

Negative earn-outs

(Lecture B1108 – 27.28 minutes)

In the past, whenever a private company was sold on an earn-out basis, it was relatively common for the deal to be structured so that the earn-out payment was satisfied by an issue of shares or loan notes in the purchasing company that fell to be dealt with under S138A TCGA 1992. Under business asset taper relief, this arrangement had a number of beneficial tax consequences:

- the gain which would have arisen on that part of the original shares attributable to the earn-out right under the rule in *Marren v Ingles* (1980) was deferred;
- the subsequent issue of shares or loan notes by the purchasing company was treated as the conversion of a non-QCB security so that the capital gains charge was postponed still further; and
- a gain, computed by reference to an appropriate part of the vendor's shares, only came into charge when the shares or loan notes in the purchasing company were eventually disposed of.

The impact of this was that all the vendor's gains would typically attract business asset taper. It should be remembered that, with a cash-based earn-out, taper was only available to reduce the gain on the original disposal and never on the subsequent ones (an earn-out right not being a qualifying business asset).

With the replacement of business asset taper by entrepreneurs' relief and changes in both the entrepreneurs' relief limit and the CGT rate, it is thought that future corporate disposals involving earn-outs should more often take the form of cash deals. The main reason is that, where S138A TCGA 1992 applies, entrepreneurs' relief is virtually never available on the earn-out element and so it will make sense to maximise the vendor's initial gain, given that this is the one time when the 10% rate can be claimed. Since the remaining gains are likely to be charged at 20%, a higher upfront gain and a lower deferred charge will normally represent good tax and cash flow planning.

Illustration

Tom formed Tom Industries Ltd in April 1996, subscribing for the entire share capital of 10,000 ordinary shares of £1 each at par. On 1 July 2015, he sold his shareholding to a plc.

The sale contract provided for:

- an initial cash consideration of £2,800,000 to be paid on completion; and
- a deferred earn-out consideration based on defined profits for the 12 months ended 30 June 2016, which was to be satisfied in the form of loan notes from the plc. (the maximum earn-out consideration was set at £2,200,000).

Tom continued to act as managing director of Tom Industries Ltd during the earn-out period (for which he was appropriately remunerated).

Tom's earn-out right was valued at £1,200,000 as at 1 July 2015. On the assumptions that the actual earn-out consideration turns out to be £1,650,000 for the 12 months ended 30 June 2016, that the loan notes were received by Tom on 1 November 2016 and that the loan notes were redeemed on 1 May 2017, Tom's CGT computations proceed as follows:

2015/16

	£
Sale proceeds	2,800,000
Less: Cost	
2,800,000	
----- x 10,000	<u>7,000</u>
2,800,000 + 1,200,000	
	2,793,000
Less: Annual CGT exemption	<u>(11,100)</u>
	<u>2,781,900</u>
CGT @ 10%	£278,190

2017/18

	£
Earn-out proceeds	1,650,000
Less: Cost (10,000 – 7,000)	(3,000)
Less: Annual CGT exemption	<u>(11,300)</u>
	<u>1,635,700</u>
CGT @ 20%	£327,140

Tom's aggregate CGT liability for this transaction amounts to £278,190 + £327,140 = £605,330.

If, however, Tom's earn-out deal had been structured in cash so that the payment of £1,650,000 was made on 1 May 2017, the tax position changes significantly:

2015/16

	£
Sale proceeds (2,800,000 + 1,200,000)	4,000,000
Less: Cost	<u>(10,000)</u>
	3,990,000
Less: Annual CGT exemption	<u>(11,100)</u>
	<u>3,978,900</u>
CGT @ 10%	£397,890

2017/18

	£
Earn-out proceeds	1,650,000
Less: Cost	<u>(1,200,000)</u>
	450,000
Less: Annual CGT exemption	<u>(11,300)</u>
	<u>438,700</u>

CGT @ 20% £87,740

Tom's total CGT liability is now £397,890 + £87,740 = £485,630, a saving of £119,700. Even though Tom has paid more tax initially, the overall saving will certainly be worth having.

Interestingly, it may be possible to save even more tax. This is achieved by having what is sometimes referred to as a 'negative earn-out'. That is to say, the sale price is set at the maximum possible figure (£2,800,000 + £2,200,000 = £5,000,000 in the example involving Tom above). Only the basic amount of £2,800,000 is paid upfront, with the remainder to be handed over in deferred cash at the earn-out date. However, this deferred cash amount is reduced if the earn-out targets are not fully met. Provided that the transaction is structured this way round, one achieves a similar economic effect between the parties to an earn-out, but the tax calculation is now based on the full £5,000,000 sale price. If less than this is received, then, under S48 TCGA 1992, it is possible to reopen the computation and adjust the sale proceeds figure to the actual receipt.

The advantages of this arrangement are that:

- the taxpayer qualifies for entrepreneurs' relief on the full amount received (subject, of course, to the £10,000,000 limit); and
- it is unnecessary to find a valuer to do the complicated exercise of working out the *Marren v Ingles* (1980) figures.

This is because the taxpayer has moved into the realm of deferred consideration rather than unascertainable consideration. In the Tom example, the taxpayer will save an additional £43,000 of CGT.

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