July 2010

Review

Corporate Strategy and Finance

EMERGENCY BUDGET 2010: MISADVENTURES WITH LOAN NOTES

INTRODUCTION

It is fairly common and usual for shareholders to sell their shares in private companies for a mixture of up-front consideration and deferred consideration. Buyers will often look to pay consideration on deferred terms as a method of funding the deal or sometimes to guarantee the performance of the target company after the sale completes. The deferred consideration is often recognised in the form of a loan note. Prior to the 22 June Budget, the loan note served two purposes: first it recognised the deferred consideration payable, and second it was a form of loan instrument that ensured that the tax payable on the deferred consideration could itself be delayed until the deferred consideration was paid out. Until the recent Budget, deferring the payment of the consideration did not prevent the shareholders from reducing their capital gains tax bill through the use of Entrepreneurs' Relief. This relief resulted in a 10% rate of capital gains tax on the first £2m of capital gain.

On the face of it, the extension of Entrepreneurs' Relief to allow up to £5m of capital gain to be taxed at 10% looks to be a favourable change for taxpayers.

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SO WHY THE LONG FACE?

Entrepreneurs' Relief used to operate by exempting part of the gain. So, if the shareholder's capital gain was 100, the Entrepreneurs' Relief would exempt 4/9ths of that gain to leave a taxable gain of 55.55. When the taxable gain of 55.55 was taxed at 18%, the actual tax payable was 10, i.e. the effective rate capital gains tax on the gain of 100 was 10%.

Prior to the Budget on 22 June, Entrepreneurs' Relief could reduce the capital gain before the gain was "rolled into" the loan note. When the loan note was redeemed, the reduced gain became taxable at 18% and, the capital gains tax rate became, effectively, 10%.

Since the Budget, the way in which Entrepreneurs' Relief is given has changed. Rather than exempting part of the gain, an actual tax rate of 10% is applied to the gain on qualifying assets. To be qualifying assets for Entrepreneurs' Relief the shareholder needs to own at least 5% of the shares in the target company and be an officer or employee of the target company. When the loan notes are redeemed and capital gains tax becomes payable, it is unlikely that the loan notes will now qualify for Entrepreneurs' Relief. The tax payable on the deferred consideration is now charged at a rate of 28%. This is true even if some or all of the deferred consideration would be within the £5m lifetime limit for Entrepreneurs' Relief and even if the shareholder owned more than 5% of the target when it was sold.

HOW DO YOU AVOID THE PROBLEM

Avoiding the problem depends, in part, on whether you already have loan notes from a deal done before the Budget on 22 June or whether you are looking to do a deal in the future.

If you already have loan notes, it might be possible to make an election to prevent the gain being "rolled into" the loan note. Whilst this will accelerate the tax charge, it should at least preserve the benefit of Entrepreneurs' Relief and the corresponding lower tax charge.

If you haven't yet completed the sale, it might be worth not taking a loan note, but instead taking some other form of acknowledgment that the deferred consideration is due, so that the capital gain is calculated as at completion of the sale, where Entrepreneurs' Relief should be available to keep the effective tax rate on the first £5m down to 10%.

FURTHER INFORMATION

For more information please contact:

Patrick Ford
T: +44 (0)161 830 5014
F: +44 (0)870 443 4098
M: +44 (0)7825 204399
E: patrick.ford@hammonds.com

Bernhard Gilbey
T+44 (0)207 655 1318
F:+44 (0)870 458 2420
M:+44 (0)7801 741812
E: bernhard.gilbey@hammonds.com

Tim Jarvis

T+44 (0)113 284 7214
F: +44 (0)870 460 3481
M:+44 (0)7931 542955
E: tim.jarvis@hammonds.com