CHAPTER 18

EARN OUTS AND DEFERRED CONSIDERATION

18.1 When does a disposal take place?

The date of disposal for capital gains tax is the **date when the contract** to sell the asset **is signed**, i.e. the date that contracts are exchanged. If a **contract is conditional** on a particular event taking place, the date of disposal for CGT purposes is the **date that all of the relevant conditions have been fulfilled.** TCGA 1992, s. 28(1) TCGA 1992, s. 28(2)

It is important that we identify the correct date of disposal as this will determine in which tax year the gain will be charged. The date of payment of the sale proceeds is largely irrelevant for CGT purposes. The date of payment is only important if the purchaser pays for the asset in instalments. In this case, in certain circumstances, the vendor can **pay his capital gains tax in instalments**.

18.2 CGT instalments

The CGT instalment option applies in two circumstances and the rules we shall look at in this chapter are in s.280 TCGA 1992. TCGA 1992, s. 280 TCGA 1992, s. 281

A vendor may be able to pay his CGT in instalments under s.280 if the **consideration** (i.e. sale proceeds) **will be receivable in instalments over a period in excess of 18 months** which ends after the normal due date for payment of the CGT. This is not automatic – if the vendor wants to pay his CGT by instalments, he must make an application in writing under s.280. If no application is made, the CGT is payable on 31 January following the tax year of the disposal.

The taxpayer will normally be expected to **pay instalments of CGT equal to 50% of each instalment of consideration receivable** under the contract until the total CGT liability has been discharged.

The period over which the vendor can pay his CGT is the **shorter of** two periods being the **period over which consideration is receivable** and **8 years.**

The final instalment of CGT can **never be due any later** than the due date for the final instalment of consideration.

For example, if the purchaser pays the consideration to the vendor in three equal annual instalments, the maximum period over which the CGT payments can be spread is three years and all the CGT must be paid by the due date for the last instalment of consideration. The CGT payments may well be spread over a shorter period depending on the actual dates and amounts of the instalments of consideration and the amount of CGT due.

Remember the CGT instalment period can never be more than **8 years** from the normal due date. For example, if the purchaser pays the consideration in 20 equal annual instalments, the maximum period over which the CGT can be spread is 8 years. However, with the current rates of CGT in most cases the CGT due will have been paid in full well within 8 years.

To the extent that instalments of consideration are receivable on or before the normal due date for CGT, the respective instalments of CGT are payable on that normal due date. Where instalments of consideration are receivable after that time, then the respective instalments of CGT are **payable on the dates when the vendor is contractually entitled to receive his consideration**.

If the consideration is receivable over intervals of less than 6 months, HMRC will arrange for the CGT to be paid at not less than 6 monthly intervals.

If a taxpayer pays his CGT in instalments under s. 280, these **instalments are interest free** – i.e. interest is not charged on the unpaid balance of CGT.

Illustration 1

Xavier enters into a contract on 1 August 2010 for the sale of an asset. The consideration is £120,000 payable by six instalments of £20,000 each, at yearly intervals, commencing on 1 September 2010.

As the contract was signed in August 2010, the disposal takes place in 2010/11. The gain will be calculated using 2010/11 rates and allowances.

The CGT payable by Xavier on the disposal is £33,600. The normal due date for the CGT is 31 January 2012. However, Xavier makes an application to pay the CGT by instalments under s.280 TCGA 1992. The maximum instalment period is 6 years. However, each instalment of CGT will be equal to **50% of the amount of each instalment of consideration receivable.**

The amounts of the CGT instalments will therefore be calculated as follows:

- 50% of the consideration receivable on 1 September 2010 = £10,000
- 50% of the consideration receivable on 1 September 2011 = £10,000
- 50% of the consideration receivable on 1 September 2012 = £10,000
- 50% of the consideration receivable on 1 September 2013 = £3,600

£33,600

However, we need to consider carefully when payment of each CGT instalment is actually due.

As the first two instalments of consideration are received before 31 January 2012, the normal due date for CGT in respect of disposals in 2010/11, the CGT due in respect of these instalments is not due until the normal due date.

This means **£20,000 of CGT is due from Xavier on 31 January 2012.**

As the two remaining instalments of consideration are receivable after 31 January 2012, the CGT relating to these instalments is due when the instalments are receivable.

Thus, a further **£10,000 of CGT is due from Xavier on 1 September 2012** and the final **£3,600 of CGT is due on 1 September 2013.**

The CGT will therefore have actually been paid in full within 3 years of the date of the first instalment of consideration.

Illustration 2

Derek sells an asset for £300,000 to Clive on 1 March 2011.

Derek makes a chargeable gain of £100,000 on the sale.

Capital gains tax of £28,000 is due.

Clive, however, cannot afford to pay Derek the whole of the sale proceeds in March 2011.

He therefore agrees with Derek that the consideration of £300,000 is paid in equal instalments over a 5-year period.

Clive agrees to pay Derek £60,000 every year, starting on 1 March 2011 with the final instalment being made on 1 March 2015.

In this case, the CGT due **cannot be paid by instalments**.

The CGT due of £28,000 is less than 50% of the first instalment of consideration and that consideration is receivable before the normal due date for the CGT.

Therefore the full CGT of £28,000 will simply be due on 31 January 2012.

18.3 Earn outs – ascertainable consideration

The consideration paid by a purchaser to a vendor for the sale of shares in a company may include something called an "earn out" element. An "earn-out" is a term which describes further or **additional proceeds**, **payable** to the vendor on the **satisfaction of some future event**.

It is common for consideration payable on the sale of a company to be split such that the vendor receives a sum of cash at the point of disposal and an additional amount on the satisfaction of a condition or on the happening of a future event. That future event may be the company reaching a **prescribed profit target**, or the company **floating** – i.e. obtaining a listing on the Stock Exchange.

If the additional consideration is **fixed** - i.e. the future amount which will be paid is ascertainable at the date of disposal - the whole transaction is **treated as one disposal** for capital gains tax purposes. Therefore all proceeds – i.e. the cash paid now plus the future consideration – is brought into the capital gains tax computation in the year that contracts are signed.

Illustration 3

A vendor sells shares in a company to a purchaser in July 2010. Contracts are exchanged in July 2010, so this is the date of disposal for CGT purposes. The capital gain therefore falls into 2010/11. The purchaser agrees to pay a consideration of £1.5 million to the vendor for the sale of the shares. The vendor will receive £1 million in cash in July 2010 and a further £500,000 if the company obtains a listing on the Stock Exchange within 2 years of the date of sale.

To calculate the capital gain in 2010/11 we take not only the cash paid in July 2010 but we also **add on the future consideration** which we know will be £500,000. Total sale proceeds in 2010/11 are therefore £1.5 million.

From this we will deduct cost to give a gain. Having calculated the capital gains tax to be £200,000 the vendor should pay this tax no later than 31 January 2012.

The full amount of the tax is due on 31 January 2012, as the total tax due is less than 50% of the initial instalment of the proceeds.

In the event that the company never obtains a Stock Exchange listing, the vendor will never receive the additional £500,000. In this case, a claim can be made to adjust the sale proceeds in the CGT computation and any excess tax paid can be reclaimed.

18.4 Earn outs – unascertainable consideration

Sometimes the additional amount that the vendor will receive cannot be ascertained at the date of disposal. If the proceeds of sale in the CGT computation are both **unascertainable and conditional** – i.e. they depend on a future event and the vendor does not know how much he will receive when he originally signs the contract - we calculate the gain by applying the **"Marren v Ingles principle".**

The case of Marren v Ingles involved the calculation of a capital gain when proceeds included an "earn out" element and was heard in the House of Lords in 1980. In 1970 the vendor sold shares in a private family company. Contracts were signed in September 1970, so the tax year of disposal was 1970/1971.

The purchaser agreed to pay the vendor an immediate sum of £750 per share in cash. In addition, the purchaser agreed to pay the vendor a future sum if the company became listed on the Stock Exchange within a specified period. The consideration for the disposal therefore included an "earn-out" element.

However, the amount that the vendor would receive on the flotation of the company was based on the share price of the company on the day it obtained a Stock Exchange listing. This meant that the additional consideration could not be ascertained at the date of disposal in September 1970.

In Marren v Ingles, the payment of sale proceeds was not only conditional on a future event taking place, but the amount of the sale proceeds could not be ascertained at the time of disposal. The question that the House of Lords had to consider was how the capital gain was calculated in the tax year 1970/1971.

The main point of discussion was the amount of sale proceeds received by the vendor in September 1970. There was no doubt that the proceeds had to include the cash of £750 per share physically paid to the vendor in 1970.

However, HMRC contended - and the Courts agreed – that what the vendor had been given in September 1970 was not just £750 in cash but they **also had a right to receive a future capital sum**. The Courts said that the right to receive future consideration was a valuable asset in itself and **must be valued at the date of disposal**.

We will assume that the right to receive future consideration was valued at £250. Sale proceeds are therefore £1,000 per share. From this figure of sale proceeds, the vendor deducted his base cost (of say £100 per share) to give a capital gain in 1970/1971.

Proceeds	£
Cash	750
Right to receive future consideration (say)	250
	1,000
Less: cost (say)	(100)
Gain 1970/71	£900

This is the Marren v Ingles principle. When a vendor is given the right to receive deferred consideration, we must value that asset – lawyers call this asset a "chose in action" – and **treat it as part of the disposal proceeds.**

In December 1972 the company floated and at that point the vendor became entitled to additional consideration. In the event, the extra consideration was substantial, amounting to £2,825 per share. This figure was based on the share price of the company at the date of flotation.

HMRC regarded this figure as a capital sum which was chargeable to capital gains tax. However, for a CGT liability to arise, the disposal of an asset must take place.

The **asset being disposed of** in December 1972 was the **right to receive future consideration** – i.e. the "chose in action". The cost of this right was its market value at the date of the original disposal in September 1970. Here, using our figures, the base cost of this right is £250. The vendor therefore had an additional capital gain on the disposal of the right in 1972/1973 as follows:

	£
Further cash received	2,825
Less: cost of "right" (1970)	(250)
Gain 1972/73	£2,575

The case of Marren v Ingles has established the principle that the right to receive cash is a capital asset in itself and when that right is disposed of, a chargeable gain will arise.

Let us consider what would happen if a taxpayer made a loss on the disposal of the right. Going back to the Marren v Ingles example, on the original sale of the shares the proceeds consisted of the cash received now plus the right to receive future cash. We assumed this right was valued at £250 per share.

Let us assume that on the flotation of the company, the additional cash received was only £50 per share. At this point, the asset being disposed of – i.e. the right to receive future cash - had a base cost of £250.

On the disposal of the right the taxpayer will be making a loss as follows:

	£
Extra cash received	50
Less: cost of "right"	(250)
Loss on disposal of right	£(200)

Under a special rule, the loss on the disposal of the earn-out right can be carried back **to a year in which a gain on the original asset accrued.** This is at odds with general CGT principles which only allow losses to be carried back if the taxpayer has died. TCGA 1992, s. 279A

The individual must make an **election** for the loss to be carried back and treated as a loss of that earlier year. The election is an "**all or nothing**" claim. There is no provision for carrying back part of the loss. The time limit for the election is one year from the normal filing date for the return of the year in which the loss arose. Therefore for a loss on disposal of a right in 2010/11 to be carried back, the election must be made by 31 January 2013.

There is no restriction on how far the loss can be carried back. The gain on the original asset must have resulted in a CGT liability in that earlier tax year. This means that, in most instances, the election to carry back the loss will generate a **CGT repayment**.

If the loss is **not completely used** up in the year it is carried back to, for example, if there were already losses in the earlier year, it can be offset as any other loss i.e. set against gains of the year it is incurred with any excess **carried forward.**

If the gain on the original disposal was deferred under the **EIS or VCT reinvestment relief** rules, the **loss will be carried back to the year in which the deferred gain** comes back into charge. We shall look at EIS and VCT reliefs later.

18.5 Share for share exchanges

If a vendor exchanges his old shares for new shares plus the right to future consideration, the normal **share for share exchange rules will not normally apply on the earn out element**, because the right to receive future consideration is a "chose in action" - it is not shares.

A **capital gain will therefore arise** on the receipt of the earn-out right, and we calculate the gain by treating the value of the right as a payment of cash. This will potentially leave the vendor with a CGT charge but no cash to settle his bill. TCGA 1992, s. 138A

To resolve this problem, if the **earn out element** is eventually **satisfied wholly by the issue of shares**, S.138A TCGA 1992 **treats the right itself as shares**. The share-for-share exchange rules therefore apply and no gain is charged on the receipt of the earn-out right.

If the taxpayer does not want the share for share rules to apply, he may make an **election to have them disapplied.** In this case the receipt of the earn-out will be treated as a chargeable disposal. TCGA 1992, s.138A(2A)

The time limit for the election is the anniversary of the 31 January following the end of the tax year of the disposal – i.e. 31 January 2013 for disposals in 2010/11.

This may be to his advantage if he either has losses to set against the gain which would otherwise arise, or if the gain is eligible for entrepreneurs' relief.

Illustration 4

Paul owns shares in Lassiter Ltd. He formed the company in May 1998 by subscribing £60,000 for the entire share capital. Paul is the managing director. He makes disposals each year to use his annual exemption.

On 30 August 2010, Paul sold all his shares in Lassiter Ltd to the Napier Group. The sales contract provided for Paul to receive:

- Initial cash consideration of £600,000; and
- Deferred earn-out consideration based on the profits of Lassiter Ltd for the two years ended 31 December 2010 and 2011. The earn-out will be wholly satisfied in the form of new ordinary shares in Napier Group plc. The earn-out right was valued at £400,000 at August 2010.

Paul's CGT position is as follows:

He will have a capital gain on the receipt of cash consideration of £600,000. This will qualify for entrepreneurs' relief as Paul had more than 5% of the shares and worked for Lassiter Ltd.

However, as the earn-out right will be satisfied by the issue of shares, S.138A will apply.

S.138A automatically treats the right to receive future shares as a security. This means that the share-for-share rules will apply, and no gain will arise on the receipt of the earn-out.

Gain on cash:

	£
Proceeds	600,000
Less: base cost (£60,000 x 60%) (N)	(36,000)
Chargeable Gain	£564,000

The gain is eligible for entrepreneur's relief and therefore the rate of CGT is 10%.

CGT @ 10%	£56,400

Note:	Value £	%
Cash	600,000	60
MV of earn-out right	400,000	40
Total	1,000,000	100

The base cost of the earn-out right will be;

£60,000 x 40%	£24,000

The earn-out is satisfied in March 2012, with Paul receiving shares in Napier Group plc valued at £575,000. There is therefore a disposal of the earn-out in return for shares. As the earn-out is treated as a security, this is treated as a share-for-share exchange. No gain arises and the base cost of the new Napier Group plc shares will be:

£60,000 x 40%	£24,000

When these shares are sold, entrepreneurs' relief will not be available unless Paul has a 5% holding and works for Napier Group plc.

Assuming Paul has taxable income in excess of the basic rate band, his CGT on an immediate sale of the shares for £575,000 in 2011/12 will be:

	£
Proceeds	575,000
Less: base cost	(24,000)
Chargeable gain	551,000
CGT @ 28%	£154,280

The total CGT payable by Paul: £(56,400 + 154,280)	£210,680

Alternatively, Paul could elect under s.138A(2A) for the share-for-share exchange treatment on receipt of the earn-out right to be disapplied.

In this case, the value of the earn-out right on takeover would be treated as cash, and a chargeable gain arises.

This gain is again eligible for entrepreneurs' relief.

Gain on takeover (August 2010):

	£
Proceeds	
Cash	600,000
MV of earn-out right	400,000
	1,000,000
Less: base cost of Lassiter Ltd shares	(60,000)
Chargeable gain	£940,000
CGT @ 10%	£94,000

The base cost of earn-out right will be £400,000. When the earn-out is exchanged for shares (MV £575,000), this will be a disposal of the earn-out. The earn-out is not treated as a security, so a capital gain arises.

His CGT on a disposal of the earn-out in 2011/12 will therefore be:

	£
Proceeds	575,000
Less: base cost	(400,000)
Chargeable gain	175,000
CGT @ 28%	£49,000
The total CGT payable by Paul:	
£(94,000 + 49,000)	£143,000
CGT saving = £(210,680 – 143,000)	£67,680

This can be reconciled as £(400,000 – 24,000) = £376,000 x 18%.

The effective saving will be partially eroded by the fact that Paul will have to pay a larger amount of CGT on 31 January 2012, than he would have done had the election to disapply not been made.

Paul now has shares in Napier Group with a base cost of £575,000. If these are sold immediately, there is no capital gain.

18.6 Earn-outs satisfied by loan notes

If a vendor exchanges his old shares for the right to future consideration in the form of loan notes, S.138A will again apply. S.138A **will treat the earn-out right as a security**.

The share-for-share exchange rules therefore apply and no gain is charged on the receipt of the earn-out. The base cost of the earn-out will be a proportion of the base cost of the original shares (depending on whether any cash proceeds are also received).

When the earn-out is eventually satisfied by the issue of loan notes, there is a disposal of the earn-out right. Whether a gain arises at this point depends on whether the loan notes are QCBs:

1) If the loan notes issued in satisfaction of the earn-out are not QCBs (for example, the loan notes could be convertible or be in a foreign currency), the non-QCBs are treated as shares. The share-for-share exchange rules will apply and the non-QCB will have a base cost equal to the base cost of the earn-out. A gain will be charged when the non-QCBs are sold or redeemed.

2) If the loan notes issued in satisfaction of the earn-out are QCBs (for example, the loan notes are non-convertible and are expressed in Sterling), there will be an exchange of a security (ie, the earn-out right) for a QCB. QCBs are not shares, therefore a gain will arise on the disposal of the earn-out. However, this gain will be "frozen" until the QCBs themselves are sold or redeemed.

No entrepreneurs' relief will be available when the gain arises on the redemption of the loan notes, as the gain relates to the disposal either of the earn-out or the non-QCB (not to the original shares).

If the taxpayer wants to take advantage of entrepreneurs' relief on the disposal of the original shares, he could make an election to disapply the "share-for-share" treatment on the takeover as illustrated above.

Example 1

Stephanie sold her shares in Scully Ltd (a trading company) to Hoyland Holdings plc in December 2010. This was her only disposal in 2010/11. Stephanie owned 100% of the shares and was managing director. She had bought the shares in January 2002 for £25,000.

Hoyland Holdings plc offered £500,000 in cash plus an additional cash payment if Scully Ltd met certain profit targets in the next 12 months. This right was valued at £200,000 in 2010.

An additional payment of £180,000 was made to Stephanie in January 2012 in respect of this right.

Assuming all appropriate claims are made, calculate Stephanie's chargeable gain in 2010/11.

Example 2

Bill sold a painting to Ben under a contract entered into on 1 September 2010. The sale proceeds were £80,000, payable in ten equal annual instalments commencing 1 September 2010. The CGT payable is £16,800.

Assuming Bill applies to pay the tax due by instalments under s280 TCGA 1992, show the due date(s) for the payment of tax.

Answer 1

Gain December 2010:

Proceeds:	£
Cash	500,000
Earn-out right	200,000
	700,000
Less: cost	(25,000)
Chargeable gain	£675,000

(The gain will qualify for entrepreneurs' relief as Stephanie had at least 5% of Scully Ltd and worked for the company).

Loss in January 2012:	£
Proceeds (sale of right)	180,000
Less: cost (December 2010)	(200,000)
Loss	(20,000)

The loss can be carried back to the year of the original gain.

Revised gain December 2010:

	£
Gain	675,000
Less: loss carried back	(20,000)
Revised chargeable gain	655,000

Answer 2

Due Date		**Amount due**
31.1.12	(normal due date)	£8,000 (50% x £8,000 x2) (1st 2 instalments paid prior to normal due date)
1.9.12	(date 3rd instalment due)	£4,000
1.9.13	(date 4th instalment due)	£4,000
1.9.14	(date 5th instalment due)	£800 (balance of tax due)