Taxing Earn-out Payments

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How much is a transaction really worth? Suppose you read online that the total purchase price for a company was $X. Even worse, suppose that someone casually mentions that their company was just sold for $X. In either case, do you ever stop to wonder how that figure was computed? Perhaps you should.

Plainly, there are standards for such things for at least some purposes. But outside regulated environments, information is often sketchy. Conversations are often casual.

The press and the Internet can be exaggerated if not downright wrong. That can mean either significant overstatements or understatements of the actual consideration. And of course, what do we mean by "consideration"?

When a cash and stock deal is valued, is the price only the cash or is it the total? That one is easy. Surely it is the total consideration, you'll say. But what if some of the consideration (cash or stock) is contingent? Suppose the purchase price is an immediate cash component of $1 million, plus an earn-out payment that may be between zero and $100 million?

Land of Earn-outs

Love them or hate them, earn-outs feature prominently in many acquisitions. It can be tempting to say that a transaction is "up to a $100 million deal." Yet if the earnings benchmarks and conditions are set so high that it is clear none of this contingent consideration will ever be paid, I'd probably answer that it is more likely only a $1 million deal.

In fact, given my personal experience, I'd have to say that most of the earn-out transactions I've seen have involved less-than-stellar payouts. Without knowing any facts, if I had to value the transaction at closing, what would I do? I might not value the transaction at the *minimum* payout. However, I would be unlikely to assume the *maximum* payout either.

These ruminations were on my mind as I began considering the tax treatment of earn-out payments and how each party to the deal thinks of them. This is an important topic. It is also a topic about which many do not give sufficient thought. And as with so much else in the field of acquisitions, structure matters. When a significant component of the sales price involves an earn-out, its structure can have a substantial effect on the seller's tax treatment.

Goals and Gyrations

Earn-outs can serve multiple goals. They can make it possible for buyers and sellers with differing views or expectations to reach an agreement and to close the deal notwithstanding their differences. That is one of the key features of the earn-out landscape. Buyer and seller often see the company and its opportunities differently. Of course, there are big risks associated with earn-outs, especially for sellers.

Moreover, earn-outs add substantial complexity to the seller's tax treatment. For that and other reasons, I admit that I am not a fan of earn-outs. In fact, I don't like them. Yet I know they can be useful.

An earn-out can be attractive when buyer and seller need to close a gap between what the buyer is willing to pay and what the seller is willing to accept. And since a huge number of private company transactions involve earn-outs, whether I like them or not, their popularity suggests that they help get deals done.

Some sellers may simply be unrealistic about what their business is worth. An earn-out can enable them to aspire to the stratosphere if the goals they anticipate can truly be realized. Conversely, from a buyer's perspective, as long as the buyer is not overpaying today for something that may or may not occur, the buyer may feel perfectly comfortable giving the seller a generous slice of the upside potential of the business.

Differing perceptions of value are fundamental, but such valuation gaps are common. This is especially so when new products or services are involved. A seller may expect a rosy future. In contrast, a buyer may be understandably circumspect.

Dramatically different perceptions of value may also arise where the target business must be turned around or rehabilitated. Such conditions can throw a wrench into any valuation equation. The seller may be confident that business changes will translate into better and more lucrative times right around the corner. Conversely, buyers may fear that all the roadblocks to success have not been removed and that much remains to be done.

The earn-out can bridge that gap. Even general economic forces and industry trends can play a role. These are large factors that can be said to impact virtually any valuation decision. Yet once again they can sometimes be ameliorated with an earn-out.

Seller Involvement Incentives

Earn-outs can also provide incentives for the seller, its founders, executives or key personnel to remain active in the company post-sale. In that sense, an earn-out can be particularly helpful in securing the transition and goodwill that can make production post-closing truly click. Consulting or personal service contracts can achieve some of this. But amping up the sales consideration in the form of a generous-sounding earn-out can translate into dramatically improved results in the short term.

Of course, an earn-out can also bring a level of distrust. There is often distrust about precisely how earn-out formulae will be applied and how revenue and cost considerations will be taken into account. In this sense, having key seller personnel involved post-sale can accomplish several goals, providing more customarily compensated incentives and also effecting the earn-out.

Keeping such key personnel in place can affect an orderly transfer of know-how, customers and the like. At the same time, ensuring that the seller is available to see first-hand how the business is being run post-closing can allay concerns the seller might have about how the earn-out will be implemented and administered.

Sales Price vs. Payment for Services?

This issue also raises a fundamental dichotomy in the taxation of earn-outs. Is it sales price or payment for services? More than any other issue in the taxation of such payments, this one can involve conflicts between buyer and seller. Whatever the dynamics, a seller that can claim capital gain treatment on the sales proceeds should (obviously) prefer the lower rates that affords.

Payments for services are not only taxed as ordinary income, but subject to employment taxes as well. That fundamental dichotomy can sometimes make the basis recovery and installment reporting issues discussed below seem to pale in comparison. Of course, the mere fact that key seller personnel are required to have a role in the acquired company post-closing does not convert sales proceeds into payments for services.

Some acquisition agreements require key shareholders to be continuously employed by the buyer post-closing up to a specified date in order to be eligible to receive earn-out payments. This is so even if the sales figures or earnings benchmarks are achieved. In such a case, the question is whether the earn-out payments when paid should be viewed for tax purposes as compensation for services rendered or as additional sales proceeds.

While sellers traditionally prefer viewing a payment as sales proceeds, buyers are likely to prefer immediate deductions to mere additions to basis. The price tag for this favorable treatment to the buyer would be the additional hassle and cost of withholding on the compensation. That includes bearing the cost of the employer's share of the employment taxes.

One convoluted case about this dichotomy is *Lane Processing Trust*, CA-8, 25 F3d 662 (1994). A trust was operating a failed poultry business, with the employees being beneficiaries of the trust. They eventually sold the business. Former employees were not eligible to receive distributions of sales proceeds unless they were employed, and the amounts each received were based on length of service, location and job classification.

They initially reported the payments as compensation, and even withheld and paid income and employment taxes. They later sued for a refund claiming these payments were not wages. They prevailed and the IRS appealed. The government won the appeal, primarily because the requirement that the employees had to be employed as of the date of the sale tied the payment to services.

Lane Processing Trust was an unusual case, of course, with facts that would be hard to replicate. Nevertheless, it does nicely illustrate the difficulty presented by having an earn-out that is tied to tenure.

Installment Reporting

One of the bedrock principles of our tax system is the annual accounting concept. By definition, earn-out payments involve multiple tax years. Although the seller invariably will have gain or loss on the sale, the seller will not be able to reach a final tally until the earn-out timetable has run its course.

Installment reporting under Code Sec. 453 can provide the answer for transactions in which payments of purchase price are made over time. However, most installment sale transactions involve a fixed purchase price, interest being the only variable. Fortunately, the regulations governing installment sales also contemplate earn-out transactions.

The installment method provided by Code Sec. 453 attempts to fit the multi-year payments received by the seller into the annual periods. An installment sale, as defined in Code Sec. 453(b), 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. When the installment method is available, Code Sec. 453(c) provides that income from the sale for any year is recognized in the proportion that the gross profit bears to the total contract price.

There are several conventions applicable to contingent earn-outs payments under Code Sec. 453.

- **Cap.** First, is there a cap on the earn-out payment? Many if not most earn-outs will also be subject to a cap. The cap may be in the earn-out itself, such as "up to but not in excess of $_____."
- **Time Period.** Second, over what period of time is the earn-out payment to be measured and collected?

These basic criteria are not all that goes into the earn-out, of course. Some of the more obvious criteria that will need to be examined include what should be the basic building blocks from which the earn-out is computed. Should it be based on sales, earnings or some particular formation of net earnings?

- **Thresholds.** Virtually every transaction will have thresholds that, if not met, will preclude any earn-out payment. But what should those thresholds be? Should there be one, or should they be split into multiple categories so that there are in effect multiple tranches of earn-out payments based on different product lines or revenue streams?
- **Termination.** Nearly every earn-out will have an event or certain date that terminates it. There may be even multiple events that could result in termination.
- **Installment Method.** Code Sec. 453 and its regulations set forth rules for the recovery of basis in transactions with contingent future payments.

All-Cash Example

Big Daddy owns 100 percent of the stock of a cloud computing firm called CloudNine.Net. International Computer Machines ("ICM") purchases all of the stock of CloudNine for $100x, with $30x payable at closing. The balance is payable in seven annual payments of $10x, plus adequate stated interest.

Big Daddy has a basis of $38x in his stock and has selling expenses of $2x. His gross profit is $60x (the $100x selling price less the $40x basis including the selling expenses). The gross profit ratio is 3/5 (gross profit of $60x divided by the $100x contract price).

Accordingly, $18x of the amount payable at closing and $6x of each fixed annual payment is treated as capital gain on the sale of the stock. $12x of the $30x paid at closing and $4x of each fixed $10x annual payment are recovery of basis. Interest received on the deferred payments is ordinary income to Big Daddy. [*See* Reg. §15A.453-1(b)(5) Example 1.]

Earn-out Example 1

Sally Seller sells all of the stock of Target Corporation to Barry Buyer for $100,000 payable at closing plus an amount equal to five percent of Target's net profits for each of the next nine years. These contingent payments are to be made annually along with adequate stated interest. The agreement provides that the maximum amount Sally may receive, including the $100,000 down payment, but excluding interest, is $2 million.

Sally's basis in the stock of Target (including selling expenses) is $200,000. The sales price and contract price are considered to be $2 million. That means her gross profit is $1.8 million and the gross profit ratio is 9/10 ($1,800,000/$2,000,000). Accordingly, of the $100,000 Sally receives in the year of sale, $90,000 is gain attributable to the sale, and $10,000 is treated as Sally's recovery of basis.

Earn-out Example 2

Clyde owns CoffeeWorks, a roaster encumbered by outside debt of $500,000. Clyde sells CoffeeWorks to Gary Gobbler under an acquisition agreement calling for Gary to assume the $500,000 debt, pay Clyde $1 million in cash on closing, and pay both deferred and revenue-based payments over time. Gary will make ten equal annual principal installment payments of $1 million commencing twelve months following closing, plus interest calculated at seven percent per annum. Finally, Gary will make nine annual payments (the first one is due 14 months following closing) equal to five percent of the gross revenue from CoffeeWorks generated during each calendar year after the closing. The maximum amount payable to Clyde under the agreement (excluding the interest) is capped at $20 million.

Clyde's basis (including selling expenses) in CoffeeWorks is $3 million. Accordingly, Clyde's selling price is $20.5 million (the cap plus the debt assumption). His contract price is $20 million (the selling price of $20.5 million less the $500,000 debt). Clyde's gross profit ratio is 9/10 (gross profit of $18 million divided by the $20 million contract price). Of the $1 million cash payment Clyde receives at closing, $900,000 is gain attributable to the sale of CoffeeWorks and $100,000 represents recovery of basis.

Conventional Wisdom

Earn-outs are contingent on future events. Reg. §15A.453-1(c) provides the conventions applied under the installment method to sales that include contingent payments. However, these conventions function in ways that can seem arbitrary. In fact, in some cases they may inappropriately accelerate gain or defer losses.

These conventions apply two factors.

First, do the contingent payments have a stated maximum amount? Second, if they do not, do the contingent payments have a maximum term? Using these factors, sales with contingent payments are classified into one of three categories:

- Sales in which a maximum selling price is determinable
- Sales in which a maximum selling price is not determinable, but which have a determinable time over which payments will be received
- Sales in which neither a maximum selling price nor a definite payment term is determinable

Sales with Stated Maximum Selling Price

A contingent sales transaction is treated as having a stated maximum selling price if the maximum amount of sales proceeds can be determined as of the end of the year in which the sale occurs. The stated maximum selling price is determined by assuming that all contingencies will be met in such a way as to maximize the selling price, and that the payment will be accelerated to the earliest possible date or dates under the agreement.

Sales Without Stated Maximum Selling Price, But with Fixed Payment Period

If the maximum selling price cannot be determined as of the end of the year in which the sale occurs, but the maximum period over which payments are made can be determined, the taxpayer's basis is recovered in equal annual increments over the maximum term. [*See* Reg. § 15A.453-1(c)(3).]

Sales with Neither Stated Maximum Selling Price Nor Fixed Period

If the transaction has neither a maximum selling price nor a maximum term, the regulations state that whether a sale has taken place and whether the economic effect of the transaction is in the nature of rent or royalty income must be questioned. In the event that it is determined that the transaction is a sale, the seller is entitled to recover its basis in equal annual installments over 15 years. [*See* Reg. § 15A.453-1(c)(4).]

In the event that a seller does not receive a payment in any particular year, the basis recovery for that year is to be reallocated in level amounts to the balance of the 15-year term. Any basis remaining at the end of the 15-year term may be carried forward from year to year until the basis has been recovered or the payment obligation is determined to be worthless.

Avoid Substantial Distortion

The IRS recognizes that the application of the Code Sec. 453 conventions may "substantially and inappropriately defer or accelerate recovery of the taxpayer's basis."

One of the bedrock principles of our tax system is the annual accounting concept.

[*See* Reg. §15A.453-1(c)(7).] In cases where this occurs and the taxpayer can satisfy the IRS, relief is available by making a ruling request. [*See* Reg. §15A.453-1(c)(7)(ii).] The ruling request must propose an alternative method of basis recovery and demonstrate to the IRS that:

- the proposed alternative is a reasonable method of ratably recovering basis; and
- under the alternative method the seller proposes, the seller will probably recover basis at a rate that is twice as fast as the rate at which the seller would recover its basis using the Code Sec. 453 conventions.

In attempting to demonstrate that the normal basis recovery rule substantially and inappropriately defers the taxpayer's recovery of basis, the seller may want to rely on relevant sales, profit or other factual data. However, the regulations caution that projections of future productivity, receipts, or profits will ordinarily not be acceptable. Moreover, the ruling request must be submitted prior to the due date of the return in which the first payment would be reported.

All of this requires work, expense and some degree of planning. Yet in many cases it will have been the lack of planning that lands taxpayers in this position. Often, problems arise because of a failure to calculate how the earn-out will affect gain recognition during the time the earn-out is being negotiated.

Electing out

The installment method is the default method for reporting a sale with payments in multiple tax years. However, in some circumstances, it may be advantageous to elect out of the installment method. A seller who elects out of the installment method is subject to the general gain-recognition rules of Code Sec. 1001, and generally reports the entire amount of gain in accordance with the seller's method of accounting. [*See* Reg. §15A.453-1(d)(2).]

For a cash-method seller, gain would be reported in the year of receipt of the closing proceeds. For an accrual-method seller, gain would be reported "when all events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy." [*See* Reg. §1.451-1(a).]

Under Code Sec. 1001(b), the amount realized from a sale or other disposition of property is "the sum of any money received, plus the fair market value of the property (other than money) received." If the seller elects out of installment treatment, the amount realized includes "the fair market value of the contingent payments." [*See* Reg. §1.1001-1(g)(2).]

When should a seller consider electing out of the installment method? The Code Sec. 453 conventions are arbitrary in nature and, as has been previously discussed, may operate to accelerate gain inappropriately. In any of those circumstances, it may be appropriate to consider electing out of the installment method. The circumstances in which it may be advantageous to elect out of the installment method include:

- an earn-out that has an unrealistically large cap; and
- an earn-out that has a long term and is not capped in amount.

Final Words

Earn-outs are often negotiated with little thought to tax effects. It makes sense that economics are more important than tax effects.

However, when the earn-out is a significant component of the sales price and the seller has basis in the sold property, the particulars of the earn-out can have a substantial effect on the seller's tax treatment.

Plainly, the Code Sec. 453 conventions are designed to include in income the maximum earn-out as quickly as possible or to defer the seller's recovery of basis as long as possible. For that reason, a seller considering an earn-out should factor in the projected tax impact in the earn-out negotiations. Provided that they do not negatively impact the overall economic goals for the earn-out, these ideas may improve the seller's tax picture.

It will help to put realistic caps on earn-out payments. This may sound counter-intuitive, but pie-in-the-sky numbers can be unrealistic and distort tax calculations. Shorter terms for the earn-out are also easier and cause fewer tax problems.

The shorter the term of the earn-out, the less damage the earn-out can do to the seller's tax posture. Caps and durations can of course be used in tandem. Although it is arguably better from a tax viewpoint to have a cap on the earn-out, if no cap is in place, it may be appropriate to consider having the earn-out extend over a relatively short term.

Even where earn-outs are structured in a disadvantageous manner, the seller can do some leg work to improve the gain reporting possibilities. If the seller can show that the application of the Code Sec. 453 conventions may "substantially and inappropriately defer or accelerate recovery of the taxpayer's basis," the seller may be able to obtain a ruling permitting use of an alternative basis-recovery method. There is cost to this of course, but it can be worth it, particularly where the taxpayer has failed to consider these tax issues during the negotiation of the transaction.

Finally, if the transaction does not involve substantial fixed deferred payments, but includes contingent payments of speculative value, the seller may find it advantageous to elect out of installment treatment.

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