Making the Most on the Sale of Your Business – An Owner's Tax Considerations on Earnouts

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As the economy starts to open, sellers of businesses are uniquely positioned to potentially capture a piece of the recovery through the way mergers and acquisitions ("M&A") transactions are priced, negotiated and closed. Changes are inevitable in all aspects of the sales process, but sellers' greatest opportunity lies in valuation. Differences of opinion as to the value of a privately owned company ("target") between the seller ("owner") and the acquirer ("buyer") are commonplace. Earnouts have traditionally been used to bridge the valuation gap. As the gap widens so too will the bridge. Rather than despair a delay in payment, an owner can take proactive steps to consider how an earnout will be taxed on the sale of the target. That exercise should include a fresh look at the "open transaction" doctrine. Recognizing that earnouts are likely to represent a much larger percentage of the total consideration that a buyer is willing to offer for target than they may have before COVID-19, this article starts sellers down that path.

Possible Tax Treatment of Earnouts

Earnout payments are taxed generally as ordinary income or as purchase price consideration (*i.e.*, capital gain). Considering that the top marginal income tax rate is currently 37%, while the highest tax rate for long-term capital gains is currently 20%, the difference to the owner could be an almost 20% difference in cash in hand. If the payments are characterized as consideration for services performed, the owner will be taxed on the payments as ordinary income. Additionally, the owner will need to consider whether the earnout payments trigger the "golden parachute rules" or deferred compensation provisions of Section 409A of the Internal Revenue Code of 1986, as amended ("code"). If the earnout payments are treated as deferred purchase price consideration for the owner's stock in the target, the owner will receive capital gain treatment on

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the portion of the payments that represents profit to the owner. Of course, each framework comes with other likely costs to be considered, such as the Federal Insurance Contributions Act (FICA) and the Federal Unemployment Tax Act (FUTA) employment related withholding and taxes for ordinary income and the 3.8% net investment income tax for capital gains.

Determining Proper Tax Treatment of Earnouts

Equipped with the options, an owner can assess proper tax treatment for the specific earnout. An earnout is a contingent payment, typically earned upon attainment of post-closing financial benchmarks by the target. The most common benchmarks are based on increases in revenue or earnings before interest, taxes, depreciation and amortization (EBITDA) over one to five years. Because the target's owner is often employed by the buyer to assist with the integration of the target into the buyer, theowner often has some leverage to control attainment of the earnout. The owner's and the buyer's interests are generally aligned in maximizing the target's earnings, but the wner should also give thought to how those earnings will ultimately be taxed when paid through the earnout. While not a definitive framework, precedent suggests some guiding principles on when earnout payments will be treated unfavorably as compensation to the owner and when they will receive favorable capital gains treatment.

- An owner's employment term relative to the earnout period: The closer the terms align, the more it favors ordinary income treatment;
- An owner's post-closing employment compensation: The closer to market, the more it favors capital gains treatment; and
- A buyer's earnout obligation if Owner's employment is terminated: The closer to continuing obligation to make payments, the more if favors capital gains treatment.

Timing of Tax to Owner

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Successfully structuring an earnout to receive capital gains treatment can also mean the difference between paying tax pursuant to the installment method under Code Section 453 (*i.e.*, paying overtime) and paying all taxes due in the year the payment is received. Under the installment method where the total purchase price is fixed, the owner will recognize the capital gain on each payment in proportion to what the gross profit on the sale bears to the purchase price for the stock. For example:

- The owner's basis in the target stock: $5 million
- The purchase price: $30 million, paid in installments
- Capital gains: $30 million – $5 million = $25 million
- Gross profit percentage = $25 million / $30 million = 83% recognized gain on each installment

This pro rata calculation does not lend itself well to earnouts because the future payments are contingent and potentially variable. Even so, the Department of the Treasury regulations promulgated under Code Section 453 ("regs") make clear that installment method of reporting applies to a "contingent payment sale" where the total sales price cannot be determined by the close of the tax year in which the sale occurs. Unfortunately for sellers, most earnouts fall under that definition. To calculate the gross profit percentage for a contingent payment sale, the regs assume that 100% of the possible contingent payments will be made in the shortest period of time permissible and use that maximum purchase price to calculate the gross profit percentage. If the maximum purchase price is not available, but the maximum period over which the earnout payments can be made is available, the capital gain is recognized ratably over the fixed period. If neither the maximum purchase price nor the maximum payment period can be determined, the capital gain is recognized ratably over 15 years.

Imputed Interest

An owner will also need to consider imputed interest. Interest will apply to the earnout payments and be taxable as ordinary income to the owner. Section 483 of the code governs imputed interest on earnouts. Code Section 453A may be applicable as well. It is

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essentially an interest charge on deferred tax. If, following the year of sale, the potential earnout obligation of the buyer exceeds $5 million dollars an additional tax, roughly equivalent to the amount of underpayment interest that would be charged if all payments were due in the first year, will be assessed to the owner.

Open Transaction Alternative

If an owner successfully structures an earnout to be taxable not as ordinary income compensation but rather as deferred purchase price consideration, are they stuck with the installment sale reporting rules and accompanying interest imputation rules? Probably. However, before summarily accepting that result, an owner may wish to consider whether the open transaction doctrine may apply. If it does, the owner will be able to recover his or her entire basis in the stock sold before recognizing any gain. The interest imputation rules also do not apply.

Key applicable rules quickly reveal the difficulty in achieving open transaction treatment:

- The regs expressly state that a "contingent payment sale" does not include a transaction "where the installment obligation represents, under applicable principles of tax law, a retained interest in the property which is the subject of the transaction, an interest in a joint venture or a partnership, an equity interest in a corporation or similar transactions, regardless of the existence of a stated maximum selling price or a fixed payment term." Packing more of the potential purchase price consideration into an earnout moves the transaction closer to the installment obligation representing an equity interest in the buyer or the target.
- The regs provide that open transaction reporting is limited to "rare and extraordinary" cases where the fair market value of the contingent payment obligation cannot be reasonably ascertained. The economic chokehold of the COVID-19 pandemic is "rare and extraordinary," even more so for a target in an industry hit especially hard by the pandemic such as the hospitality industry, but not certain to guaranty

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favorable treatment for any industry.

- The open transaction rule is based on common law. The basic premise is that the contingent payments are so uncertain that the parties cannot calculate with any measure of certainty what, if anything, the seller will receive. However, be cautious. The tax court in *Friedman v. Commissioner*, TC Memo 2015-177, denied open transaction treatment and the 20% accuracy related penalty applied because the taxpayer did not have substantial authority for its position.

Earnouts will likely be used more frequently to address valuation uncertainties. A prudent owner will consider more closely the tax implications of earnouts to potentially avoid compensation income treatment. If the earnout is purchase price consideration, it will most likely be treated as a contingent payment sale, allowing the owner to use the installment method of payment. If the earnout constitutes a significant portion of the total consideration and the owner has a measure of control over the target post-closing, the open transaction doctrine should be considered.

For more information, please contact Richard Nickels, Kacy Joy or any attorney in Frost Brown Todd's Private Equity industry team.

To provide guidance and support to clients as this global public-health crisis unfolds, Frost Brown Todd has created a Coronavirus Response Team. Our attorneys are on hand to answer your questions and provide guidance on how to proactively prepare for and manage any coronavirus-related threats to your business operations and workforce.

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