Analysis of the financial and income tax aspects when an earnout is used for the sale of a business

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Abstract *When a buyer and seller cannot agree upon a price for a business, an earnout is generally used and may result in selling the business for less than its true value. The materials will discuss how earnout formulas can be adjusted to ensure that true value is paid.*

The materials will first apply the contingent payment installment sale and contingent payment OID rules to illustrate the income tax treatment of earnouts. Because earnouts can sometimes result in adverse income tax treatment to the seller, the materials will then illustrate how the adverse income tax treatment can occur and go on to discuss how to eliminate these adverse income tax results.

Why Use an Earnout?

The sale of a business is complex and dynamic. The parties to the transfer of a going concern are subject to many variables and risks, both known and unknown. If the absolute value of the business were determinable, there would be little need for earnouts. However, that is seldom the case. There may be liabilities that over time will reveal themselves but may not be known at the time of the sale. There may be changes anticipated in the way the business will be run that could impact the bottom line but whose impact will only reveal itself over time. There may be circumstances where the seller is needed to play an ongoing role in the business that can impact future performance. Likewise, the seller may need to step aside from existing relationships and abstain from competition. Each of these features, and more, can warrant an earnout because they can impact ultimate results of operations and profitability. A well thought out earnout can provide a bridge to meet the different expectations of the seller and purchaser as well as a method to adjust for the risks (and rewards) that may be unknown at the time of the sale. The earnout can also provide incentives so that the parties to the sale will behave in a manner that maximizes the outcome.

The income tax and financial consequences of the different types of earnouts are varied. The tax advisor should play a key role in structuring the transaction to achieve the optimal balance and to avoid hidden perils. One purpose of this paper is to sensitize the advisors to all the factors, both financial and income tax, that impact the sale terms and must be considered when the sale of an operating business is involved.

An earnout can have certain tax advantages. For example, if there is a desire that the sellers refrain from competing, a non-compete clause can accomplish that objective. However, payments allocable to a non-compete agreement are viewed as compensation for services, not only characterized as ordinary income to the recipient, but also subject to employment taxes. And, the buyer cannot take a current deduction for non-compete payments. Instead, they must be capitalized as Section 197 intangible and amortized over 15 years. An alternative may be to give the seller an earnout that provides a strong disincentive for the seller to compete but will be taxed to the recipient as capital gain. This is not necessarily an all or nothing proposition. But, the earnout may enable the parties to reduce the payments under a non-compete while preserving the optimal balance of incentives and income tax consequences. Likewise, a seller retained as a consultant or key employee may be willing to accept a lower level of compensation if he or she retains an earnout. Again, the benefits of using an earnout rather than relying exclusively upon

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