DEAL OR NO DEAL

Owner managers must carefully plan their company sales to obtain maximum benefit from the 10% CGT entrepreneurs' relief rate, says Peter Rayney

Many owner managers will be asking themselves – is now a good time to sell? There are some positive signals – private equity investors are selling, sale price multiples are strong and there is increased economic confidence. Yet further away on the horizon is the general election in May 2015, which brings uncertainties.

The capital gains tax (CGT) regime remains relatively benign for owner managers, with entrepreneurs' relief (ER) allowing them to obtain a 10% CGT rate on their first £10m of eligible gains. This means that ER is capable of producing tax savings of up to £1.8m (ie, £10m x 18% (ie, 28% main CGT rate less 10% ER CGT rate).

The sales of owner-managed companies frequently contain different elements of sale consideration, such as loan notes and earn-put arrangements. In such cases, special care is required to ensure the full benefit from ER is obtained, since the relevant rules are not straightforward and therefore steps must be taken to ensure the full benefit of ER is realised.

In this article, I shall review the operation of ER in relation to a recent owner managed company sale on which I advised. This is presented as a case study, with the background details outlined in figure 1, and has been anonymised to protect client confidentiality. Unless stated otherwise, all statutory references are to the Taxation of Chargeable Gains Act 1992 (TCGA).

ER – MAIN CONDITIONS

Based on the facts, Jim should have little difficulty in satisfying the main conditions for ER on a share sale (s169I (6)). Briefly, Jim will need to meet all the following conditions in the 12 months before his shares are sold to qualify for ER:

- Scruffy Jeans and Vests Ltd (SJV) must be a qualifying trading company or holding company of a trading group (see below);
- Jim needs to hold at least 5% of both SJV's ordinary share capital/voting rights (he has the entire shareholding/voting rights); and
- Jim must be an employee or director of GP (or a fellow group company). (Again, no problem here as he has always been managing director of SJV.)

TRADING STATUS OF COMPANY

Jim's company (SJV) is entirely carrying out trading activities and hence easily meets the ER 'trading company' requirement. However, the legislation permits a deminimis level of 'non-substantial' non-trading/investment activities to be carried on without jeopardising a company's ER 'trading' status (see s165A (3)).

In practice, HMRC generally applies a 20% benchmark to various financial and employee/management time measures when deciding whether this de minimis level of non-trade activities is breached.

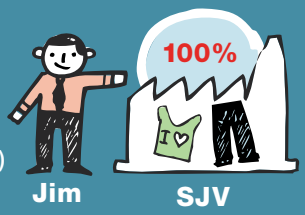
If the level of non-trade activities is held to be 'substantial', the ER CGT 10% rate would not be available and the main rate of 28% would apply to the entire share sale gain.

If there is some doubt about a company's 'trading' status for ER purposes, it can apply for an informal (non-statutory) clearance to obtain some certainty on the point. This should be possible in those cases where there is material uncertainty about a company's ER 'trading' status and the proposed transaction is commercially significant. »36

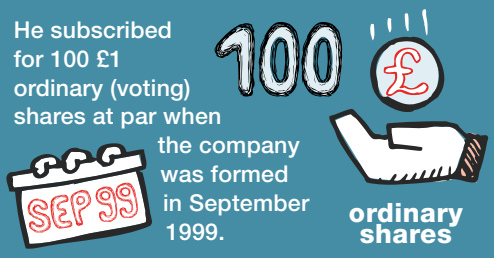
FIGURE 1

CASE STUDY: SALE OF JIM'S 100% HOLDING IN SCRUFFY JEANS & VESTS LTD

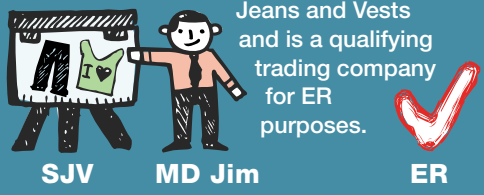
Jim has owned 100% of the share capital of Scruffy Jeans & Vests Ltd (SJV) for many years.



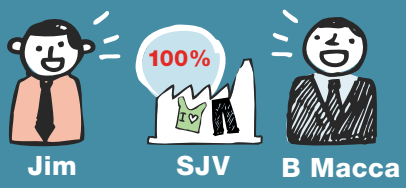
He subscribed for 100 £1 ordinary (voting) shares at par when the company was formed in September 1999.



He has always been the managing director of the company, which manufactures 'retro' Jeans and Vests and is a qualifying trading company for ER purposes.



Since mid-2014, Jim has been in negotiations with B Macca plc, which is seeking to purchase a 100% stake in SJV.



The sale consideration for Jim's 100% holding has recently been agreed as follows:

	£m
Cash consideration (on completion)	4.5
B Macca plc 8% loan note (redeemable after 18 months), structured as a qualifying corporate bond (QCB)	2.0
Deferred earn-out consideration, to be satisfied in cash, based on a multiple of profits for the year to 31 Dec 2015. Payable when accounts for 2015 agreed, estimated to be May 2016. Maximum earn-out consideration	1.8

The sale is expected to be concluded in December 2014 (2014/15).

APPLYING ER TO JIM'S SALE CONSIDERATION

As Jim meets the relevant ER conditions, he will be entitled to claim ER on his share sale. It is important to appreciate that ER must be claimed (it is not given automatically). Assuming the sale takes place in 2014/15, Jim will have to claim his ER by 31 January 2017 (being the first anniversary of the 31 January following the end of the 2014/15 tax year in which the sale takes place). In practice, sellers normally claim their ER when submitting their personal self assessment (SA) tax returns.

Where there are different elements of sale consideration, a number of factors should be considered to determine how ER applies to each one.

CASH PROCEEDS – £4.5M

The cash proceeds will be taxable at the date of the share sale contract. Based on the above analysis, ER would clearly apply to the capital gain arising on the cash element of the sale consideration.

QCB LOAN NOTE – £2M

A qualifying corporate bond (QCB) is the technical tax term for a standard loan note. Under the rule in s116 (10), Jim's gain relating to his £2m loan note would be deferred, providing HMRC accepts that the 'B Macca plc' deal is being entered into for genuine commercial purposes and not mainly for tax avoidance. An advance s138 clearance is normally obtained to obtain certainty from HMRC on this point. The deferred gain would become taxable when the loan note is encashed.

However, in this case, the deferred gain would not be eligible for ER when Jim redeems his loan note. This is because B Macca plc will not qualify as Jim's personal company - he would not hold any voting ordinary shares in this company.

Thus, the taxable gain on the redemption of the loan note would be taxed at the main 28% CGT rate (assuming this rate remains in 2016/17), producing a tax liability of some £0.56m. This is probably contrary to what Jim expects since he is likely to anticipate the gain being taxed at the 10% ER CGT rate.

However, the legislation does permit Jim to tax the QCB related gain at 10% (since he meets the qualifying conditions), but he must make an election under s169R for it to be taxed at the date of the share sale. This means he has to give up his right to defer the QCB gain. By electing, Jim's QCB consideration is brought into charge along with the cash consideration.

Sellers therefore have a choice – pay 10% ER CGT on their QCB loan note gain at the time of sale or defer the gain and (invariably) pay tax of 28% on encashment. Although electing for 'CGT disposal' treatment accelerates the seller's CGT liability, the 18% tax saving will generally make this the preferred route.

However, sellers need to be aware of their tax cashflows when negotiating the terms of the sale transaction. They will have to fund the CGT on both their cash and loan note consideration (which may still be fully or partly outstanding) by the 31 January following the tax year of sale. Consequently, they should ensure there is sufficient cash flowing from the sale to enable the CGT to be paid (comfortably) on time.

Sellers therefore have a choice – pay 10% ER CGT on their QCB loan note gain at the time of sale or defer the gain and (invariably) pay tax of 28% on encashment

ISSUES WITH S169R ELECTIONS

One of the potential difficulties with the s169R election is that there is no statutory mechanism for unwinding the CGT disposal treatment if all or part of the QCB consideration becomes irrecoverable. With the s169R election, the 'up-front' CGT charge is fixed and cannot be adjusted downwards for irrecoverability.

Consequently, if a seller anticipates making a 169R election, important consideration should be given to seeking bank guarantees on the QCB loan notes,which is also a sound commercial requirement. This removes the 'bad debt' risk. Although some purchasers will resist providing bank guarantees (the amount guaranteed generally forms part of their borrowing facility), sellers are often advised to push for it and accept the inherent cost.

If the loan notes are relatively short-term ones (as in Jim's case), then it may be possible to keep the election open to the last minute so that a 'wait and see' approach can be taken. The decision to make an s169R election would have to be made by the first anniversary of the 31 January following the tax year of sale (ie, just less than 22 months following the tax year of sale).

Unfortunately, the use of non-QCB loan notes does not solve this problem. Although the CGT deferral mechanism works in a different way for non-QCBs, an election under s169Q is needed to tax the gain 'up-front' if the 10% ER rate is required. This has the same effect as locking in the tax charge as an s169R 'QCB' election. » 38

FIGURE 2

CASH V LOAN NOTE-BASED EARN-OUT COMPARISON

	Cash earn-out			Loan note-based earn-out		
		CGT			CGT	
2014/15	£m		£m			£m
Value of earn-out right = gain	1.0	@ ER 10%	0.10		(s138A deferral)	-
2016/17						
Actual earn-out payment	1.4			1.4		
Less: Base value of right	(1.0)			-		
Gain	0.4	@ 28%	0.11	1.4	@ 28%	0.39
		Total CGT	0.21		Total CGT	0.39

Assumptions

- Value of earn-out right at sale (Dec 2014) – (say) £1m
- Actual earn-out payment in May 2016 (say) £1.4m
- A QCB loan note for the £1.4m earn-out consideration would be issued in May 2016 and redeemed December 2016
- CGT rates remain unchanged and annual exemption is ignored

There is a potential solution to this problem. If a seller is unable to obtain a suitable bank guarantee for their loan notes, they might (in appropriate cases) consider restructuring the sale transaction so that the 'loan note' consideration is brought within the CGT deferred consideration rule in s48.

To do this, the debt would have to be a simple debt arising from the share sale contract and the purchaser must not issue any debenture or loan note evidencing the debt. The beauty of s48 is that it would enable sellers to obtain ER on their deferred consideration (since it is taxed 'up-front') but the gains can subsequently be reduced if all or part of the deferred consideration becomes irrecoverable.

EARN-OUT CONSIDERATION CAPPED AT £1.8M

The tax treatment of earn-outs has never been straightforward. The case of *Marren v Ingles* [1980] STC 500 firmly established that the market value of a right to receive any deferred consideration, which cannot be 'ascertained' at the time of the sale, must be included as part of the seller's sale proceeds. Formula-based earn-outs clearly fall into this category, even if they are subject to a 'cap' or maximum limit.

Furthermore, the *Marren v Ingles* case also decided that an earn-out right is itself a chargeable asset for CGT purposes. Thus, when an actual earn-out payment is made, the seller would be subject to a further CGT charge on the gain under the 'capital sums derived from assets' provisions in s22.

Broadly speaking, gains on earn-out rights represent the amount by which the actual earn-out payment exceeds the base value of the right. (The right is treated as acquired under the share sale agreement and its base value equates to the value of the right that was taxed 'up-front'.)

Before the CGT rate was increased to 28% in June 2010, sellers generally sought to avoid the 'up-front' tax charge that typically arises on earn-outs satisfied in cash. They achieved this by taking their earn-out entitlements in the form of 'short-dated' (ie, more than six months) loan notes, which were issued when the actual earn-out payments were finally determined. Such arrangements enabled the earn-out right to be treated as a 'deemed security' within s138A. This meant that the full gain on the earn-out could be deferred until the (actual) loan notes were encashed.

28%

The CGT payable on earn-out gains will invariably be charged at 28%. This is because earn-out gains do not qualify for ER – they arise from the right and do not relate to a disposal of shares

Since June 2010, it has been necessary to rethink tax planning in relation to earn-outs. The CGT payable on earn-out gains will invariably be charged at 28%. This is because earn-out gains do not qualify for ER – they arise from the right and do not relate to a disposal of shares. Further, the ER lifetime gains allowance now stands at £10m, which increases the seller's ER capacity.

Taking all these factors into account, the planning objective will be to maximise the amount of the earn-out value 'up-front' at the 10% ER rate rather than incur 28% CGT on the earn-out payment(s).

Jim has ample scope for taxing his earn-out right under the *Marren v Ingles* rule and paying 10% ER CGT on it. This treatment does not require any specific action by him. However, if he wished to defer the earn-out tax charge, he would need to alter the terms of the sale agreement to provide that the earn-out could only be satisfied in the form of further (short-dated) B Macca plc loan notes.

FIGURE 3

ESTIMATED CGT ON SALE OF JIM'S SJV SHARES IN DECEMBER 2014

2014/15 - December 2014	
Sale consideration	£m
Cash	4.5
QCB consideration (with s169R election)	2.0
Value of earn-out right	1.0
	7.5
Less: Base cost (negligible)	(-)
Taxable gain (ignoring annual exemption)	7.5
ER CGT @ 10%	0.75

A futher CGT liability will arise when the earn-out payment is made in May 2016. If the actual earn-out payment turns out to be (say) £1.4m, the CGT payable would be around £0.11m (being £0.4m (earn-out proceeds of £1.4m less base value of right £1m) x 28%)

In practice, earn-out payments are usually paid for the two or three years after the sale. In the case study, the earn-out is only based on one year's profits (to keep things simple). The value of the earn-out right will generally have to be agreed with HMRC – Shares and Assets Valuation (SAV) office.

Broadly, the value of the right is based on the expected earn-out cashflow receipts. These would be derived from the relevant earn-out formula (multiple) being applied to the estimated earn-out profits (as at the date of the share sale). In Jim's case, it is assumed that the current value of the earn-out right is £1m. (The maximum potential earn-out payment is £1.8m and Jim is able to produce a robust profit forecast for 2015.)

A brief indicative comparison of Jim's CGT position between having his earn-out satisfied in cash and in QCB loan notes is shown in figure 2. Based on the assumptions used in the calculations, Jim is likely to pay less tax by taking a cash earn-out payment.

JIM'S ANTICIPATED CGT POSITION

Based on the relevant points discussed above, it is expected that Jim will make an s169R election to tax the QCB gain 'up-front' and will seek to apply the normal *Marren v Ingles* treatment to his earn-out by taking it in cash.

Taking all these facts into account, Jim's expected CGT liability on the sale of his shares to B Macca plc is likely to be around £750,000 (as shown in figure 3).

TRANSACTION IN SECURITIES LEGISLATION

Close company sales have historically fallen within the wide ambit of the Transaction in Securities (TiS) anti-avoidance rules. However, since 2010, sales to unconnected 'third parties' (as in Jim's case) should escape any challenge under the TiS rules (in s684 and s685 Income Tax Act (ITA) 2007) since they should qualify for the fundamental change of ownership 'exemption' in s686 ITA 2007.

Such cases do not (strictly) require an advance s701 ITA 2007 TiS tax clearance. However, it should be remembered that advance tax clearances under s138 TCGA 1992 would often be required for share exchanges and where loan note consideration is taken.

SHARE SALE PLANNING

Many owner managers appreciate the important benefits of the 10% CGT rate offered under the ER regime. However, some careful consideration and planning is necessary on the majority of company sales to ensure the low 10% rate is fully realised by sellers. Owner managers should normally seek specialist advice, especially where the purchaser is offering different elements of sale consideration.

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