TAPER RELIEF AND RELEVANT DISCOUNTED SECURITIES

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A potential problem, in relation to earn-outs to be satisfied by loan notes is this: an earn out within TCGA 1992, section 138A is both a security for TCGA purposes and a non QCB (section 138A(3)(a), (b)). An earn out to be satisfied by loan notes, structured so as to be non QCBs, should, if issued by a qualifying company, which retains its status at all material times, therefore, permit a chargeable gain to be tapered down to 10%, over the life of the earn out and the loan notes, once issued (ignoring any application of Schedule A1, paragraph 10 to the loan note). However, this is not always the case.

Earn outs can be given for (at least) one of three reasons. Firstly, the earn out might be the result of a "wait and see" valuation. That is the Acquirer says to the Vendor: "You say that the shares are worth £150; as far as I am concerned, I am prepared to accept that they are worth at least £100 but I will only accept that the shares are worth an additional £50 once that has been proved by the company having made profits of a specified minimum over the next two years." Therefore the additional consideration of £50 is structured as an earn out right which, if it fructifies, will produce loan notes with a face value of £50. Secondly, the earn out might be an allocation of future profits to the Vendor. Both Vendor and the Acquirer agree that the shares are worth £100 but the Acquirer agrees (especially if the Vendor continues to work for the company) to give the Vendor a proportion of the profits which the company makes over the next, say, two years as additional consideration for the shares (assuming that this additional consideration cannot be properly categorised as Schedule E consideration for the continued provision of services by the Vendor, qua director). Thirdly, the earn out right might be indeed given simply as an incentive for the Vendor to carry on as a director or employee of the company

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sold to the Acquirer, in which case the earn out right will, of course be Schedule E income. I do not address this last circumstance any further here but it is worth saying this: the fact that the earn out right and the consideration loan notes might have a clause which requires forfeiture by the holder if he leaves the employment of the company does not of itself conclusively show that the earn out right and/or loan notes are Schedule E income. Such a provision might simply demonstrate that the shares are only worth the price paid by the Acquirer if the Vendor continues to work for the company and is perfectly consistent with a "wait and see" valuation. Whether an earn out right reflects a "wait and see" valuation or whether it simply allocates some future profits to the Vendor, as additional consideration for the shares, is a revealed by the valuation put on the shares by the parties at the time of sale by the Vendor and the terms of the earn out. If the price is, for example, calculated on a net asset basis, and the entire net present value of the company is paid immediately, the earn out right is likely to be an allocation of future profits. As for the distinction between an earn out right which is consideration for shares and an earn out right which is consideration for the continued provision of services this will, of course, depend on the facts and circumstances of each case.

An earn out right which reflects a "wait and see" valuation poses no problem. The true transaction is to sell a company the value of which is unknown. In the example given above, where the Acquirer will only accept that the net present value of the company, at the time of acquisition, is £150 after seeing the level of profits over the next two years, it is only when the earn out period ends that the true value (£150) is known and therefore the "issue price" for the loan note is £50; i.e. the sale is of a company for £150, with £50 payable in the future, albeit contingent. The issuing company will account for the loan notes as an adjustment to the consideration price of the shares (the accounting entry is likely to be debit cash, credit cost of investment; there will be no debit to profit and loss at all). Equally the holder can say: "My company was indeed worth £150 at the time of sale and now that this has been established, I can receive my additional £50, which has nothing to do with any reward for the company's performance over the two years which followed the sale." This means that I have, in fact paid £50 for the earn out right (and therefore for the loan notes). The "issue price" for the loan notes is the "issue price" for the earn out right, which is £50. Since the face value of the loan notes is £50, the loan notes effectively redeem at par and provided that they are structured as non QCBs, taper relief should apply to both the earn out right and the loan notes.

However, this analysis is not technically correct, where the earn out reflects an allocation of future profits to the Vendor of shares by an acquiring company, rather than the result of a "wait and see" valuation of the shares. I should say straightaway that the point I set out below has been present at least since 1989 and I have never seen the Inland Revenue take it to date. However, the point has arisen in another context, which may tempt the Revenue to take it now, in the light of its hostility to taper relief in the case of loan notes.

The problem is this: suppose that an individual vendor sells his 100% interest in a trading company to XYZ Ltd (also a trading company) for cash of £100 and an earn out right with a maximum value of £50, to be satisfied in [non QCB] loan notes. The earn out right only fructifies if certain profit targets are met by the trading company sold to XYZ Ltd and this is a [non Schedule E] allocation of future profits. The consideration price for the shares is the [agreed] net present value of the shares (£100) plus a percentage of the next two years' profits. Suppose that the earn out right does fructify, so that the loan notes are issued to the vendor. Section 138A(3)(c) ensures that the issue is treated as a reorganisation within section 135. Thus the vendor ought to inherit the base cost of the earn out right, in the loan note, which will be negligible [on the basis that the shares in the trading company were presumably worth £100, reflecting the cash consideration received and the earn out right was obtained to ensure, as in the normal course of events, that the vendor maintained the performance of that company, after its acquisition by XYZ Ltd; thus only a minuscule proportion of the value of the shares in the trading company (£100) can be attributed to the acquisition of the earn out right]. As I observe above, one would expect the rolled over gain to be tapered for the combined duration of ownership of the earn out right and the loan notes.

What, however, is the "issue price" of the loan notes, issued in satisfaction of this type of earn out right, for FA 1996, Schedule 13 purposes? The answer is critical, since if the loan notes are relevant discounted securities, within paragraph 3, the consequences are catastrophic. The loan notes will be automatically QCBs (TCGA 1992, section 117(2AA)), so that taper relief is inevitably lost on the loan notes. The issue of the loan notes will, furthermore, be caught by TCGA 1992, section 116, not section 135, with the result that the latent [albeit tapered] chargeable gain will be held over in the loan notes and crystallise on redemption/other disposal of the loan notes. Finally, the whole of the difference between the issue price and redemption price will be taxable to Schedule D, Case III (**in addition to** the held over gain: TCGA 1992, section 37 will not prevent a double charge, since the held over gain is not part of the "consideration" received for the loan note; thus section 37(1) cannot apply to deduct proceeds subject to income tax from any chargeable gain arising under section 116).

The (unfortunate) answer seems to be that the "issue price" of the loan notes is, for FA 1996, Schedule 13 purposes, the negligible value originally ascribed to the acquisition of the earn out right. "Issue price" is not defined in Schedule 13 and therefore takes its natural meaning of the price paid by the issuer for the loan notes (that is, almost nil). Since the redemption value is, on my example, £50, there is clearly a "deep gain" within Schedule 13, paragraph 3(3) and the loan notes are, equally clearly, relevant discounted securities, within paragraph 3(1), with the consequences set out above.

It is true that the earn out right is a "security" for TCGA purposes and it is tempting to argue that the vendor has exchanged the earn out right (worth £50) for the loan notes (in which case the "issue price" of the loan notes is £50, there is no "deep gain" and the catastrophe is averted). However, the earn out right is only a "security", under TCGA 1992, section 138A(3)(a), for TCGA purposes, not for FA 1996 purposes. More fundamentally, the holder of the earn out right does not "pay" for the loan note by "giving up" the earn out right; the earn out right fructifies, so that the issuing company is obliged to issue the loan notes. The holder does not say; "You, the issuing company, owe me £50, which claim I will give up if you grant me another claim, worth £50 [in the form of loan notes]"; rather, the holder says: "You owe me £50, as it happens in the form of loan notes and I want satisfaction of my claim now: so grant me the loan notes". The giving up of the earn out right is not "consideration" granted to the issuing company at all, any more than a beneficiary of a trust, who has a power to, say, call for the appointment of trust assets to him (as was common in certain CGT planning schemes) gives consideration to the trustees, when exercising that power. Indeed, it would be fatal to any holdover claim, on the appointment being made on the exercise of the power, if the beneficiary was seen to give consideration to the trustees.

It is also true that there is no debit to the profit and loss account of the issuing company on the issue of the loan notes. This is because the accounting treatment of the issuing company is to adjust the consideration price of the asset it acquired (in my example, the trading company). If the earn out fructifies, the debit (to cash) is matched by the credit attributed to the increased value of the acquired asset: the issuing company effectively says to itself: "I have had to pay an additional £50 for the asset I have acquired but this is only because the asset is now worth £50 more than I thought it was; actually I have paid £150 for something worth £150, rather than £100 for something worth £100. There is, therefore, no reduction in my profits on the issue (or redemption) of the loan notes (that is, no debit to the profit and loss account)."

However, unlike the case of a "wait and see" valuation, the holder cannot plausibly say "what I sold were shares in my trading company, which looking back must have been worth £150, so that in fact I "paid" £50 for the earn out right (and therefore £50 for the loan notes)", if the valuation put on the shares by both Vendor (the holder of the loan notes) and the acquiring company is made on a "wait and see" basis. Where the earn out right is an allocation of future profits, the shares are only worth £150 because of the events which occurred between the sale to the issuing company (XYZ Ltd) and the fructification of the earn out right; at the date of the sale to XYZ Ltd the trading company shares were worth £100 and the earn out right may never have fructified at all. Schedule 13 is entirely unconcerned with the position of the issuing company. It simply asks what the quantum of the profit which arises to the holder is, that is the difference between the price paid on issue and the redemption price. The vendor can only recognise any increased value in the earn out right in any accounts which he prepares if and when the conditions of satisfaction of the earn out right have been met. Neither can it be plausibly said that the issuing company has "paid" £50 "on behalf" of the vendor, for the purpose of ascertaining the commercial profit to *the holder* . The whole point of an earn out right is to oblige a purchaser to give additional consideration if the asset sold increases in value (however measured by the parties).

This point has been present at least since the enactment of FA 1989; the old Deep Gains Securities provisions in Schedule 11, which used virtually identical terms of art: see paragraph 1(9). The Inland Revenue has, to date, never taken the point but may well be inclined to do so now, on the basis that taper relief for loan notes is viewed with great hostility (and particularly given that, certainly, for fixed rate loan notes, Schedule A1, paragraph 10 is unlikely to deny relief). Furthermore, the Revenue has taken the point that a loan note issued on a bonus issue is a relevant discounted security, for the reason that the issue price is nil, which demonstrates that it is alive to the point. Further guidance as to the Revenue's approach would be helpful.