

Disapplication election on takeover (Lecture P1398 – 18.33 minutes)

An agreement for a corporate takeover may include the right to receive future consideration which is unascertainable at the time of the contract, often because it depends on the acquired company's performance over the next year or so.

Such a right was held by the House of Lords in *Marren v Ingles* (1980) to be a separate asset under what is now S22(1) TCGA 1992. It is typically referred to as an 'earn-out right'. However, where the earn-out right is a right to receive shares or debentures in the acquiring company, this right is treated as a security so that the paper-for-paper exchange legislation in S135 TCGA 1992 can apply. The subsequent issue by the acquiring company of, say, loan notes in these circumstances is regarded as a conversion of securities so that no tax charge arises. A charge will only occur when the relevant securities are disposed of, i.e., when the loan notes are cashed in. These rules are set out in S138A TCGA 1992.

This treatment is mandatory, subject only to the taxpayer's option to disapply it by making an election under S138A(2A) TCGA 1992.

Example 1

Robin sold his 100% interest in Linda Logistics Ltd (an unquoted trading company) to a plc for £480,000 on 1 July 2022. He had acquired these shares following his mother's death in November 2007 when they were worth £60,000. Robin is a higher rate taxpayer and has been the company's managing director since before his mother's death.

Under the terms of the transaction, Robin received his initial payment in cash, but he was also entitled to further consideration depending on Linda Logistics Ltd's profit performance over the year to 30 June 2023. This further consideration was to be satisfied by an issue of loan notes in the plc. Robin's right to receive this future consideration was professionally valued at £420,000 on 1 July 2022.

On 1 December 2023, Robin received loan notes worth £640,000 which he encashed six months later on 1 June 2024.

Because the terms of the deal satisfy the requirements of S138A TCGA 1992, Robin's CGT position is calculated as follows:

2022/23

	£
Sale proceeds	480,000
Less: Cost	
	<u>32,000</u>
	448,000
Less: Annual exemption	<u>12,300</u>
	<u>£435,700</u>
CGT @ 10%	£43,570

2024/25

	£
Earn-out proceeds	640,000
Less: Cost (60,000 – 32,000)	<u>28,000</u>
	612,000
Less: Annual exemption	<u>3,000</u>
	<u>£609,000</u>
CGT @ 20%	£121,800

Robin's aggregate CGT liability for this transaction amounts to £165,370 (43,570 + 121,800). The gain on the earn-out proceeds does not attract business asset disposal relief.

However, if Robin's earn-out deal with the plc had been structured in cash so that the final payment was made on 1 June 2024, the tax calculation changes significantly. It now derives from the ruling in *Marren v Ingles* (1980):

2022/23

	£
Sale proceeds (480,000 + 420,000)	900,000
Less: Cost	<u>60,000</u>
	840,000
Less: Annual exemption	<u>12,300</u>
	<u>£827,700</u>
CGT @ 10%	£82,770

2024/25

	£
Earn-out proceeds	640,000
Less: Cost	<u>420,000</u>
	220,000
Less: Annual exemption	<u>3,000</u>
	<u>£217,000</u>
CGT @ 20%	£43,400

Robin's aggregate CGT liability is now only £82,770 + £43,400 = £126,170, a saving of £39,200. This would have been Robin's preferred structure, but, because the deal was framed under S138A TCGA 1992, that provision takes precedence.

However, if Robin makes an irrevocable election under S138A(2A) TCGA 1992 by the first anniversary of 31 January following the tax year in which the sale transaction took place (i.e. by 31 January 2025), S138A TCGA 1992 treatment does not apply and the calculation proceeds on the basis of the decision in *Marren v Ingles* (1980). This is clearly what Robin should do.

Contributed by Robert Jamieson