Tax Treatment of Contingent Payments to Individuals in M&A Transactions

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The volume of mergers and acquisitions (M&As) involving startups has increased significantly in recent years. In these transactions, the founders play a central role, as they are key to both the management of the business and the generation of value in the target companies.

As a result, it is common for the purchase price to be structured in multiple installments, with part of it contingent on the occurrence of future and uncertain events, which are typically linked to the founders' continued involvement in the company after closing and the achievement of specified performance targets. This structure is designed to ensure that the economic value projected by the acquirer is effectively realized, reflecting the fact that, in these types of transactions, the founders' continued involvement is often a determining factor in the generation of value in the acquired business.

The challenge presented by contingent payments, however, is that their characteristics can give rise to a divergence between their legal nature and their accounting treatment.

From a civil law perspective, these amounts are treated as part of the purchase price for the equity interest acquired in the target company. For accounting purposes, however, they may either be treated consistently with that classification, forming part of the carrying amount of the investment, or be categorized differently – as compensation for services, for example, in which case they are recognized as an expense in profit or loss.

Under item B55 of CPC 15 – Business Combinations (the Brazilian equivalent of IFRS 3 – Business Combinations), this classification does not depend on how the payment is described by the parties in their agreement, but rather on an assessment of whether there is an explicit or implicit link between the payment and continued provision of services by the founders.

Under this accounting guidance, continued provision of services is treated as the primary indicator: where payment is contingent on the seller's continued involvement in the business, it will generally be classified as compensation for services for accounting purposes, with other factors only considered in the absence of such a condition.

The accounting treatment of contingent payments does not necessarily determine their tax treatment. It is possible to argue that such amounts, even if recognized as compensation for accounting purposes, should be treated from a legal perspective as part of the purchase price, provided they constitute a genuine component of that price.

This reflects the principle that the legal nature of the transaction and its tax consequences should prevail over its accounting treatment. Divergences between the tax and accounting treatment of the same transaction are possible, and in some cases expected, given the different criteria applied under the law and by accounting rules in classifying transactions.

Contingent payments are one example of how accounting and tax treatment can diverge. From a tax perspective, however, the effects of the underlying legal transaction should prevail: (i) for the acquirer, the amounts paid should be treated as part of the cost of acquiring the investment; and (ii) for the seller, they should be included in the calculation of the capital gain arising from the disposal of the equity interest.

Nonetheless, treating payments to the seller as compensation for accounting purposes tends to increase the risk that the tax authorities will take a similar view. In the absence of clear guidance in the case law, and given the well-established divergence between accounting and tax treatment, the use of contingent payments in these transactions warrants careful analysis. In practice, in some cases this has led to a reassessment of contractual structures – and even of the overall terms of the deal – in order to mitigate risk and ensure that the payments are properly classified for tax purposes.

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