Taxing the Earnout: Calculating Gain or Loss

By Walter Rogers

Agreements for the sale of privately-held companies often call for part of the purchase price to be paid in the form of an earnout. The earnout provision requires the buyer to pay an additional amount in purchase price after the closing of the sale, if after the closing the company achieves certain financial results or meets certain goals. Earnouts may be described in various ways, but they usually call for one or more installments of additional purchase price to be paid to sellers when, usually in a later year or later years, the parties can determine whether or not the specified financial results have been achieved or the goals have been met.

There are many things for sellers to think about when considering an earnout, including how much of the purchase price should be fixed and how much should depend on meeting the earnout's requirements, how the parties should describe the earnout's requirements and when the earnout payment or payments should be due. Sellers should also consider how they will be taxed on a sale involving earnout payments. Unfortunately, the income tax aspects of the sale are often glossed over by dealmakers with statements such as "You'll pay the tax on the money when you get it." While there is some truth to that statement, the real truth is that the income taxation of sales involving earnouts is complex. Sellers who do not understand the tax rules may neglect opportunities to improve the after-tax results of their sales or may be surprised at the tax results that follow from the deals they have struck.

A sale of the stock of a privately-held company involving an earnout raises a number of tax questions, including:

- How much of each seller's gain on the sale will be taxed each year and how will that gain be calculated?
- Will any part of the earnout payments be classified for income tax purposes as interest rather than payments of the purchase price?
- If a part of the earnout payments is classified as interest, when must the seller take such interest into account as income?
- Will any part of the earnout payments be classified as compensation (taxable at ordinary income rates for federal income tax purposes) rather than payments of the purchase price (subject to tax only to the extent they exceed seller's basis in seller's stock and then, for federal income tax purposes, usually at more favorable long-term capital gain rates for non-corporate sellers)?
- If there is also an escrow arrangement provided for in the sale agreement to secure the seller's representations and warranties, how will payments from the escrow (and any income on the escrowed funds) be taxed?

Here we will focus on how much of seller's gain on the sale will be taxed each year and how that gain will be calculated. We will assume, for the sake of simplifying the illustration of the taxation of seller's gain, that each earnout payment carries with it an appropriate amount of interest.

For federal income tax purposes, sales of privately-held companies involving earnouts are generally taxed as "installment sales." Some may not be, but those exceptions need not concern us here. An installment sale is a sale of property; here we are talking about corporate stock, where at least one payment is to be received after the close of the taxable year in which the sale occurs. Sales involving earnouts are a special kind of installment sale. They are "contingent payment sales." Contingent payment sales are sales in which the aggregate selling price cannot be determined by the close of the taxable year in which the sale occurs.

The "installment method" of income tax accounting applies to installment sales, including contingent payment sales unless the seller "elects out" of the installment method. The installment method determines how much of the taxpayer's gain on the sale is taxed when the taxpayer receives each payment. (If the seller elects out of the installment method, the entire gain is subject to tax in the year of sale.) Under the installment method, generally the amount of any payment which is income to the taxpayer is that proportion of the installment payment received in the year which the gross profit realized or to be realized on the sale bears to the total contract price (this is called the "gross profit ratio"). Gross profit is the selling price less seller's basis in the property. In most sales of stock of privately-held companies, the contract price will be the selling price.

Example 1: Installment Sale with No Earnout

Ms. A sells all the stock of X corporation to Mr. B on January 1, 2015. The stock purchase agreement provides that Mr. B will pay to Ms. A (i) $10,000,000 at closing, (ii) $5,000,000 on February 1, 2016, and (iii) an additional $5,000,000 on February 1, 2017. The agreement also provides that Mr. B will pay adequate interest in addition to any deferred payment. Ms. A's basis in her stock is $2,000,000.

<u>Ms. A's 2015 tax year</u>
Ms. A's gross profit is $18,000,000 ($20,000,000 selling price minus $2,000,000 basis). Her gross profit ratio is 9/10 ($18,000,000/$20,000,000). Of the $10,000,000 received by Ms. A at closing, $9,000,000 is reportable as gain attributable to the sale, and $1,000,000 is recovery of basis.

<u>Ms. A's 2016 and 2017 tax years</u>
Of the $5,000,000 Ms. A will receive in each of 2016 and 2017, $4,500,000 will be reportable as gain attributable to the sale, and $500,000 will be recovery of basis.

With sales involving earnouts, however, neither the contract price nor the gross profit to be realized can be determined in the year of the sale. Sellers do not yet know if the earnout requirements will be met and therefore do not yet know what the total selling price will be. This is where the special rules for contingent payment sales come in. These rules describe how seller's basis in the property sold, here, in seller's stock, is to be allocated among the payments received and to be received in a contingent payment sale.

The rules divide contingent payment sales into three groups: sales for which a maximum selling price is determinable, sales for which a maximum selling price is not determinable but the time over which the payments will be received is determinable, and sales for which neither a maximum selling price nor a definite payment term is determinable.

If the sellers can calculate the most they might be entitled to be paid, for example if the earnout is described as one or more contingent payments of fixed amounts, or the earnout, however described, is subject to a cap, the maximum selling price is determined by assuming that all of the contingencies contemplated by the sale agreement are met (i.e., the full earnout is earned) in a manner that will maximize the selling price and accelerate payments to the earliest date or dates permitted under the agreement. The seller's basis is then allocated to the payments received and to be received by treating the maximum selling price as the "selling price" for purposes of applying the installment method.

Example 2: Earnout Capped

Ms. A sells all the stock of X corporation to Mr. B on January 1, 2015. The stock purchase agreement provides that Mr. B will pay to Ms. A (i) $10,000,000 at closing, (ii) $5,000,000 on February 1, 2016 if X achieves a specified net income goal for 2015, and (iii) an additional $5,000,000 on February 1, 2017 if X achieves a specified net income goal for 2016. The agreement also provides that Mr. B will pay adequate interest in addition to any earnout payment. Ms. A's basis in her stock is $2,000,000.

Ms. A's 2015 tax year
The maximum amount that Ms. A may receive (not including interest) is $20,000,000. It is assumed that Ms. A will receive the maximum amount. Thus, Ms. A's gross profit is $18,000,000 ($20,000,000 selling price minus $2,000,000 basis). Her gross profit ratio is 9/10 ($18,000,000/$20,000,000). Of the $10,000,000 received by Ms. A at closing, $9,000,000 is reportable as gain attributable to the sale and $1,000,000 is recovery of basis.

Ms. A's 2016 and 2017 tax years
Assume that X achieves its specified net income goals in 2015 and in 2016. Of the $5,000,000 Ms. A will receive in each of 2016 and 2017, $4,500,000 will be reportable as gain attributable to the sale and $500,000 will be recovery of basis.

If the maximum selling price is reduced, the selling price and thus the gross profit are recalculated.

Example 3: Earnout Reduced

Assume the same facts as in Example 2 except X does not achieve its net income goal for 2015.

Ms. A's 2015 tax year
The calculations and the result are the same as in Example 2. Of the $10,000,000 received by Ms. A in the year of the sale, $9,000,000 is reportable as gain attributable to the sale and $1,000,000 is recovery of basis.

Ms. A's 2016 tax year
Since X does not achieve the net income goal for 2015, Mr. B is not obligated to make the first earnout payment of $5,000,000. Ms. A will not recognize any gain in the 2016 taxable year since no payment is received in that year.

Ms. A's 2017 tax year
Since X does achieve the net income goal for 2016, Mr. B is obligated to make an earnout payment of $5,000,000 on February 1, 2017. And since it is no longer possible for A to receive the maximum amount, the gross profit ratio to be applied to the 2017 earnout payment must be recomputed. The recomputed total gross profit is $13,000,000, which equals the selling price of $15,000,000 (as adjusted to reflect the fact that the first earnout payment was not earned and received) minus Ms. A's adjusted basis of $2,000,000. However, since Ms. A has already recognized $9,000,000 of gain, the gross profit for purposes of calculating the gross profit ratio to be applied to the 2017 earnout payment is $4,000,000. The recomputed selling price is $15,000,000, but this must be reduced to $5,000,000 in calculating the "new" gross profit ratio to reflect the receipt of $10,000,000 at closing. Accordingly, the gross profit ratio to be applied to the 2017 earnout payment is 4/5 ($4,000,000/$5,000,000). Accordingly, Ms. A will recognize $4,000,000 of gain on the receipt of the 2017 earnout payment (4/5 x $5,000,000).

If sellers cannot calculate the most they might be entitled to be paid, but they do know the period over which they may be paid, for example, if the earnout is not subject to a cap but is to be paid each year (if requirements are met for the year) for a fixed number of years, a seller's basis is allocated to the taxable years in which payment may be received in equal annual increments.[1] If in any year no payment is received, or the amount of the payment received is less than the basis allocated to the year, no loss is allowed unless the year is the final year under the sale agreement (or the earnout obligation has become worthless). When no loss is allowed, the unrecovered portion of the basis allocated to the year is carried forward to the next year.

Example 4: No Maximum Amount/Fixed Term of Payments

Ms. A sells all of the stock of X corporation to Mr. B on December 31, 2015. The stock purchase agreement provides that Mr. B will pay to Ms. A five annual earnout payments beginning January 31, 2017, with each payment being equal to 10% of X's net income for the preceding calendar year. The agreement further provides that adequate interest will be paid in addition to each payment. Ms. A's basis in the stock of X is $2,000,000.

Ms. A's 2017 Taxable Year
Since the maximum amount Ms. A may receive cannot be determined, Ms. A must allocate her $2,000,000 adjusted basis equally among the five years in which payments may be received (2017-2021). Accordingly, $400,000 of basis is allocated to each year. Assume the first earn out payment, received January 31, 2017, equals $300,000 (excluding interest). As this is less than the basis allocated to Ms. A's 2017 taxable year, the entire payment would be treated as a recovery of basis and Ms. A would reallocate the remaining $100,000 in basis to the 2018 taxable year.

[1] However, if the purchase price incorporates an arithmetic component that is not identical for all taxable years (for example, 40% of net profits of X in year 1, 30% in year 2, 20% in year 3) basis is generally allocated to account for that component.

Ms. A's 2018 Taxable Year

Assume Ms. A receives an earnout payment of $700,000 (excluding interest) on January 31, 2018. Ms. A would recognize gain of $200,000 in the 2018 taxable year ($700,000 payment minus [$400,000 original allocation of basis + $100,000 of basis re-allocated from the 2017 taxable year]).

Ms. A's 2019 and 2020 Taxable Years

Assume Ms. A receives earnout payments of $400,000 (excluding interest) on January 31, 2019 and January 31, 2020. Ms. A would recognize no gain in the 2019 and 2020 taxable years. All basis allocated to those tax years would be recovered, so no basis reallocation would be required.

Ms. A's 2021 Taxable Year

Assume Ms. A receives an earnout payment of $350,000 (excluding interest) on January 31, 2021. As this is less than the basis allocated to the 2021 taxable year, and as 2021 is the last taxable year in which payments may be received, Ms. A would recognize a loss of $50,000 in the 2021 taxable year ($350,000 payment less $400,000 basis allocation). Across the five taxable years from 2017 to 2021, Ms. A would have recognized a net gain of $150,000 ($200,000 gain in the 2018 taxable year minus $50,000 loss in the 2021 taxable year). This equals the total gross profit realized on the sale of $150,000 (payments received of $2,150,000 [or $300,000 + $700,000 + $400,000 + $400,000 + $350,000] minus adjusted basis of $2,000,000).

It would be an unusual sale of the stock of a privately-held company that would fall into the third group – one in which sellers can calculate neither the most they might be entitled to be paid under the earnout provision nor the period over which the earnout payments will be made. (Under such circumstances the IRS may question whether a sale has actually occurred.) Nevertheless, there is a rule for how to apply the installment method to such sales. Seller's basis is allocated in equal annual increments over a period of 15 years beginning with the date of the sale. If in any year no payment is received, or the amount of payment received is less than the portion of seller's basis allocated to the year, no loss is allowed (unless the earnout obligation has become worthless), and the excess basis is reallocated in level amounts over the rest of the 15-year term. Any basis not recovered at the end of the 15th year is carried forward from year to year until all the basis is recovered or the earnout obligation becomes worthless.

The IRS recognizes that application of the general rules to a sale falling into any one of the three groups may be inequitable (or in words of the tax regulations, may result in a "substantial distortion"). If a seller can convince the IRS that the general rule "would substantially and inappropriately defer recovery of the seller's basis," the IRS will agree to an allocation of basis which is more favorable to the seller. The tax regulations require sellers to receive a ruling from the IRS before using any such alternative method of basis recovery. The regulations also specify what showing sellers must make to receive such a ruling.

It will often be in seller's best interest to put a cap on the earnout payments. Compare the following examples which describe the same deal with and without a cap on the earnout.

Example 5: Earnout Is Subject to a Cap

Ms. A sells all the stock of X corporation to Mr. B on January 1, 2015. The stock purchase agreement provides that Mr. B will pay to Ms. A (i) $10,000,000 at closing, (ii) cash in an amount equal to 10 percent of X's net profits for 2015 in excess of a specified threshold on March 1, 2016, and (iii) 10 percent of X's net profits for 2016 in excess of a specified threshold on March 1, 2017, the 2016 and 2017 payments not to exceed, in the aggregate, $1,200,000. The agreement also provides that Mr. B will pay adequate interest in addition to any earnout payment. Ms. A's basis in her stock is $2,100,000. The actual earnout payment turns out to be $1,000,000 made on March 1, 2017 with respect to 2016 net profits. X's net profits for 2015 did not exceed the specified threshold.

Ms. A's 2015 tax year
The maximum amount Ms. A may receive (not including interest) is $11,200,000. It is assumed that Ms. A will receive the maximum amount. Thus, Ms. A's gross profit is $9,100,000 ($11,200,000 selling price minus $2,100,000 basis). Her gross profit ratio is .8125 ($9,100,000/$11,200,000). Of the $10,000,000 received at closing, $8,125,000 is reportable as gain attributable to the sale and $1,875,000 is recovery of basis.

Ms. A's 2016 tax year
Ms. A receives no earnout payment in 2016 and thus has no gain or loss to report.

Ms. A's 2017 tax year
Since it is no longer possible for Ms. A to receive the maximum amount, the gross profit ratio to be applied to the 2017 earnout payment must be recomputed. The recomputed total gross profit is $8,900,000, which equals the selling price of $11,000,000 (as adjusted to reflect the fact that the maximum earnout payment was not earned and received) minus Ms. A's adjusted basis of $2,100,000. However, since Ms. A has already recognized $8,125,000 of gain, the gross profit for purposes of calculating the gross profit ratio to be applied to the 2017 earnout payment is $775,000. The recomputed selling price is $11,000,000, but this must be reduced to $1,000,000 in calculating the "new" gross profit ratio to reflect the receipt of $10,000,000 at closing. Accordingly, the gross profit ratio to be applied to the 2017 earn out payment is .775 ($775,000/$1,000,000). Thus, Ms. A will recognize $775,000 of gain on the receipt of the 2017 earnout payment (.775 x $1,000,000) and $225,000 is recovery of basis.

Example 6: Earnout Is Not Subject to a Cap

The facts are the same as in Example 5 except the stock purchase agreement does not specify any cap on the earnout payment.

Since the maximum amount that Ms. A may receive cannot be determined, Ms. A must allocate her $2,100,000 basis equally among the three years in which a payment may be received (2015, 2016 and 2017). Accordingly, $700,000 is allocated to each year.

Ms. A's 2015 tax year
Of the $10,000,000 received at closing, $9,300,000 is reportable as gain attributable to the sale and $700,000 is recovery of basis.

<u>Ms. A's 2016 tax year</u>
Ms. A receives no earnout payment in 2016 and thus has no gain or loss to report. The $700,000 of basis allocated to 2016 is carried forward to 2017.

<u>Ms. A's 2017 tax year</u>
Ms. A receives an earnout payment of $1,000,000 (excluding interest) in the final payment year under the agreement. Ms. A will recognize a loss of $400,000 in 2017 ($1,000,000 payment minus [$700,000 allocation of basis to 2017 + $700,000 of basis reallocated from the 2016 tax year]). Since it is a capital loss, it cannot be carried back to offset the gain Ms. A recognized in 2015. While Ms. A can carry the capital loss forward, it can only offset future capital gain and $3,000 of ordinary income each year.

Ms. A's tax results were significantly better in Example 5 when she agreed to a cap on her earnout payments. But how should one determine what cap to use? It is a matter of forecasting and balancing. The greater the cap, the more of seller's basis is allocated to future earnout payments. The more of seller's basis that is allocated to future earnout payments, the greater the gain that is allocated to the earlier tax years, and, what may be worse, the greater the risk of a capital loss at the end of the earnout period. On the other hand, the smaller the cap, the greater the chance that some portion of the earnout described by the earnout terms may be forfeited. This complicates deal making, but a more informed seller is a better bargainer and has a better chance of receiving a better tax result.

For more information about taxing the earnout, contact a member of Smith Anderson's **Tax Group**, ***business lawyers who understand taxation***.