CCH
a Wolters Kluwer business

THE M&A Tax Report
THE MONTHLY REVIEW OF TAXES, TRENDS & TECHNIQUES

VOLUME 21, NUMBER 6
JANUARY 2013

Installment Sales, Earnouts and Rollups

Robert W. Wood and Brian L. Beck • Wood LLP

Start-up companies need good ideas, financing and development, often from venture capital. That generally involves successive rounds with ever-greater dilution so that the founder(s) own a tiny fraction by the time the company is fully monetized. However, in some cases, a contingent price acquisition can be struck that ends up being taxed more like a joint venture.

These deals are not done primarily for tax advantages, and there are several possibilities when it comes to tax reporting. However, the tax treatment can complement them nicely and make rich rewards for successful founders.

Factual Setting

Suppose Fred Founder has a high-technology company, Start-up LLC ("Start-up"), with a potentially innovative product. Founder needs capital to complete his research and development. First he needs to complete a working prototype. Assuming that is successful, he'll need even more investment capital to take his prototype into mass production.

Founder is worried about losing equity to venture financing and wants to go directly to the logical buyers of his technology. Founder cannot obtain funding to complete development of the products based on hypothetical future sales, and he cannot sell Start-up on favorable terms without completing development.

One possible solution may be a staggered and deferred acquisition referred to as a rolling acquisition or roll-up. The buyer may be an established company producing complimentary or possibly even competitive products ("Acquirer"). Founder's product is something that could complement Acquirer's preexisting, historic business.

ALSO IN THIS ISSUE

Roll-Up Details

A key characteristic of the roll-up is that the funding and acquisition are structured so that much of the risk associated with development is allocated to Founder. Acquirer will want to limit its losses if Founder's product is not successful and have a degree of insurance that Founder's product will not end up somewhere else.

The roll-up starts with Acquirer purchasing an interest in Start-up and providing credit. In exchange, Acquirer acquires an option to later acquire the remaining outstanding shares. With a stake in Start-up, Acquirer is better able to monitor its investment.

In the meantime, Start-up and Founder have the much-needed capital required to develop the product and begin moving toward production. If the product is promising, Acquirer will surely exercise its option and buy Founder's shares.

THE M&A Tax Report
THE MONTHLY REVIEW OF TAXES, TRENDS & TECHNIQUES

EDITOR-IN-CHIEF
Robert W. Wood

MANAGING EDITOR
Kurt Diefenbach

COORDINATING EDITOR
Tara Farley

THE M&A TAX REPORT (ISSN 1085-3693) is published monthly by CCH, 4025 W. Peterson Ave., Chicago, Illinois 60646. Subscription inquiries should be directed to 4025 W. Peterson Ave., Chicago, IL 60646. Telephone: (800) 449-8114. Fax: (773) 866-3895. Email: cust_serv@cch.com.

The business and tax considerations largely complement each other. From a business perspective, neither party wants an immediate cash payment or a flat fee. Acquirer does not want to be saddled with a flop and only wants to pay if the product is successful.

Even if the product is successful in some measure, Acquirer wants to pay proportionally to that success. Founder recognizes that the value in Start-up grows over time and wants his payment to reflect the full measure of that growth. If Founder is right about his product, the later he is paid, the more he will receive. Payment to Founder is therefore likely to be contingent, delayed and based on success.

Closed Transaction

Founder's tax treatment will depend on the timing and allocation of basis and gain. But there are several possibilities for the tax treatment Founder will receive.

They include closed transaction treatment, the installment method or open transaction treatment. If the roll-up was simply a sale of the Founder's stock for cash, Founder would be taxed on the gain (*i.e.*, amount realized less basis) in a transaction that closes in the year of sale.

However, this direct sale is directly contrary to the business principles that underlie the transaction, and Founder clearly will not want this. In fact, Founder and Acquirer want the sale to be contingent upon success. To a large extent, they want to allocate the risk to Founder so that in effect, Founder is selling his interest for contingent payments. Founder will be paid at a later date, and the amount of the payment is not fixed.

Installment Method

A more accurate (although still imperfect) alternative to closed transaction treatment is the installment method. An installment sale is a disposition of property where at least one payment is to be received after the close of the tax year in which the disposition occurs. *See* Code Sec. 453(b)(1). Under Code Sec. 453, income is taken into account under the installment method. The total payments expected under the sale are calculated in the first year, as is the basis.

The seller is taxed each year, and each payment retains the same proportion of gain and return of basis as was calculated in the year of the transaction. Gain is taken into account ratably over the course of the installment payments. Thus, if the seller sells an item with basis of $50 and a total contract price of $100 and reports gain under the installment method, half of each payment will be recovery of basis and half will be gain.

A taxpayer can, however, elect out of the installment method. *See* Code Sec. 453(d). Electing out of installment treatment to immediately recognize all gain may sound counter-intuitive. However, it can be attractive in times of increasing rates and where the taxpayer's other offsetting losses are available to absorb the gain.

For a taxpayer that elects out of installment treatment, the election cannot be revoked without IRS consent. *See* Code Sec. 453(d)(3). Moreover, the installment method is not available for any installment obligation arising out of a sale of stock or securities which are traded on an established securities market. *See* Code Sec. 453(k)(2).

Open Transaction

Because installment sale treatment matches recognition with receipt, it has a distinct advantage for taxpayers over a simple closed transaction. The installment method treats income as received in the year of payment. *S*ee Code Sec. 453(b)(1). Open transaction treatment, on the other hand, presumes that we really do not know how much the seller will ultimately receive.

There is a reason the IRS does not like the open transaction doctrine. In fact, the IRS states clearly that it should only be used in unusual circumstances. Open transaction treatment gives taxpayers an even better deal than the installment method.

In an open transaction, the taxpayer does not recognize *any* gain until he has recouped his basis. *See Burnet v. Shaw*, SCt, 2 USTC ¶736, 283 US 404, 51 SCt 550 (1931). There can be material state tax advantages to open transaction treatment too. For example, California conforms to the federal installment sale regime. *See* CAL. REV. & TAX C. § 24667(a)(1).

In California, the source of all the installment sale income relating to the sale of intangible personal property is determined at the time of the sale. *See* 18 CAL. C. REG. § 17952(d). If a California resident later becomes a nonresident, the income may remain California-source. *See id.* Moreover, if intangible personal property of a nonresident acquires a business situs in California, the income may become California-source. *See* CAL. REV. & TAX C. § 17952(c).

Tax Under Code Sec. 453A(c)

In comparing installment sale to open transaction treatment, interest should also be addressed. Under the installment method, there may be interest on deferred tax liability. *See* Code Sec. 453A; *Principal Life Ins. Co. v. United States,* 70 FedCl 144, 153-57 (2006) (interpreting Code Sec. 453A). The tax is not simply imputed interest. *See* Code Sec. 483; see, further, Christopher H. Hanna, Samuel Olchyk, "Interest Under Section 453A(c): Is It or Isn't It?," 92 TAX NOTES TODAY 184-50 (Sep. 10, 1992).

This tax could apply to a roll-up if the amount of payment is greater than $5 million (or $10 million for spouses filing jointly). Indeed, this tax can apply to any obligation arising from the disposition of property under the installment method. *See* Code Sec. 453A(b)(1). However, the obligation must remain outstanding as of the close of the taxable year and the face amount of all such obligations held must be greater than $5 million. *See* Code Sec. 453A(b)(2).

Generally, imputed interest is calculated by treating two parties as having made a loan of an assumed principal amount and interest rate. As a result, the creditor will have additional interest income, potentially leading to additional tax based on the applicable rate on that income. Rather than adding this figure to income, Code Sec. 453A adds an amount to the *tax* due (*i.e.*, after the rate of tax is applied).

However, this amount retains some characteristics of interest. It can be treated as interest for computing an applicable interest deduction. *See* Code Sec. 453A(c)(5).

The tax is roughly equivalent to underpayment interest that would accrue if all payments were due in the first year, with significant modifications. The tax is only applied to the applicable portion of the installment obligation. *See* Code Sec. 453A(c)(4). An amount representing the deferred tax liability of the remaining gain is calculated by multiplying the remaining gain by the maximum rate of tax for the tax year under Code Secs. 1 or 11, as applicable. *See* Code Sec. 453A(c)(3)(B).

What's a Contingent Payment Sale?

The current installment sale rules date to the Installment Sales Revision Act of 1980, P.L. No. 96-471, 94 Stat. 2251. One purpose of the Installment Sales Revision Act was to require the use of the installment method for certain contingent payment sales. *See* S. Rep. No. 96-1000, at 22-24 (1980). Previously, the selling price had to "fixed and determinable." *Id.* at 22 (citing *B. Gralap*, CA-10, 72-1 USTC ¶9388, 458 F2d 1158 and *In re C.A. Steen*, CA-9, 75-1 USTC ¶9199, 509 F2d 1398.

The Senate Finance Committee hoped that the enactment of the contingent payment sale rules would discourage convoluted deferred payment obligations and would "reduce substantially the justification for treating transactions as 'open'." *Id.* at 24. Under current law, a contingent payment sale is an installment sale in which the aggregate selling price cannot be determined by the close of the initial tax year. *See* Reg. §15A.453-1(c); *see further* Code Sec. 453(j)(2) (authorizing regulations to provide for ratable basis recovery where the gross profit or the total contract price (or both) cannot be readily ascertained).

Generally, if a contingent payment sale has a stated maximum selling price, the installment method can be applied by using the stated maximum selling price as the total contract price. *See* Reg. §15A.453-1(c)(2). If there is no stated maximum selling price, but the contingent payment sale occurs within a fixed period, basis is recovered ratably over the fixed period. *See* Reg. §15A.453-1(c)(3).

If there is no stated maximum selling price and no fixed period, the taxpayer's basis is recovered ratably over 15 years. *See* Reg. §15A.453-1(c)(4). In some circumstances, an income forecast method of basis recovery can be used. *See* Reg. §15A.453-1(c)(6).

Retained Interest

If a multi-year sale is not a typical installment sale, it may be a contingent payment sale. However, there are circumstances in which an installment sale is not a contingent payment sale. Indeed, the consideration paid to Founder in a roll-up is unlikely to be either a straight installment sale or a contingent payment sale.

After all, both Founder and Acquirer want the transaction to be success-driven, an earn-out in the extreme. Founder's interest should represent the type of interest explicitly excluded from the definition of a contingent payment sale. *See* Reg. §15A.454-1(c)(1). Founder retains a risk of loss inconsistent with a completed sale. Founder is likely to be directly involved with managing and developing Start-up, and his eventual payment from Acquirer should be based on the success of his participation.

Joint Venture?

The arrangement can be seen as akin to a joint venture. Under the Treasury Regulations, some transactions are simply not treated as contingent payment sales. They include transactions in which the installment obligation represents a retained interest in the property, an interest in a joint venture or a partnership, an equity interest in a corporation or similar transactions. *See* Reg. §15A.453-1(b)(3) (defining installment obligation as the evidences of indebtedness provided by the buyer to the seller in an installment sale); Reg. §15A.453-1(c)(1).

How does one decide what qualifies? Whether an installment obligation represents such a retained interest is made "under applicable principles of tax law." *Id.* Any multi-party organization carrying out a business and formed to share profits and losses can be a partnership. *See* Code Secs. 761(a); 7701(a)(2); *W.O. Culbertson*, SCt, 49-1 USTC ¶9323, 337 US 733, 69 SCt 1210.

The determination of whether an organization is a partnership is based on the facts and circumstances and the intent of the parties. *See H.M. Luna*, 42 TC 1067, Dec. 26,967 (1964). Similar principles are used to determine whether there is a joint venture. The determination of whether an installment obligation is actually an equity interest in a corporation raises issues of debt versus equity characterization.

These interests are characterized by the level of exposure to risk and the role played by the seller in the business sold. The putative seller (Founder in our example) reaps the benefit and bears the burden of growing the equity interest. The payment to Founder is uncertain and his actions determine whether the business will succeed or fail.

These interests are distinct from the creditor interest typically associated with an installment obligation. A creditor interest typically features a return on investment resembling interest, rather than appreciation of equity. If the seller has a creditor interest, then the seller's affiliation with the business ends with the sale, except to receive payment.

All of the examples of contingent payment sales in the Treasury Regulations are situations in which the seller has a creditor interest rather than a retained proprietary interest. In a typical example, the seller sells stock and is paid based on a percentage of profit over a period of years. *See, e.g.,* Reg. §15A.453-1(b)(5), Exx. 1, 2, 3, 7, 8; Reg. §15A.453-1(c)(2)(i)(B), Ex.1; Reg. §15A.453-1(c)(2)(iii), Exx.1, 2. The profit of the corporation is no longer influenced by the former owner.

In contrast, a roll-up is structured so that the Founder's stake more closely resembles a retained proprietary interest. Founder must manage and develop Start-up so that it is profitable.

Getting Open Transaction Treatment

All of this brings us back to the open transaction doctrine. Can Founder treat the roll-up as an open transaction? The leading case remains *Burnet v. Logan*, 2 USTC ¶736, 283 US 404, 51 SCt 550 (1931). In an open transaction, the amount of payment is indeterminate.

The Treasury Regulations clearly state that there are situations in which the fair market value is not ascertainable. Not surprisingly, though, the regulations limit it to "rare and extraordinary case[s]." Reg. §15A.453A-1(d)(2)(iii). Just what these "rare and extraordinary" situations might be is defined by the case law. *S.H. Dorsey,* 49 TC 606, 629-30, Dec. 28,876 (1968); *see Cloward Instrument Corp.,* TC Memo. 1986-345, at 31-32, Dec. 52, 229(M), TC Memo. 1986-345 (1986), *aff'd,* CA-9, 842 F2d 1294.

A situation is rare and extraordinary enough that the fair market value cannot be ascertained based on:

- conditions prevalent in the industry, particularly the past reputation and its unknown future potential;
- obstacles to the success of the product within the industry, including the uncertainty as to their acceptance by the public and proprietors, their unproven status as a unique new product and marketing problems;
- problems facing the product, including the quantity and quality of competition and the product's unproven character; and
- difficulties of ascertaining how much of any success would actually redound to the seller.

How does Founder's roll-up transaction stack up to these criteria? These factors tend to indicate that open transaction treatment should be available for the roll-up, particularly if Start-up is developing an entirely novel product.

Case Law

One of the seminal cases, *S.H. Dorsey,* 49 TC 606, 629-30, Dec. 28,876 (1968), involved the invention of pinsetting machines used in bowling. Prior to automation, bowling alleys employed pinboys to handle the removal and placement of tenpins. In *Dorsey,* the Tax Court held that the right to receive payment from the sale of devices used to automate bowling had no ascertainable fair market value. Joseph C. Clark developed a fully automatic bowling machine, and Mr. Clark's device would clear away fallen pins in a lane without knocking over any standing pins. *Id.*

In 1944, Mr. Clark formed the Automatic Pinsetter Co. to obtain funding to implement his ideas. In 1946, the American Machine & Foundry Co. ("AMF") acquired all of APC's assets. AMF would pay APC one percent of all rentals received and one percent of all sales of pinsetting machines. The first pinsetting machine was sold in September 1951. APC was liquidated in 1954, and the shareholders received participation certificates entitling the bearers to the rights to sales and rentals from AMF.

The IRS claimed that the shareholders should recognize gain at the time of the 1954 liquidation and that this gain would be based on the future value of AMF's payments. *Dorsey* involved approximately 30 taxpayers, and the IRS proposed deficiencies totaling nearly $450,000. The taxpayers argued that any gain on the 1954 liquidation was not ascertainable. Based on the four factors cited above, the Tax Court agreed.

The other seminal case involved a more esoteric invention. In *Cloward Instrument Corp.*, TC Memo. 1986-345, at 31-32, Dec. 52, 229(M), TC Memo. 1986-345 (1986), the Tax Court determined that a right to receive payment from the sale of certain devices used in neurosurgery did not have an ascertainable fair market value. *See Cloward*. Beginning in 1951, Dr. Ralph B. Cloward, a neurosurgeon, developed surgical procedures for repairing spinal disc injuries. Dr. Cloward provided his designs to the Cloward Instrument Corporation ("CIC"). CIC and Dr. Cloward contracted with Codman & Shurtleff, Inc. ("Codman"), a subsidiary of Johnson & Johnson, to sell the devices. Codman paid amounts to CIC based on sales of the instruments.

In 1976, CIC was liquidated, and the shareholders received the right to payments from Codman from the sale of Dr. Cloward's devices. Based on the presumed value of these rights, the IRS found a deficiency of approximately $125,000. The Tax Court, however, determined that this right had no ascertainable fair market value.

Uncertainty of Acceptance

As our economy emerges from the worst downturn since the Great Depression, production often involves international sources and numerous subcontractors. There can be distant supply and engineering problems that may threaten the entire endeavor. In *Dorsey*, the products had been the subject of at least some sales, but there was not enough sales activity to establish a definite pattern. In *Cloward Instrument*, there were seven years of sales.

Both of these situations were arguably less uncertain than the difficulties facing many of today's technology companies. Technology start-ups often face novel difficulties. Some products, however attractive, may appear to be more costly than the problem they are intended to resolve. In some cases, the product may require additional training or may be a radical departure from accepted standards. The technology may not be standardized, least of all commercially practicable.

Difficulty of Fixing Founders' Shares

One of the hallmarks of the roll-up fact pattern is uncertainty in pricing. Founder's interest in Start-up may be worth millions or a few pennies. The certificate holders in *Dorsey* were entitled to one percent of certain payments between February 4, 1947, and December 31, 1966. The certificate holders were paid based on the actual sales, not on estimates.

In *Cloward Instrument*, the royalty agreement continued for 10 years and was based on 10 percent of "net proceeds from sales." There were minimum payments required during the first two years. With today's start-ups, it is often difficult to fix each founder's share. There may be numerous classes of stock, conversion rights and multiple rounds of investment.

In Founder's roll-up, the payments are likely to be based on sales during discrete periods. The arbitrary nature of such calculations adds to the uncertainty. A small delay can eliminate all sales in a testing period, and delays are commonplace.

Conclusion

Founders are often not in the driver's seat when it comes to deal structure. Yet a modified installment structure calling for founders to be paid a highly contingent purchase price—so contingent that installment sale treatment may be inapplicable—can be highly attractive. Not only is the tax treatment advantageous, but the dynamics of the situation can produce highly motivated buyers and sellers.