

Earn-Outs

When a company is sold, it is common for the purchaser to defer payment of some of the purchase price until the results of the current, and sometimes the next few, trading periods are known. In many such cases, the amount finally payable may vary according to the results of the business on an ongoing basis. This is known as an "earn-out".

The conventional structure of an earn-out

Until now, such earn-outs have invariably been structured for tax purposes so that, once the targets are achieved, rather than paying cash, the purchaser would issue loan-notes (or occasionally shares) to the sellers. The loan-notes would typically be held for at least 6 months and would then be cashed-in. This structure is effectively blessed by H M Revenue & Customs (HMRC) and is designed to fall within s138A Taxation of Chargeable Gains Act 1992.

Since April 2003, this conventional structure has occasionally been overridden due to concerns that it might be taxed as an unapproved share option under the Employment-Related Securities provisions ("Schedule 22"). However, in most cases HMRC's frequently asked questions – see www.hmrc.gov.uk/shareschemes/faq_emprelatedsecurity-ch5.htm – give comfort that the Schedule 22 provisions will not apply. As a result the conventional structure is still frequently adopted.

However, since Alastair Darling's pre-budget announcement on 9 October 2007, conventional earn-outs which pay out after 6 April 2008 will now typically face 18% CGT rather than the 10% which currently applies.

This briefing therefore looks at whether anything can be done for earn-outs which are currently in the process of being negotiated.

Solutions

For anyone involved in the sale of a company, there are two main solutions to the CGT changes. Interestingly these two solutions also go a considerable way to answering the Schedule 22 difficulties introduced in 2003. As such conventional wisdom as to how to structure an earn-out may shift radically over the next 6 months until 6 April 2008.

The two possible solutions are:

- Cash earn-outs
- Artificially capped cash earn-outs

Cash earn-outs

The first solution may be to revert to a cash-based earn-out. Because the earn-out is now a "right to acquire cash", it cannot be taxed in the same way as a share option and therefore largely answers many of the Schedule 22 concerns introduced in 2003.

It should be noted that the Revenue do still have other powers to re-characterise such an earn-out as a disguised bonus if blatant tax avoidance is taking place. However, their powers are much more limited. It is therefore likely that a cash earn-out will be taxed as a capital gain rather than as income.

Traditionally, cash earn-outs have not been favoured for reasons which are highlighted by the case of *Marren v Ingles*.

Marren v Ingles decided that where shares are sold for a price which includes an earn-out, one needs to calculate - at the date of completion - the present value (PV) of the earn-out. This is not an easy exercise and will invariably require a professional valuation. However, the broad principle can be illustrated by an example.

Assume that a company is sold for £10m upfront + earn-out. The valuer calculates that there is a 60% chance that the earn-out may pay out £4m. In broad terms, therefore, the PV of the earn-out is $60\% \times £4m = £2.4m^1$.

On completion, the taxpayer pays tax on £12.4m

The earn-out is then treated as a separate asset in its own right. If it ultimately pays out, say, £4m then there is a further disposal at that stage. The earn-out's base-cost is its PV. So if it pays out £4m, there is a further gain at that point of £4m less £2.4m = £1.6m.

So, conventionally, cash earn-outs have had two main problems:

- Tax is payable on completion on £12.4m even though only £10m of cash is received.
- Until now the earn-out right will not have been a business-asset and therefore the additional gain of £1.6m would typically have been taxed at 40% rather than 10%.

¹ This is obviously a hugely simplified calculation and is used merely to illustrate the principle

The first of these problems still exists. However, if the earn-out pays out after 6 April 2008, the rate will now be 18% rather than 40%. And, in addition, the higher the PV, the greater the percentage which will continue to benefit from the existing 10% rate.

If the above transaction were conventionally structured the tax would be $10\% \times \text{£}10\text{m}$ plus (after April 2008) $18\% \times \text{£}4\text{m}$. The total is therefore $\text{£}1.72\text{m}$. By using the cash earn-out route, the tax is reduced to $10\% \times \text{£}12.4\text{m}$ plus $18\% \times \text{£}1.6\text{m} = \text{£}1.53\text{m}$ - a saving of nearly $\text{£}200,000$ - albeit at the cost of an accelerated tax charge.

Prior to 2003 there were additional problems if the earn-out actually paid less than its PV. In that case a loss arose on the earn-out which could only be carried forward. Fortunately, Finance Act 2003 introduced new provisions allowing the loss to be carried back in these circumstances.

Artificially capped cash earn-outs

Many earn-outs are open-ended. For instance, they will be structured so that the payment is - say - $\text{£}2$ for every $\text{£}1$ by which EBITDA exceeds a certain figure. As seen above, where they are paid in cash, this brings in the problems associated with .

One possible solution is to apply an artificial cap to the earn-out. For instance take an earn-out which pays $\text{£}2$ for every $\text{£}1$ by which EBITDA exceeds $\text{£}X$.

Suppose that EBITDA will never conceivably exceed $\text{£}4\text{m}$. Given this, the earn-out could be restructured so that it pays out from the top down rather than the bottom up. Rather than paying $\text{£}2$ for every $\text{£}1$ by which $\text{£}X$ is exceeded, the earn-out could pay a flat $\text{£}4\text{m}$ but reduced by $\text{£}2$ for every $\text{£}1$ by which EBITDA is less than $\text{£}4\text{m}$.

By paying a flat sum which is reduced, different taxation treatment applies. Tax is now payable upfront on the full amount of the possible payment ($\text{£}4\text{m}$ in the above example). The legislation then states (s48 TCGA) that a tax reclaim can be made if less is actually received.

The advantage of this approach is that the whole of the earn-out will be taxed as part of the consideration for the main sale. This means that a 10% rate of CGT should apply prior to 6 April 2008.

Compared to a conventional earn-out this reduces the tax bill to $\text{£}14\text{m} @ 10\% = \text{£}1.4\text{m}$ saving $\text{£}320\text{k}$ compared to the earlier example. This structure also alleviates possible Schedule 22 problems.

The disadvantage is that tax is usually paid immediately on completion and that an artificial cap must be applied to the earn-out. Set the artificial cap too high and too much tax will be paid upfront. Set it too low and the commercial deal may be prejudiced.

Despite these disadvantages, the artificially capped cash earn-out may prove to be increasingly popular where deals complete before 6 April 2008. This will particularly be the case for shorter earn-outs which may be close to paying-out anyway by the date the additional tax is payable (31 January 2009).

Conclusion

All deals currently being negotiated need to consider whether earn-outs should be restructured. This will require a careful calculation in each case balancing up the pros and cons.

For existing earn-outs which pay out after 6 April 2008, it may be possible to look at restructuring, although this will require detailed analysis on a case-by-case basis. Urgent advice needs to be taken well ahead of 6 April 2008.

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