

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

By

Jerome M. Hesch
Miami, Florida

Director, 46th Annual Notre Dame Tax & Estate Planning Institute
October 29 and 30, 2020

Adjunct Professor of Law
Florida International University Law School
On-Line LL.M. Program Boston University Law School

And

Stephen M. Breitstone, Esq.
Mineola, New York
Head of Private Wealth & Taxation Group
Meltzer, Lippe, Goldstein & Breitstone, LLP

University of Texas School of Law
67th Annual Taxation Conference
Austin, Texas
December 5, 2019

Stephen M. Breitstone is Chair of the Private Wealth and Taxation Group at Meltzer, Lippe, Goldstein & Breitstone, LLP in Mineola and New York, NY. His approach combines business planning and income tax planning with estate planning for businesses and investments, with a special emphasis on real estate. His clients include domestic and international real estate owners and developers, closely held businesses, public companies, private equity funds, trusts, and charitable organizations. His combination of skills as a transactional and income tax attorney and as an estate planner enables him to effectively advise clients on their individual needs and those of their businesses. He frequently serves as general counsel and financial and business advisor to several of his clients and has been an expert witness in litigation over Section 1031 exchange transactions. He is as an adjunct professor, teaching Tax and Business Planning for Real Estate Transactions at Cardozo Law School and is a Fellow of both the American College of Trusts and Estates Council and the American College of Tax Council. He has presented papers at the NYU Institute on Federal Taxation, Practising Law Institute, Notre Dame Tax and Estate Planning Institute, Bloomberg BNA Tax Management, National Multi-Housing Conference, Jeremiah Long Section 1031 Conference, and Federation of (1031) Exchange Accommodators. His style of practice is personal, not institutional; and his clients' goals and objectives are his priority. He has been interviewed on tax and financial topics by local and national media, including CBS, ABC, Fox, Fox Business News, and Bloomberg, among others.

Jerome M. Hesch, Miami, Florida serves as an income tax and estate planning consultant for lawyers and other tax planning professionals throughout the country. He is Special Tax Counsel to Oshins & Associates in Las Vegas Nevada, Dorot & Bensimon, in Aventura, Florida, Jeffrey M. Verdon Law Group, in Newport Beach, California and Meltzer, Lippe, Goldstein & Breitstone, in Mineola, New York. He is the Director of the Notre Dame Tax and Estate Planning Institute, scheduled next year for October 29 and 30, 2020 in South Bend, Indiana, on the Tax Management Advisory Board, a Fellow of both the American College of Trusts and Estates Council and the American College of Tax Council and is in the NAEPC Estate Planning Hall of Fame. He published numerous articles, Tax Management Portfolios, and co-authored a law school casebook on Federal Income Taxation, now in its fourth edition. He presented papers for the University of Miami Heckerling Institute on Estate Planning, the University of Southern California Tax Institute, the Southern Federal Tax Conference, the AICPA, and the New York University Institute on Federal Taxation, among others. He participated in several bar association projects, including the Drafting Committee for the Revised Uniform Partnership Act. He received his BA and MBA degrees from the University of Michigan and a JD degree from the University of Buffalo Law School. He was with the Office of Chief Counsel, Internal Revenue Service, Washington, D.C. from 1970 to 1975, and was a full-time law professor from 1975 to 1994, teaching at the University of Miami School of Law and the Albany Law School, Union University. He is currently an adjunct professor of law, having taught courses in the past at Vanderbilt University Law School, Florida International University Law School, University of Miami School of Law Graduate Program in Estate Planning, Nova University School of Law and On-Line LL.M. Programs for University of San Francisco Law School and Boston University School of Law.

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

Find the full text of this and thousands of other resources from leading experts in dozens of legal practice areas in the [UT Law CLE eLibrary \(utcle.org/elibrary\)](https://utcle.org/elibrary)

Title search: Analysis of the Financial and Income Tax Aspects When an Earnout is Used for the Sale of a Business

Also available as part of the eCourse

[2019 Taxation eConference](#)

First appeared as part of the conference materials for the
67th Annual Taxation Conference session

"Analysis of the Financial and Income Tax Aspects When an Earnout is Used for the Sale of
a Business"