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EARN-OUTS IN M&A TRANSACTIONS: WORKING HARD FOR CAPITAL TREATMENT?

Earn-outs are common in M&A transactions and can be an attractive mechanism for many reasons, including for their potential for incentivising senior management. However, where an earn-out does form part of an acquisition and individual shareholders are staying on as employees post-completion, that can result in unexpected UK tax consequences – for employment tax, capital gains and stamp duty purposes. It is important to involve tax advisers as early as possible in drafting any earn-out to ensure that the respective parties understand what is achievable from a tax perspective.

An earn-out is a form of deferred consideration, and may be used as a mechanism in private M&A transactions for various reasons, including to deliver value to sellers where some (or all) of those sellers are individuals who will continue to be employed by (or act as directors of) the target business following acquisition (the **"seller-managers"**). An earn-out provision in the purchase agreement will mean that at least part of the purchase price for the target is payable upon the occurrence of future events, usually dependent on the performance of the target business post-sale.

Earn-outs are often used in private equity transactions where part of the value of the target lies in the retention of the existing management, and commercially are often seen as helping to retain and incentivise those seller-managers. An earn-out can also be used to bridge the gap between buyers and sellers when agreeing the right valuation for the target proves difficult.

There is often an inherent tension between the understandable commercial desire to use earn-outs to incentivise seller-managers (for example, by making payments conditional on the seller's personal performance), and the sellers' equally understandable aim that their earn-out payments are taxed in the same way as their other sale proceeds - in other words, as capital gains rather than employment income.

This article explores some of the UK tax pitfalls that can occur, for both purchasers and sellers, in structuring earn-out arrangements. It is concerned with share sales where some or all of the sellers are individuals who are being retained as employees or directors following the acquisition, and not where earn-out payments are made solely to a UK corporate seller (where the UK tax analysis is significantly more straightforward).

Structure

The most common earn-out structure involves one or more payments, calculated by reference to the profits of the target business over a specified period, although it could instead be linked to other financial metrics such as turnover. The precise mechanics for achieving the earn-out will be set out, following detailed negotiation, in the relevant purchase agreement.

In a "true" earn-out payments will be variable amounts, for example calculated as a percentage of the profits over a hurdle for the specified period, rather than a fixed sum paid out when the appropriate hurdle is cleared. Payment under the earn-out to seller-managers is often tied to the continuing employment of those individuals in the target business.

Although the parties will be aligned on ensuring that any earn-out operates as intended, there may well be tension between their respective objectives, both commercial and tax. To the extent possible, sellers will want to maximise earn-out payments and preserve CGT treatment. A purchaser will want payments to be determined by reference to ordinary course performance by the target business and to minimise any unexpected tax costs for the target and itself.

Further sale consideration or remuneration for employment?

Where an acquisition incorporates an earn-out, the (not unreasonable) expectation of the seller-managers is normally that the earn-out is deferred consideration for the sale of their respective shares, which is taxed at the 20% CGT rate rather than at income tax rates of 40% or 45%.

There is no relevant case law on the employment tax treatment of earn-outs, so this is an area where taxpayers need to rely, even more than usual, on the guidance in HMRC's manuals. The manuals accept that where an earn-out represents further proceeds of sale, with no element of remuneration, then no income tax or NICs should be due under ITEPA 2003 (see HMRC's Employment Related Securities Manual at ERSM110910). However, HMRC goes

on to say that will not be the case to the extent the earn-out represents a reward for employment services, with the remuneration element being chargeable to income tax (probably under the ITEPA 2003 s 62 general earnings charge) and NICs. The various charging provisions in Part 7 of ITEPA 2003 also need to be borne in mind when considering the tax treatment of an earn-out (or indeed any deferred consideration), especially Chapter 3D of Part 7 which charges, as employment income, any amount received on a disposal of employment-related securities that exceeds their market value.

HMRC indicators of purchase price vs employment income

HMRC (at ERSM110940) sets out the factors that it considers demonstrate whether an earn-out is further sale consideration, rather than employment income:

1. the sale agreement demonstrates that the earn-out is part of the valuable consideration given for the securities in the target;
2. the value received from the earn-out reflects the value of the securities given up;
3. where the vendor continues to be employed in the business, the earn-out is not compensation for the vendor not being fully remunerated for continuing employment;
4. where the vendor continues to be employed, the earn-out is not conditional on future employment, beyond a reasonable requirement to stay to protect the value of the business being sold;
5. where the vendor continues to be employed, there are no personal performance targets incorporated in the earn-out; and
6. non-employees or former employees receive the earn-out on the same terms as employees remaining.

Of these factors, (1) to (3) are not hugely enlightening; obviously the earn-out will be drafted as part of the sale consideration, and sellers are unlikely to agree to reduced remuneration in return for an earn-out. So, in practice, compliance with factors (4) to (6) above is the most critical element.

As noted above, seller-managers will be concerned to preserve the CGT treatment of any earn-out, because of the significant tax rate differential between income tax (up to 47%, including employee NICs) and CGT (20%).

The purchaser will also hope to preserve the capital treatment of the earn-out. Absent any permissible contractual allocation to the contrary, any employer NICs due on the earn-out payments will be borne by the relevant employing entity, and therefore practically a cost for the purchaser. Where an earn-out is treated as employment income, this is likely to result in a particularly high tax outcome for the purchaser as (in addition to the employer NICs cost) the purchaser is generally unlikely to get a corporation tax deduction on the earn-out payments, which are likely to continue to be treated as (capital) purchase price in the purchaser's corporation tax computation, whereas a plain vanilla bonus paid to the seller-managers would generally be deductible from the employer's taxable profits.

Drafting the sale agreement

The tax advisers involved in the transaction will obviously need to ensure that factors (4) to (6) in ERSM110940 are factored into the commercial negotiations and drafting so far as possible, including as part of discussions around the future employment contracts of the seller-managers. Raising these points early means that it should be easier to set out a framework for what is achievable in tax terms, and minimises the risk of needing to unstitch a "handshake deal" on earn-outs which has already been reached between principals.

In particular, it is important that the purchase agreement is drafted on the basis that any earn-out refers to business performance targets only, rather than the personal performance of particular sellers or the management team collectively; and that all sellers, whether individual or corporate and whether exiting in full at completion or not, receive the earn-out on the same terms (referring to factors (5) and (6) at ERSM110940). A good rule of thumb is that the simpler the earn-out mechanic, the easier it is to secure capital treatment.

Dealing with leavers

Simplicity is not, however, always achievable in practice, and the indicators that most commonly cause practical issues are (4) (the earn-out should not be conditional on future employment, beyond a reasonable requirement to stay to protect the value of the business being sold) and (6) (non-employees or former employees must receive the earn-out on the same terms as employees remaining).

It is common in any deferred consideration arrangement to include "leaver" provisions, with the effect that a seller-manager forfeits their right to an earn-out payment if they are no longer an employee at the time that it is due. Again, it is easy to see how tension can arise here between the commercial objectives of the parties and the tax analysis, particularly where a purchaser considers that part of the value it is purchasing lies in the seller-managers, and thus that it should not have to pay them if they are no longer employed by the target business.

Putting aside the commercial considerations on the extent of any "leaver" provisions (for example, what constitutes a "leaver"), if the earn-out differentiates between retained sellers and leavers, or the forfeiture provisions are not limited to a "reasonable requirement" to protect the value of the business being sold, then this risks the CGT treatment of the earn-out. The specific fact pattern will need to be worked through in the context of the HMRC guidance, such as whether there is evidence that the continued employment of the seller-managers has a real and immediate impact on the value of the target business (for example, in the purchaser's evaluations of the target).

It is clear that HMRC acknowledges that some conditionality on employment can be acceptable, but that it has to be "reasonable" (whatever that means!) – so an exercise needs to be undertaken to test whether the "leaver" provisions are sufficiently tightly drafted and do

actually protect the value of the target business. There is also some unhelpful in-built tension here between the indicators themselves, where (6) suggests that all sellers should be treated equally (which, by implication, must encompass both leavers and ongoing employees), whilst (4) states that some employment conditionality is permissible.

The main questions to ask the deal team include whether the seller-managers subject to "leaver" restrictions are the most important management personnel and not easily replaceable, and whether the business case for the transaction is demonstrably clear that the purchaser is acquiring the target (at least partly) because of those individuals, and has been modelled on the basis that they will be retained post-completion. A possible alternative structure could involve making the earn-out conditional on some other factor rather than the employment of the seller-managers, such as on any non-compete obligations entered into by those senior individuals – though even there, any solution along these lines may be inconsistent with indicator (6).

Reallocation

Another area of tension can often result from proposals to "reallocate" forfeited earn-out amounts arising when a seller-manager does become a "leaver". The other remaining seller-managers might well want that forfeited amount to be reallocated back into the earn-out pot, on the basis that the total earn-out was meant to reflect the value of the target business as a whole, as determined at completion.

However, in our view a reallocation along these lines risks not only the CGT treatment of the reallocated amount, but also casts doubt on the overall CGT treatment of the earn-out. As noted above, indicator (4) at ERSM110940 is clear that the only accepted rationale (in HMRC's view) for the forfeiture of an earn-out on ceasing employment is "to protect the value of the business being sold". It seems to us that it follows that the departure of one seller-manager was expected to reduce the value of the target business. But, in that case, why would the purchaser agree to pay the same total earn-out amount, albeit split amongst a smaller number of sellers?

CGT considerations

Assuming that the CGT hurdle is cleared, so that any earn-out is further consideration for the sale shares, rather than employment income, the seller-managers still need to identify their CGT disposal proceeds for the shares, where the existence of an earn-out necessarily means that the amount of the consideration payable for those shares cannot be established with certainty at completion.

Following the case of *Marren v Ingles* (1980) 54 TC 76, the contingent right to a future unascertainable sum (i.e. a "true" variable earn-out, rather than deferred consideration) is a "chose in action" and so is a separate chargeable asset for CGT purposes. Therefore, the chargeable gain for any sellers at completion will strictly be calculated by reference to the initial cash consideration plus the market value of the right to the earn-out – with the exercise of determining that value often being difficult. The right to the earn-out is then treated as being disposed of when the earn-out payments are actually received, and a further gain (or loss) will be realised under TCGA 1992 s 22, on the difference between the earn-out payments and the original value of that right.

This is usually not an ideal outcome for individual sellers, because they will then have to pay CGT at completion on the value of the earn-out right (in addition to the CGT on the share disposal) before they receive any earn-out payments. Such sellers may also not be able to adjust any CGT due on completion by reference to the earn-out amounts subsequently received, if the earn-out payments are lower than expected. They would, in that situation, realise a capital loss on the disposal of the earn-out, but (if this occurs in a later tax year) would be unable to offset the resulting loss against the gain realised on selling the shares.

One way to avoid this complication is to ensure that any earn-out is satisfied in the form of loan notes (written IOUs issued by the purchaser at the point that payment under the earn-out would otherwise have been due), so that the earn-out can fall within TCGA 1992 s 138A. This section applies where a seller has no right to receive cash earn-out payments and the value of the loan notes issued is linked to the earn-out and so not ascertainable at completion.

Where the conditions in s 138A are met, it will apply automatically (unless a seller elects out) such that the earn-out right is treated as a security (in the purchaser) in its own right, and therefore roll-over relief can be obtained under TCGA 1992 s 135 in relation to the tax that would have been chargeable on completion on disposal of the target shares pursuant to *Marren v Ingles*. When that earn-out right is then satisfied by the issue of loan notes, this is treated as a conversion of securities within TCGA 1992 s 132. The end result is that any chargeable gain that would have arisen on the earn-out right at completion will be deferred until the loan notes are redeemed. Compared to a simple cash structure, the loan note alternative requires some delay for the seller-managers in terms of when they receive cash (as this is normally not payable immediately after the loan notes are issued). But importantly the seller-managers would not pay CGT on the earn-out until they actually receive their cash.

The terms of s 138A require that the exchange of target shares for the earn-out rights would otherwise be within s 135 if the loan note consideration had been ascertainable at completion. This means that (a) the exchange must form part of a transaction where the purchaser holds or will acquire at least 25% of the ordinary share capital, or the majority of the voting rights, in the target, and (b) for any seller-managers who hold more than 5% of the shares in target, the exchange is effected for bona fide commercial reasons and does not form part of a scheme or arrangement which has a main purpose of avoiding CGT or corporation tax. Helpfully, the Upper Tribunal recently confirmed in *HMRC v Euromoney* [2022] UKUT 205 (TCC)

that the "arrangement" for this purpose should mean the overarching transaction, rather than any "sub-arrangement" limited to the loan note structure. (We understand that *Euromoney* remains subject to appeal, and in any case the "exchange" of shares for the earn-out rights still needs to satisfy the 'bona fide commercial transaction' requirement on a standalone basis.)

Stamp Duty

Assuming that any earn-out payments do constitute further consideration for the sale shares, those amounts are subject to stamp duty at the normal 0.5% rate. Stamp duty will be chargeable in accordance with the contingency principle (see HMRC's Stamp Taxes on Shares Manual at STSM021120), which asks whether the earn-out has a stated minimum, a stated maximum or is wholly unquantifiable. If the purchase agreement includes a floor (but no cap) on the earn-out then stamp duty will be due on that floor amount, and if the earn-out is wholly unquantifiable then it will not be chargeable to stamp duty at all.

Stamp duty is another area where there can be tension in the drafting of an earn-out between commercial aims and a favourable tax treatment. The purchaser will generally want to cap the maximum amount payable for the target business under the earn-out for certainty, even if having no cap on the earn-out would mean no stamp duty should be payable on that element of the consideration.

However, a capped earn-out means the purchaser will be paying stamp duty by reference to the largest possible earn-out payment, even if there is a minute chance that the ceiling will be reached. As stamp duty is a "once and for all" tax, it is not possible to recoup any excess stamp duty if it turns out that the earn-out ceiling is not achieved. Ultimately, though, this extra stamp duty may be a cost that the purchaser is willing to bear to ensure it has certainty on the maximum earn-out payable. (Indeed, it seems to us that the stamp duty costs arising from a cap could theoretically be dealt with by providing for a continued earn-out payment, at a much lower rate, in the unlikely event that the commercially agreed cap is reached. But we have not yet found a purchaser prepared to agree to this extra complexity!)

Concluding Thoughts

Even putting aside the tax considerations, an earn-out is likely to be one of the most heavily negotiated parts of any M&A transaction, especially where individual sellers are involved. In light of the risks to CGT treatment outlined above in particular, it is critical that the tax team is involved, at an early stage, in structuring and drafting the earn-out provisions.

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