An early exit

Employment Tax OMB



01 September 2019

Tom Klouda and *Daniel Andreca* explain the tax considerations of earn-out structures

Key Points

What is the issue?

An inappropriately structured earn-out risks some (if not all) of the consideration being taxed as employment income rather than a capital gain, resulting in significant additional tax charges.

What does it mean to me?

Advisers need to be able to guide on the design of an earn-out structure which presents a low risk and minimises the potential tax liabilities, while considering each individual's specific requirements.

What can I take away?

The design of an efficient earn-out structure is a complex tax area and appropriate guidance should be sought, minimising the risk of unforeseen tax charges which could make the transaction unviable for both sides involved in the deal.

Without appropriate planning, it is well known that earn-outs can make the negotiation of a deal more challenging, especially when compared with a no earn-out deal. The main difficulties centre around the potential tax issues and a poorly designed earn-out structure which can result in neither side obtaining the commercial benefits they desire.

Definition of an earn-out

Depending upon the terms of the share purchase agreement (SPA), the proceeds payable on the acquisition of a business could be paid entirely at the deal competition date, with the alternative being for only a proportion of the total consideration to be paid at the completion date, with the remaining balance remaining to be paid at a later date.

Where some of that remaining balance is contingent on, or calculated by reference to, some measure of the financial performance of the target company, it is commonly called an earn-out.

Benefits of an earn-out

Situations where it can be beneficial to include an earn-out into a deal can include the following:

- A prospective buyer is looking to minimise the risk of overpaying for a target company when the future performance of the business can be difficult to predict.
- The seller wishes to benefit from expected future growth of the target company.
- The existing management needs to be retained and incentivised in order to ensure the continued or future growth of the target company.
- There is a value perception gap created from the parties' different expectations in relation to the future performance of the target company that needs to be bridged.

Challenges of an earn-out

There are also a series of challenges that could be faced when including an earn-out:

- Depending on the drafting, there is a risk for a dispute to arise between the parties.
- In the case of an ineffectively designed earn-out structure, the continuing management's focus might shift towards achieving the earn-out targets, at the detriment of the long-term success of the target company.
- If the earn-out targets are only marginally met, but a significant amount of deferred consideration becomes payable, the buyer will likely require a detailed inspection of the earn-out accounts, which could possibly lead to a dispute between the parties involved in the transaction if any discrepancies are found.
- Careful consideration needs to be given to the preparation of the earn-out accounts of the target company, which should follow the guidelines set out in the accounting standards while also minimising the risk for any disputes to arise between the two sides.

Risks of the earn-out being treated as employment income

From a tax perspective, there is a risk that the earn-out element of the consideration is taxed as income paid to the vendor by virtue of his/her continuing employment in the target company, rather than as funds due as part of the seller's original disposal of the business.

As a result, the earn-out proceeds could be taxed as employment income rather than as a capital gain. This means that the seller could pay additional tax of up to 37% (made up of 47% additional rate income tax and NICs less 10% entrepreneurs' relief) on the earn-out consideration plus NICs for the employer, as compared with the lowest capital gains tax (CGT) rate. The potential for additional tax is relevant for officers or employees and not for corporate vendors or non-employee individual shareholders.

HMRC's standard position is that the earn-out element of consideration needs to be taxed as employment income, unless it can be demonstrated that the funds are owed to the seller based on the structure of the original SPA. HMRC have published guidance (ERSM110940) listing a set of indicators which they will consider in establishing whether the earn-out consideration should benefit from the preferential capital gains tax treatment.

However, many of the factors published by HMRC are subjective and involve a significant degree of judgement before a seller can decide whether these indicators are applicable to his or her individual circumstances. In order for an accurate conclusion to be reached, it is also important for these factors to be analysed with a holistic approach. Despite many tax advisers having developed various rules of thumb in this area (such as the amount of time a seller should remain an employee of the company post sale), there are no definitive rules as to when the earn-out element of consideration is taxed at the lower capital gains tax rates, with HMRC reviewing these situations on a case by case basis.

Despite the uncertainty highlighted above, in cases where the same earn-out terms are available to both non-employees, such as private investors, and/or individuals who are employees but will cease their employment with the company following the completion of the transaction, HMRC normally accept that consideration would be taxed as a capital gain at the lower CGT rates.

If the vendors are still in doubt after considering the above factors, HMRC offer a ‘non-statutory clearance’ service where sellers can apply for confirmation that their earn-out would qualify as a capital gain, rather than employment income. However, in order for HMRC to respond and provide clearance, there would need to be material uncertainty around the tax treatment of the earn-out element of the consideration. Otherwise, HMRC might refuse to offer a view. On the basis that the transaction meets HMRC’s threshold for uncertainty, HMRC will usually reply to the clearance application within 28 days.

A buyer would also normally seek protection against future employment tax charges which could be due as a result of an inefficient earn-out structure by inserting various provisions into the SPA. These could include the following:

- Describe the procedure to be utilised in establishing the tax treatment of the earn-out consideration, which could include applying for a non-statutory clearance application to HMRC.
- Outline the dispute resolution process in the event of disagreement between the parties involved in the transaction.
- Establish which party would bear the cost of any potential tax charges and/or tax deductions arising to the target company as a result of an incorrectly designed earn-out structure.

In addition to including the above provisions into the SPA, a buyer could seek additional protection by asking the seller to provide warranties and indemnities in relation to future employment tax charges.
Ultimately, the parties involved in the transaction could also consider altering the terms of the earn-out in order to minimise and/or defer the potential tax charges. Careful consideration would be required in this case to ensure that the commerciality of the transaction is maintained.

Gains taxation

In the event that the earn-out proceeds received by the seller are not taxed as employment income, the consideration would represent a capital gain which would be subject to CGT. The quantum and timing of any CGT liability would depend upon the terms of the earn-out structure and also upon the various points in time when the earn-out would be payable.

If the amount of the future earn-out is fixed or can be calculated based on events that have already happened at the date of the disposal, the consideration will be deemed to be ‘ascertainable’. In this case, regardless of whether the future earn-out will be paid in instalments or will be contingent upon the occurrence or non-occurrence of specific future events, CGT would be due on the full consideration by the seller upfront following the end of the tax year in which the transaction is performed. If the amount ultimately received is less than the amount taxed, a shareholder can claim to substitute the final consideration for the original amount taxed and claim a tax refund, provided that it is a payment for a warranty or indemnity.

Alternatively, if the amount of the earn out cannot be calculated at the date of entering into the share and purchase agreement, usually because it is tied to some financial measure of the future performance of the target business (e.g. a percentage of earnings above a hurdle amount), the consideration will be deemed to be ‘unascertainable’. In this case, the seller would initially be required to estimate the present value of the right to receive future earn out payments, described as the ‘chose in action’ element. The sum of the ‘chose in action’ element and any proceeds payable at the date of disposal less the original cost of the asset would give rise to either a capital loss or a chargeable gain upon which a CGT liability could potentially arise.

On the receipt of the earn-out, the seller will be liable to make an additional CGT payment if the amount of the actual deferred consideration is in excess of the ‘chose in action’ element; or will be able to claim an additional capital loss for the difference if this amount is lower than the present value originally estimated.

This is a complex area and we strongly recommend that professional advice is sought by each seller in order to minimise the risk of any unforeseen CGT liabilities.

Stamp duty

Consideration also needs to be given to the stamp duty payable on the earn-out element as part of the overall consideration payable in exchange for the acquisition of shares in the target company. The terms of any earn-out deal should precisely explain the basis upon which the earn-out consideration arises, facilitating the calculation of any stamp duty payable.

Conclusion

Designing an efficient earn-out structure is a complex exercise which involves consideration of a significant number of variables, with each constraint having the potential to make the transaction commercially unviable or less advantageous for the parties involved. This article highlights some of the most important tax matters that should be considered when designing an earn-out structure and does not cover all of the tax considerations that might be relevant. We strongly recommend that taxpayers take advice tailored to their personal circumstances.