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Tax issues on earn-outs

Earn-outs are an extremely popular method of pricing businesses in the advertising and marketing sector. This article explains some of the key tax issues that can arise for both buyers and sellers when they enter into a transaction with an earn-out, and follows on from the overview of earn-outs.

If you're a UK tax-resident individual selling shares in your business and getting an earn-out then you might make one or more of the following assumptions. You might assume (1) that you are guaranteed to pay capital gains tax, (2) that you will pay CGT only when you receive your earn-out, and (3) that if your earn-out is delivered in shares or loan notes you will only get taxed when you convert those to cash (e.g. by selling shares or redeeming loan notes. These are easy and intuitive assumptions to make…but unfortunately they are also dead wrong. So we're going to look at some of the assumptions you might make and compare them with how His Majesty's Revenue & Customs see the world. Buyers and sellers both need to be alive to these issues. For sellers the points are obvious; tax can directly hit them in the pocket. For buyers, they will want to ensure that the deal they are offering is actually attractive to the sellers on a post-tax basis, otherwise the whole deal might be jeopardised.

Assumption 1

"Earn-outs are always capital, I'm only going to pay capital gains tax right?"

While this is often the case, it's not guaranteed. There are some circumstances where a seller (and their employer) might be exposed to PAYE / NIC risk at much higher rates. To remind ourselves how much is at stake, remember that the top rate of CGT is 20% (and rates of 10% are often accessible). Whereas the top rate of income tax is 45%, and that's before you factor in employee NICs of 3.25% and employer NICs of 15.05%. Yikes!

This risk is one that buyers AND sellers get excited about, because if there is PAYE / NIC then HMRC can pursue the employer company and not just the individual sellers.

In short, HMRC is alert to the risk that the purchase price on a share sale can include value which is – in reality - remuneration for someone's services as an employee. If that's the case, then the fact that it is labelled as earn-out in a purchase contract does not determine its tax treatment. The employer entity would still be obliged to self-assess it as a payment of taxable employment bonus (subject to PAYE and NICs), and HMRC will be entitled to challenge the employer if they do not comply with their self-assessment obligations. So it's necessary to look at the overall commercial deal realistically. There are warning signs for when an earn-out is at risk, including:

- the earn-out can be forfeited for ceasing to be an employee, so called 'leaver provisions' (because this might be an indicator that it's a payment linked to post-sale employment not the value of the shares); or
- when the seller is employed by the group post-sale on an uncommercially low remuneration package (because this might indicate that the earn-out is being used to 'top up' inadequate salary).

No single factor is determinative and, in particular, leaver provisions are not automatically fatal. In a people-focused business (like many in Advertising & Marketing) they can be a recognition of the importance of senior managers to the goodwill of the business which was acquired.

Assumption 2

"OK, but if it is capital, I'll only pay tax when I receive my earn-out, right?"

Bad news I'm afraid. The mere right to receive an earn-out in future is treated as a kind of payment for tax purposes. So if someone sells shares and gets some cash plus an earn-out, then at the end of the tax year they will have to report – and calculate their CGT on – both the cash and the value of the earn-out. The value of the earn-out can be a vexed question all its own, and might need a valuer to help, but it's generally calculated based on some kind of estimate of the likely earn-out receipts in future, perhaps discounted for some combination of general business risk and the time value of money.

Cash-flow is therefore an important concern whenever structuring a deal with an earn-out. Buyers will want to make sure that the deal is appealing, taking into account the slug of

CGT which the sellers will be paying, and sellers will want to make sure that they are getting enough cash to pay their tax and that little place in the south of France which they have their eye on.

The initial tax which sellers pay also isn't the end of the story. If they end up crystallising a bigger earn-out than the amount they pay tax on then they will have to pay CGT to account for the difference as a kind of 'true-up'. Any such 'true-up' event will have a different tax point and so be subject to whatever rate of tax is payable in the future. The flip side of this is that if the business performs worse than expected and it turns out they paid too much CGT then they should be able to claim a refund.

Assumption 3

"OK, but my buyer isn't even offering a cash earn-out – it's paid in shares in the buyer. Surely that won't trigger any CGT?"

Erm…maybe. There's a special tax treatment known as 'rollover' tax treatment which can apply where someone swaps shares in their company for shares or loan notes in the buyer. As long as they meet various conditions they can 'rollover' the capital gain which they might have triggered and only pay tax if / when they dispose of the shares or loan notes. But if they fail to meet the conditions then they have to pay CGT based on the value of their earn-out, whether it's delivered in cash or not.

In order to get rollover treatment the transaction needs to be a commercial transaction and not undertaken for tax avoidance purposes. It's possible to get advance clearance from HMRC on this point, so clearance should be considered. But let's assume that the sellers and the buyer have purely honourable intentions. Are there any other conditions?

Well, yes. The two that often catch people out are:

- The shares or loan notes must be issued by the buyer and not by some other entity in the group. This is sometimes a problem if the buyer is a subsidiary in a group but the shares being issued are at the parent level. Fortunately, there are legal tricks of the trade that can be used to maintain rollover treatment in such circumstances (by using what we might poetically call a loan note ladder) but care needs to be taken.
- In order to get rollover treatment on an earn-out it must be satisfied in shares, or loan notes, or shares/loan notes but there cannot be a cash option. If the buyer has the ability to satisfy the earn-out in cash, then it can disapply rollover treatment entirely. To avoid this happening, any cash option should be swapped for a loan note option. If you're a seller that's not quite as appealing because you will have to wait at least six months longer for your money, but it's potentially better to incur that cashflow cost instead of a hefty, up-front (and unfunded) CGT bill.

"You're full of problems. Aren't there any solutions?"

Yes! In fact some of them are alluded to above. But mostly it's about ensuring that the parties have their eyes wide open to the tax at an early stage. For example if a cash earn-out has very unappealing negative cashflow consequences for the seller (because it will trigger a big tax bill), then they might try to negotiate a loan from the buyer, or they might structure the earn-out using loan notes instead to defer the tax point.

Forewarned is forearmed. Get the tax right and you'll avoid nasty surprises. Well, you'll avoid nasty tax surprises at least. The rest is up to you!

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