The cashflow catastrophe?

Selling shares in small and medium-sized enterprises between now and 5 April 2008 raises considerable difficulties. LESLEY STALKER presents some planning possibilities.

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AFTER THE DRAMA of the Pre-Budget Report capital gains tax changes, Kevin Slevin's article 'Life's a lottery, Darling!', *Taxation*, 25 October 2007, page 452 provided a very thorough overview of the likely impacts of the changes particularly on small and medium-sized businesses. In his analysis, Kevin considered the position of those owning shares in SMEs and the ways in which their entitlement to business asset taper relief and indexation allowance could be harvested before both of these reliefs disappear on 6 April 2008.

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Advice to clients up to now has relied upon these reliefs to continue. Their abrupt ending, assuming that the Pre-Budget Report proposals will be fully enacted, means most clients owning shares or securities in SMEs, and other entities, must be reviewed on a case by case basis; there is no 'one size fits all' answer.

> **KEY POINTS**
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> - Deferred consideration was often taken in the form of loan notes – this is less likely to be so beneficial.
> - Cash may now be preferable as deferred consideration.
> - Businesses which were sold before 9 October 2007 have some limited planning options.
> - Earn-outs may benefit from *Marren v Ingles* treatment.
> - Each case needs to be reviewed on its own merits.

This article considers specifically the position of clients selling shares in SMEs between the date of the Pre-Budget Report (9 October 2007) and 6 April 2008, together with the often complex position of those clients who sold their shares before 9 October, but have not yet received full consideration for the disposal.

Shares of small and medium-sized companies are usually sold for consideration including all or some of the following:

- initial cash consideration;
- deferred consideration;
- shares in the purchasing company; and
- an 'earn-out'.

We will consider the case of business owners who intend to sell their shares between now and 6 April 2008 when their entitlement to the current reliefs expire. While initial cash consideration will be liable to capital gains tax in this period in the same way as before, the position with regard to deferred consideration is rather more problematic and often involves a reversal of the advice we would previously have offered.

Until 9 October, business owners who were accepting part deferred consideration for the sale of their shares will generally have been advised to take this in the form of loan notes which were either qualifying corporate bonds or non-qualifying corporate bonds and which were not redeemable for at least six months. In this case, the appropriate clearances will have been obtained from HMRC and, irrespective of the differences in treatment depending on whether the loan notes are in the form of qualifying or

Example 1

Mr D is selling his shares in company L on 30 November 2007:

- the initial cost of the shares was £60,000 on 30 November 1990;
- he has full entitlement to 75% business asset taper relief;
- he has fully used his annual capital gains tax exemption elsewhere; and
- he is a 40% taxpayer.

The proceeds are £6 million and allocated as follows:

Initial cash consideration: £3 million
Deferred consideration 1: £1.5 million receivable 30.11.08
Deferred consideration 2: £1.5 million receivable 30.11.09

CGT position if he takes the deferred consideration as loan notes and defers the tax payable

		Total	*Cash*	*Loan note 1*	*Loan note 2*
			30.11.07	30.11.08	30.11.09
		£	£	£	£
Proceeds		6,000,000	3,000,000	1,500,000	1,500,000
Less:					
Cost	30.11.90	60,000	30,000	15,000	15,000
		5,940,000	2,970,000	1,485,000	1,485,000
Indexation (e)	0.6		18,000		
			2,952,000		
BATR	75%		2,214,000		
			738,000		
CGT 31.1.09	40%	295,200	295,200		
CGT 31.1.10	18%	267,300		267,300	
CGT 31.1.11	18%	267,300			267,300
Total CGT		**829,800**			

CGT position if he takes the deferred consideration as cash

		Total	*Cash*	*Deferred 1*	*Deferred 2*
			30.11.07	30.11.08	30.11.09
Proceeds		6,000,000	3,000,000	1,500,000	1,500,000
Less:					
Cost	30.11.90	60,000	30,000	15,000	15,000
		5,940,000	2,970,000	1,485,000	1,485,000
Indexation (e)	0.6		18,000	9,000	9,000
			2,952,000	1,476,000	1,476,000
BATR	75%		2,214,000	1,107,000	1,107,000
			738,000	369,000	369,000
CGT 31.1.09	40%	590,400	295,200	147,600	147,600

non-qualifying corporate bonds, the effect will be that the capital gains tax on the exchange of shares for loan notes will not be payable until the loan notes are redeemed. This has been fairly standard tax planning advice given to clients in order to postpone the tax on the deferred consideration until it has actually been received.

However, this advice has been turned on its head for those sales taking place since the Pre-Budget Report and which will take place before 6 April 2008. It is likely that the most tax-effective advice during this period, as far as deferred consideration is concerned, will be that it should be taken in the form of cash. Although this brings the payment date of the capital gains tax forward to 31 January 2009, and may therefore cause cash flow issues, it will also crystallise the entitlement to business asset taper relief and indexation allowance. When this treatment is compared with the capital gains tax liability which would otherwise arise under the new regime when the loan notes are redeemed, it will often be far more beneficial, as ***Example 1*** illustrates.

By taking the deferred consideration as cash, the capital gains tax liability is reduced from £829,800 to £590,400. This is a massive saving of £239,400, i.e. nearly 30%.

Similar principles will apply in the case of new shares and earn-outs taken in exchange for the sale of shares:

- shares acquired will be liable to capital gains tax at the rate of 18% if sold after 5 April 2008, and therefore it will probably be beneficial not to seek clearances for TCGA 1992, s 135 treatment, but rather to pay the tax now, at an effective rate of 10% on the current value of the shares, leaving only the future uplift in value exposed to capital gains tax at the rate of 18%;
- earn-outs will probably benefit from the *Marren v Ingles* [1980] STC 500 treatment (outlined below), again to crystallise capital gains tax at an effective rate of 10% on the current value of the earn-out, leaving only any increase exposed to capital gains tax at the rate of 18%, and relying on the conditions of s 279 in order to receive effective offset of any future reduction in the value.

While there is a cash flow issue to consider with this planning advice, in most cases of deferred consideration the fact that the initial capital gains tax payment is not due until 31 January 2009, coupled with the likelihood that the first tranche of deferred consideration will be payable 12 months after the completion of the sale, will mean the cash flow impact is not great when compared to the tax savings.

The cashflow impact in ***Example 1*** is shown in ***Example 2***.

Example 2

Cash flow with loan notes

	Income	*Tax*	*Balance*
	£	£	£
30.11.07	3,000,000		3,000,000
30.11.08	1,500,000		4,500,000
31.1.09		-295,200	4,204,800
30.11.09	1,500,000		5,704,800
31.1.10		-267,300	5,437,500
31.1.11		-267,300	5,170,200

Cash flow with cash

	Income	*Tax*	*Balance*
30.11.07	3,000,000		3,000,000
30.11.08	1,500,000		4,500,000
31. 1.09		-590,400	3,909,600
30.11.09	1,500,000		5,409,600

HMRC have confirmed that no entitlement to business asset taper relief can be carried over into 2008-09 under the new rules.

There is, however, a potential complication in this arrangement; it is common in small and medium-sized company sales for the payment of deferred consideration to be dependent on the continuing employment of the vendor shareholder by the purchasing company, at least until the date on which the deferred consideration becomes due for payment. This is often viewed by the purchasing company to be necessary, for a set period, to aid the transfer of the business from the vendor shareholder to the new owners.

If there is certainty that the client will remain in the employment of the purchasing company and hence will receive the full amount of the deferred consideration, cash flow considerations permitting, the advice will be to take the deferred consideration in the form of cash and obtain the capital gains tax benefits outlined above.

There will, however, be a risk that the vendor shareholder may decide not to continue as an employee in the new company structure because he may not be happy with the new management, or may simply want to start up a new enterprise earlier than anticipated. In this case, the advice may still be to take the deferred consideration in the form of cash. If, however, the full amount of the deferred consideration is not actually received, it will be necessary to rely on the provisions of s 48 in order to obtain relief should the consideration prove to be irrecoverable.

In summary, planning for a company sale where the proceeds include deferred consideration creates some difficulty between now and 5 April 2008, unless it is anything other than straightforward deferred consideration which is receivable with no conditions attached. Experience of SME sales says this is a rare occurrence, although perhaps vendor shareholders will be able to influence this position rather more, once they are aware of the implications.

Sold already?

At least planning between now and 5 April will be undertaken with full knowledge of the implications (unless further changes are introduced). What of those clients who have sold shares in their business before the Pre-Budget Report and are locked into a structure which includes deferred consideration in the form of loan notes which are not redeemable until after 5 April 2008? These clients are caught in a position where redemption of those loan notes will attract capital gains tax at the rate of 18%, rather than the effective rate of 10% they could reasonably have expected. If they have taken qualifying corporate bond loan notes, they have also fully anticipated that, along with freezing the gain, they have frozen their entitlement to business asset taper relief. In fact HMRC have confirmed that no entitlement to business asset taper relief can be carried over into 2008-09 under the new rules; therefore the gain will be fully taxed at the 18% rate, as will the gain arising under a non-qualifying corporate bond loan note.

In this case, the planning opportunities are limited and are fraught with questions and potential difficulties. The planning strategies to be considered and their related issues follow.

It may be possible to negotiate a pre-6 April 2008 redemption of the loan notes with the acquiring company; however; it is necessary to consider:

- whether the loan notes represent a retention against further claims, in which case the purchasing company will be unlikely to agree;

- whether the purchasing company has the cashflow to enable an early redemption. If not, perhaps it is possible to redeem the loan note and lend the proceeds net of the capital gains tax back to the company in the form of a separate loan note;
- whether redemption of the loan note is contingent on continued employment;
- seeking further clearance from HMRC under s 701 for an early redemption.

Alternatively, perhaps the loan notes can be transferred to a third party, e.g. a family trust. However, in this case it is necessary to consider:

- whether the loan notes are transferable;
- the cashflow impact of paying the capital gains tax (albeit at an effective rate of 10%) before the loan notes can be redeemed;
- the open market value which can be agreed with HMRC and based on which the capital gains tax will be payable. This will be particularly problematic if some or all of the consideration is contingent on continued employment;
- the effects if some or all of the value of the loan note is not actually received;
- inheritance tax issues;
- stamp duty issues.

Shares in the acquiring company

There will be situations where a vendor shareholder has received shares in the acquiring company in exchange for shares in the company he has sold. If clearance has been obtained that s 135 applies, the new shares stand in the shoes of the old with the gain on exchange having been deferred. When these shares are eventually sold, if after 5 April 2008, the entire gain since the date of the acquisition of the original shares will be charged to capital gains tax at the rate of 18%, with no indexation or business asset taper relief applying. A gift or sale of the shares into trust will trigger a gain based on the current market value of the shares and, if undertaken before 6 April 2008, can be used to harvest the availability of indexation and business asset taper relief.

While the issues outlined above still apply, the transfer and valuation of shares should be less problematic than the transfer and valuation of loan notes.

Earn-outs

An earn-out arises broadly when shares are sold wholly or partly on terms that some of the consideration payable is unquantifiable and is dependent on the future performance of the company. Depending on the industry sector, using earn-outs as a form of consideration varies greatly, but this form of consideration has become increasingly popular in recent years. Typically, an earn-out will have been treated in one of two ways.

Based on the decision in *Marren v Ingles,* the value of the earn-out will have been included as part of the capital gains tax consideration on sale and, in this case, capital gains tax will already have been paid based on this value. The vendor will have thus acquired a chose in action which is a separate non-business asset and any amount received in exchange for this will be charged to additional tax based on the date of receipt. If the date of receipt is after 5 April 2008, the rate charged will be 18%; however, the client will have harvested his entitlement to the 10% effective rate based on the value at the date of the transaction. If a lesser amount is received than the value already charged to tax, the capital loss can, on election, be treated as if it arose in the year of the original transaction.

Alternatively, the earn-out will have been structured to be received in the form of loan notes rather than cash, with the gain being deferred by making an election under s 138A. The entitlement to the earn-out will thus be treated as a security rather than a chose in action and will continue to accrue business asset taper relief. When the entitlement to the earn-out arises, this will be satisfied in the form of loan notes which are not capable of being redeemed within six months. If the tax liability in this case crystallises after 5 April 2008, the liability will arise at 18% and a planning review will need to be undertaken now. In this case, it may be beneficial to disapply the provisions of s 138A before 6 April 2008 and within the time limit of two years following the date of the original transaction, in order to bring the value of the consideration into charge at the time of the original transaction, and thus take advantage of the business asset taper relief available.

Uncertainty abounds

As this analysis demonstrates, although the Pre-Budget Report will definitely affect SMEs and entrepreneurs in the future when they try to sell their company shares, those who have already done so are also not necessarily safe from the changes.

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Exit planning has always involved many complex arrangements, and these changes, although they may provide simplicity for the future, produce yet more complex arrangements in the meantime. Advisers must review client situations on a case by case basis, and then translate all this technical jargon into something that clients understand, to enable them to make informed decisions.

It may be possible to find an effective solution for some clients but, for others, the solutions are based on uncertainties which perhaps cannot be answered. ■

Lesley Stalker is head of tax at the Robert James Partnership, www.rjp.co.uk. Lesley and her team were awarded a tax team of the year award at the 2006 LexisNexis Tax Awards and were finalists for best general tax practice in 2007.