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Federal Tax Bulletin: Avoiding Tax Traps in Structuring M&A Earnouts

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Small differences in the structure and documentation of an M&A transaction can result in dramatic differences in the federal income tax consequences of the transaction to the parties. For example, consider the following situation involving the terms of a post-closing earnout.

An LLC owned by individuals is selling business assets, with a tax basis of $100 million, for $100 million cash at closing plus an earnout payable over four years based on the post-closing productivity of the assets. **If the agreement does not include a cap on the earnout, the federal tax consequences to the seller could be disastrous.** Here are the results on the seller with and without an illustrative cap of $10 million (based on the seller's belief that the earnout is likely to range from zero to $10 million in total for the four years): **Year of Closing Earnout Years No Cap** $80 million of capital gain!

- If the earnout is zero: $20 million of capital loss per year
- If the earnout is $2.5 million per year: $17.5 million of capital loss per year

But these capital losses may *not* be carried back to prior years **Cap** $9 million of capital gain

- If the earnout is zero: $2.25 million of capital loss per year (but these capital losses may *not* be carried back to prior years)
- If the earnout is $2.5 million per year: $0.25 million of additional capital gain per year

If the seller undervalued the earnout, though, the seller no longer would be entitled to receive the portion in excess of $10 million. For that reason, the seller should consider building in some cushion in the cap (e.g., a cap of $15 million).

There is an alternative solution under the Internal Revenue Code. The seller may "elect out" of the installment method, reporting the closing payment plus the fair market value of the earnout in the year of the closing. Thus, if the seller determines that a $5 million earnout is most likely, the seller would report $105 million, less $100 million of tax basis, or **$5 million of capital gain in the year of the closing**. Adjustments are then made in subsequent years to the extent that the earnout ultimately is more or less than $5 million.

Which solution is preferable depends on the specific facts.

Our tax lawyers have extensive experience in M&A transactions of all sizes and complexity. If you would like assistance in identifying and avoiding potential tax pitfalls in an M&A transaction, please contact us.