

Thoughts on the decision in *Marren v Ingles* (Lecture P1308 – 22.08 minutes)

The background to business earn-out deals

One eminent tax commentator has neatly summarised the rationale for business earn-out deals in the following way:

‘Earn-outs fulfil a useful function by reconciling the so-called “price gap” that often exists between a seller and purchaser. Many sellers believe that they are selling their business ahead of its maximum profit potential. Consequently, they will want to negotiate a price for the business that reflects its future earnings potential. On the other hand, most prudent purchasers will only be willing to agree a deal based on future (increased) profits when they are actually “delivered” by the business. Thus, by incorporating an earn-out arrangement as part of the pricing mechanism for the purchase of the shares, the seller’s and purchaser’s objectives can be satisfied.

An earn-out deal typically involves the seller receiving a fixed sum on completion, with further sums being paid over the next two or three years, calculated on a formula based on the actual results of the business over this period. The seller usually continues to be employed in the business during the earn-out period in a key management, technical or sales position. Thus, through their efforts during the earn-out period, sellers have the incentive to increase their disposal consideration, thereby ensuring that the purchaser’s acquisition is successful.’

The tax consequences

In essence, the tax consequences of an earn-out transaction are based on the House of Lords’ decision in *Marren v Ingles* (1980). Where a taxpayer sells an asset such as shares and there is a right for that person to receive a future unquantifiable sum, the value of the right forms part of the consideration for the sale of the shares. To the extent that business asset disposal relief is available, the gain enhanced by the value of that right will qualify for this important CGT relief (subject, of course, to the availability of the cumulative lifetime limit).

The *Marren* case further held that the taxpayer, in these circumstances, acquires an entirely separate asset, i.e. a right (or *chose in action*). As and when earn-out payments are received, additional CGT disposals take place by virtue of S22 TCGA 1992 in respect of this earn-out right. However, even where the individual still has some of their business asset disposal relief limit available, the transaction involving the earn-out right will not attract the lower CGT rate – it is not a disposal of *shares* and so is typically taxed at 20%.

The problem of losses

One of the problems arising from this treatment is the possibility of being taxed on an unrealised gain. If the taxpayer puts forward an unrealistically high value for the earn-out right or if the situation changes (e.g. because of COVID-19), this could give rise to a capital loss on the disposal of the earn-out right. As has been pointed out:

‘Before FA 2003 introduced a special relief, any such capital loss could not be carried back to reduce the seller’s original capital gain. This meant that the seller would suffer tax on an amount that exceeded his overall economic gain from the earn-out transaction.’

In other words, the taxpayer's loss was – for the time being – stranded.

Prior to FA 2003, the capital gains rules only allowed a capital loss to be carried back to an earlier year in two scenarios:

1. where a loss accrues to an individual in the tax year of his death, in which case it can be carried back and set against gains of the three immediately preceding tax years on a LIFO basis (S62(2) TCGA 1992); and
2. where a loss accrues in respect of a mineral lease, in which case it can be carried back and set against gains of up to 15 years preceding the year of the loss (S202(9) TCGA 1992).

However, following the relief brought in by FA 2003, where the right to deferred unascertainable consideration is disposed of, any resulting capital loss can, on election, be carried back and treated as though it arose in the tax year of the original transaction (provided that this gave rise to a chargeable gain). Notice that the length of the carry-back does not matter.

In essence, the legislation under what is now Ss279A – 279D TCGA 1992 has effect where:

- a person within the CGT regime disposes of an asset and incurs a liability to tax on the gain on this disposal;
- some or all of the consideration for the disposal of the original asset consists of a right to a further payment, the amount or value of which cannot be established at the time when the right is conferred;
- the person subsequently disposes of the right at an allowable loss for CGT purposes in a later tax year than the one in which the original transaction took place; and
- the person elects to treat that loss as accruing in the same tax year as that in which the original gain arose.

It should be emphasised that this loss carry-back election is only available to individual and trustee disposers. Companies cannot benefit from the facility.

Illustration 1

On 1 December 2019, Monty, a higher rate taxpayer, sold some land in return for cash of £500,000 and a right to deferred unascertainable consideration valued at £126,000. This disposal gave rise to a gain of £370,000 and so Monty paid CGT at 20% on this amount less the annual CGT exemption for 2019/20.

On 1 July 2023, Monty received £90,000 for his right and, in doing so, realised a capital loss of £36,000.

He therefore elected under S279A TCGA 1992 for his loss of £36,000 to be treated as a loss in 2019/20, reducing his gain for that year to $£370,000 - £36,000 = £334,000$. He is therefore entitled to a CGT repayment of $20\% \times £36,000 = £7,200$.

The interaction of a S279A TCGA 1992 election with other allowable losses also calls for comment. The basic principle, which is set out in S279C TCGA 1992, is that such losses are deducted in priority to the carry-back loss.

Illustration 2

Mortimer disposed of private investment company shares in 2017/18, making a gain of £68,000. He had allowable losses on sales of other assets in the same tax year amounting to £17,000. In addition, he had unused losses brought forward of £32,000.

After deducting the 2017/18 annual exemption of £11,300, Mortimer had paid CGT on:

	£
Gain on private investment company shares	68,000
Less: Current year losses	<u>17,000</u>
	51,000
Less: Losses b/f	<u>32,000</u>
	19,000
Less: Annual CGT exemption	<u>11,300</u>
	<u>£7,700</u>

In 2022/23, Mortimer disposed of the right to deferred unascertainable consideration which he had received on the sale of the private investment company shares. This gave rise to a loss of £20,500.

Because he had no gains in 2022/23, Mortimer elected under S279A TCGA 1992 to treat his loss of £20,500 as a loss which accrued in 2017/18.

Mortimer's other losses are set off in priority to the loss of £20,500. Consequently, only £19,000 of the loss of £20,500 can be deducted from Mortimer's gains in 2017/18 – note that his annual CGT exemption for that year is wasted – and the balance of £1,500 (£20,500 – £19,000) is carried forward for offset against Mortimer's gains in 2023/24 and later years. He is not permitted to deduct this loss carry-forward from gains in 2018/19 and the other intervening tax years.

A S279A TCGA 1992 election is irrevocable and (*inter alia*) must specify:

- the relevant capital loss;
- the right disposed of;
- the tax year in which the right was disposed of;
- the tax year in which the right was acquired; and
- the nature of the original asset.

The election must be made by the first anniversary of 31 January next following the tax year in which the loss was made (S279D TCGA 1992).

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