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# Earn-out provisions in M&A transactions: price or remuneration?

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M&A transactions involving start-ups and scale-ups are increasing, and so is the number of transactions where selling shareholders and key personnel are retained post-sale. In large part, this movement reflects the importance of these individuals to the development of the company sold, which is often still in the growth phase. In general, retained personnel have a fundamental role in integrating the businesses after closing, and that integration may be crucial for the success of the deal.

One strategy to promote successful integration has been payment of a contingent price (i.e., an earn-out), which makes a portion of the price contingent on a future and uncertain event, generally the performance of the acquired company in the years following the acquisition. In order to retain the selling shareholders and ensure the deal's success, in addition to the unconditional portion of the price, part of the price will be made conditional on achieving certain metrics, provided for in the purchase and sale agreement, one of which is the selling shareholders remaining with the acquired company for a certain period of time.

From an accounting point of view, auditors have been carefully analyzing earn-out payments made to sellers who remain with the company post-sale, in order to determine if the payments should be treated as part of the purchase price paid for the investment acquired (and so recorded as part of the acquisition cost) or as remuneration for provision of services (and so recorded as a expense in the company's P&L).

CPC 15, correspondent to IFRS 3, which establishes accounting rules for business combinations, lists the basic elements to be taken into account when classifying payments as price or as remuneration. For accounting purposes, even if the earn-out has been treated as part of the purchase price in the purchase agreement, it can be classified as remuneration, depending on the facts surrounding the deal, as described in B55 of CPC 15.

The main element that can characterize an earn-out payment as remuneration is an explicit or implicit link between the payment and continued employment relationship. As a rule, whenever there is a condition of permanence for the earn-out payment, the amounts tend to be classified as remuneration for the provision of services.

In the absence of the permanence condition (employment relationship), it must be examined other factors that bring the payment closer to, or farther from, personal services or performance of the sellers, such as metrics related to the sellers' functions in the company, the amount of standard remuneration, the manner of calculating the earn-out.

Although, from an accounting point of view, the earn-out reflexes are very distinct, especially for the purchaser, it does not affect the legal nature of earn-outs and should not be determining in how those amounts are treated for tax purposes. The legal nature of the transaction should prevail over accounting rules.

Even if earn-outs are recorded as remuneration in the company’s accounting books, as long as they are part of the purchase price and not a disguised payment for services, they should be treated by the parties as follows: (i) the purchaser should consider the earn-out to be part of the acquisition cost of the investment, including for goodwill purposes, and (ii) the seller should include the earn-out amount in any capital gain realized on the sale.

For now, neither the tax authorities nor the courts have expressed their position on the issue, so it is not possible to discard the risk that the tax treatment given to earn-outs by the parties in M&A transactions may be challenged, especially if they are reclassified as remuneration for accounting purposes. But just as in many other situations, there are solid legal arguments to demonstrate that the manner of accounting for these amounts is not the only factor in determining how earn-outs should be treated for tax purposes.

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