

Business issues, CGT and OTS (Lectures P1277/ P1278 – 31.17/ 22.01 minutes)

In May 2021, the OTS published their second report on CGT. One of the chapters of this OTS review deals with various troublesome business issues in their examination of three pertinent areas:

1. deferred sale proceeds;
2. different types of debt; and
3. a timing matter in relation to business asset disposal relief.

Deferred sale proceeds

Deferred sale proceeds most commonly arise on the disposal of an unincorporated business, unlisted shares or land. The way in which the payment of the proceeds is structured affects how much CGT is payable and when. For example, a company may be sold for an upfront cash sum, with further proceeds becoming due over the next few years. The further proceeds may be a combination of cash and other assets such as shares or loan notes in the acquiring company. Alternatively, land or shares in a company may be sold for an uncertain price, the level of which depends on subsequent events.

When discussing these arrangements, the OTS remark:

‘In the context of the challenging economic conditions stemming from the COVID-19 pandemic, it is possible that the use of deferred proceeds on a sale of a company could become more common in future.’

Where the sale proceeds relating to the disposal of, say, a private company are paid over a period of several years but the value of the proceeds is fixed, they are usually referred to as ‘ascertainable’. In these circumstances, CGT is due on the full amount of the sale proceeds, regardless of when payment is made (S48 TCGA 1992).

Illustration 1

Jan sells her company, which has a negligible base cost, for £2,500,000. This sum will be paid in cash, with £1,500,000 being due immediately and the remaining £1,000,000 being paid in two equal instalments on – respectively – the first and second anniversaries of the transaction.

Jan is taxed on her gain of £2,500,000 at the time of the sale. There is no allowance for the delay in handing over the two instalments totalling £1,000,000 and all of Jan’s tax is payable on the normal due date.

If she ultimately receives a lower amount (because, for example, the buyer defaulted), she can make a claim for an adjustment to the original CGT calculation so as to obtain a tax repayment (see Para CG14933 of the Capital Gains Manual for the practical details). The time limit for this claim is four years from the end of the tax year in which it became clear that the full amount would not be paid. Thus Jan’s ultimate tax liability will be based on what she actually receives.

Sometimes the sale proceeds will include a payment determined by an agreed formula based on a future event (which cannot therefore be known at the time of the sale). Such a transaction is typically described as an ‘earn-out’ and the proceeds are referred to as ‘unascertainable’.

In this situation, CGT is payable on:

- (i) the upfront cash proceeds; and
- (ii) the present value of the estimated proceeds which will be received in the future.

This is because CGT is due on sale proceeds whether they are received in the form of money or money's worth. As a result, depending on how the sale is structured, the vendor may be paying tax on an element of proceeds which he has not yet received. The figure put on the estimated proceeds is the value of the right to receive those future amounts. This follows from the decision of the House of Lords in *Marren v Ingles (1980)*. The OTS summarise the position with these words:

'A professional valuation is normally required to determine (the estimated) figure. When the right is later exchanged for cash, this disposal is a taxable event in its own right – it is not related to the original share disposal. The base cost is the original valuation of the right and the proceeds (are) the amount of cash received. There will be multiple such taxable events if the proceeds are received over a number of tax years.'

Illustration 2

Priscilla sells her company for an immediate cash sum of £2,000,000 plus 10% of the company's net profit for the next 12 months. The earn-out element will be paid in two years' time.

If the present value of the future proceeds is estimated to be £450,000, Priscilla's initial liability will be based on proceeds of £2,000,000 + £450,000 = £2,450,000, taxable in the year of disposal.

However, there will be a second CGT event when Priscilla receives the earn-out proceeds in a later tax year. If she is paid £575,000, she has made a further gain of £575,000 – £450,000 = £125,000, taxable in the year of receipt. On the other hand, if she only receives £150,000, she has made a capital loss. Thus:

	£
Earn-out proceeds	150,000
Less: Base cost of earn-out right	<u>450,000</u>
CAPITAL LOSS	<u>£(300,000)</u>

As an alternative to carrying this loss forward, Priscilla can make an election under S279A TCGA 1992 to carry it back against the gain on the original disposal which will result in a repayment of some of her CGT.

As has already been noted, non-cash proceeds are taxed in the same way as cash. However, if the proceeds are deferred and are payable in the form of specified assets such as shares or loan notes in the buyer's company, the vendor can normally postpone the taxation of the deferred element until the disposal of the new shares or the redemption of the loan notes (S138A TCGA 1992). In this case, there is no need to go through with the exercise of valuing the right to the future proceeds. Although this provision sounds helpful, it has not usually been tax-efficient to pursue such a structure in recent years.

Illustration 3

Jonathan formed a trading company (Jonathan Enterprises Ltd) in March 2003, subscribing for the company's entire share capital of 100 ordinary shares of £1 each at par. On 1 July 2021, he sold his shares to a plc.

The sale contract provided for:

- (i) an initial cash consideration of £360,000 to be paid on completion; and
- (ii) a deferred earn-out consideration based on the company's profits for the 12 months ended 30 June 2022 which was to be satisfied in the form of loan notes from the plc (the maximum earn-out payment was set at £640,000).

Jonathan continued to act as managing director of Jonathan Enterprises Ltd during the earn-out period (for which he was appropriately remunerated by the plc).

Jonathan's earn-out right was valued at £540,000 on 1 July 2021.

On the assumptions that the actual earn-out consideration turns out to be £600,000 for the 12 months ended 30 June 2022, that the loan notes were received by Jonathan from the plc on 1 December 2022 and that the loan notes were redeemed on 1 June 2023, Jonathan's CGT computations would proceed as follows in line with S138A TCGA 1992:

2021/22

	£
Sale proceeds	360,000
Less: Cost	
360,000	
<u> </u> x 100	<u>(40)</u>
360,000 + 540,000	
	359,960
Less: Annual CGT exemption	<u>(12,300)</u>
	<u>£347,660</u>
CGT @ 10%	£34,766

2023/24

	£	
Earn-out proceeds		600,000
Less: Cost (100 – 40)	<u>(60)</u>	
	599,940	
Less: Annual CGT exemption	<u>(12,300)</u>	
	<u>£587,640</u>	
CGT @ 20%	£117,528	

Jonathan's aggregate CGT liability for this transaction amounts to £34,766 + £117,528 = £152,294. Note that Jonathan is not entitled to claim business asset disposal relief on the encashment of his loan notes on 1 June 2023. It is generally accepted that a loan note should have a life of at least six months – as here – in order to be effective (see Para CG52570 of the Capital Gains Manual).

If, however, Jonathan's earn-out deal had been structured in cash so that the payment of £600,000 was made on, say, 1 June 2023, the tax position changes significantly. The calculation below now derives from the ruling in *Marren v Ingles (1980)*:

2021/22

	£
Sale proceeds (360,000 + 540,000)	900,000
Less: Cost	<u>(100)</u>
	899,900
Less: Annual CGT exemption	<u>(12,300)</u>
	<u>£887,600</u>
CGT @ 10%	£88,760

2023/24

	£
Earn-out proceeds	600,000
Less: Cost	<u>(540,000)</u>
	60,000
Less: Annual CGT exemption	<u>(12,300)</u>
	<u>£47,700</u>
CGT @ 20%	£9,540

Business asset disposal relief is again not available on the disposal of the earn-out right. However, Jonathan's aggregate CGT liability is now £88,760 + £9,540 = £98,300, a saving of £53,994. Even though Jonathan has paid more tax initially, the overall saving will certainly be worth having. Hence the comment about S138A TCGA 1992 being less useful for tax planning than it used to be.

The OTS have not commented on this discrepancy and content themselves with a number of general observations which may be summarised as follows:

- (i) Understanding the tax rules in this area is 'beyond even the most sophisticated non-professional taxpayers' and the whole process is certainly not intuitive.
- (ii) The regime can result in tax being charged upfront on cash which has not yet been received.
- (iii) The valuation of future proceeds, which is a required part of the exercise, can be challenging.
- (iv) The differences in tax treatment can create an 'uneconomic distortion' in the sense that they push taxpayers away from arrangements which make the most commercial sense.
- (v) The reliefs apply inconsistently – for example, business asset disposal relief, as Illustration 10 demonstrates, is often not available where it would have been if the company had been sold for a known amount of cash. However, it is possible to sidestep this problem – see below.

The recommendation of the OTS for improving the system is that CGT should be charged on a receipts basis. In other words, tax would only be payable when the sale proceeds are actually available or received (and are therefore quantifiable).

The OTS say that this would have several benefits:

- (i) tax would be paid out of the cash which the taxpayer has received without the need to make a claim or election if a lesser amount is paid than was anticipated;
- (ii) there would be no need to value the right to future proceeds which can be complex and expensive; and
- (iii) it would not be necessary to structure a disposal using, say, loan notes in order to defer the payment of CGT on sums which have not yet been received.

Mention was made above that, with appropriate tax planning advice, it is possible to structure these sorts of transaction so that full business asset disposal relief is available. This is achieved by having what is sometimes referred to as a 'negative earn-out'. That is to say, the price is set at the maximum possible figure (£360,000 + £640,000 = £1,000,000 in the example involving Jonathan above).

Only the basic amount of £360,000 is paid upfront, with 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 deal is structured this way round, one obtains a similar economic effect between the parties to an earn-out, but the tax calculation is initially based on the full £1,000,000 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 main advantage of this arrangement is that the vendor qualifies for business asset disposal relief on the full amount received (subject, of course, to the cumulative lifetime limit). This is because he has moved into the realm of *deferred* consideration rather than *unascertainable* consideration. In the Jonathan example, the taxpayer saves an additional £3,600.

Different types of debt

Debts can be classified as either:

- (i) a simple debt; or
- (ii) a debt on a security.

A simple debt falls outside the CGT regime as long as it remains in the hands of the original lender. The rationale for this rule is that, when individuals make a loan, i.e. a simple debt, they will generally be repaid the same amount or – perhaps – a lesser sum. However, it would be unusual for them to be repaid more. By making simple debts an exempt asset, there is no allowable loss if the funds repaid are less than the original amount lent, but it should be noted that second-hand simple debts are within the charge to CGT.

If a debt is not a simple debt, it is usually known as a debt on a security and falls within the scope of CGT. When considering the type of debt, the OTS say:

‘Whether the debt is classified as a simple debt or a debt on a security is not always obvious.

A debt on a security is a debt with added characteristics which generally enable it to be realised at a profit or a loss. These characteristics are based on case law and include, for example, that the debt:

- (i) is marketable;
- (ii) is held as an investment;
- (iii) is capable of being realised at a profit; and
- (iv) is at a commercial rate of interest (see *WT Ramsay Ltd v CIR (1981)*).

Not all of these characteristics need to be present and whether the debt is marketable is considered to be the main one. Just because a debt is documented in writing does not mean it is a debt on a security.’

‘Corporate bond’ is a generic term for debts or securities issued by a company in order to raise finance. There are different tax treatments depending on whether the corporate bond is what is termed:

- (i) a qualifying corporate bond (QCB); or
- (ii) a non-qualifying corporate bond (non-QCB).

A QCB is defined in S117 TCGA 1992. It can generally be described as a debt:

- (i) which is on normal commercial terms (see S162 CTA 2010);
- (ii) which is denominated in sterling; and
- (iii) where there is no provision for conversion into, or redemption in, another currency.

Any corporate bond which is not a QCB is a non-QCB. QCBs are exempt from CGT, whereas non-QCBs are taxable.

The sale arrangements for a company can include corporate bonds. Given that they form part of the proceeds, this will have the effect of deferring the CGT on that part of the proceeds until such time as they are redeemed and the cash received. Where the bonds issued are QCBs, S116(10) TCGA 1992 applies and the gain which would have arisen on a market value sale of the shares at the date of the paper-for-paper exchange is held over until the redemption of the QCBs. Effectively, the vendor’s tax position is frozen at the date of the exchange, with the payment of CGT being postponed on an interest-free basis.

A disadvantage with QCBs is that no loss relief is available if the acquiring company is unable to redeem them (because, for example, it has become insolvent). Despite this, when the QCB is ‘redeemed’ (albeit for no value), the original held over gain is still taxed in full. It is therefore always advisable for vendors to insist on bank guarantees for QCBs in order to protect their

position. However, in the absence of a bank guarantee, HMRC have confirmed that a worthless QCB can always be gifted to a charity in order to avoid a charge on the held over gain (see Para CG66624 of the Capital Gains Manual).

It is possible to ensure that bonds are not QCBs by a variety of devices which generally have no other purpose than to ensure that the bond is a non-QCB. One of the more common is to insert a foreign currency component into the bond's terms and conditions. Another is to give the bond holder the right to subscribe for additional shares or securities in the acquiring company or to convert his bonds into shares in the acquiring company.

The vendor then holds non-QCBs. The exchange of shares for non-QCBs is treated for tax purposes in exactly the same way as a share-for-share exchange (S135 TCGA 1992). By virtue of S127 TCGA 1992, there is no disposal of the original shares and the new holding is treated as the same asset as the original one. This means that, if the worst comes to the worst, automatic loss relief is available in that any gain or loss on the ultimate redemption of the bond is computed by reference to the amount actually repaid.

Where an individual has made a loan to a trader which is a simple debt, any loss would not normally be allowable. However, there is a specific relief in S253 TCGA 1992 which can allow the lender to claim a capital loss on the debt, provided that:

- (i) the money lent was used wholly for the purposes of the trade; and
- (ii) all or part of the money loaned has become irrecoverable.

Thus, if a loan of £250,000 to a trading business goes bad, S253 TCGA 1992 provides the taxpayer with relief in the form of a capital loss which he can offset against his current or subsequent capital gains.

The OTS have made a number of suggestions for improving the tax position of debts:

- (i) They recommend that it should be possible for the choice about the tax status of a corporate bond to be made by the inclusion of a 'permanent irrevocable upfront provision in the legal documentation for the bond'. This would avoid the need for the insertion of complex clauses which serve no other purpose and which make it difficult for the parties involved to know which type of corporate bond they hold.
- (ii) In the absence of such provision, the OTS recommend a default position whereby the bond is automatically a QCB and therefore exempt from CGT. This outcome, they argue, 'is more intuitive for taxpayers and reflects that there are wider uses of corporate bonds beyond company sales'.
- (iii) HMRC should consider improving their guidance on when relief under S253 TCGA 1992 will not be permitted on the basis that it was unreasonable for the lender to believe that a debt was recoverable at the time when the loan was made. This guidance 'should include relevant case studies of situations which are definitely within the rules to bring further clarity for taxpayers'.

A timing matter in relation to business asset disposal relief

The CGT legislation specifies that, where at the time when a business ceases there is a disposal of one or more business assets, business asset disposal relief can be claimed as long as this disposal takes place within a three-year period following the date of the cessation (S169I(2)(b) TCGA 1992).

The OTS observe that this requirement to sell at or shortly after the cessation of the business 'may not reflect some common retirement scenarios'.

They go on:

'For example, a farming business could be sold but the farmer may continue to harvest existing crops after the sale or a retail business may need to continue for some time after the retail premises are sold. However, a strict interpretation of the legislation could lead to the relief being forfeited if trading continues after exchange of contracts for the sale of a business.

The specific awkwardness of the timing of . . . disposals in relation to entrepreneurs' relief (now business asset disposal relief) used to be covered by a formal HMRC concession. However, this has been withdrawn.'

The last point is referring to ESC D31 which was deleted more than 15 years ago. It stated that, for CGT purposes, HMRC 'are prepared to accept the date of completion as the date of disposal where, pending completion, business activities continue beyond the date of unconditional contract'. Despite the reassurance given by HMRC in published correspondence with the ICAEW, the OTS have been told that, in order to mitigate the risk of losing relief, businesses are seeking other practical ways of circumventing the legislative position such as the use of cross options between vendor and prospective purchaser.

The OTS conclude that HMRC should provide more detailed examples in the Capital Gains Manual and elsewhere about how they interpret the legislation in situations where the date of cessation is unclear in order to help and reassure farming and other businesses whose proprietors are looking to retire over a period of time.

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