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

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Why use an earnout?

- The seller and the buyer cannot agree upon a value for the operating business or feel uncomfortable relying upon a valuation report prepared by a qualified appraiser.
- The seller will continue to participate as part of the operating business after it is sold, and the buyer desires to provide the seller with an incentive to actively participate and grow the business.
- The seller will not participate after the business is sold but can impact future performance directly or indirectly and ensures that the seller will not divert future customers.
- The seller and the buyer should share the risks of underperformance and the benefits of increased profitability.
- The business has a different value to the buyer because the buyer can reduce costs through economies of scale, or the buyer has a distribution channel that can increase sales.

When negotiating the sale of an income-producing commercial asset or a business, it is not unusual that the parties have differing perceptions as to its value. The buyer may feel that the seller's asking price is inflated, while the seller continues to feel that the asking price is fair. The differing perceptions can be resolved using an earnout arrangement. In such a situation, the parties agree on a minimum value, but allow for the payment of additional amounts based on the future profitability or future performance of the business. The earnout protects the buyer from overpaying for the business because the post-sale performance determines the final amount paid for the business. Similarly, the seller should not be short-changed if the business is as valuable as the seller believed.

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- **The financial problem with an earnout is that even an earnout negotiated in good faith by the seller and by the buyer can result in the seller inadvertently shifting value to the buyer because neither party understood the financial implications of the earnout terms. Our purpose is to demonstrate how to evaluate the factors used in an earnout and how they need to be structured so that the seller receives fair value for the business and so that the buyer does not overpay for the business.**
- **The earnout protects the buyer from overpaying but may not benefit the seller.**

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The series of examples covered are designed to point out the distortions that can occur over the earnout period

The objective in demonstrating the distortions caused by the income tax rules for earnouts (a contingent liability) is to sensitize you to these potential income tax distortions so that you can modify the earnout terms to either eliminate these income tax distortions or at least reduce their negative impact.

Of course, the potential income tax solutions will require that the buyer and the seller will need to modify the business terms.

What is "Contingent" Liability?

Two Elements:

1. The liability itself may not occur.
2. The liability exists but the amount is not known.

Income tax treatment.

- Contingent liabilities are not taken into account for the Federal Income tax until it becomes fixed.

-The Seller cannot include a contingent liability undertaken by the buyer as amount realized until it becomes fixed. See *Burnet v. Logan*.

-The Buyer cannot include a contingent liability in basis until it becomes fixed. See *Albany Car Wheel*.

Is an earnout a contingent liability?

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