15% dividend withholding tax applies, subject to any applicable tax treaty, the EU Parent-Subsidiary Directive or domestic dividend withholding tax exemptions. Profits that are attributed to the general partner of the Open CV are taxed in the hands of the general partner. No distribution of profits to the general partner is recognised for dividend withholding tax purposes.

A Closed CV is tax transparent and is taxed in the same way as a general partnership. A Closed CV does not qualify as a resident of the Netherlands for tax treaty purposes and therefore it cannot benefit from any such treaty.