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Published on *Taxation* (https://www.taxation.co.uk)

10 July 2018

Readers' forum : Overpaid

Reclaiming tax on the sale proceeds of a company when final instalment unpaid.

My client was one of several shareholder/directors of company A. A few years ago, they sold company A to company B (which was unrelated) for a substantial sum that was paid in several instalments. They paid tax on the full sale value after the first instalment was paid, although the final instalment was never made.

Three years later, company B made a claim against the shareholders of company A. This resulted in lengthy discussions involving counsel but, to avoid going to court, a settlement was reached. The shareholders of company A agreed to repay some of the proceeds to company B.

What happens to the tax paid by the shareholders of company A? Is HMRC likely to agree to a refund – especially as the final settlement was reached more than four years after the sale? Also, would they be able to claim any tax against the lawyers' fees for dealing with the claim?

I look forward to hearing from readers.

Query 19,196– Unsure.

Reply by Goston

Can a contingent liability be taken into account?

After the sale of shares in company A, the purchaser made a claim presumably under the warranties or indemnities in the sale contract. It is common to have many such indemnities and warranties when selling the whole of the share capital of a company. The claim resulted in a settlement that resulted in both a return of part of the proceeds already paid and the non-payment of the final instalment of the consideration.

In preparing the capital gains calculation, the shareholders of company A can take account of the estimated value of a contingent liability unless it falls within TCGA 1992, s 49.

It is clear from the query that no such estimate was made. However, one of the instances in which a contingent liability cannot be taken into account is in s 49(c). This applies to warranties and representations made to the purchaser. The section confirms that, if such a contingent liability is enforced, adjustment may be made to sale consideration of the shares, so reducing the profit by the amount of the payment.

There is a distinction between a warranty and an indemnity. The advantage of an indemnity to the purchaser is that it gives them a quicker and simpler method of obtaining payment if they

suffer a loss. Indemnities are not covered by s 49, but extra-statutory concession D33 grants similar relief for indemnities as for warranties.

The fact that the final instalment of the consideration was unpaid is covered in TCGA 1992, s 48 and this confirms that any unpaid instalments may be the subject of a claim for repayment of tax.

Any claim for repayment must be made within the time limits prescribed by TMA 1970, s 43, normally four years after the end of the year of assessment. The Capital Gains Manual at CG14933 mentions that a claim for irrecoverable consideration that is payable by instalments must be made within four years of it becoming irrecoverable; this is likely to be the date of the settlement with the purchaser.

If a reduced profit arises as a result of s 49, it is not clear whether this relaxation would apply to any further reduction caused by the shareholders having to repay some of the proceeds that had been paid.

It seems that more than four years have passed since the disposal of the shares, but I would suggest that a claim be made as soon as possible, both for the non-payment of the final instalment and for the sum that had to be repaid to the purchaser. HMRC considers there is no provision for a claim of any lawyers' fees in connection with the settlement – see the Capital Gains Manual at CG14809.

Reply by Pete Miller, The Miller Partnership

A claim may be made for irrecoverable consideration

Unsure's client may be able to claw back some capital gains tax under either TCGA 1992, s 48 or s 49 (or both). Section 48 simply applies to state that the capital gains tax charge and the timing of tax payments are not affected by any deferral or contingent element in the consideration. Indeed, the question explicitly states that Unsure knew this because all the tax was paid despite the consideration being paid in instalments.

The section goes on to say that, if an amount of consideration becomes irrecoverable, the client can claim to have the capital gains computation adjusted and a proportionate amount of tax repaid. There is no time limit for claims under s 48.

Section 49 similarly states that no allowance is made in completing a gain for any contingent liability on warranties or representations. It is not clear whether any such warranties or representations were made. If they were, and if the amounts that were repaid to the purchasers were done on the enforcement of the warranties or representations, a claim can be made to HMRC for an adjustment of the gain and repayment of the tax. Again, there appears to be no time limit for such a claim.

The important point on s 49, of course, is to ask whether the repayment arose out of a warranty or representation. Although warranties are, I believe, a formal legal document, my understanding is that a representation does not necessarily have to be written; it may be verbal.

So, even if the clients were sued for something that wasn't part of the original disposal documents, it may be that the facts and circumstances support a claim on the basis that, in some way, the business or its value was misrepresented to the purchasers outside the scope of the documentation, which is why they sued.

A closer look ...

Reclaiming tax on sale proceeds when final instalment is unpaid

Unsure's question 'Overpaid' is a reminder that the capital gains tax system is not straightforward when dealing with consideration received after the disposal itself.

First, it is important to distinguish between payments by instalment and true deferred consideration when the amount to be received is unascertainable at the date of disposal because it depends on future events. This is typically found in company sales involving an earn-out based on future profits. In these cases, the right to receive further consideration is an asset in itself, following the decision in Marren v Ingles [1980] STC 500, and that right has to be valued at the date of the original disposal. This creates all sorts of complications, particularly in the case of entrepreneurs' relief.

The other situation is if the consideration is known at the date of disposal, but will be paid in instalments. Alternatively, full consideration may be payable upfront but some of it could be repayable if a future event occurs.

Unsure's case seems to involve both. If the consideration has been taxed upfront but part of it becomes irrecoverable – in other words, the balance won't be paid – TCGA 1992, s 48 allows the vendor to make a claim to reduce the consideration by the amount that is not paid. No time limit is specified for such a claim, so the default four-year limit (TMA 1970, s 43) applies. But when does the four-year period start? It might be thought that it would be from the end of the year in which the original gain arose. However, HMRC's Capital Gains Manual at CG14933 does accept that the four years run from the date on which the consideration became irrecoverable.

What about a situation in which the proceeds must be paid back? Here, TCGA 1992, s 49 applies. It states that, in the initial computation of a gain, no allowance is made for a contingent liability, including a warranty. However, if the liability is enforced the taxpayer may make a claim to adjust the original computation to reduce the consideration by the amount paid under the warranty. Again, there is no particular time limit specified and the default four-year limit will apply. But from when? HMRC's manuals seem to be silent on the matter and it may be that the four-year clock starts to run by reference to the original disposal. In Unsure's case, assuming that the settlement payment is a contingent liability (that is not clear from the stated facts), the client may already be out of time to make a claim. There is no specific authority for HMRC to admit late claims. In any case, the Court of Appeal decision in HMRC v Raftopoulou [2018] EWCA Civ 818 shows, reasonable excuse provisions under the TMA 1970, s 118 do not apply to claims.

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