RIDDELL WILLIAMS P.S.

Contingent Consideration, Earnouts and Holdbacks in M&A Transactions

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Presented by:
Pamela A. Grinter

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Contingent Consideration

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- Many M&A transactions have an element of contingent consideration
  - Closing date balance sheet or net working capital adjustment
  - Earnout
  - Escrow/Holdback

Contingent Consideration

- Purchase Price Adjustment
  - **<u>Typical example</u>**: Post closing purchase price adjustment based on net book value as of the closing
  - Within 60 days post closing, buyer will prepare a draft closing date balance sheet
    - There is a practical advantage to being the party to prepare the draft closing date balance sheet
    - Buyer is normally in the best position to prepare this since it is in control of the books and records, and possibly financial personnel
  - Draft closing date balance sheet to be prepared in accordance with GAAP applied on a basis consistent with the target company's prior year financial statements
  - Sellers have the opportunity to object – including the right to review back up documentation

Contingent Consideration

- Purchase Price Adjustment
  - Fixed time period during which the parties attempt to resolve any disputes
  - Any remaining disputes resolved by an independent accounting firm
    - The parties may choose a firm when drafting, agree on one later, or each pick one which then picks a third
    - The accounting firm may have the right to independently prepare the balance sheet or may be constrained to choose between the positions of the buyer and seller
    - Costs may be
      - shared equally
      - allocated among the parties based on the degree to which the accounting firm accepts the position of the other side in the dispute, or
      - allocated in some other manner

Contingent Consideration

- Purchase Price Adjustment
  - Preliminary purchase price (purchase price set as of closing) is then adjusted to the extent of any change in net book value
    - Dollar for dollar adjustment
      - If net book value is above a certain target, that difference is paid by buyer to seller
      - If net book value is below a certain target, that amount is paid by seller to buyer
    - The parties may prefer a different formulation than dollar for dollar – for example if valuation is based on a multiple of net book value, the adjustment may include that multiple
    - May include interest from closing date

Contingent Consideration

- Purchase Price Adjustment
  - Treated as an adjustment to purchase price for tax purposes
  - Consider payment and collection issues
  - Brief time period for payment
  - If due from seller may be collected from escrow

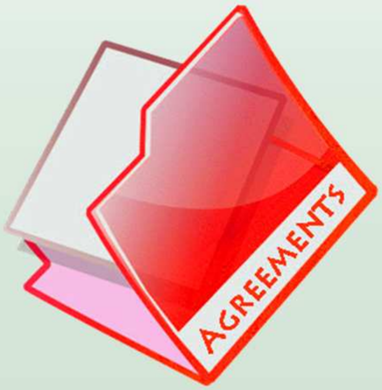
Earnout

Earnout

- What is an Earnout?
  - Typically, a portion of the purchase price is contingent on the **future financial performance of the target business**
  - Buyer pays the agreed earnout amount, if at all, in the years subsequent to the sale upon satisfaction of the contingency
  - Payment is contingent on a future event, such as hits on a website, or, more typically, exceeding a specified gross revenue, net income, or EBIDTA

Earnout

- Contingent purchase price, or an “earnout” is an increasingly popular technique in private, middle market M&A transactions
- An earnout is a valuable device for permitting a buyer and seller to reach agreement on a sale when the parties cannot agree on price



Earnout

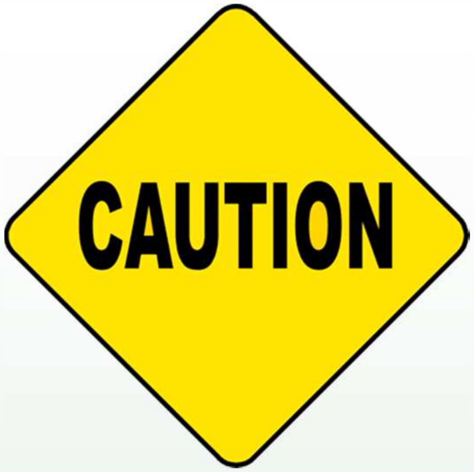
- According to the Houlihan Lokey 2011 Purchase Agreement Study, summarizing 2002-2010 transactions in which Houlihan Lokey acted as investment banker:
  - In **<u>2002 - 2010</u>** 18% of transactions included an earnout
  - From **<u>2009 – 2010</u>** 21% of transactions included an earnout
  - The median earnout as a percentage of price was **9%** in 2009 and 2010

Earnout

- Why use an earnout?
  - Gap in valuation between buyer and seller
  - Buyer may only be willing to meet seller's price if certain milestones are met
  - Seller may be more willing to accept less up front if she is confident that the business can achieve post-closing performance goals
  - Buyer wants the seller to stay active in and focused on the business after closing
  - Less risk for buyer; buyer can avoid overpaying for the target
  - Earnout as an incentive to retain and motivate key personnel of the target after closing

Earnout

- Seller's counsel should beware of the talkative seller that oversells the long term growth or productivity of the business



- Risk allocation
    - Seller will want more cash up front and less on earnout
    - Buyer will want less up front and more on earnout

Earnout

- Practical implementation can be difficult
  - Will the seller stay involved in the business to ensure that the earnout is earned?
    - Buyer will prefer to leave this open ended
    - Seller may require that the business be held in a separate legal entity
    - Will the buyer give assurance regarding the level of working capital that will be available?
  - Will seller have the right to manage the business?
  - Seller will want to manage the business to maximize the earnout
  - Will the new parent have the right to allocate overhead to reduce net income?
  - During earnout period, buyer is incentivized to front load costs

Earnout

- Practical implementation can be difficult
  - What method of accounting is used? Is it consistent with target's past practices or with the buyer's practices?
  - Buyer may not be able to integrate the business (and reap the benefits of consolidation) until the earnout period is over
  - If valuation was based on EBIDTA, were expenses deferred to maximize sales price?
  - **Example**: If a seller typically spent 5% of sales on advertising, buyer may wish to make a larger investment in those items, without input from the seller. From the buyer's viewpoint the additional short terms costs will have long term benefit (which will likely extend past the earnout period).

Earnout

- Practical implementation can be difficult
  - If the buyer acts in bad faith, a court may require payment of an earnout even if the metrics are not met.
  - In Horizon Holdings, LLC v. Genmar Holdings, Inc. 244 F.Supp.2d 1250 (D. Kansas 2003), the seller of a business sued the buyer for failure to pay the earnout. Delaware law applied. The seller was able to demonstrate to the court's satisfaction that:
    - The buyer undermined the president's ability to manage the company's business, which was not in the "spirit of the agreement"
    - The target company's brand name was abandoned post-closing, with a negative impact on sales
    - Post-closing manufacturing focused on two less profitable product lines
    - Reimbursement for manufacturing those lines was accounted for in a manner that increased production costs and negatively impacted the plaintiffs' ability to achieve the earnout

The seller was successful in its recovery.

Earnout

- Practical implementation can be difficult
  - Any earnout provision should be specific and address:
    - Control of the post-closing entity
    - Method of operation of the business post-closing
    - Method of accounting for profits, losses and expenses
  - Earnout provisions should include the following:
    - The performance metrics or milestones
    - The timeframe for achievement of the earnout metrics and milestones
    - Methods to be used in determining whether the performance metrics have been attained
    - Control issues relating to the earnout business against which performance is being measured

Earnout – Methods of Calculation

- Designing the Earnout
  - Designing the earnout and determining the method of computation will vary depending on industry and valuation methodology
  - Options for measure of earnout include (among others):
    - EBIDTA
    - Income or revenue growth
    - Gross profit
    - Specific event

Earnout – Methods of Calculation

- EBIDTA
  - Measured by an absolute target or an increase over time, or some combination of both
  - Business valuations are frequently based on some multiple of EBITDA
  - If buyer and seller disagree on an appropriate multiple of EBIDTA in computing the purchase price, the spread can be set up as an earnout
  - Seller – will likely prefer a certain percentage of all future EBITDA for a certain number of years
  - Seller will not want a cap; Seller should fully participate in business success

Earnout – Methods of Calculation

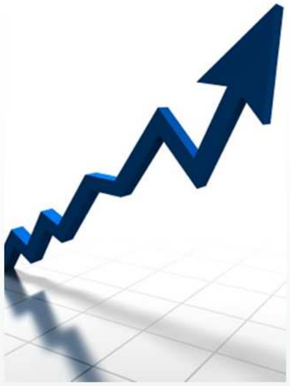
- EBIDTA
  - Buyer – will likely prefer a threshold, such that seller is entitled to receive an earnout on amounts over a certain level EBITDA
  - Buyer will prefer a cap on total earnout

Earnout – Methods of Calculation

- EBIDTA
  - Likely there will be issues with regard to management of the business during the earnout period
  - One solution may be to cap selling, general and administrative expenses at some level for purposes of the earnout calculation
    - This allows the buyer to incur expenses that it sees as reasonable without affecting seller's earnout
  - Alternatively, the parties could agree that, for purposes of the earnout, selling, general and administrative expenses are capped at a fixed percentage of gross revenue

Earnout – Methods of Calculation

- Income or Revenue Growth
  - Easy to measure
  - Difficult to manipulate
  - Typically used in earlier stage companies before there is positive EBITDA
  - Buyer may be concerned that this form of measurement does not take into account the quality of the revenue and whether or not it may be recurring
    - Although, this may be less of a concern if buyer takes over management
  - Seller may prefer this measure for the same reason
    - Although, this may be more of a concern if buyer takes over management



Earnout – Methods of Calculation

- Income or Revenue Growth
  - Parties should negotiate and agree on revenue recognition policies and procedures to be used on computing income or revenue growth
    - Does seller recognize revenue when a product is shipped
    - Does a buyer recognize expense only when the product is accepted?
    - Does the target use percentage of completion accounting and does that raise any issues?

Earnout – Methods of Calculation

- Gross Profit
  - Compromise
    - Seller's wish for simplicity and reduced possibility for manipulation
    - Buyer's desire to mirror EBITDA target used in valuation of the company
  - Similar issues to EBITDA calculations
    - Target or increase over time
    - Threshold or not
    - Cap or not
    - Cap on selling, general and administrative expenses or not
  - Parties need to agree on the components of cost of goods sold as used to determine gross profit
    - Allocation of overhead

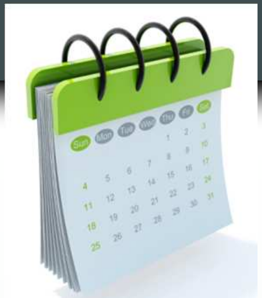
Earnout – Methods of Calculation

- Specific Event
  - Hits on a website
  - New product launch
  - New client acquisition
  - Sale of a certain number of widgets
  - Execution, maintenance or renewal or one or more key agreements
  - Great potential for dispute
    - If a key agreement is not renewed, is it the buyer's fault for not properly managing the client?
    - Is the renewed agreement sufficient if the material terms are different?
    - Does the renewed agreement confer the same benefits to the company?

Earnout

- Computing the Earnout – Time Period
  - How long will it take to properly assess the performance of the target?
  - A longer earnout period make not be practical
  - If an earnout period is too short, the incentives may promote actions like driving revenue growth without proper regard for issues such as customer creditworthiness, cost of goods sold, product quality and other issues that have long term importance

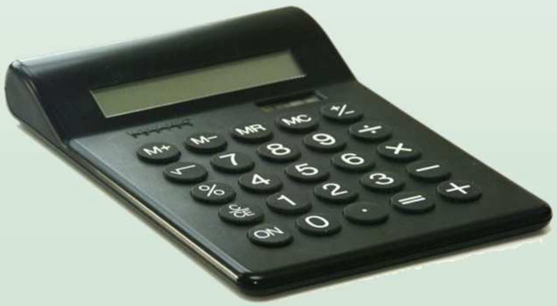
Earnout



- Computing the Earnout – Time Period
  - **Seller**
    - A higher EBITDA goal may take longer to meet
    - Will likely prefer annual payments for meeting annual goals (or quarterly)
    - Will want to avoid penalty for a down year or two during transition period – if goals aren't met can those amounts be carried over to future years?
  - **Buyer**
    - Will generally prefer a longer period to be sure of the consistency of the financial situation
    - If a buyer agrees to a year by year earnout, it may require that seller pay back an earlier earned about for poor results in a later year (possible use of escrow)

Earnouts

- Computing the Earnout
  - Parties should clearly agree on the calculation methodology
    - Involve the accountants
    - Attach a schedule and a sample computation
    - Precise and careful drafting
    - Buyer will prefer a simple reference to GAAP and less specificity which gives Buyer more wiggle room in computation
    - Seller with prefer more certainty



Earnouts

- Computing the Earnout – GAAP
  - The earnout measurement will almost always have a reference to GAAP
  - GAAP can be subjective and applied in different ways by different companies
  - Whose method of GAAP will be used?
    - Seller will prefer the method used for valuation purposes
    - Buyer will argue that while seller’s GAAP is a good starting point for discussing purposes, buyer’s will be converting the books for internal purpose and it is not reasonable to keep two sets of GAAP books
    - Parties may agreement to certain adjustments to seller’s GAAP for purposes of computing the earnout

Earnouts

- Computing the Earnout – Extraordinary events
  - The earnout computation methodology should address the accounting treatment for extraordinary events:
    - Transaction expenses
    - Purchase or sale of a line of business or a product line
    - Receipt of insurance proceeds from a catastrophic or unexpected loss

Earnout

- Specific Areas of Concern
  - Consistency of policies
    - Sales discounts
    - Business methods
    - Business policies
    - Inventory accounting method
  - Even with reasonable precautions, differences of opinion can arise in the computation of an earnout
  - GAAP is subjective and can be abused

Earnout

- Specific Areas of Concern
  - GAAP Accounting issues – items to **exclude**
    - Change in depreciation policies to accelerate expense
    - Any goodwill included in purchase price and its amortization
    - Non-recurring expenses related to acquisition and integration
    - Allocation of overhead from buyer's operations
    - Acceleration of write off of bad debts
    - Control over budget and expenses

Earnout

- Payment and Security for Payment
  - The earnout will provide for a period of time after the end of the earnout period during which the buyer will be required to compute the earnout
  - Seller should be entitled to all materials relevant to the computation and have a reasonable period of time to makes its own computations and propose any changes
  - Then there will be a finite period during which time the parties will attempt to negotiate a final number.
  - There may be particularly difficulty if seller is an employee of buyer

Earnout

- Payment and Security for Payment
  - Seller may seek a third party guaranty or other collateral to assure payment
  - Will buyer have the ability to pay?
    - Is the transaction an LBO?
    - Are there bank restrictions that do not allow a second lien on company assets?
    - Is there likely to be sufficient cash flow at the end of the earnout period?
    - Parent company guaranty?
  - The seller may be willing to accept a second security interest in the business being sold
    - Practically may have no value

Earnout

- Payment and Security for Payment
  - Acceleration of payment – it may be appropriate to provide for acceleration of payment under certain circumstances:
    - Buyer's business is sold
    - Buyer has not met its obligation to properly fund the business
      - Although, buyer has a fiduciary duty to its shareholders to maximize the value for shareholders
    - Change in management personnel
      - Seller's employment is terminated by buyer
        - Although severance and earnout are two different things
      - Key personnel leave (sales team, management team)
        - Voluntary vs. involuntary termination?
    - Buyer does not meet its commitments to seller

Earnout

- Dispute Resolution
  - Well drafted provisions can minimize disputes, costs and time
  - Appointment of an independent accounting firm – or each of buyer and seller has the right to appoint one and those two appoint a third
  - The independent accounting firm may
    - Be required to adopt either buyer or seller's computation
    - Be allowed to determine a number independent (either within the range or not)
    - Be allowed to use a different methodology than that used by the parties
  - Costs may be split or borne by the losing party
  - Finally determined amount may include interest from the anticipated payment date

Earnout

- Dispute Resolution
  - Seller will want any undisputed portion of the earnout paid immediately

Earnout – Tax Consequences

- Buyer's Tax Consequences
  - Earnout is contingent consideration
  - The buyer cannot generate depreciable basis until the earnout has been earned
  - Frequently it will be allocated to goodwill and amortized over the remaining 15 year period

Earnout – Tax Consequences

- Installment Sales
  - Any disposition of property in which at least one payment is to be received after the close of the taxable year in which the disposition occurs
    - Does not require a promissory note or multiple payments
  - Installment treatment applies unless the taxpayer elects out of the installment method
  - Certain transfers not allowed installment treatment including sales of inventory and disposition of depreciable property between related persons

Installment Method

- Taxpayer using the installment method recognizes taxable gain on a disposition of property as installment payments are received, rather than all at once in the year of disposition
- Use of "**gross profit ratio**": The gross profit ratio is a fraction, the numerator of which is the total amount of profit that ultimately will be realized on the disposition and the denominator of which is the total price of the property under the sale contract
- Each installment payment received by the seller is multiplied by the gross profit ratio to determine the amount of gain recognized with respect to that installment

Installment Method – Example

- JKL Inc. sells business assets having an adjusted tax basis of $1 million for $1 million in cash at closing and payments of $1.5 million 1 and 2 years after closing
- The gross profit ratio is 3/4:
  - The numerator is $3 million ($4 million in total purchase price minus $1 million in basis)
  - The denominator is the $4 million total purchase price

Installment Method – Tax Computation

- If the disposition qualifies as an installment sale, on receipt of the $1 million in **year 1**, JKL, Inc. will recognize gain in the amount of $750,000 ($1 million times ¾). In **years 2 and 3**, JKL, Inc. will recognized gain in the amount of $1,125,000 ($1.5 million times ¾).
- If the disposition does not qualify for installment treatment, JKL, Inc. would recognize gain of $3 million in **year 1** ($4 million in total purchase price minus $1 million in basis). Assuming a 35% tax rate, tax in **year 1** would be $1.05 million – more than the total cash received in that year

Installment Method with Contingent Payment

- Installment sales rules apply unless the seller elects out
- Total sales price of the property can be difficult to determine when there is a contingent payment
- Special rules apply where there is a contingent payment sale – i.e. a sale of property in which the aggregate selling price cannot be determined by the close of the taxable year in which the sale occurs
- Three categories:
  - Sales with a stated maximum selling price
  - Sales with a fixed period, and
  - Sales with neither a stated maximum selling price nor a fixed period

Installment Method with Contingent Payment

- Sales with a **stated maximum selling price**
  - Stated maximum selling price used in determining gross profit ratio by assuming that all contingencies will be met or otherwise resolved in a manner that maximizes the payments to the seller and accelerates payments to the earliest date or dates permitted under the purchase agreement
  - The stated maximum selling price is treated as the selling price in computing the gross profit ratio until that amount is subsequently reduced by the terms of the original purchase agreement, a subsequent amendment or a similar occurrence.
  - Gross profit ratio is recomputed for payments received in or after the taxable year of such reduction if the stated maximum selling price is reduced.

Installment Method with Contingent Payment

- Sales with a **fixed period**
  - If a stated maximum selling price cannot be determined but the purchase agreement fixes a maximum period over which payments may be received, the seller must recover basis ratably over the fixed period
    - Or, if the payments are not equal each year, based on a formula
  - Under some circumstances, the payment actually received in any particular year may be less than the amount of basis that should be recovered in that method. In that event, the taxpayer generally does not recognize a loss; instead the excess is carried forward to the next succeeding year
  - A loss may be recognized in the final year

Installment Method with Contingent Payment

- Sales with **<u>neither</u>** a **stated maximum selling price** nor a **fixed period**:
  - The IRS will closely scrutinize the arrangement to determine whether a sale has actually occurred, or whether the seller is receiving payments as rent or royalties
  - If a sale has occurred, the seller generally must recover its basis in equal annual installments over a period of 15 years

Installment Method with Contingent Payment

- Potential Issues
  - **<u>Acceleration of Gain Recognition</u>**. When contingent payment amounts are high, but the likelihood of receiving the full amount of the payments is not great, the stated maximum selling price rules may inappropriately accelerate recognition of gain or create timing and character issues.
  - **<u>Failure to Receive Contingent Payments</u>**. If gain is recognized in the early years of an installment sale but one or more contingent payments are not earned and paid, a seller may be left with a large loss. Capital losses can be hard to deduct for many taxpayers.
  - In a stock sale with a Section 338(h)(10) election with a contingent payment, there is trap that can result in excess gain recognition in the year of sale.

Installment Method

- Election out of installment method
  - A taxpayer electing out of installment reporting is required to report the entire amount of gain in the year of sale and is subject generally to the gain recognition rules of Section 1001
  - When a debt instrument is issued in exchange for property and the income is not reported on the installment method, the amount realized that is attributable to the debt instrument equals the lesser of:
    - The sum of all noncontingent principal payments
    - The sum of the present values of all noncontingent payments (including payments of stated interest) plus the fair market value of the contingent payments payable on the debt instrument (the earnout portion)

Holdback

Holdback Escrow

- In a typical purchase and sale agreement:
  - The seller makes certain representations and warranties regarding the business being sold
  - The seller makes covenants, including those regarding operation of the business between signing and closing
  - The seller indemnifies the buyer for losses caused by any breach of the representations, warranties or covenants
  - Seller may agree to place a portion of the purchase price in an escrow account for a period of time to secure payment on the indemnification
  - If there are no claims against the escrow the full amount is ultimately paid to the sellers; if claims are made, all or a portion of the escrow will be paid to the buyer and any balance paid to the seller

Holdback Escrow

- What is an escrow?
  - Written agreement between buyer, seller and escrow agent
  - Escrow agent will typically establish an account in which the buyer deposits a portion of the purchase price
  - Escrow agreement will place restrictions or limits on seller's right to receive the escrowed sales proceeds
    - Seller will forfeit funds related to indemnification provisions

Holdback Escrow

- Benefits

  - Mitigate risk to buyer
  - Helps facilitate a smooth transaction
  - Likely to fall within installment sales rules
  - Willing seller may get a higher overall price on sale

Holdback Escrow

- Major terms
  - There is no consensus on what is “**fair and reasonable**” or “**market**”
  - How much should be placed in escrow?
    - Depends on relative bargaining power
      - Seller may get higher total price by agreeing to indemnification holdback
      - Recent surveys estimate that 10% is reasonable
  - For how long?
    - Recent surveys suggest 18 months
    - Tiered release?

Holdback Escrow

- According to the Houlihan Lokey Study
  - For 2002-2010
    - Of transactions in which the representations and warranties survived the closing, 66% had an escrow
    - The median escrow amount was 7.4% of purchase price
    - The median escrow term was 18 months
  - For 2009
    - The median escrow amount was 7% of purchase price
    - The median term was 18 months
  - For 2010
    - The median escrow amount was 7% of purchase price
    - The median term was 18 months

Holdback Escrow

- Escrow Agreement
  - Deposit funds with Escrow Agent
    - Escrow agent must be a party to the agreement and will need to approve its terms. This can take some time to negotiate.
    - Escrow agent should be independent - bank, trust company, other professional service provider
    - Escrow agent has specific duties and responsibilities – including following the terms of the Escrow Agreement and ensure that the other parties comply

Holdback Escrow

- Escrow Agreement
  - Investment Authority
    - The escrow agent will be delegated certain specific investment authority
    - These provisions should be negotiated specifically with the escrow agent
    - Both parties have an vested interest in the way the escrow amount is invested
      - Buyer will likely prefer more security – to ensure that if there is a claim that funds are available
      - Seller may prefer slightly more risk and possibility of return

Holdback Escrow

- Escrow Agreement

  - Example: "The Escrow Agent shall hold and invest the Escrow Fund in certificates of deposit, direct obligations of the United States Government, or money market instruments during the term of this Agreement and shall treat the Escrow Fund as a trust fund in accordance with the terms hereof. Any income received by the Escrow Agent in respect of the Escrow Fund shall be deposited into and become a part of the Escrow Fund and shall be distributed by the Escrow Agent from the Escrow Fund pursuant to the terms of this Agreement."

Holdback Escrow

- Escrow Agreement
  - Claims under the escrow fund:
    - If buyer wishes to make a claim for indemnification under the business purchase agreement an officer of the buyer is required to give written notice of the claim, with specific details, to the escrow agent
    - Escrow agent gives a copy to the seller and the seller has a specific time period (45 days may be reasonable) to respond with specific objections, if any
    - If the seller objects, the parties attempt to negotiate for a specific period of time (45 days may be reasonable)
    - The escrow agent can rely on a written direction signed by both parties to make a distribution
    - If the parties cannot agree they follow a set dispute resolution procedure – procedure should specify allocation of dispute resolution costs

Holdback Escrow

- Escrow Agreement
  - Claims under the escrow fund
    - The escrow agent is entitled to rely in accordance with any final decision made in accord with the dispute resolution provisions
    - Payment to buyer on a claim may include interest from the date of the claim or from the date of the loss
    - At the end of the term, any balance, including income, is paid to the seller

Holdback Escrow

- Escrow Agreement
  - Other provisions
    - Indemnification of escrow agent
    - Escrow agent fee
    - Notice provision
    - Governing law

Holdback Escrow – Tax Consequences

- Use of the installment method is generally mandatory if the seller realizes a gain and the transaction meets the requirements
  - A disposition of property if at least one payment is received after the close of the tax year in which the disposition occurs
- **Question**: When is payment received?
  - On deposit in escrow?
  - When paid out of escrow?
- **To answer**:
  - Economic benefit doctrine
  - Constructive receipt

Holdback Escrow – Tax Consequences

- Constructive Receipt
  - Income is constructively received by a taxpayer when, without substantial limits or restrictions on his control of receipt, the income is either:
    - Credited to his account
    - Set apart for him, or
    - Made available so he may draw on it at any time
  - There is **no** constructive receipt when:
    - The taxpayer enters into an agreement to defer income before it is earned
    - The taxpayer’s right to the income has not yet matured or vested, or
    - The taxpayer’s right to the income is contingent on the occurrence or nonoccurrence of an event or condition

Holdback Escrow – Tax Consequences

- **<u>Economic Benefit Doctrine</u>**: A taxpayer must include immediately in income the value of cash or other property set aside in a separate escrow, fund, or trust for the benefit of the taxpayer

- Amounts are included **only** if:
  - The fund is irrevocable and beyond the reach of creditors of the party who transferred the funds to the escrow; and
  - The taxpayer has a vested right to the money, with receipt conditioned only on the passage of time

Holdback Escrow – Tax Consequences

- **<u>Accrual Basis Seller</u>**: A taxpayer using the accrual method of accounting must include income in gross income in the taxable year when all the events that fix the right to receive the income have occurred and the amount of the income can be determined with reasonable accuracy
- All of the events that fix the taxpayer's right to receive the income occur at the earliest of the following:
  - The time that the income is earned
  - The time that payment to the taxpayer is due, or
  - The time that payment is made to the taxpayer

Holdback Escrow – Tax Consequences

IRS Publication 537

If an escrow arrangement imposes a substantial restriction on seller's right to receive the sale proceeds, the sale can be reported on the installment method, provided it otherwise qualifies. For an escrow arrangement to impose a substantial restriction, it must serve a *bona fide* purpose of the buyer, that it, a real and definite restriction placed on the seller or a specific economic benefit conferred on the buyer

Holdback Escrow – Tax Consequences

- Income is not constructively received if the taxpayer’s right to receive it is subject to substantial limitations or restrictions
- If the terms of the escrow arrangement are such that the nonoccurrence of breach is remote, the IRS may argue that the escrow amount should be recognized

Holdback Escrow – Tax Consequences

- Direct or indirect control over escrowed funds, even without an absolute right to possess them, may constitute an economic benefit in the year of sale
  - Seller's ability to withdraw, sell or borrow against the funds indicate constructive receipt
  - Seller's ability to control investment of the escrow fund and subsequently receive the investment income should **not** give rise to a finding of constructive receipt
- Some restrictions will not be considered "**substantial**"
  - If they are or appear to be based solely on the expiration of time
  - If they are self-imposed
  - If the give the seller too much control over the escrowed funds

Holdback Escrow – Tax Consequences

- If the installment method is applicable, gain is recognized **over a period of time**, as discussed earlier
- If the installment method is <u>**not**</u> applicable, gain is taxed is recognized **in the year of sale**

Resources

- Ginsberg, Martin D. and Jack S. Levin, *Mergers, Acquisitions, and Buyouts, Continent Consideration and Liabilities in Acquisitions*, Aspen Publishers, 2010.
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Questions?

Please contact us any time with additional questions.

Pamela A. Grinter
206.389.1568
pgrinter@riddellwilliams.com