

Another Look at U.S. Federal Income Tax Treatment of Contingent Earnout Payments

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I. Introduction

The sale of a company in an M&A transaction often involves consideration to the selling shareholders that is deferred and contingent on subsequent events in the life of the company, such as the post-acquisition performance of the business (an “**earnout**”). Earnouts are typically used where a buyer and seller disagree on the value of the target company or its business as of the date of the transaction. Through the use of earnout payments, buyer and seller can defer this valuation decision to a later point in time, and link it to the performance of the business or the target company’s product sales. Such valuation difference can be especially prominent for early-stage companies, with unproven products or technologies, or other companies for which historical results may be unreliable indicators of future value.

A typical earnout provision in an M&A agreement could provide, for example that, if the target company’s EBITDA percentage for the measurement period¹ is greater than a certain percentage (*e.g.*, 15%) the selling shareholders will be entitled to receive an additional consideration for their stock. The additional consideration amount could be determined by multiplying, the target company’s revenues for the measurement period by a certain percentage (*e.g.*, 0.025).²

Often, the earnout payments made by the buyer are contingent on whether certain employees of the acquired company or business remain employed by the company for a specified period of time after the acquisition.³ When an employee is also a shareholder of the acquired target

company, an issue can arise as to whether an earnout payment that is contingent on continued employment represents compensation for the employee-shareholder’s services, or consideration for the employee-shareholder’s stock. The U.S. federal income tax stakes are significant.

A selling shareholder generally recognizes capital gain or loss on the sale of stock. The amount of gain (or loss) recognized is the excess of the amount realized over the shareholder’s basis in the stock.⁴ The amount realized usually consists of cash received and a note or another right to deferred payments or the fair market value of any other property received. Installment method reporting applies to a gain on a sale if at least one payment is to be received after the tax year of the closing.⁵

If contingent earnout payments are for stock, the seller will likely qualify for capital gain treatment,⁶ although a portion of any deferred payment will also be classified as

¹ EBITDA percentage usually means, for a particular measurement period, the quotient obtained from dividing the company EBITDA recognized in that particular measurement period by the company revenue recognized in that particular measurement period. A measurement period could be, for example, a taxable year of the target company.

² The earnout amount could grow bigger as the target company achieves better financial result or higher sales. For example, for a greater EBITDA (*e.g.*, 30%) the additional consideration amount could be determined by multiplying the target company’s revenues for the measurement period by a greater percentage (*e.g.*, 0.05).

³ Such provision could provide, for example, that the seller shareholder’s right to receive the earnout amount, or any portion thereof, is subject to her continued employment with the target company, the buyer or any of their affiliates, through the date when such earnout payment is made.

⁴ § 1001(a). All section (§) references are to the Internal Revenue Code of 1986, as amended (the “Code”), and the Treasury regulations (“Treas. Reg.”) promulgated thereunder.

⁵ § 453. A selling shareholder typically reports gain on deferred payments in the tax year the payments are received under the installment method. The seller reports gain based on an incremental basis by allocating part of the stock basis to each tax year a payment is received. The amount of gain recognized is generally an amount equal to the payment multiplied by the ratio of (i) the amount of gross profit to be recognized on the transaction, to (ii) the total contract price (this ratio is known as the “gross profit ratio”). § 453(c). Contingent payment sales are also subject to the installment sale rules. Treas. Reg. § 15A.453-1. Thus, unless the taxpayer otherwise elects, contingent payment sales are to be reported on the installment method. The term “contingent payment sale” means a sale or other disposition of property in which the aggregate selling price cannot be determined by the close of the tax year in which such sale or other disposition occurs. Treas. Reg. § 15A.453-1(c)(1).

⁶ This assumes that the stock is held by the seller as a capital asset.

interest.⁷ The buyer will capitalize the payment as part of the cost of the acquired asset and generally will be entitled to a deduction for the portion of the payment classified as interest.

However, if the earnout payment represents compensation for the employee-shareholder's services, the recipient will be treated as having received ordinary wage income; and the payor generally will be entitled to a compensation deduction. Furthermore, if the earnout payment is compensatory, the parties also will be subject to all other employment-related taxes and requirements, including, for example, income tax withholding,⁸ Federal Insurance Contributions Act ("FICA")⁹ and Federal Unemployment Tax Act ("FUTA").¹⁰ In addition, receipt of the earnout payment could raise issues under the § 280G and the "golden

parachute" provisions,¹¹ as well as § 409A, relating to certain deferred compensation.

However, surprisingly little authority directly addresses with this common issue – namely, whether such contingent earnout payments should be classified as compensation for the employee-shareholder's services, or consideration for the employee-shareholder's stock. Based on the limited precedent, the issue is generally resolved by a facts and circumstances test, with no single factor or group of factors necessarily controlling the outcome in a particular case. The following discussion addresses the main factors that are often considered when characterizing these contingent earnout payments.

II. Characterizing Earnout Payments

The following factors are potentially relevant to determine whether contingent earnout payments should be characterized as compensation for the employee-shareholder's services, or consideration for the employee-shareholder's stock (*i.e.*, a sale treatment):¹²

1. Whether the employee-shareholder is required to be employed by the target, the buyer or their affiliates, as of the date of the transaction, or a subsequent date, to be eligible to receive the earnout payment. A provision in the stock purchase or merger agreement that require the employee-shareholder to be so employed in order to be eligible to receive the earnout amount is indicative of compensation treatment.
2. Whether the earnout payments are made in proportion to the target shareholders' equity interest in the target. Proportionate payments made to target's shareholders are indicative of a sale treatment.
3. Whether the person receiving the payments is otherwise adequately compensated for the services provided after the acquisition. The existence of an adequate compensation amount that is independent and unrelated to the earnout payment is indicative of sale treatment.

⁷ When a payment for the sale or exchange of property is deferred, or when a non-publicly traded debt instrument is issued as consideration for the sale or exchange of non-publicly traded property (whether the payment is contingent or non-contingent), the deferred payment obligation or debt instrument must be tested to determine whether it provides for the proper amount of interest. If the interest is inadequate, § 483 or § 1274 may re-characterize a portion of any payment as interest. Generally, § 1274 imputes interest on a non-publicly traded debt instrument that is (1) issued in exchange for non-publicly traded property; (2) that has at least one payment due more than six months after the exchange; and (3) where there is not adequate stated interest provided in the debt instrument. § 1274(c). As defined, § 1274 only applies to certain debt instruments. Therefore, if a deferred payment obligation is not a debt instrument for federal tax purposes, § 1274 does not apply; however, these obligations may be subject to other interest imputation rules. The interest imputation rules of § 483 generally apply to certain deferred payment sales contracts for property. § 483(a). Specifically, § 483 applies to contracts for the sale or exchange of property (1) with payments due more than six months after the date of the sale if some or all payments are due more than one year following the sale and where there is total unstated interest; (2) with sales prices in excess of \$3,000; (3) that are not subject to § 1273 or § 1274; and (4) that are not payments for certain patents or related-party real estate transfers. § 483(a)-(e). Since a wholly contingent earnout is not a debt instrument, it likely will be subject to the interest imputation rules of § 483. For a comprehensive discussion on this topic, see, e.g., BNA Portfolio 566-1st: Tax Consequences of Contingent Payment Transaction.

⁸ Section 3402 requires employers to withhold income tax on wages that are paid to employees. Section 3401(a) defines wages as "all remuneration... for services performed by an employee for his employer." Treas. Reg. § 31.3401(a)-1(a)(2) further provides that "[t]he name by which the remuneration for services is designated is immaterial."

⁹ §§ 3101, 3102, 3111 and 1401. *See also*, Notice 2013-72, 2013-48 I.R.B. 592 (11/5/13). Section 3121 defines "wages" for purposes of FICA to mean (with exceptions not pertinent here) "all remuneration for employment, including the cash value of all remuneration (including benefits) paid in any medium other than cash."

¹⁰ § 3301.

¹¹ The § 280G "golden parachute" rules relate to certain payments "in the nature of compensation" that are made contingent on a change of ownership or effective control of a corporation, or the ownership of a substantial portion of the assets of a corporation.

¹² For additional indications *see also*, Accounting Standards Codification Topic 805, "Business Combinations," ¶ 805-10-55-25.

4. Whether the overall payments, including the earnouts, made or to be made for target equity represent a reasonable value of the target business. That the sum of all such payment represents a reasonable value for the target is indicative of a sale treatment.
5. Whether the amount of the earnout payments varies based on length and type of the service of the employee-shareholder. That the amount of the earnout payments so varies is indicative of compensation treatment.
6. Whether the transactional documents characterize and treat the earnout payments as compensation for services or proceeds of the sale.
7. How the parties report the earnout payments for tax purposes.¹³
8. How the earnout payments are reported for non-tax purposes, including, for example, for financial accounting purposes.¹⁴

III. Discussion

As mentioned above, to determine whether contingent earnout payments should be classified as compensation for the employee-shareholder's services or as consideration for the employee-shareholder's stock, all the facts and circumstances surrounding the transaction should be considered, with no single factor or group of factors controlling. However, although all of the above factors can be important, the first two (namely, whether the employee-shareholder is required to be employed to be eligible to receive the earnout payments, and whether the contingent earnout payments are made in proportion to the target shareholders' equity interest) have drawn the most attention by the authorities and by the courts. When both of these conditions are present, the parties are required to make a difficult determination as to how the contingent earnout payments should be treated for U.S. federal income and employment tax purposes.

¹³ An inconsistent reporting of the earnout payments by the parties is highly suspicious and likely to be examined and challenged by to the Internal Revenue Service (the "IRS").

¹⁴ See Accounting Standards Codification Topic 805, "Business Combinations," *supra* note 12.

One case dealing with this issue is *The Lane Processing Trust v. United States*.¹⁵ In *The Lane Processing Trust*, the assets of an employee-owned business were sold at a substantial profit, and the sales proceeds were distributed to the employee-owners. To be eligible to receive a distribution, an owner was required to be employed by the company on the sale date. The amount of each employee-owner's distribution was based on the employee's job classification, location, and length of employment. The company initially reported the payments as wages for employment tax purposes, but later filed a refund claim, asserting that the payments were not wages, and sought a return of FICA and FUTA taxes paid. The court rejected the claim. The court stated the term "wages" is "broadly defined" by FICA and FUTA to include "all remuneration from employment" and that "courts are to construe these provisions broadly to effect FICA's and FUTA's remedial purposes."¹⁶ The court then stated that the payments had been based on factors "traditionally used to determine employee compensation, specifically the value of services performed by the employee, the length of the employee's employment, and the employee's prior wages."¹⁷ The court also noted that a person was required to be employed by the company at the time of the sale to be eligible to receive a payment.

The Lane Processing Trust case addressed the question of whether payments to employee-shareholders were compensation, or instead represented consideration in exchange for their stock. A similar issue that sometimes arises is whether payments to employee-shareholders are compensation, or instead are distributions with respect to their stock (*i.e.*, dividends). Although this is a different issue from that addressed in *The Lane Processing Trust* case, the analysis and approach taken by the courts are similar, and provide some guidance on the issue of whether earnout payments to shareholder-employees are compensatory.

For example, in *R.J. Reynolds Tobacco Company v. United States*,¹⁸ the employer made payments to employee-shareholders pursuant to a "bylaw profit distribution plan," with the payments being proportionate to their stockholding

¹⁵ 25 F.3d 662 (8th Cir. 1994). *Cf.*, *United States v. Quality Stores, Inc.*, 134 S. Ct. 1395, 1396, 2014 BL 80719 (2014) (severance payments at issue are taxable wages for FICA purposes); *CSX Corp. v. United States*, 518 F.3d 1328 (Fed. Cir. 2008) (all of the supplemental unemployment benefits a group of railroad companies paid to various groups of employees as part of a workforce reduction were wages for purposes of FICA and the Railroad Retirement Tax Act.).

¹⁶ 25 F.3d at 665 (citing § 3121(a) (for FICA) and § 3306(b) (for FUTA)).

¹⁷ *Id.*

¹⁸ 149 F. Supp. 889 (Ct. Cl. 1957).

percentages in the company. For many years, the company classified these payments as dividends on its books, records and tax returns. The company, however, filed a refund claim for certain years, claiming that the payments were in the nature of compensation (and not dividends) and therefore deductible. The U.S. Court of Claims held that the payments were dividends, not compensation, based on the following factors:

1. The payments were in proportion to stock ownership and were in addition to fixed compensation, regardless of the duties or responsibilities of the employees.
2. In prior tax years, the company had treated the payments as dividends, and not compensation, for tax purposes.
3. The treatment of the payments as dividends was approved by the company's auditors as being in conformity with generally accepted accounting principles. Further, in its filings to the U.S. Securities and Exchange Commission, the company referred to the payments as dividends. In a state court case (not relating to taxes), the company alleged that the payments were dividends, and that court so held. Also, certain board of director resolutions referred to the payments as "participating dividends."
4. The company admitted during the tax litigation itself that "large amounts" of the claimed compensation were not reasonable in amount.
5. The fixed salaries and hourly wages paid to employees below the director level were at the going rate in the industry and were reasonable before taking the disputed payments into account.

Based on the examination of these factors, the court concluded that the payments to employees were a return on their stock and "not purely for services."¹⁹

The IRS and the Courts may also consider on how the earnout payments at question are classified for accounting and other non-tax purposes. In that regard, U.S. generally accepted accounting principles provide broadly that contingent payments made to employee-shareholders generally are classified as compensation for post-transaction

services if "the payments are automatically forfeited if employment terminates."²⁰

IV. Conclusion

Ultimately, whether a contingent earnout payment should be treated for tax purposes as compensation for the employee-shareholder's services or as consideration for the employee-shareholder's stock is to be determined under the particular facts and circumstances of each case. The parties should carefully craft the relevant provisions in the transaction documents so as to properly express their intent on this issue. As always, with careful planning and proper documentation, the parties often can increase the likelihood of the earnout payments being treated in the desired manner.

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¹⁹ 149 F. Supp., at 896.

²⁰ Accounting Standards Codification Topic 805, "Business Combinations," ¶ 805-10-55-25 ("The terms of continuing employment by the selling shareholders who become key employees may be an indicator of the substance of a contingent consideration arrangement. The relevant terms of continuing employment may be included in an employment agreement, acquisition agreement, or some other document. A contingent consideration arrangement in which the payments are automatically forfeited if employment terminates is compensation for post-combination services. Arrangements in which the contingent payments are not affected by employment termination may indicate that the contingent payments are additional consideration rather than compensation.").

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