Practice guide
Sale consideration loan notes for OMBs

SPEED READ **Many company sales entail part of the consideration being satisfied in the form of loan notes issued by the purchaser. Most 'owner-manager' sellers will wish to obtain enterpreneurs' relief (ER) on their loan note consideration by making a s 169R election (in the case of QCBs) or s 169Q election (non-QCBs). However, they must recognise that in both cases, the statute does not allow them to reduce their taxable (ER) gains if the acquiring company gets into financial difficulties and the loan notes become a bad debt.**

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Many company sales entail part of the consideration being satisfied in the form of loan notes issued by the purchaser. In effect, the owner manager is agreeing to finance the deferral of part of their sale proceeds. Many sellers could be forgiven for thinking that they would automatically be entitled to entrepreneurs' relief (ER) on their 'loan note' consideration in the same way as the immediate cash proceeds. However, as tax advisers know, this is not a straightforward matter.

On 23 June 2010, the ER regime underwent a rather important structural change - ER eligible gains ceased to be subject to a 4/9ths gains reduction and instead ER simply became a 10% CGT rate. This revamping had a significant 'knock-on' effect on the treatment of deferred gains, especially the deferral normally given by taking qualifying corporate bond (QCB) loan notes on a company sale. The lifting of the ER ceiling to £5m (on 23 June 2010) and then to £10m (from 6 April 2011) also means that sellers now have significantly more ER capacity and hence the treatment of 'loan note' gains becomes a more important issue.

Unless stated otherwise, all statutory references are to The Taxation of Chargeable Gains Act 1992.

QCB deferral

Where part of the sale proceeds for shares is satisfied in the form of QCBs (and HMRC accepts that the transaction is for genuine commercial reasons and not for tax avoidance), the normal CGT share reorganisation rules in ss 135 and 127 are disapplied.

QCBs are not a chargeable asset for CGT (s 115(1)), so the relevant gain must be captured at the date of the share sale. Section 116(10) achieves this by providing that:

- there is *no* CGT disposal of the original shares;
- the gain (or loss) relating to the QCB consideration is computed at that time;
- this gain (or loss) is carried forward and an appropriate part is subsequently taxed (or arises) when a corresponding part of the QCB loan note is disposed of (typically when it is repaid).

Under the pre-23 June 2010 regime, if the seller had ER capacity, it would have been possible to capture the relevant ER within the s 116(10) gain since it would have been reflected as a 4/9ths reduction in the deferred gain. However, due to the structural change in ER on 23 June 2010, this is no longer possible.

Nevertheless, the legislature still provides an opportunity to benefit from ER on QCB consideration, but this requires the seller to elect under s 169R to disapply the s 116(10) deferral mechanism.

Electing under s169R

Where an individual or trustee seller makes a s 169R election, they are effectively opting to treat the QCB consideration as being given for the disposal of the 'old' shares. This inevitably means that there can be no deferral of the gain. Thus, under the current regime, obtaining ER and deferring the gain will, in the vast majority of cases, be mutually exclusive options.

Where the seller qualifies for ER, they have a choice. Should they elect under s 169R to enjoy an ER-CGT rate of 10% 'up-front' on the QCB gain *or* should they defer their gain under s 116 (10) and (probably) pay CGT at 28% on the full held-over gain when the QCB is redeemed?

Although electing for 'CGT disposal' treatment accelerates the seller's CGT liability, the 18% tax saving will generally make this the preferred route.

> The revamping [of ER] had a significant 'knock-on' effect on the treatment of deferred gains

However, sellers need to be aware of their tax cash flows when negotiating the terms of the sale transaction. They will have to fund the CGT on *both* their cash *and* loan note consideration (which may still be fully or partly outstanding) by the 31 January following the tax year of sale. Consequently, they should ensure there is sufficient cash flowing from the sale to enable the CGT to be paid (comfortably) on time.

See the worked example showing the effect of an s 169R election is shown.

Deferred QCB gains that subsequently crystallise on redemption can qualify for ER but only where the seller satisfies the relevant ER conditions in relation to the acquiring company

Example: QCB loan notes – electing under s 169R

Bruce has owned 100% of the share capital of Wrecking Ball Ltd (WB) for many years, subscribing for 20,000 £1 ordinary (voting) shares at par when the company was formed in 1975. He has always been the managing director of the company

WB is a leading manufacturer of guitars and other musical instruments. It has no investment assets.

Since early 2012, Bruce has been in negotiations with Backstreet plc, which is seeking to purchase a 100% stake in WB. The total sale consideration for Bruce's 100% holding in WB has recently been agreed at £2,500,000, which is made up as follows:

	£
Cash consideration (on completion)	1,500,000
Backstreet plc 7% loan note (redeemable after 18 months), and structured as a qualifying corporate bond (QCB)	1,000,000

The sale is expected to be concluded in June 2012.

If Bruce makes a s169R election, the CGT liability on the sale of his 100% WB holding is likely to be as follows (ignoring the annual CGT exemption):

	£
Cash	1,500,000
QCB (with s 169R election)	1,000,000
Total consideration	2,500,000
Less: Base cost	(20,000)
Capital gain	2,480,000
ER CGT @ 10%	£248,000

Bruce would have to make his s169R election by 31 January 2015. If he does not elect, then the gain on the loan note - £992,000 (£1,000,000 less pro-rata base cost £8,000) would be deferred and taxed at (probably) 28% in 2013/14).

One of the potential difficulties with the s 169R election is that there is no statutory mechanism for unwinding the CGT disposal treatment if all or part of the QCB consideration becomes irrecoverable

when the gain is taxed. This would require, amongst other things, for the seller to hold at least 5% of the ordinary (and voting) share capital in the acquirer for at least twelve months, which would be extremely rare.

Potential issues with s 169R elections

One of the potential difficulties with the s 169R election is that there is no statutory mechanism for unwinding the CGT disposal treatment if all or part of the QCB consideration becomes irrecoverable. The 'up-front' CGT charge still remains but this is due to the s 169R election. (For the avoidance of doubt, this is *not* the latent tax charge under s 116 (10)(b) that has always been a problem with QCBs, which (by concession) HMRC does not seek, provided the 'worthless' QCB is donated to charity!)

Consequently, if a seller anticipates making a s 169R election, important consideration should be given to seeking bank guarantees on the QCB loan notes.

This removes the 'bad debt' risk. Although some purchasers will resist providing bank guarantees (the amount guaranteed generally forms part of their borrowing facility), sellers are often advised to push for it and accept the inherent cost.

If the loan notes are short-dated ones, then it may be possible to keep the election open so that a 'wait and see' approach can be taken. The decision to make an s 169R election would have to be made by the *first anniversary* of the 31 January following the tax year of sale (i.e. just less than 22 months following the tax year if sale).

Can non-QCBs solve the problem?

The CGT deferral mechanism for non-QCBs works in a completely different way to QCBs. In practice, some alteration may be required to the terms of the conventional loan notes to give them 'non-QCB' status, such as by the insertion of a suitable 'foreign currency' conversion clause (see also helpful judicial comments in *Harding v HMRC* [2008] EWCA Civ 1164)).

Where non-QCBs are received as part of the consideration for a share sale, the normal share/security exchange rules in s 135 come into play. Consequently, the non-QCBs (being a chargeable asset) are deemed to have been acquired at the same time and the same (pro-rata) base cost as the original shares in the target company (s 127).

In contrast to QCBs, non-QCBs do not carry any deferred gain from the share sale.

Instead, they will generate a normal capital gain/loss on disposal (ie, typically on encashment) based on the excess of the redemption proceeds less the base cost (inherited from the original shares).

This is why non-QCBs loan notes have traditionally been preferred where there was a perceived risk of non-payment.

If a non-QCB proves to be fully irrecoverable, the result is simply a capital loss equal to the original (low) base cost without any postponed gain to worry about.

Since non-QCBs are securities, they can qualify for ER when they are encashed (see s 169I(2)(*c*)). However, as with QCBs, this will rarely be the case (see above). Thus, if ER is unlikely to be secured on the subsequent 'disposal' of a non-QCB, many 'ER-eligible' sellers will wish to access ER by making a s 169Q election to tax it at the time of the share sale.

The CGT effect of a s 169Q election is to displace the 'new for old' CGT reorganisation rules, thus ensuring that the seller makes a CGT disposal with the non-QCB loan notes forming part of the taxable consideration. The CGT effect of the s 169Q election is therefore exactly the same as the s 169R one for QCBs.

Thus, in the worked example above, if Bruce had taken *non-QCBs* instead and made a s 169Q election, his capital gain would be calculated in exactly the same way. Once again, this means that if the non-QCB loan note proves to be irrecoverable, the CGT charge is fixed and cannot be adjusted.

Sellers should therefore seek to protect their position by seeking bank guarantees etc (see above).

Final thoughts ...

Most 'owner-manager' sellers will wish to obtain ER on their loan note consideration by making a s169R election (QCBs) or s169Q election (non-QCBs).

However, they must recognise that in both cases, the statute does not allow them to reduce their taxable (ER) gains if the acquiring company gets into financial difficulties and the loan notes become a bad debt.

On the other hand, it seems that the loan note gains can be reduced under s 49 if all/part of the loan note consideration is reduced due to a warranty or indemnity payment being made by the seller. Unfortunately, s 49 does not permit any reduction for irrecoverability.

One final thought – if a seller is unable to obtain a suitable bank guarantee for their loan notes, they might (in appropriate cases) consider restructuring the sale transaction so that the 'loan note' consideration is brought within the deferred consideration rule in s 48.

To do this, the debt would have to be a simple debt arising from the share sale contract and the purchaser must not issue any debenture or loan note evidencing the debt.

The beauty of s 48 is that it would enable sellers to obtain ER on their deferred consideration (since it is taxed 'up-front') but the gains can subsequently be reduced if all or part of the deferred consideration becomes irrecoverable. ■

Most 'owner-manager' sellers will wish to obtain ER on their loan note consideration by making a s169R election (QCBs) or s169Q election (non-QCBs)

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Consultations: your A-Z guide (Andrew Goodall, 5.9.11)

Cases: GB Forbes v HMRC (Alan Dolton, 11.8.11)

Cases: Golding & Middleton (Golding's Executors) v HMRC (Alan Dolton, 24.6.11)