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KEY SERVICE INSIGHTS

MERGERS AND ACQUISITIONS NEWSLETTER

TAX COMPLICATIONS OF AN EARNOUT:

HOW EARNOUTS TRIGGER TAX CONSIDERATIONS IN M&A DEALS

What Is an Earnout?

An earnout is a contractual mechanism in acquisitions that provide for contingent additional payments from the buyer of the company to the seller's shareholders. Earnouts are usually received if the business that is acquired meets certain financial or other milestones after the acquisition is closed.

An earnout is a useful tool where the buyer and seller cannot agree on the upfront purchase price, with the earnout as a way of overcoming the different views on valuation of the business being acquired. Earnouts are primarily used in the acquisition of a privately held company which are harder to value than a publicly traded company.

Navigating Earnout Tax Issues in Post-Acquisition Restructurings

If there will be post-acquisition restructuring of the acquired business ("**Target**"), the earnout could present a tax issue. For example, the Target is a c-corporation for federal income tax purposes and under the structure of the acquisition the Target is responsible for the earnout payment to the seller shareholders. If the plan is to liquidate the Target post-acquisition because the acquiror fund does not want a c-corporation in its portfolio of companies, then the earnout would present tax implications on the liquidation.

When a c-corporation is liquidated, the c-corporation is first treated as selling all of its assets for fair market value and there would be gain or loss to the c-corporation on the deemed sale of the assets. Next, the shareholders of the c-corporation recognize gain or loss on the difference between the fair market value of assets received or deemed to be received and the shareholders' stock basis.

The issue for an earnout under the post-acquisition liquidation, is that the fair market value of the contingent earnout right at the time of the liquidation is subject to income tax to the c-corporation. This creates a tax implication on an event, the earnout payment, that is not certain to occur in the future. The larger the earnout the more the gain recognition will impact the buyer. The buyer will have a basis in the earnout on the gain recognized through the liquidation, so in the future if the earnout does or does not occur, there will be a reconciliation to get to the correct tax result. However, deferring payment of tax is always preferred to recognizing tax today and receiving a refund in the future.

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Importance of Engaging with Trusted Tax and M&A Professionals

In acquisitions it is important to review the tax implications of each component of the deal through post-acquisition restructuring. For the buyer, post-acquisition restructuring can certainly impact the structure of the deal. It is important to work with acquisition advisors that can fully understand the tax implications of all aspects of the deal.

Strategic Business Planning that is collaborative, integrated, and bespoke.

Praestans Global Advisors is neither a law firm nor a CPA firm.

Praestans Global Advisors provides collaborative, coordinated, integrated, strategic, and customized professional services customized to our clients' needs. Our services include accounting, bookkeeping, and financial services; tax services; crypto tax, accounting, and funds; fund administration; domestic and international business consulting; and mergers and acquisitions due diligence. Through our association with Integra International, we can provide coordinated services to include business valuation and audit and other professional services worldwide.

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