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ADVISORY

Taxation of earn-outs on business sales: capital gain or disguised salary?

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Key Takeaways

- **HMRC is increasing scrutiny of earn-out arrangements**, particularly where founders remain involved in the business after completion and deferred consideration depends on future performance of the target company.
- **The tax treatment of earn-outs can materially affect both sellers and buyers**, with genuine deferred consideration generally taxed as capital gains, while amounts recharacterised as employment income may trigger higher income tax, National Insurance contributions for the seller and buyer, PAYE obligations, interest and potential penalties.
- **Deal documentation should clearly support capital gains treatment**, including by framing earn-out payments as consideration for shares, tying targets to overall business performance and distinguishing them from compensation for services.
- **Founders who continue working in the business should receive market-rate remuneration**, and earn-out payments should not be tied to personal performance or continued employment beyond what is commercially reasonable to protect the value of the business being sold.
- **Early tax advice and a supporting business valuation help strengthen the earn-out position** and reduce the risk of HMRC challenge after the transaction closes.

Increased HMRC scrutiny

A recent article in the *Financial Times*[1] reports what tax advisers have been experiencing for some time: HM Revenue & Customs (HMRC) have been stepping up enquiries of how founders are taxed when they sell their businesses, particularly where consideration is tied to continued involvement — earnouts, rollover equity and performance-linked payments common in high-growth start-ups. Increased challenges include a growing involvement of HMRC's technical team that typically engages in more thorough tax enquiries, greater focus on the terms of share purchase agreements (SPAs) and sale documentation and nudge letters, etc. Together, these measures raise concern that HMRC's more aggressive approach also captures genuine commercial arrangements. This advisory discusses the earn-out (business performance) alternative for individual sellers where the consideration is cash-based.

Earn-out explained

While a significant part of the consideration is normally payable on completion of the sale, buyers frequently prefer to pay less than 100 percent of the consideration upfront. The term "earn-out" refers to a pricing mechanism whereby a part of the consideration for the sale of a company's shares becomes payable over a period of time after completion. The amount of post-completion consideration is typically calculated by reference to (or contingent on) the company's performance after completion.

Where earn-outs are involved, business founders normally stay on for a transitional period (typically 12–24 months) after they have sold their company to a buyer. The main purpose for their continued involvement is to ensure that the transferred business operates successfully under the new ownership and, where applicable, continues to grow to levels (milestones) which trigger the earn-out. It is quite common for any future consideration payments to be made only if the earn-out targets are met.

The key tax question arising in relation to earn-outs is their commercial nature: are they genuinely deferred consideration, or is there an element (or more) of personal remuneration for the founders' on-going involvement in the business? The difference is material. Genuine earn-outs are subject to capital gains treatment in the UK – likely 24 percent for individual sellers (with the first million potentially subject to business asset disposal relief at 18 percent). Conversely, individuals treated as receiving employment income for continuing to work in the business can be taxed at up to 47 percent, plus 15 percent National Insurance contributions (NICs) for the company. Thus, the consequences of getting it wrong will penalise both the selling founder and the buyer.

The line between capital gains and income treatment is not always straightforward to draw, particularly in high-growth startups. Therefore, paying attention to tax treatment early on will considerably mitigate later challenges. It should also be noted that any review by HMRC of the tax treatment will, by its nature, take place only after the transaction has completed. We set out practical guidance on how to maximise capital gains treatment below.

How earn-out taxation works

There are two principal alternatives of capital gains-based earn-out taxation for cash consideration:

1. **Ascertainable consideration.** Where the deferred amount is known at the time of completion or can be calculated for such time, the full consideration (i.e., both the deferred and non-deferred amounts) is brought into the completion computation and taxable at completion. To the extent post-completion conditions are not met so that a deferred payment does not become payable by the buyer, the seller can make a claim for a tax adjustment — typically a discharge or repayment of tax.
2. **Unascertainable consideration.** Where the amount of the earn-out cannot be calculated on completion and is therefore "unascertainable" (for example, because the deferred consideration is determined by reference to a percentage of future profits) a "two disposal" approach applies:

   The first capital gains disposal occurs on completion and is calculated by adding up (i) the actual payment received on completion; and (ii) the value of the right to receive further cash consideration, which is generally referred to as a Marren v Ingles asset (based on a decision in a tax case of the same name by the then House of Lords). The Marren v Ingles asset (i.e., the right to deferred consideration) is a "chose in action" and a capital gains asset. In practice, the value of this asset is often heavily discounted to take account of any uncertainty of deferred payments and the time value of money.

   The second disposal occurs when the *Marren v Ingles* asset is exchanged for an earn-out payment (note: it is possible for several disposals to occur). Where the second payment is greater than the value attributed to the *Marren v Ingles* asset, the excess is subject to tax at the capital gains tax rate then in force. Conversely, if it is less than expected, a capital loss arises. Where relevant conditions are satisfied, the individual seller may be able to elect for any loss to be carried back for offsetting the tax at the time of the original disposal.

It should be noted that where consideration is payable over a period exceeding 18 months, the seller may make a claim to HMRC for payment of the capital gains tax in instalments.

Employment income recharacterisation risk

The principal risk is that the earn-out in reality represents disguised employment income, including the possibility that HMRC recharacterise some or all of the earn-out as such. As indicated above, the difference in tax treatment is substantial: the highest rate of income tax for UK taxable individual sellers is currently 45 percent, plus 2 percent primary (employee) Class 1 NICs. In addition, the company will incur secondary (employer) Class 1 NICs at 15 percent on any amount deemed to be employment income. Importantly, the company should have operated Pay As You Earn (PAYE) on any amount recharacterised as employment income. As it will not have done so, interest and potentially penalties apply. In circumstances where the parties genuinely thought the payment qualified as earn-out, the commercial consequences of recharacterization are harsh.

HMRC's published factors when considering whether a deferred consideration payment qualifies as earn-out or is recharacterised as employment income include:

- The terms of the SPA provide that the earn-out is part of the consideration given for the shares in the target company. This argument is considerably strengthened if it is supported by a business valuation.
- The value received from the earn-out reflects the value of the shares sold.
- Where the seller continues to be employed in the business, the individual must receive market-rate compensation for the services provided. Also, the earn-out must not be conditional on future employment, beyond a reasonable requirement to stay to protect the value of the business being sold.
- Any targets need to be measured against the business performance as a whole. Conversely, personal performance targets incorporated in the earn-out point towards employment.

Apportionment and scope

Where the earn-out is reality (or under successful HMRC challenge) consists of partly deferred consideration for the sale shares and partly a reward for services to continue working, HMRC requires an apportionment of the value on a just and reasonable basis which it applies to the recharacterised employment income. Any consequential impact on capital gains treatment for the residual earn-out will need to be looked at in addition.

Practical tips for individual sellers

Take advice before heads of terms or SPA, not after: tax advice need not be detailed in the early stages of the sales process, but earn-out and individual performance requirements should be approached separately from the beginning.

Documentation must reflect earn-out treatment: ensure provisions are included in the sale documentation that support capital gains treatment, including deferred consideration wording in the SPA, measuring targets at business-level (not personal), and ensure that documentation generally distinguishes between earn-out payments and remuneration.

Compensation for founders: individuals helping with transitioning the business must receive market-rate remuneration (salary, bonus, etc.) for their services.

Obtain a business valuation: a business valuation, which is reflected in the SPA consideration, will be important to support the earn-out case.

Conclusion

Achieving certainty of capital gains treatment for earn-outs should be sustainable where backed by appropriate facts. However, achieving capital gains treatment is not always clear. The key is to take early initial advice to make a strong case that holds up against HMRC scrutiny.

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1 "HMRC broadens scrutiny of founders' pay in company sales", *Financial Times*, 18 June 2026

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