

Selling company shares - consideration (Lecture B1322 – 17.18 minutes)

Where company shares are sold, there will be a disposal of that asset by the shareholder. If the proceeds of that sale exceed the acquisition cost for the shareholder there will be a capital gain arising. The actual liability arising on that capital gain will depend on the circumstances of each individual shareholder. The rate of CGT will be 10%, 20% or 10% if business asset disposal relief (BADR) is available. Availability of BADR is a very important facet of company sales although less so since the lifetime limit was reduced to £1m.

Business asset disposal relief (BADR)

BADR is available where there is a material disposal of business assets by an individual. One of the material disposals is the disposal of shares and securities in a company.

In order to be a qualifying disposal, either condition A or B must be met:

- Condition A is that throughout a period of two years ending on the date of disposal the company is:
 - the individual's personal company;
 - is either a trading company or a holding company of a trading group; and
 - the individual is an officer or employee of the company or the trading group.
- Condition B is that those conditions are met throughout a period of 2 years ending with date of ceasing to trade or ceasing to be part of a trading group (without becoming a trading company) and that cessation is within 3 years of the date of disposal. This does not necessarily mean the cessation of all activities but just cessation of qualification as a trading company.

A company is an individual's personal company if the individual concerned holds at least 5% of both the ordinary share capital and the voting rights plus 5% of rights to income and assets on a winding up (or 5% of sale proceeds).

It is obviously key that the company is a trading company or the holding company of a trading group.

This is defined as follows:

1. A trading company means a company carrying on trading activities whose activities do not include to a substantial extent activities other than trading activities (considered by HMRC to mean any activity contributing more than 20% of turnover, profit, asset value or time employed in the business).
2. A holding company means a company that has one or more 51% subsidiaries.
3. A trading group means a group of companies one or more of whose members carry on trading activities and the activities of whose members taken together do not include to a substantial extent activities other than trading. Effectively you take the single company definition and apply it to the group as if it were a single company (ignoring inter-company transactions).

4. Trading activities mean activities carried on by a company:

- In the course of carrying on its trade
- For the purposes of preparing to trade
- With a view to acquiring or starting to acquire a trade
- With a view to acquiring a significant interest in the share capital of another company which is a trading company or the holding company of a trading group and which is not a member of the same group of companies as the company acquiring the shares.

Types of consideration

Where shares are being sold, there are a number of ways in which the deal can be structured with different types of consideration available to the purchaser. The tax treatment will depend on the nature of the consideration.

The types of consideration we are normally looking at are:

- a) cash;
- b) loan notes issued by the acquiring company (QCBs and NQCBs);
- c) shares in the acquiring company

Each type of consideration will give rise to different tax effects for the purposes of capital gains tax and should be considered in turn to determine which consideration may be most tax efficient and desirable for each of the shareholders in this situation.

Cash consideration

If any part of the consideration is in cash, that proportion of the gain will immediately crystallise as an immediate liability to CGT.

If the consideration is only partly cash for a share sale, the allowable costs to set off against the proceeds will be calculated using the $A/A+B$ formula where A is the cash consideration received and B is the value of the non-cash consideration received. It will be chargeable in the tax year/chargeable period in which the sale takes place.

Example

Mr A sells shares for £1,000,000 cash. He had previously purchased those shares for £100,000.

Disposal proceeds	£1,000,000
Less cost	<u>(100,000)</u>
Gross gain	<u>£900,000</u>

If he had sold for £1,000,000 cash plus shares worth £600,000, the cost of £100,000 would have been apportioned using formula A/A+B:

$$100,000 \times (1,000,000)/(1,000,000 + 600,000) = £62,500$$

The initial gain then increases to £937,500 due to a lower cost price. The £37,500 of cost is carried forward as the base cost for the new shares received (see below).

Consideration satisfied in shares

Where the shareholder vendor in question chooses to receive shares in the acquiring company in exchange for his shares, the CGT liability on the disposal of the original shares will be deferred if the conditions are met. In fact, the legislation does not actually defer the gain, rather treats the disposal as if it had not taken place. The acquisition cost of the original shares is simply transferred to the new shares.

This treatment is mandatory although it is possible to elect for it to be disapplied.

As the original shares are treated as if no disposal is made there is a continuous holding period for BADR assuming other conditions continue to be met.

The primary condition for the no disposal/no acquisition rule to apply is that there must be an issue of shares or debentures by the predator company to a person in exchange for shares or debentures in the target company.

One of three other conditions must then be satisfied:

1. the acquiring company already holds, or as a result of the transaction will hold, more than 25 per cent of the ordinary share capital of the target or
2. the acquiring company makes a general offer for the shares in the target with the intention of gaining control of the target or
3. the acquiring company already holds, or will hold as a result of the transaction, the majority of the voting power in the target

There is an overriding condition is that the exchange must be carried out for bona fide commercial reasons and not as part of a tax avoidance scheme. However, this only applies where the shareholder together with persons connected with him hold 5% or more of the shares in the target company. This anti-avoidance rule will not apply if, on an application being made in advance of the transaction, HMRC are satisfied that the exchange or reconstruction will satisfy the conditions set out above.

There is a problem, however, if the target company shares qualify for BADR but the acquiring company's shares will not. In this instance, the shareholder can elect to disapply the provisions of s135 so that the share exchange constitutes a disposal. This would enable the BADR to be claimed. The consideration would be the market value of the shares being acquired. This may seem like a sound idea but will obviously mean the potential of crystallizing a tax liability without the corresponding income to pay the tax. This would need to be factored into any negotiation.

Consideration as loan notes

Loan notes can be qualifying corporate bonds (QCBs) or non-qualifying corporate bonds (NQCBs).

If the loan notes are short dated, it may be considered to be consideration as cash.

A corporate bond is a qualifying corporate bond if it is issued after 13 March 1984 and corporate bond is defined by s117 TCGA 1992 as:

'a security ...

- (a) The debt on which represents and has at all times represented a normal commercial loan and*
- (b) Which is expressed in sterling and in respect of which no provision is made for conversion into, or redemption in, a currency other than sterling'*

It should be noted that conversion at the prevailing exchange rate would be ignored for the purposes of this definition.

'Normal commercial loan' has a specific definition and excludes loan notes where there is an ability to convert the loan note to shares and where interest is payable according to results.

The default position will therefore be that loan notes are QCBs, with specific clauses having to be inserted into the loan note to make it an NQCB.

Where shares in a company are swapped for loan notes the normal share exchange rules apply in basic terms. It would therefore be usual to apply for the relevant clearances to ensure that s135 TCGA 1992 applied (see above).

Where the loan note is an NQCB, the treatment is identical to shares. Whether ER is due on the eventual encashment of the NQCB will depend on whether the issuing company meets the necessary conditions at the point of encashment.

However, there are special rules for QCBs. Where consideration is satisfied by the issue by the acquiring company of loan notes which are QCBs, no immediate CGT liability arises. The gain or loss is calculated as at the date of disposal but does not crystallise until the QCB is redeemed.

For deals involving QCBs from 23rd June 2010 onwards, the gain which comes into charge on the encashment of the QCB will only be eligible for BADR if the qualifying conditions are met at the point of encashment. This will necessitate the QCB holder being an officer or employee of the company and for the company to be the personal company of that individual (which will not be possible via the loan note holding as they will never be vote bearing so would only apply if the individual retains sufficient voting shares).

In reality, the QCB holder will have two options: elect to disapply the share exchange provisions so that the gain crystallises immediately or to accept the default for QCBs but risk not having BADR on the eventual encashment.

Deferred consideration

The comments above regarding the taxability of the different types of consideration assume that the shareholder will be paid immediately on completion. However, consideration may be offered on a deferred basis. Deferred consideration may be structured either as fixed, or variable, for example, in an earn-out arrangement it may be dependent on future profits.

Fixed deferred cash consideration

If a fixed part of the cash consideration is deferred this has to be included in the calculation of CGT initially, with no regard for the delay in receipt or for the fact that it may not be paid. The same applies even if the deferred consideration is contingent upon a specified event.

Example

Mr B sells his company for £500,000. Of this, £250,000 is to be paid immediately and then he is to receive £50,000 every six months until the debt is paid. He will be subject to CGT as if the full £500,000 had been paid initially. This would be the same even if the additional payments were contingent upon the company meeting certain targets at each six-month point.

The CGT liability can be repaid if the consideration becomes irrecoverable. S48 TCGA 1992 states that a claim can be made for discharge or repayment of tax and there are no other specific provisions within the legislation other than that.

In fact, a claim can also be made to adjust the CGT computation where a contingent liability may become payable. This legislation is at s49 TCGA 1992 and states the taxpayer may lodge a claim for repayment of tax where a contingent liability has to be paid. This would normally cover payments been made under warranties and indemnities.

Having said that, there is currently some uncertainty in this area following the case of *R & C Commissioners v Sir Alexander Fraser Morrison*. This case was about the deductibility of a contingent liability. Whilst the taxpayer lost in the FTT (which was reported in the anonymised decision of *Nevis*), and the Upper Tribunal, he has recently won his appeal in the Court of Sessions. The taxpayer was the Chief Executive of Matalan who provided a profit forecast to a potential purchaser of that company. He was also a minority shareholder. The purchaser accepted the forecast and completed the purchase.

Sometime later the purchaser brought an action against the taxpayer for misrepresentation in respect of the profit forecast. The action was settled by agreement with the taxpayer paying the purchasers the sum of £12m, which he then claimed as a deduction under s. 49 on the basis that it was a contingent liability in respect of a 'representation' made on a disposal by way of sale.

HMRC argued that the representation had been made in the taxpayer's capacity as a director of the target company and for it to fall within s49 it had to be made in the capacity of a vendor. The First-tier Tribunal found that, on the balance of probabilities, the representation had been made in that capacity in that he would have provided the profit forecast even if he had not been a shareholder. The FTT therefore accepted that this was a representation made on the disposal of shares and also held that the taxpayer's liability was contingent.

When the case went to the Upper Tribunal there were two issues in dispute from the FTT. First, was the payment of £12m a contingent liability within the meaning of s49, and second, were the taxpayer's costs of defending the proceedings brought by the purchaser also such a contingent liability. For the Upper Tribunal, the fundamental question was whether the payment of £12m was 'directly related to the value of the consideration' received by the taxpayer on the disposal of his shares in the target company. The taxpayer received his price for his shares by virtue of his ownership of the shares and he received the same price per share as was received by any other shareholder. That price was not adjusted to reflect the taxpayer's position as chairman of the target company, or any other factors. There was no direct relationship between the payment of £12m and the consideration for the disposal and so the payment was not a contingent liability. As it was not

suggested that the taxpayer could succeed on the second issue if he failed on the first, the taxpayer failed on the second issue also.

The Court of Sessions, however, felt that it was clearly a liability arising out of the sale notwithstanding that it was personal to the taxpayer. They took a more generous view although they did refer the case back to the FTT to establish if the whole of the compensation related to the representations made or whether there were other matters covered.

Obviously, the requirement to bring into the original CGT computation the deferred consideration and pay tax on it before it has been received or even confirmed, may lead to cash flow difficulties. However, it is possible for the vendor to claim to pay the tax by instalments where the deferred consideration is payable over a period of more than 18 months, the tax may be paid in instalments. The legislation that allows this is at s280 TCGA 1992. The instalments must be payable over a period exceeding 18 months. The instalments can be made, if agreed by HMRC, over a period not exceeding 8 years but each instalment must be more than 50% of the consideration that has been received.

Variable deferred consideration

An earn-out deal is one example of variable deferred consideration. This typically involves the vendor receiving a fixed sum on completion, with additional 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 vendor normally continues to be employed in the business during the earn-out period in a key management, technical or sales position. Consequently, the vendor has the incentive to increase his disposal consideration thereby ensuring that the purchaser's acquisition is successful.

Such consideration will still be treated as unascertainable even if there is a maximum put on the potential earn-out.

The tax treatment of an earn-out transaction is based to a large extent on the *Marren v Ingles [1980] STC 500* decision. It was decided in this case that where a taxpayer sells an asset with a right to receive a future unquantifiable sum (e.g. the formula on an earn-out), then a valuation of that right should be included as part of the CGT consideration received for the main asset, together with any immediate proceeds. It was also held that the taxpayer is acquiring a 'right' or 'chose in action', as an entirely separate asset.

When the additional amount is eventually received this is a capital sum is derived from an asset.

The actual amount received is therefore assessable to CGT after deducting the valuation of that right which was originally included in the first computation (that is then treated as being acquired at the date of the disposal of the main asset).

In practice this caused difficulties because if the right was overvalued, a capital loss arose on the disposal of the chose in action. In many situations, the original vendor could not utilise that capital loss in any way. This led to significant arguments with HMRC about valuation issues. However, the legislation was amended. A capital loss incurred on or after 10 April 2003 on disposal of a right to 'unascertainable deferred consideration' can be carried back and offset against earlier capital gain from the same asset.

If there is an increase in the value on payment of the earnout this will not be eligible for BADR as it is not a qualifying asset. This gives an incentive to maximise the original value of the earnout even though there is a timing disadvantage in doing that.

Example

Ms C receives £500,000 initial cash consideration plus an earn-out right which will see her receive a proportion of profits made by the company over a pre-set figure. The earn-out is set at a maximum figure of £1,000,000 but she feels it is more likely that she will receive around £600,000. It is assumed that she holds a single £1 share purchased for par at the time the company was incorporated. BADR is available on the shares.

The initial consideration is taken to be £500,000 plus the value of the deferred consideration. She values the deferred consideration at £600,000.

Her initial capital gain is £1,100,000.

Let us assume she receives

- (a) £1,000,000
- (b) £600,000
- (c) £400,000

If she received £1,000,000 there is a further capital gain arising of £400,000 on which she will pay £80,000 (assuming the liability is taxed at 20%).

If she received £600,000, there is no further liability.

If she received £400,000 there is a capital loss on the earn-out of £200,000. This can be carried back and set off against the original gain, thus earning her a repaying of £20,000 of tax.

Earn-outs satisfied in shares or loan notes

Often, earn-outs are structured so that all or part of the vendors earn-out can only be satisfied by shares or loan notes in the purchasing company. In this event, a corresponding part of the capital gain on the future earn-out right, which would otherwise be taxed under the principles in *Marren v Ingles*, can be deferred.

S.138A will only apply where the earn out can only be satisfied by paper ie shares or loan notes. If an identifiable amount only can be satisfied as cash, then the remainder is eligible for s.138A relief.

The deferral relief in s138A TCGA 1992 can only operate if the share exchange rules in s135 would apply but for the intermediate earn-out right that is, assuming the earn-out right is shares or loan notes issued by the acquiring company.

Consequently, the detailed requirements of s135 must also be fulfilled.

It is possible to elect that s.138A does not apply.

Earn-outs as employment income

Care must be taken to make sure that HMRC are not going to try and argue that the earn-out is actually employment income, on the assumption that the individual is working for the purchaser after the transaction.

The type of issues that might lead HMRC to make this argument would be:

- The earnout is dependent on personal performance criteria
- There is a difference in payment for individuals who will be employees after the deal and those who will not
- The market value of the shares is already paid out on the original deal (although this is often a very difficult issue for HMRC to tackle).

Contributed by Ros Martin