

# Ask an expert

## Reverse earn-outs

**Q** I act for a private UK company which is negotiating the purchase of another. An earn-out has been commercially agreed, so the consideration would include deferred payments payable (if at all) by reference to future profits. The sellers (all individuals) suggest that, instead, the buyer issues loan notes to them, with a face value equal to an optimistic estimate of the earn-out. They would then warrant the future profits of the target and, in the event of a breach, the redemption value of the loan notes would be reduced. Are there any tax issues attached to this for a buyer?



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**A** Reverse, or negative, earn-out structuring like this is increasingly common. For the sellers, the aim is generally to maximise the value that would be charged to capital gains tax at the entrepreneurs' relief rate, rather than it being (potentially) chargeable at the full rate of capital gains tax.

Going back to basics a little, and ignoring the loan note proposal for the moment, an earn-out will give contingent unascertainable consideration. Following *Marren v Ingles* [1980] STC 500 HL, the disposal consideration for the target shares would have to include the market value of that earn-out right so that it would be taxable at completion – at the entrepreneurs' relief rate assuming the relevant conditions are met.

Later, there would be a taxable disposal of that earn-out right – a chose in action separate from the shares, with a base cost equal to its market value as at completion – when the actual contingent payments are received.

The effect is that the subsequent 'disposal' of the earn-out (which occurs under TCGA 1992 s 22(1)) can give a loss or a further gain, depending on whether the market value of the earn-out right which has been taxed as at completion is greater or less than the actual payments that are finally received.

An earn-out loss may possibly be set off, under TCGA 1992 s 279A, against the gain that accrued on the earlier disposal of the shares, but a gain will be taxable at full rates and will not get the benefit of entrepreneurs' relief, whether or not the sale of the underlying shares did.

Clearly, then, a seller will often prefer a high valuation of the earn-out right at completion in order to maximise entrepreneurs' relief. Where the relief is available, this gives a better result than having a lower valuation which is followed by an earn-out gain charged at full CGT rates, but an optimistic valuation could be difficult to justify.

Depending (for instance) on the time value of money, the track record of the target, and the volatility of its markets and client base, it may be more appropriate for the value of an earn-out which is geared to the profits of the target to be discounted significantly in the initial capital gains computation. At the very least, there is likely to be scope for the earn-out valuation that is adopted to be challenged.

The loan note proposal seems to be an attempt to remove this valuation risk, so that the consideration that would otherwise be

paid as earn-out is reframed as consideration which is contingent but ascertained, taxed in full at completion under TCGA 1992 s 48. The sellers would then presumably make an election under TCGA 1992 s 169Q or 169R, claiming entrepreneurs' relief on the full completion disposal value, claiming relief under s 48 if the loan notes are subsequently cancelled.

There are two particular issues with this proposed loan note structure from the buyer's perspective, namely:

- the loan relationship rules; and
- stamp duty.

### Loan relationships

The sellers' proposal relies on the redemption value of the loan notes being reduced if their profit warranties are breached, which appears to mean that the loan is effectively released in part. This release would give a non-trading loan relationship profit to the buyer, which would be subject to corporation tax under CTA 2009 Part 5. The practical effect then seems to be that the buyer would face a corporation tax charge in the event, and to the extent, that the face value of the loan notes is reduced – and, on the facts, a downward adjustment is probable.

It should be possible to avoid this charge (for instance) by ensuring that the loan notes themselves are not actually reduced, but that damages or other consideration adjustments are simply paid to the buyer out of other assets. Or, the earn-out consideration could be converted to a cash balance, rather than loan notes, which is held in escrow pending the determination of the warranty position. All of these alternatives are very different commercial propositions for your client when compared to the original proposal, and it may well be that the practicalities involved would render each of them unacceptable.

### Stamp duty

The loan note proposals could also increase the stamp duty costs – possibly, by some way. Assuming the original earn-out would have given simple post-completion payments calculated by reference to a percentage of post-completion profits, with no maximum or minimum payment being stipulated, the earn-out element would not have been subject to duty.

However, with the consideration framed as an amount which is contingent but ascertainable, then the contingent element would be brought within the charge to stamp duty. With loan notes, their value would be subject to duty under Stamp Act 1891 s 55(2), with no right to relief in the event the loan note value is subsequently reduced.

This stamp duty charge could be a significant additional transaction cost and so where a reverse earn-out is proposed, and given that it would be incurred in pursuit of proposals intended to benefit a seller, the seller will often be asked to compensate the buyer for incurring it. ■

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