

Press Release

CLB LITTLEJOHN FRAZER
Chartered Accountants

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EARN-OUT TRAP WARNING FOLLOWING CAPITAL GAIN TAX CHANGES

Individuals rushing to sell their trading businesses before Business Asset Taper Relief expires on 5 April 2008 may still be caught by the increase in Capital Gains Tax (CGT) announced in the Pre-Budget Statement if they plan to use an earn-out¹ agreement warns CLB Littlejohn Frazer.

“This hike in the capital gains tax payable on disposal of business assets is triggering a mass exodus as shareholders aim to sell up before the 5 April 2008 deadline to minimise their capital gains tax liabilities, but many will be caught out by the structure of the deal,” explains Chris Riley a tax manager with accountancy firm, CLB Littlejohn Frazer.

“Businesses are frequently sold using an earn-out agreement, and payments under such arrangements will probably be made past the new CGT rate deadline, meaning sellers may still therefore be liable for the new 18per cent rate,” explains Riley.

“Changes to CGT mean that taper relief will be abolished for all disposals of privately owned companies and trading assets such as properties used in a trading business, with effect from 6 April 2008. This alone will represent a potential increase in the rate of the tax of up to 80per cent (the difference between the previous effective 10per cent rate and the new 18per cent rate). In addition, Indexation Allowance² will also be scrapped and the loss of the flexibility of the ‘kink test’³(which in some cases, for assets owned before March 1982 could increase the level of allowable costs) may increase that differential further.

“It is understandable why business owners would want to accelerate a sale in order to avoid paying additional tax. But business owners need to make sure that the deal is a good one commercially and not be bamboozled into an unsatisfactory sale in order to complete in a hurry, especially when it is possible that the sale will not entirely avoid the new rules because of an earn-out arrangement. Investors must consider all the implications, and not purely the tax consequences of selling business investments, potentially at a discounted value, before the 5 April 2008 deadline.

“But individuals can still benefit from the 10per cent rate whilst it is still in force by selling entirely for cash prior to 5 April, or by ensuring that any earn out mechanism used provides that proceeds under the earn out can be cash-settled. This creates potential cashflow issues for the vendor, as the tax liability will crystallize immediately, which will need to be balanced against the potential overall tax saving. A considered approach is needed to address the proposed capital gains tax changes.”

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Notes to editors:

¹An earn out provides a mechanism that assists the cashflow of the purchaser by deferring payments for the purchase of a business, typically over several years. This assists the cashflow of the purchaser by enabling payments for the business to be funded from future profits. As payments under the earn out will be triggered by the achievement of specific performance criteria, this also enables both the purchaser and vendor to achieve a fair value for the business based on future results. However, where an earn out is to be cash settled, the tax liability on the anticipated future proceeds crystallizes immediately, which may give the vendor cashflow problems, as tax liabilities arise on proceeds that have not yet been received. Therefore in recent years, it has been typical to structure earn out arrangements such that they are settled in loan notes or new shares issued by the purchaser as this will defer the tax liability until they are cashed in. Under the new regime, these would be taxable at 18per cent.

² For assets acquired by individuals prior to 5 April 1998, Indexation Allowance provided relief for the effects of inflation up to that date (inflation was high during the 80s and early 90s)

³ The 'kink test' lets you chose whether to use the pre-1982 cost of the assets or the 1982 market value. From 6 April 1998 only use 1982 market value can be used.

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