Taxation of Earnout Payments in M&A Transactions

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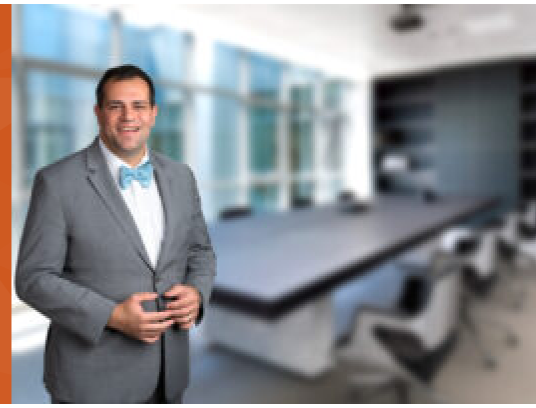

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Earnout payments are generally taxed as either ordinary income or as capital gains, with the ultimate consideration dependent on how the transaction and earnout mechanics are structured. It has become increasingly common in M&A transactions that the consideration paid to the sellers includes amounts that are contingent upon later events, such as the post-transaction performance of the target company. For example, the buyer and seller may agree that the sellers will be paid an additional amount if the target hits certain revenue or earnings goals over some agreed period of time after the closing. These "earnout" payments are often used to help bridge a valuation gap when the seller and buyer cannot reach an agreement on the value of the target to facilitate deal making, as well as to incentivize a seller to stick around post-closing and continue to grow the business. Earnouts can be particularly helpful when dealing with early-stage companies where value may be better represented by future (rather than historic) performance.

The tax treatment (to both the buyer and the seller) of the earnout payments can vary depending upon the application of some basic income tax principles. Buyers and sellers may have adverse interests in the character of the payments, so advance planning and careful negotiation is recommended.

Purchase Price or Compensation.

When earnout payments to a selling shareholder are conditioned upon the performance of services by the seller, the issue arises as to whether the payments are properly viewed as purchase price for the shares or compensation for the services rendered. While gain on purchase price paid for shares is typically taxed (for US income tax purposes) to a seller at favorable capital gains rates, compensation for services is taxable at higher ordinary income tax rates and is subject to employment taxes. Buyers may prefer to treat such payments as compensation for services because they would generally be deductible, while payments of purchase price are not deductible.

In short, if an earnout is deemed to be part of the compensation paid to the seller for services provided, then it generally will be taxed as ordinary compensation income. If an earnout is considered to be part of the purchase price of the broader transaction, then it will be taxed at a more favorable capital gains rate. In considering whether an earnout is purchase price or compensation for services, the Internal Revenue Service will consider the facts and circumstances surrounding the payments, including:

- Whether the selling shareholder is required to provide services in order to be eligible for the earnout payment;
- Whether the selling shareholder is otherwise adequately compensated for the performance of the required services;

- Whether the earnout payments are proportionate to the selling shareholder's equity in the target;
- Whether the total payments made to the sellers when viewed together represent a reasonable price to be paid for the target;
- The manner in which non-seller employees are compensated for post-closing services; and
- How the parties report the payments for both tax and financial reporting purposes.

None of the factors noted above is controlling. Parties should consider each of them when structuring an earnout and in drafting the related provisions in the purchase agreement when the seller will be providing post-closing services to the target or the buyer.

Timing of the Taxation of Deferred Purchase Price.

When an earnout is properly considered compensation for services, the payments are treated as taxable income when received by the service provider (note that there are special rules under Section 83 and 409A that can affect this timing). The timing of the related deduction will depend upon the accounting method of the buyer.

Where the earnout is properly treated as purchase price for shares of stock, and one or more payments of purchase price will be made in later taxable period(s), special rules applicable to "installment sales" apply for calculating the gain or loss on the transaction and the timing of that gain or loss for US federal income tax purposes. In simple installment sales, the purchase price is fixed and is paid over two or more tax periods of the seller. The rules provide that the gain is recognized in proportion that the gross profit bears to the contract price.

For example, assume a seller sells stock to a buyer for a fixed price of $1,000,000 and her basis in the shares sold is $200,000. Buyer will pay $400,000 at closing and the $600,000 balance in three equal installments over three years. In this example, the seller's gross profit is $800,000 ($1,000,000 minus $200,000), and the seller's gross profit ratio is 80% (gross profit /contract price). Of the $400,000 received by Seller at the closing, $360,000 (80% x $400,000) is taxable, with the remaining $40,000 received in the year of closing constituting a tax-free recovery of basis. Over the following three years, Seller would receive $200,000 payments each year, reporting taxable gain of $160,000 ((80% x $600,000) / 3) and $40,000 of tax-free recovery of basis per year.

Suppose instead that the deferred payments are contingent on the performance of the target, such that the total purchase price is uncertain at the time of closing. This may be because the buyer will pay a formulaic amount which has no stated maximum payment, no maximum time period, or neither. In such cases, special rules apply to calculating the taxable portion of each payment.

If the earnout formula has a "maximum sales price" the gross profit ratio is determined using the above formula to calculate a gross profit ratio, which is applied to each payment. An earnout transaction with a contingent sale price will be treated as having a "maximum sale price" if the maximum amount of purchase price can be determined by the end of the taxable year in which the sale closes. The maximum stated selling price is determined by assuming that all of the contingencies will be met and that payments will be made at the earliest times provided for. If the maximum selling price cannot be determined by the end of the taxable year in which the closing occurs, but the maximum period over which those payments can be made is determinable, then the taxpayer's basis is recovered in equal shares over the maximum term. Where there is neither a stated maximum payment, nor maximum time period, a question arises as to whether there has been a sale of property at all, or whether the transaction is properly viewed as a lease or license (resulting in ordinary income to the "seller" when received). Where such a transaction is a sale, the seller's basis is recovered over 15 years.

Because the application of the basis allocation rules can distort or inappropriately defer the recovery of a seller's basis, the Internal Revenue Service will consider ruling requests for relief in the way of an alternative method of basis recovery. Under the applicable guidelines, a requesting taxpayer must demonstrate that the alternative method is a reasonable method that ratably recovers her basis and she will likely recover the basis at a rate that is at least twice as fast as the rate at which the seller would recover its basis using the standard conventions.

Interest Component.

If the installment agreement does not provide for interest at the market rate, imputed interest rules will recharacterize a portion of the purported principal payments as interest payments taxable at ordinary income rates. Large installment sales of stock are also subject to an imputed interest charge on a portion of the sellers deferred tax liability. This rule applies generally where the seller's installment receivables exceed $5M at year-end.

Summary.

The installment method is the default method for reporting installment sales where the seller will receive at least one payment following the year of closing; however, a seller may elect out of installment method. Where such an election is made, the seller will recognize gain or loss in the taxable year of the transaction in an amount equal to the difference between the amount realized and her basis. The amount realized is the sum of any money received, plus the fair value of the property received. Where there are contingent earnout payments, the value of property received includes the value of the right to receive the contingent payments. Sellers with earnouts with maximum selling prices that are unlikely to be achieved may consider electing out.

A buyer may generally prefer (at least from a tax perspective) that the earnout payments be treated as compensation income, because that would give rise to a compensation deduction for the earnout payment in favor of the buyer. A seller, however, would generally prefer (at least from a tax perspective) that the earnout be considered part of the purchase price paid for the business, since it will be taxed at a capital gains rate that is generally much lower than the top marginal income tax rate.

The tax implications of earnout payments in M&A transactions are numerous and can be quite complicated. Competing tax goals and transaction considerations may lead to necessary good faith negotiations on both sides of a deal, but an earnout presents an opportunity for both buyers and sellers to bridge the gap in valuing a business and consummating a transaction.

For more information, please contact Joe Hunt.