THE IMPORTANCE OF EARNESTLY MODELING EARNOUTS: PITFALLS AND PLANNING RELATING TO THE PURCHASE OF A SERVICE BUSINESS

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Recovery Group, Inc. v. Commr.

INTRODUCTION

> It is a terrible thing for a man to find out suddenly that all his life he has been speaking nothing but the truth.
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> – Oscar Wilde, *The Importance of Being Earnest*, Act III

This article addresses common pitfalls and planning opportunities relating to the sale of a service business.[1] It does so in the context of a business devoted to sourcing of news leads for major news conglomerates. The example looks at possible transactional models for reporting the sale and demonstrates the importance both of familiarity with structuring alternatives, and the necessity of modeling, as an aid both to decision-making and to communication with one's client.

While various references to rules are included, the series of examples are intended to demonstrate the obvious, yet important proposition that, before applying the technical definitions in the Code to a business transaction, it is necessary first to understand in simple terms what the parties are seeking to accomplish. The tax adviser's greatest contribution is often simply asking the right questions and then taking the time to think through the structure from different angles in a manner that helps the client reach a decision.

THE BASE CASE

In our example, the news business employs a small, dedicated staff of employees who rely on internet sleuthing, phone calls, occasional travel, and general savviness, to zero in on leading news stories at a speed that is faster than Google's algorithms. The business is carried on in the form of an L.L.C. treated as a disregarded entity because it is wholly owned by one person. One day, that person ("Seller") announces she would like to sell the L.L.C. to a key employee ("Buyer"). You have been retained by Buyer to advise on the tax consequences of the deal.

Your first observation is that the business involves minimal fixed asset investment — computers, office furniture, and coffee mugs — and the lion's share of the business value is attributable to intangibles, primarily the customer list of news conglomerates that purchase news stories and proprietary knowhow. The proposed transaction contemplates the sale of these business assets accompanied by standard non-compete and non-solicitation agreements.

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[1] The author thanks his colleagues, Nina Krauthamer and Stanley C. Ruchelman, for their helpful comments and insights.

As the agreement between Buyer and Seller begins to take shape, Buyer provides you with the following expected purchase price allocation under Code §1060 which will be set forth in the contract.[2]

Table 1 — Purchase Price Allocation

Total Consideration	$100
Fixed Assets (computers, furniture, coffee machine, notebooks, pencils)	$15
Noncompete Agreement	$20
Customer List / Goodwill	$65

You counsel Buyer that his $85 of basis in intangible assets, including the noncompete,[3] will be amortized on a straight-line basis over 15 years, resulting in $5.67 of amortization per year.[4] Buyer may have preferred a greater allocation to assets eligible for first-year bonus depreciation, but would be advised to prepare a tax return consistent with the agreed allocation.

To explain what this means, you prepare a simple model for the first five years of operations. For simplicity, the following examples generally assume that Buyer and Seller live in States which do not impose an income tax.[5]

Table 2 — Results of Operations: Initial 5 Years

	Y1	Y2	Y3	Y4	Y5
Revenue	$60	$60	$60	$60	$60
Expense	($35)	($35)	($35)	($35)	($35)
§168(k) Bonus Depreciation	($15)	–	–	–	–
§197 15-year Amortization	($5.67)	($5.67)	($5.67)	($5.67)	($5.67)

2 In an asset deal, the buyer and the seller report the purchase price allocation on Form 8594, *Asset Acquisition Statement Under Section 1060*. As a practical matter, all allocations of the purchase price will be respected by the I.R.S., if agreed to by adverse parties in an arm's length transaction, see Question Five of Form 8594.

3 Because the noncompete agreement is in connection with the acquisition of a trade or business, the $5 is amortized over 15 years per Code §197(d)(1)(E). Also see *Recovery Group, Inc. v. Commr.,* 116 T.C. 289 (2001), *aff'd,* 329 F.3d 1131 (9th Cir. 2003), involving redemption of a shareholder plus a noncompete.

4 This is computed as $85/15; see Code §197(d), defining "section 197 intangibles."

5 It should be kept in mind that real-world buyers and sellers live in jurisdictions with an applicable State income tax and that various structures explored herein would have to be revisited to account for state income taxes.

	Y1	Y2	Y3	Y4	Y5
Taxable Profit	$4.33	$19.33	$19.33	$19.33	$19.33
Buyer's Tax @ 37%	($1.60)	($7.15)	($7.15)	($7.15)	($7.15)
After-Tax Profit	$2.73	$12.18	$12.18	$12.18	$12.18
Cash Flow[6]	$23.40	$17.85	$17.85	$17.85	$17.85

Based on the above numbers, Buyer will report all of the business income reported on the Taxable Profit line of the chart on his personal income tax return, at ordinary income rates topping out at 37%, without ability to accelerate the recovery of cost basis under Code §197. State and local income taxes will increase the tax cost that will be incurred from profits.

EARNOUT ARRANGEMENT

As you contemplate the deal, an alternative structure springs to mind — a deferred payment arrangement, which may at least defer Buyer's upfront cost of acquiring the news business.

"Before you do so," Buyer asks, "what effect will that have on my taxes and cashflow?"

You suggest that one or more payments to Seller could be made on a deferred basis. In the simplest case, the seller may agree to accept an interest-bearing note for the balance of the purchase price. In addition, or as an alternative, the Seller may be willing to accept future payments contingent on cash flow or future performance of the business. This is a negotiating point as Seller may demand a higher price (in addition to interest payments on a note) if payment is deferred. If structured properly, the deferred payment arrangement may enable Buyer to use cash flow from the business to pay for the acquisition. These arrangements must be carefully negotiated to ensure that the transaction is treated as an asset sale for tax purposes, and not some other arrangement, such as a joint venture or partnership, particularly if the seller has a continuing interest in the profitability of the business being sold. An earnout is typically negotiated where a seller does not believe that he or she is realizing the full value of the enter`prise at closing.

All aspects of the deferred payment terms will have to be hammered out between Buyer and Seller in the negotiations running up to the agreement of purchase and sale. Buyer looks at you warily. "I sense rising costs." Buyer says, with a hint of recrimination. You rush to assure Buyer that you will work efficiently to research this alternative approach, though you'd like to check with Seller's counsel first to see whether it can even work.

"Before you do so," Buyer asks, "what effect will that have on my taxes and cashflow?"

Table 3 illustrates a simple earnout arrangement designed to provide Seller with proceeds close in amount to the foregone upfront payment, over a period of five

[6] Cash flow is computed adding back depreciation (a noneconomic expense) to after-tax profit.

years, plus some additional cash, which presumably serves to compensate Seller for the deferral. A down payment of $15 is assumed.[7]

Table 3 — 5-Year Earnout at 90% of Base[8]

	Y1	Y2	Y3	Y4	Y5	
Revenue	$60.00	$63.00	$66.15	$69.46	$72.93	
Expense	($35.00)	($36.75)	($38.59)	($40.52)	($42.54)	
§168(k) Bonus Depreciation	($15)	–	–	–	–	
§197 15-year Amortization	–	($1.50)	($3.08)	($4.73)	($6.47)	
Taxable Profit	$10.00	$24.75	$24.49	$24.21	$23.92	
Buyer's Tax @ 37%	($3.70)	($9.16)	($9.06)	($8.96)	($8.85)	
After-Tax Profit	$6.30	$15.59	$15.43	$15.25	$15.07	
Earnout Base (100%)	$25.00	$26.25	$27.56	$28.94	$30.39	
Seller's Earnout (90%)	($22.50)	($23.63)	($24.81)	($26.05)	($27.35)	= ($124.33)[9]
Cash Flow	($1.20)	($6.53)	($6.30)	($6.06)	($5.81)	= ($25.91)[10]

You note that if the annual installments are properly classified as deferred purchase price, Buyer's amortizable basis will have to be redetermined each year to take the most recent earnout payment into account.[11]

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[7] In Table 3, it is assumed that the Buyer makes an initial down payment of $15, based on which $34.36 will be the total additional cash to the Seller over the $100 purchase price initially discussed. The down payment also results in $15 of depreciable asset basis in Year 1. The following examples, in tabular form, refer to the earnout as a percentage of "base", or revenues less expenses (cash items), but ignores the depreciation, amortization and taxes imposed on the seller. In the real world, earnouts would typically be in addition to other consideration and would be applied at a lower percentage. However, the examples are simplified, and the numbers have been chosen simply to illustrate the cashflow problems that a real-world buyer may experience with even a realistic earnout percentage.

[8] This example and the following example assume a purchase price that is determined based on a fixed percentage of pretax profits, payable out of cash flow.

[9] The earnout does not reflect an assumed $15 down payment at the beginning of Year 1, which factors into the total $139.33 of cash ultimately to be received by Seller.

[10] Similar to the earnout total, the net cashflow figure of ($25.91) does not reflect the assumed down payment of $15, meaning that it understates the Buyer's negative cash problem by the same amount — the total cash outlay required by the end of Year 5 is therefore ($40.91).

[11] See also Treas. Reg. §1.1060-1(e)(1)(ii)(B), which requires each year's payment to be separately reported on Form 8594.

However, after reviewing Table 3, you remain transfixed by the final row, realizing that the negative cashflow implications of the arrangement could seriously hamper Buyer's attempts to take on the business successfully. The problem is accentuated by the fact that Seller notified Buyer that she intends to leave no cash behind and the long period over which the Buyer will recover his basis, made yet longer in consequence of the annual readjustments for earnout payments. Happily, however, toggling payment terms in the model, including the number of years over which the earnout will be paid, yields a possible solution as shown in Table 4.

Table 4 — 6-Year Earnout at 70% of Base

	Y1	Y2	Y3	Y4	Y5	Y6	
Revenue	$60.00	$63.00	$66.15	$69.46	$72.93	$76.58	
Expense	($35.00)	($36.75)	($38.59)	($40.52)	($42.54)	($44.67)	
§168(k) Bonus Depreciation	($15)	–	–	–	–	–	
§197 15-year Amortization	–	($1.17)	($2.39)	($3.68)	($5.03)	($6.45)	
Taxable Profit	$10.00	$25.08	$25.17	$25.26	$25.36	$25.46	
Buyer's Tax @ 37%	($3.70)	($9.28)	($9.31)	($9.35)	($9.38)	($9.42)	
After-Tax Profit	$6.30	$15.80	$15.86	$15.92	$15.98	$16.04	
Earnout Base (100%)	$25.00	$26.25	$27.56	$28.94	$30.39	$31.91	
Seller's Earnout (70%)	($17.50)	($18.38)	($19.29)	($20.26)	($21.27)	($22.33)	= ($119.03)[12]
Cash Flow	$3.80	($1.41)	($1.04)	($0.67)	($0.27)	$0.15	= $0.57

By adding an extra year and reducing the earnout percentage to 70%, Buyer's cashflow problem appears to be solved.[13]

"OK, now you can call Seller's counsel!"

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[12] The earnout does not reflect an assumed $15 down payment at the beginning of Year 1, which factors into the immediate bonus depreciation and results in a presumed total of $134.03 in cash ultimately received by Seller by the end of Year 5.

[13] The problem of negative cashflow remains if the $15 down payment is taken into account, resulting in a total cash outlay of ($14.43) by the end of Year 5. In addition, real-world buyers likely live in a State with an income tax. Based on the earnout arrangement in Table 4, if a 50% cumulative income tax rate is used, a positive cashflow can be achieved by extending the earnout period by a year and decreasing the payout percentage to under 60%. Modeling involves constantly stress-testing the underlying assumptions and rerunning the model in this way.

BUT WAIT A MINUTE WHAT IS AN EARNOUT?

As Buyer's counsel, your first task is to help Buyer understand the U.S. Federal income tax consequences of the transaction, and any reasonable alternatives.

Before calling Seller to propose the new structure, you realize you have not yet clearly explained what a deferred payment in the form of an earnout is. While you mentioned that it generally refers to consideration paid in a subsequent year that is contingent on subsequent events, you neglected to mention that it does not have a set meaning for tax purposes. Earnout arrangements refer to a variety of contingent payment structures, each of which must further be analyzed to determine how they are classified for U.S. Federal income tax purposes.

For example, if the earnout is paid in the employee-shareholder context and is contingent on Seller remaining on the payroll of the business for a definite period after the sale, the payments must be analyzed to determine if they are considered to be compensation or contingent purchase price.[14]

In our transaction, the earnout is to be paid for a fixed period based on earnings of the news business, and clearly seems to be deferred consideration for Seller's proprietary interests. As such, no alternative analysis seems relevant,[15] and so "sale or exchange" treatment under Code §1001 would apply, entitling Seller basis offset. But does it? It is possible that the I.R.S. might nevertheless seek to characterize an earnout arrangement as a disguised partnership, denying a buyer the benefit of basis step-up in the acquired business assets. This risk increases as the portion of the fixed amount that is paid up front decreases and the number of years of the payout increases.

Understanding that Seller likely qualifies for long-term capital gain treatment on most of the assets from a fixed price sale, Seller's tolerance for alternative structures likely is low. Further, the transaction also falls in the definition of an "installment sale" under Code §453(b)(1), and absent an election to the contrary, it will be reported by Seller under the installment method.[16] And as previously discussed with the client, unless Seller elects out of installment sale treatment (unlikely, unless the Seller has an expiring net operating loss carryforward), Buyer's amortizable basis will probably also have to be redetermined each year based on the actual numbers, further reducing deductions relating to the purchased customer list/goodwill.

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[14] *Lane Processing Trust v. U.S.*, 25 F.3d 662 (8th Cir. 1994), addressed this in the context of an employee-shareholder whose interests were redeemed and who received annual earnout payments while remaining employed in the business.

[15] For example, in *Central Life Assurance Soc'y v. Commr.*, 51 F.2d 939 (1931), the Eighth Circuit concluded that a 1919 acquisition of all the assets of one insurance company by another, followed by the transfer of its earnings to former owner individuals for a period of 22 years, was in fact not a sale but a retained interest.

[16] Code §453(d); the transaction is also a contingent payment sale. Code §453(j)(2). Because there is deemed unstated interest with regard to the deferred earnout payments, interest may be required to be computed by the seller on each of those payments under Code §483. See Pub. 537, *Installment Sales*. Such interest would be reported by the buyer on Form 1099-INT. See the General Instructions to Form 6252, *Installment Sale Income* (Line 5). For the seller, Form 4797, *Sales of Business Property*, may also be relevant.

Finally, it occurs to you that properly understanding the benefits and the downsides of the earnout arrangement also requires familiarity with some additional alternative structures that Buyer and Seller might have considered in other circumstances. For example, Table 5 reflects the income tax and cashflow consequences of a profit-sharing agreement. (The down payment is assumed to be $0 in this case.)

Table 5 — The 75-25 Profit Split[17]

	Y1	Y2	Y3	Y4	Y5	Y6	Y7	Y8	
Revenue	$60.00	$63.00	$66.15	$69.46	$72.93	$76.58	$80.41	$84.43	
Expense	($35.00)	($36.75)	($38.59)	($40.52)	($42.54)	($44.67)	($46.90)	($49.25)	
Taxable Profit	$25.00	$26.25	$27.56	$28.94	$30.39	$31.91	$33.50	$35.18	
Seller's 75% Share	$18.75	$19.69	$20.67	$21.71	$22.79	$23.93	$25.13	$26.38	
Buyer's 25% Share	$6.26	$6.56	$6.89	$7.24	$7.60	$7.98	$8.38	$8.79	
Seller's Tax @ 37%	($6.94)	($7.28)	($7.65)	($8.03)	($8.43)	($8.85)	($9.30)	($9.76)	
Buyer's Tax @ 37%	($2.31)	($2.43)	($2.55)	($2.68)	($2.81)	($2.95)	($3.10)	($3.25)	
After-Tax Profit & Cash (Seller)	$11.81	$12.40	$13.02	$13.67	$14.36	$15.08	$15.83	$16.62	= $112.80
After-Tax Profit & Cash (Buyer)	$3.94	$4.13	$4.34	$4.56	$4.79	$5.03	$5.28	$5.54	= $37.60

While the profit-sharing deal provides nearly comparable aggregate cash to Seller and avoids cashflow problems to Buyer, Seller likely will consider it a non-starter, given the risk of an I.R.S. adjustment on auding, recharacterizing capital gain as simply a share of partnership profits. Your client is happy not to spend further time thinking about this approach.

Yet another transactional approach you consider briefly would be a consulting arrangement whereby the $100 could be paid to Seller over a number of years to retain him as an employee or consultant.[18] Assuming that services worth $100

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[17] Similar to "earnout," stating that something is a profit-sharing agreement does not answer the question of how the structure is to be treated for U.S. Federal income tax purposes. Presumably, it would be treated as a partnership, albeit of limited duration, and the parties would adopt consistent reporting.

[18] Buyer and Seller could explicitly link payment of the earnout to Seller continuing as an employee (or consultant) for the initial three or four years after the disposition, to assist with the transition. See *Lane Processing Trust*, in *supra* note 10. Very little of the $100 of consideration would be allocated as purchase price, resulting in a significantly speedier recovery period than under Code §197.

are performed by Seller during each year of that period, little of that amount would be allocated as amortizable purchase price under Code §197, and most would be immediately deductible. Again, the amount of the salary or consulting fee cannot be determined "out of whole cloth." A no-show job for Seller payable over a period of time would likely be treated as deferred sales price, leading to replacing compensation with 15-year amortization. When you tell this to Buyer, you notice his eyes have begun to glaze over. Before you have time to ask, the client suddenly says:

"I've had enough of talking and all this modeling. Let's fix a price and pay her!"

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