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Open Transaction Treatment for Earn-outs

By Jonathan Van Loo • Wood LLP • San Francisco

Sales of private companies are frequently structured as earn-outs, with the price contingent on future performance. Most classically, an earn-out can help to bridge the gap when a buyer and seller can't agree on the company's current value. However, earn-outs can also serve a variety of other functions.

Earn-outs can be crafted to incentivize sellers to remain with the company and deliver results. Earn-outs can also be used by new management to buy out old management. New management may be short on cash or old management may be willing to bet they'll be better off with a stream of income from the business rather than a one-time payoff.

In all of these circumstances and more, earn-outs can be invaluable for achieving business goals. Yet despite how common earn-outs have become, their tax treatment remains surprisingly murky. This should not be surprising, for in most cases earn-out transactions stretch over a number of years.

In this sense, earn-out transactions challenge the tax accounting principle that each year stands on its own. Earn-outs also raise fundamental issues about the difference between payment for assets that may be capital in nature and payment for services that are not. Given the sheer popularity of earn-out transactions, particularly in sales and acquisitions of start-ups, questions abound.

In some cases, the IRS is having to answer questions and provide more guidance concerning the tax treatment of these increasingly popular acquisition arrangements. A recent Chief Counsel Advice (CCA) Memorandum addresses several aspects of an earn-out in which sellers suffered an unexpected loss. Before turning to that ruling, it is worth reviewing the basic issues of characterizing earn-out obligations.

Debt-Equity Characterization

Earn-outs are frequently contingent on the target's earnings. Because of this contingency, they generally do not include a guaranteed principal amount. Therefore, provided the contingency has substance, they generally should not qualify as debt.

In one case, the court defined a debt obligation as "an unqualified obligation to pay a sum certain at a reasonably close fixed maturity

date … ." [*B.D. Gilbert*, CA-2, 57-2 USTC ¶9929, 248 F2d 399, 402 (1957).] Debt is commonly understood as requiring an unconditional obligation to pay a sum certain. The IRS's position bears out this fundamental truth. In one ruling, the IRS stated simply: "The presence of a sum certain payable at maturity is a *sine qua non* of debt treatment under the Code." [FSA 199940007 (June 15, 1999).]

Thus, a contingent earn-out obligation appears on the surface not to qualify as debt. However, it is not easily classified as equity either. An earn-out obligation is typically an obligation of the *acquirer* of the target corporation.

Nevertheless, the amount to be paid typically depends on an attribute of the *target*. In fact, the amount to be paid on an earn-out obligation may bear little or no relation to the earnings or profitability of the issuer-acquirer. Moreover, in contrast to a typical equity instrument, an earn-out obligation frequently has a relatively short maturity date.

This short but fixed duration does not necessarily disqualify an earn-out from equity treatment. After all, preferred stock sometimes has a fixed maturity date. Indeed, the Internal Revenue Code itself provides for the possibility that an equity instrument may have a fixed payment term. Under Internal Revenue Code Section ("Code Sec.") 305(c)(1), the holder of preferred stock issued with "redemption premium" must accrue that premium over time under principles similar to those for debt instruments issued with original issue discount. Nevertheless, a fixed maturity date tends to be *unusual* for equity.

In addition, in contrast to a typical equity instrument, earn-out obligations generally do not carry any rights of control, management or ownership. Despite the popularity of earn-outs, it turns out to be surprisingly difficult to apply the debt or equity dichotomy, something that generally precedes consideration of tax treatment. If an earn-out does not easily fit into debt or equity classification, how should it be characterized?

Open Transaction Treatment

Some taxpayers argue that instead of taxing earn-outs as equity or debt, open transaction treatment is more appropriate. While the IRS has been notoriously resistant to open transaction treatment, taxpayers still argue it, and sometimes successfully. The open transaction doctrine can be traced to *Burnett v. Logan*, SCt, 2 USTC ¶736, 283 US 404 (1931), which was itself an earn-out.

In *Logan*, the seller of stock received payment based on the number of tons of iron ore mined in a specific mine. The court explained that the promise to pay was so uncertain that it could not be considered to be the equivalent of cash or to have a determinable fair market value. Although the IRS pointed out that the taxpayer's right to the future payments was valued for estate tax purposes, the Supreme Court did not consider that to be sufficient to provide a basis for fair market value.

Today, open transaction treatment is disfavored by the IRS and courts. For example, in *Bernice Patton Testamentary Trust*, FedCl, 2001-1 USTC ¶50,332 (2001), *aff'd*, CA-FC

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(unpublished *per curiam* opinion), 2002-1 USTC ¶50,277 (2002), the taxpayer sold a slaughterhouse business in exchange for a note. The taxpayer argued in favor of open transaction treatment because repayment of the note depended on the continued economic viability of an uncertain business.

The court in *Patton* noted that, while uncertain, the business was a proven concern. The court was not dealing with a contingent obligation of an *uncertain* business but a fixed payment obligation of an *established* business. The mere possibility that the business would fail did not justify open transaction treatment. The decision in *Patton* suggests that a debt instrument will not generally qualify for open transaction treatment. Indeed, even equity instruments will not necessarily qualify.

The definitive factor is generally whether the fair market value of the instrument can be determined. This focus on ascertainability is borne out in other cases. Thus, in *G.J. Campbell, Jr.,* CtCls, 81-2 USTC ¶9676, 661 F2d 209 (1981), the sellers received notes and stock of the acquirer. The notes and stock in *Campbell* were unregistered with the SEC, and therefore could only be sold to certain sophisticated investors. However, other shares of the same class of the company's stock were publicly traded. The notes and stock were sufficiently similar to the publicly traded instruments to provide a reasonable basis for determining their value.

Other types of earn-out obligations are also susceptible to valuation, even if their market price may not be readily available. For example, in *S. McCormac,* CtCls, 70-1 USTC ¶9345, 424 F2d 607 (1970), shareholders in a corporation that sold burial plots in a cemetery received an earn-out that entitled them to 40 percent of the revenue from a cemetery. The shareholders had estimated the present value of the future income stream based on projections from historical trends of revenue generation at the cemetery.

The shareholders in *McCormac* generated these calculations to support the price for the corporation, but such calculations can be bothersome in later tax disputes. Indeed, the shareholders argued that the earn-out had no determinable fair market value. The court held that the present value of the earn-out could be reasonably determined, relying in part on the taxpayers' own calculations.

Open transaction treatment is generally reserved for those "rare and extraordinary" circumstances when the value of the property received cannot be determined. [*See* Reg. §1.1001-1(a).] That means open transaction treatment would generally only be available in the context of contingent obligations issued in private company sales, when equity is difficult to value. Of course, this difficulty in valuation is often one of the reasons buyers and sellers may agree on an earn-out to begin with. This suggests that, in the context of earn-outs involving private companies, open transaction treatment may not be so rare after all.

Installment Sale or Open Transaction?

A dramatic simplification and broadening of the installment sale rules was enacted in 1980. Since then, sellers have had an alternative to open transaction that achieves a middle ground. In the context of private companies, the installment sale rules apply unless the taxpayer elects otherwise. This election to opt out of the installment sale rules must be made by the due date for the tax return in the year of the transaction. Exceptions are limited to a showing of good cause. [Reg. §15a.453-1(d)(3).]

In contrast to open transaction, the installment sale rules require a *pro rata* allocation of basis based on the projected installment payments. Installment sales are subject to an anti-pledging rule and interest charge under Internal Revenue Code Section ("Code Sec.") 453A. Moreover, the recognition of ordinary income and recaptured income on depreciated property is accelerated under Code Sec. 453(i). If the property has been depreciated, gain first consists of recapture of any depreciation deductions under Code Sec. 453(i). This has the effect of forcing taxpayers to first recognize income taxed at the highest rates. [*See* Reg. §1.453-12(d)(ii), *Example 4*.]

Allocating Basis in Installment Sales

Under open transaction treatment, the seller uses the cost recovery method. The seller is permitted to allocate basis to payments as they are received. The seller only recognizes gain after basis is completely exhausted. In contrast, in an installment sale the taxpayer must

allocate basis. In case of a fixed installment obligation, a taxpayer is generally required to allocate basis ratably to each fixed installment payment. [Reg. §15a.453-1(b)(2)(i).]

In a contingent sale such as an earn-out, the stated maximum selling price is used to allocate basis. [Reg. §15a.453-1(c)(2)(i)(A).] In the absence of a stated maximum price, basis is allocated ratably over the term of the installment obligation. [Reg. §15a.453-1(c)(3)(i).] If there is no fixed term, basis is allocated using some other method such as an assumed 15-year term. [Reg. §15a.453-1(c)(4).] Using the stated maximum sales price to allocate basis may inappropriately defer recovery of basis.

As a result, the seller may be forced to recognize capital gain in one year even if he does not realize any economic gain overall. Consider the following example.

> **Example 1.** Buyer agrees to pay $100,000 in year one, with an additional contingent payment capped at $900,000 in year five. The seller has $400,000 of basis. There is adequate stated interest.
>
> Based on the maximum sales price, Seller is assumed to have $600,000 of gain, and 60 percent of each payment represents gain. Thus, $40,000 of basis is allocated to year one, and the seller recognizes capital gain of $60,000.
>
> Due to the contingency, the buyer only owes $200,000 (plus interest) in year five, which the buyer duly pays. The seller will have a capital loss of $160,000 in year five.

If the installment sale rules result in a "substantial and inappropriate" deferral of basis recovery, the taxpayer may use an alternative method, but only if he obtains a ruling. [Reg. §15a.453-1(c)(7)(ii).] It may be highly difficult for taxpayers in contingent earn-outs to satisfy the stringent requirements for such a ruling.

Earn-outs and Claim-of-Right Doctrine

As Example 1 shows, the installment sale rules sometimes require taxpayers to inappropriately defer basis recovery. One taxpayer arrived at a creative and elegant way to deal with this problem in CCA 201328031 (Apr. 3, 2013). The taxpayer in that case sold property for two notes: one with fixed payments and the other with an earn-out.

Although the sale apparently could have qualified for installment sale treatment, the taxpayer did not pursue that treatment, in the year of the sale, the taxpayer took the position that the amount realized was equal to the maximum amount payable on the notes. By doing that, the IRS ruled that the taxpayer effectively elected out of installment sale treatment.

However, not only did the business fail to meet the threshold for the earn-out, but the buyer also defaulted on the fixed note. Thus, despite recognizing gain in the year of the sale, the seller realized a loss when payment was due on the notes. The ruling addressed whether the seller could claim a refund under Code Sec. 1341.

Code Sec. 1341 is the statutory response to the perceived unfairness of the "claim-of-right" doctrine, which requires taxpayers to include an item of income even if that item must be returned in a later year. This approach certainly has an appeal. It is a twist on open transaction doctrine. Instead of waiting until the contingency is resolved to pay tax, the seller pays the maximum amount of tax in the year of the sale. If things don't work out, the taxpayer then seeks a refund under Code Sec. 1341.

In one sense, this approach is not as taxpayer-friendly as open transaction treatment or the installment sale rules. After all, it requires the taxpayer to pay a hefty sum in the year of the sale before receiving payment. It is almost as if the taxpayer posts a bond. However, in another sense this approach is more taxpayer-friendly than the installment sale rules because it allows a taxpayer to get a refund of any tax that was overpaid.

Another ruling addresses a taxpayer in a similar predicament. Just as in CCA 201328031, the taxpayer in LTR 9853002 (Sept. 11, 1998) proved to be overly optimistic. When it became apparent that the earn-out would not prove to be as lucrative as originally expected, the taxpayer sought a refund of interest paid under Code Sec. 453A. The taxpayer argued that he paid interest on amounts in excess of the actual deferred tax liability.

The IRS rejected the argument. Instead, the IRS explained that the purpose of Code Sec. 453A is to put the taxpayer in the same position as if he elected out of installment sale treatment. In that case, he would pay tax on the fair market value of the earn-out in the year of the sale and would not be able to claim a refund if things did not turn out as expected.

Obviously, the same concern with parity did not apply in CCA 201328031, because the taxpayer elected out of installment sale treatment. Nevertheless, the IRS reached a similar conclusion and denied a refund to the taxpayer. Perhaps the IRS interpreted this strategy as an end-run around the contingent installment sale rules. However, this wait-and-see approach does not appear to do violence to those rules. In fact, as discussed in the next section, the IRS endorsed the wait-and-see approach in at least one ruling in the installment sale context dealing with the Code Sec. 453A interest charge.

Perhaps the IRS is concerned about an overly expansive claim-of-right doctrine. In any case, the IRS CCA 201328031 ruled that the taxpayer did not qualify for Code Sec. 1351. The IRS pointed to the fact that the taxpayer had an "actual" right to the items of income (the notes) rather than an "apparent" right. This was so despite the contingency on the earn-out note.

At least some courts considering the "actual" versus "apparent" issue have held that taxpayers may qualify for Code Sec. 1341 even if they had an actual right to the item. [*See, e.g., E. Van Cleave*, CA-6, 83-2 USTC ¶9320, 718 F2d 193, 196–97 (1983).] Even the government itself has not been wholly consistent on this issue. [*See* 2001 IRS CCA LEXIS 304 (June 15, 2001) (citing *Van Cleave* in approval).] Nevertheless, the IRS CCA 201328031 suggests that the government is maintaining its restrictive interpretation of Code Sec. 1341.

Imputing Interest on Contingent Payments

Even if a contingent sale payment does not qualify as debt, interest is still imputed under Code Sec. 483. [*See* Reg. §1.483-4(a) (explaining that interest is imputed for contingent deferred payments for the sale of property under rules similar to the rules for contingent payment debt instruments).] Code Sec. 483 applies *both* to contingent payment installment sales *and* to sales subject to open transaction treatment. [*See* CCA 200722027 (Apr. 27, 2007).]

Code Sec. 483 imputes interest to a contingent payment on a wait-and-see basis. The amount of interest is only calculated in the year of the contingent payment, when the amount of the contingent payment is known. The Code Sec. 483 imputed interest amount is deductible by the buyer and includible in ordinary income by the seller in the year of the contingent payment. [*See* Reg. §1.483-4(b), *Example 2*.]

Entirely independent of Code Sec. 483, there is an interest charge on the deferred tax amount of installment obligations. Under Code Sec. 453A, taxpayers holding installment obligations that have an aggregate "face amount" greater than $5 million generally must pay an interest charge on the amount of "deferred tax." The Code Sec. 453A imputed interest is treated as the cost to the taxpayer of deferring the payment of tax on the installment obligation. By virtue of an interest charge on the deferred tax amount, the seller is treated as if he borrowed that deferred tax amount from the government.

The interest charge is treated as deductible in principle under Code Sec. 453A(c)(5). However, it appears that individuals generally will not be able to use this deduction because it is personal interest. [Temporary Reg. §1.163-9T(b).]

In a contingent installment sale, it is unclear how to determine if the "face amount" of a taxpayer's installment obligations exceeds $5 million. In one ruling, the IRS conceded that contingent installment obligations "do not have a face amount." [CCA 201121020 (Apr. 27, 2011).] This is not particularly surprising. After all, the term "face amount" typically refers to the principal amount of a debt instrument, but contingent installment obligations generally do not qualify as debt.

However, the IRS did not conclude that the interest charge did not apply to contingent installment obligations. Instead, the IRS applied the same wait-and-see approach from the Code Sec. 483 imputed interest regulations to determine the appropriate interest charge under Code Sec. 453A. Thus, the first $5 million in contingent installment payments should be received by the taxpayer without any deferred tax interest charge. Any contingent installment payments above $5 million would be subject to the interest charge on the deferred tax amount.

This approach is more favorable than using the maximum sales price assumption to calculate interest. Nevertheless, it is questionable if the imputed interest charge applies to contingent installment sales in the absence of any regulations. What if the interest charge only applies to instruments with a "face amount" above $5 million, and contingent installment obligations have no face amount?

It would seem to follow that the interest charge simply doesn't apply. Of course, some may consider this to be an aggressive position when a taxpayer actually receives more than $5 million. In any case, the IRS has obviously taken a different view.

Is Open Transaction Treatment Viable?

Although battered and disfavored, the open transaction doctrine is not yet extinct. Indeed, the installment sale rules themselves acknowledge the viability of the open transaction doctrine in "rare and extraordinary" circumstances. [Reg. §15a.453-1(d)(2)(iii).] The open transaction doctrine even seems to thrive in the context of corporate liquidations, where shareholders generally do not recognize any gain until their basis is exhausted. [*See* Rev. Rul. 68-348, 1968-2 CB 141.] Even the IRS itself has had occasion to argue in favor of open transaction treatment as well as in favor of deferring recognition events more generally.

In the same way that taxpayers generally want to *defer* the recognition of gain, they also generally want to *accelerate* the recognition of losses and liabilities. [*See, e.g., D.B. Merkel,* CA-9, 99-2 USTC ¶50,848, 192 F3d 844 (1999) (government argued that a taxpayer's liability was too speculative to be taken into account for purposes of the insolvency exception to cancelation of debt income under Code Sec. 108(d)(3)).] Sometimes, therefore, the government finds itself in the position of using open transaction principles to argue in favor of deferring the recognition of a loss.

For example, in *H.B. Grudberg,* Dec. 31,199(M), 34 TCM 669, TC Memo. 1975-142, the taxpayer sold his stock in a helicopter sales and training company in 1965 for a contingent note. The acquirer would only have to pay the contingent note in 1970 if the helicopter company achieved a certain level of profitability. When the helicopter company failed to achieve its target level of profitability, the taxpayer claimed an ordinary loss.

In an unusual twist, the IRS argued that the contingent note was so uncertain that it could not be valued at the time of the sale. When the sale closed in 1970, the contingent note became fixed at zero. At that point it was clear that the company had failed to achieve the necessary level of profitability.

According to the government, the taxpayer only realized a capital loss on the sale of stock in 1970. Such authority can come back to bite the IRS.

In *E.G. Baumer,* CA-5, 78-2 USTC ¶9725, 580 F2d 863 (1978), a corporation granted an option to purchase land to the son of the corporation's sole shareholder. The government argued that the grant of the option constituted a constructive dividend, but that the option could not be valued upon grant. Therefore, the constructive dividend only occurred when the son exercised the option to buy the land several years later. [*See also Simmonds Precision Products, Inc.,* Dec. 37,338, 75 TC 103 (1980) (holding in favor of taxpayer that options issued in consideration for patents were not capable of valuation until exercised).]

The outcomes of *Baumer* and *Simmonds* suggest that, given the right facts, open transaction treatment is still appropriate. In keeping with this line of reasoning, courts have reaffirmed the doctrine even after the advent of the installment sale rules. For example, in *Cloward Instrument Corp.,* Dec. 43,241(M), 52 TCM 34, TC Memo. 1986-345, *aff'd,* CA-9 (unpublished opinion), 842 F2d 1294 (1988), the taxpayer received the right to a percentage of net sales proceeds from the sale of certain surgical instruments.

In *Cloward Instrument*, the court explained that the right to sales proceeds from a novel surgical instrument was so uncertain and contingent on future events that it was not possible to value. [*See also Mothe Funeral Homes,* DC-LA, 95-1 USTC ¶50,248 (1995) (holding that contracts to purchase burial plots were not capable of valuation).]

The *Fisher* Factors

In *E.A. Fisher,* FedCl, 2008-2 USTC ¶50,481, 82 FedCl 780 (2008), *aff'd,* CA-FC (unpublished opinion), 2010-1 USTC ¶50,289, 333 FedAppx

572 (2009), the taxpayer purchased an insurance policy from a mutual insurance company in 1990. In 2000, the mutual insurance company implemented a demutualization plan and offered shares in an IPO. The taxpayer received rights to shares of the new public insurance company in exchange for its voting and liquidation rights that were previously part of its insurance policy. The taxpayer elected to offer its shares as part of the IPO and received cash from the sale of the shares.

The court held that the taxpayer's ownership rights were not capable of valuation, partly because they were inseparable from the underlying insurance policy. Thus, open transaction treatment applied. As a result, the taxpayer applied the entire cost of insurance premiums against the proceeds from the sale of his shares in the IPO.

Indeed, the court explained that the taxpayer's ownership rights in the mutual insurance company were not capable of valuation. However, in the transaction at issue, the taxpayer gave up those ownership rights and received cash in exchange (the proceeds from the sale of the stock of the insurance company). Surely, it should be possible to value ownership rights when the taxpayer exchanged those rights for cash. In this sense, the court's decision in *Fisher* seems perplexing.

Unfortunately, other taxpayers have not received such generous treatment when arguing that demutualization should be accorded open transaction treatment. [*See B. Dorrance,* DC-AZ, 2012-2 USTC ¶50,463, 877 FSupp2d 827 (2012).] Nevertheless, the court did offer an interesting framework for analysis. The *Fisher* court applied three factors to determine if open transaction treatment should apply: marketability, existence of proxies, and contingency of valuation.

The first factor focuses on whether the asset is marketable or alienable. If an asset cannot be sold, any estimate of its price or value of the asset may be purely speculative. Marketability formed an important aspect of the analysis in *Baumer*.

In that case, the government argued in favor of open transaction treatment in part because of the difficulty of valuation when the option was granted by a closely held corporation to the shareholder's son. Similarly, sellers sometimes receive earn-outs that are subject to a variety of restrictions. Commonly, they include restrictions on pledging or selling the earn-out.

In addition, it is not unusual for the earn-out to be contingent on continued employment by the seller. From the buyer's perspective, the earn-out is a financial incentive for the seller to remain employed and to perform well on the job. Therefore, marketability will frequently favor open transaction treatment for earn-outs.

The second factor focuses on comparable assets. Even if the asset itself cannot be sold, if it is sufficiently similar to other marketable assets, a price may be determinable. This was arguably the determining factor in *Campbell*. The seller there received stock that was subject to SEC selling restrictions, but some of the same class of stock was publicly traded. In contrast, the earn-out in *Cloward Instrument* was far more difficult to value because there are no clearly comparable publicly traded assets.

Again, this factor will frequently favor open transaction treatment in the context of earn-outs of private companies. Such companies frequently have a short history of generating revenue and/or novel products and business plans. These are precisely the kinds of fact patterns in which earn-outs are attractive.

The third factor is perhaps the most subjective. It asks how much the value of the asset depends on contingencies. This was arguably the decisive factor in *Patton*, where the court determined that a promise to pay a fixed amount was not sufficiently contingent when the business was a proven concern.

Taxpayer estimates of deal value—something most people do as a business matter—can prove to be damaging. Thus, the court in *McCormac* noted that the taxpayer himself was able to estimate the value of the right to receive a percentage of sales from the cemetery. In contrast, the court in *Cloward Instrument* held that the amount of revenue from the sale of an unproven and novel surgical instrument was too speculative.

Indeed, the courts in both *Cloward Instrument* and *Mothe Funeral Homes* emphasized the contingency of the sales contract. In both cases, the buyer had the right to cancel

the contract on terms that were relatively favorable to the buyer. In private earn-outs, this last factor may again favor open transaction treatment. After all, part of the reason that buyers and sellers may agree to an earn-out is the difficulty of estimating the future profitability of the business. Plainly, that was the situation in *Cloward Instrument* and *Simmonds Precision Products*.

Conclusion

The installment sale rules provide a framework for deferring recognition of gain in the context of private earn-outs. At the same time, they include several unfavorable aspects relative to open transaction. They require acceleration of recaptured depreciation, an interest charge on the amount of "deferred tax," and possibly also an inappropriate deferral of basis recovery.

The IRS was not receptive to the "self-help" approach taken by the taxpayers in CCA 201328031. That approach certainly has an appeal and the CCA may not even spell the end to Code Sec. 1341 in the context of earn-outs. After all, the IRS's analysis was based on arguing that the taxpayers had an "actual" right to the notes in the year of the sale, but this principle has been rejected by more than one court.

Nevertheless, the claim of right approach certainly appears to be an uphill battle. Sellers in private earn-outs may want to consider whether they should report the earn-out as an open transaction instead. Installment sale treatment may be particularly appropriate if the earn-out satisfies the three factors in *Fisher*.

In many cases, a private earn-out may not be marketable or comparable to other assets with determinable market prices. In addition, it may be subject to various contingencies. This may make an earn-out eligible for open transaction treatment.

Of course, many advisors may feel uncomfortable with earn-outs to begin with. They may feel doubly nervous relying on the vague principle that open transaction treatment is appropriate only when the value of an earn-out cannot reasonably be determined. However, sellers that receive an earn-out subject to a genuine contingency should consider whether they can and should report the earn-out as an open transaction.

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