Deferred Consideration & Earn-Outs

Tracey Wright, Senior Associate in the corporate tax team at Osborne Clarke, revisits the taxation of deferred consideration and earn-outs in light of Finance Bill changes

On a private company takeover an individual shareholder is often required to take deferred consideration – this may be because the Purchaser does not have sufficient cash to pay the full purchase price, or it may be because Purchaser and Seller cannot agree on the correct valuation and part of the purchase price will depend on future profits.

Prior to 6 April 2008 such a shareholder usually wished the deferred consideration to be satisfied by the issue of a loan note to defer the tax charge. The Finance Bill 2008 changes to capital gains tax (CGT) affect the taxation of such consideration. So will we see a shift in shareholders' requirements?

BASIC TAX POSITION

In most cases the deferred consideration will be:

(i) contingent but ascertainable at the time of sale; or

(ii) contingent and unascertainable at the time of sale – for example, an 'earn-out'.

Ascertainable consideration

A shareholder who sells shares for contingent ascertainable cash consideration will be taxed on the full amount on disposal of his shares pursuant to TCGA 1992, s 48, ignoring any contingency. If the amount ultimately received is less than the amount taxed, a shareholder can make a claim to substitute the final consideration for the original amount taxed and claim a tax refund.

Prior to 6 April 2008 such consideration was usually satisfied by a loan note issued by the Purchaser. Under TCGA 1992, s 116 if shares are sold for a qualifying corporate bond (QCB) loan note the gain is calculated at the time of disposal but is 'frozen' until the QCB is disposed of.

Under TCGA 1992, s 135 if shares are sold for a non-qualifying corporate bond (non-QCB) loan note, the original shares and the non-QCB are treated as the same assets for CGT purposes and no gain arises until the non-QCB is disposed of.

Shareholders who take loan notes instead of cash in circumstance (i) above will avoid an immediate gain coming into charge if either s 116 or s 135 applies. The fact that there is a gap between the sale and receipt of the loan note should not prevent these provisions applying.

Unascertainable consideration

The most common form of unascertainable consideration is an earn-out where part or all of the purchase price for the sale of shares in a company is calculated by reference to the future performance of the target company.

A shareholder who sells shares for an earn-out payable in cash will be taxed on the value of the 'right' to receive the earn-out at the point of disposal of the shares. The right is often known as a *Marren v Ingles* right after the case which determined the tax treatment (*Marren v Ingles* [1980] STC 500). When the earn-out crystallises and the right is disposed of, a further gain or a loss may arise. An election can be made under TCGA 1992, s 279A to treat any loss as arising in the year of the share sale and so can be used to offset the original gain.

A shareholder who receives a cash earn-out may, unless payment is made within a short period, pay tax before he receives the cash. The shareholder also has the added complexity of valuing the right for tax purposes.

As a result of this an earn-out is often satisfied in loan notes, so that the transaction falls within TCGA 1992, s 138A, enabling it to benefit from the rollover provisions of s 135. This would allow tax to be deferred until cash was realised under the loan-note.

HISTORIC IMPORTANCE OF TAPER RELIEF

Prior to 6 April 2008 a shareholder's decision on whether to have deferred/earn-out consideration satisfied in cash or loan notes was also based on the effect of business asset taper relief (BATR).

If shares were sold for ascertainable deferred consideration the BATR clock stopped at the point of disposal if the consideration was payable in cash. If loan notes were taken in such circumstances, there was a concern about whether BATR continued if the loan notes were not issued until the time the amount of the deferred consideration was determined – that is, some time after the disposal. Was the loan note deemed to be received at the time of the disposal (by virtue of TCGA 1992, s 48) or did s 135 operate in isolation from s 48, in which case there must be some form of 'right' in existence until the loan note was issued, which might not itself qualify for BATR? As a result of these concerns most transactions were structured either to create a right to unascertainable consideration falling within TCGA 1992, s 138A or a non-QCB loan note was issued which was subject to reduction or cancellation if the full amount of the consideration was not payable. Both routes allowed the BATR clock to continue but the later route needed careful structuring for the Purchaser to make sure that a taxable profit did not arise under the loan relationship rules.

Where unascertainable consideration was payable in cash, BATR was not available on any amount paid in excess of the initial value of the right. If, however, an

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earn-out was satisfied by the issue of a non-QCB loan note, the earn-out was viewed as a security and the BATR continued to run until the loan note was disposed of.

If a shareholder had not accrued full BATR, the earn-out would be satisfied by the issue of a non-QCB loan note (with the need for the BATR conditions to continue to be fulfilled until the loan note was disposed of). However, if a shareholder had accrued full BATR the earn-out could be satisfied by the issue of a QCB which effectively banked the taper but ran the risk of all the initial gain still coming into charge if the loan note went bad.

THE NEW REGIME

With effect from 6 April 2008 the new CGT regime has introduced a flat 18% rate of CGT, abolished BATR and indexation allowance and introduced the new entrepreneurs' relief (ER). So what should shareholders do now?

EXISTING DEFERRED CONSIDERATION ARRANGEMENTS

Any deferred consideration arrangements where gains have been held over or rolled over into loan notes, or where earn-out rights have not yet crystallised, will now be in the new regime. Accordingly, when the loan notes are redeemed, CGT will be payable at 18% and accrued BATR will be lost. HMRC's view is that this will be the case even if the deferred/earn-out consideration has been satisfied by the issue of a QCB (unless ER applies, see below). There is a school of thought that BATR should be calculated on a gain at the time of receipt of the QCB. However, HMRC has confirmed that in its view BATR is not to be calculated until the gain comes into charge (that is, when the QCB is disposed of), so that no accrued BATR is available if the disposal occurs on or after 6 April 2008. We wait to see if any brave taxpayer seeks to challenge HMRC's interpretation of some pretty obscure drafting.

The new regime is beneficial for shareholders who received an earn-out right to be satisfied in cash prior to 6 April 2008, as any amount over and above the value of the right will be taxed at 18% and not at rates of up to 40%.

However, any shareholder with an earn-out to be satisfied in loan notes which has not yet crystallised will be subject to 18% tax even though at the time of entering into the transaction the shareholder would have expected BATR to be available. Shareholders who disposed of shares in the 2006/07 or 2007/08 tax years are still in time to make an election under s 138A(4A) to elect for rollover treatment not to apply.

Tracey Wright

If such an election is made the earn-out will effectively be treated as a cash earn-out and the value of the right may then attract any accrued BATR up to the point of the original disposal. For a disposal in 2006/07 interest will be charged on the late payment of the tax.

ER

ER is available on the first £1 million of qualifying gains arising after 5 April 2008. By reducing the chargeable gain by four-ninths, ER creates a pot of gains arising which may be liable to capital gains tax at an effective rate of 10%. ER is available if a shareholder disposes of shares or securities in a trading company, or the holding company of a trading group, on or after 6 April 2008, provided that he holds 5% of the ordinary share capital entitling him to 5% of the voting rights and he has been an officer or employee of the company or a company in the trading group for one year before the disposal. Therefore the relief is unlikely to be available on redemption of loan notes issued in satisfaction of deferred consideration/earn-outs, unless the Seller still owns a 5% shareholding and remains employed.

Under transitional rules ER will be available on the disposal of a QCB acquired before 6 April 2008 if ER would have been available had the QCB loan note been acquired after 5 April. This means that an effective rate of 10% may be available if QCB loan notes (but not non-QCB loan notes) had been issued in satisfaction of deferred or earn-out consideration prior to 6 April.

NEW ARRANGEMENTS

The availability of ER will be a key driver in structuring of deferred and earn-out consideration post 6 April.

Ascertainable consideration

As a result of the introduction of the new section TCGA 1992, s 169R, if the deferred consideration is satisfied by the issue of a QCB loan note the 'frozen' gain will be calculated taking into account available ER. If no ER is available the shareholder is likely to want the deferred consideration to be satisfied by the issue of non-QCB loan notes to defer the gain but also to ensure that no tax is payable if the Purchaser defaults in the loan notes. Loan notes taken in either circumstance will still need to have a term of at least six months and prior HMRC clearance will be required under s 135.

Unascertainable consideration

There will be a tension between deferring the tax charge and capturing available ER in structuring earn-outs in such cases.

If the traditional route of having an earn-out satisfied by the issue of loan notes so that tax is deferred under s 138A is adopted, it is very unlikely that ER will be available on disposal of the shares or on ultimate redemption of the loan note.

An alternative, if ER is available at the point of disposal of the shares, will be for the earn-out right to be structured as a QCB loan note under which the amount payable is reduced if the earn-out targets are not met.

In many cases it may be possible to fully utilise ER in respect of any cash consideration to be received on a deal. However, if ER is available, a shareholder who has a fairly short-term earn-out right (that is, over one to three years) may decide to have the earn-out right satisfied in cash, on the basis that it is worth paying the up-front tax to take advantage of the 8% tax saving. The need to value the earn-out right is likely to be less of a concern to the shareholder where this will affect the date on which the tax is payable rather than the rate of tax payable on such gains.

Clearly shareholders with more than one shareholding (or with very significant single holdings) may find that they use up their ER very quickly and that it is not a consideration on later transactions, or they may view the maximum £80,000 saving as too small to be concerned with. In such circumstances we would expect loan notes to still have a significant role in deferring the tax charge.

Despite the Government's profession that the CGT reforms are a simplification measure, there remains a significant amount of complexity in structuring earn-outs and many of the tax planning techniques employed under the BATR regime will remain relevant.