THE WAGNER LAW GROUP
A PROFESSIONAL CORPORATION

EARNOUTS AND CODE SECTION 409A

I. Question: Purchase Price or Compensation

A. Purchase Price Argument

1. Earn-out payments relate back to the sale of the business
2. *Arrowsmith v. CIR*, 344 U.S. 6 (1952). Losses postdating liquidation of corporation related back to the liquidation
3. Supporting factors:
   a. Earn-outs payable in proportion to the selling shareholders' interests
   b. Key shareholders rendering services are adequately compensated compared with other employees providing similar services
   c. Earn-outs not contingent on continuing employment (pay a retention bonus instead)

B. Compensation Argument

1. Earn-out payments contingent on employment-related factors are attributable to services rather than ownership
2. *Lane Processing Trust v. U.S.*, 25 F3d 662 (8^{th} Cir. 1994) - proceeds of sale of business distributed to employee-owners if they were employed by the business as of the date of sale; amounts of distributions were based on length of service, location and job classification. *Alves v. CIR*, 79 T.C. 864 (1983), aff'd 734 F.2d 478 (9^{th} Cir. 1984) - compensatory intent of restricted stock was shown by forfeiture restriction tied to employment, even though the employee paid the same price that other non-employee subscribers paid.
3. Supporting factors
   a. Earn-out forfeitable if employment terminates before a specified date
   b. Amount of earn-out affected by employment-related factors

II. Treatment of Property Underlying the Earn-Out

A. Applicability of Section 409A. Deferred compensation is "a legally binding right during a taxable year to compensation that, pursuant to the plan [or arrangement], is or may be payable to (or on behalf of) the service provider in a later taxable year." Treas. Reg. Section 1. 409A-1(b)(1).

1. Deferred compensation within the meaning of Section 409A does not exist if the compensation may be reduced unilaterally or eliminated by the employer.
2. This exclusion does not apply merely because the compensation may be reduced or eliminated by the operation of objective, nondiscretionary plan terms.
3. If an earn-out is classified as compensation, it would generally meet the legally binding right test, so that it would also be deferred compensation under Section 409A, even if the earn-out formula could reduce or eliminate the payment.

B. Restricted Stock Subject to Code Section 83. Property [*e.g.*, employer stock] transferred to an employee or independent contractor in recognition of the performance of services would satisfy the prerequisite for applicability of Section 83.

If a transfer is taxable under Section 83, Section 409A will not apply. However, Section 83 treatment would not automatically apply to earn-out payments on the sale of the property, and the purchase price v. compensation argument would need to be resolved with respect to such payments.

C. Profits Interest in Partnership or LLC. Under Revenue Procedures 93-27 and 2001-43, the grant or vesting of a profits interest to a service provider is generally not a taxable event. In Notice 2005-1, Q&A 7 and in the preamble to the final 409A regulations, the IRS stated that until further guidance is issued, taxpayers may treat the issuance of a partnership/LLC interest in connection with the performance of services in the same manner as corporate stock, and therefore, as not resulting in the deferral of compensation for purposes of section 409A. While payments under the partnership/LLC interest should be outside of Section 409A, earn-out payments pursuant to the sale or extinguishment of the interest could be subject to Section 409A if classified as compensation rather than as consideration for the interest.

III. Permissible Payments under Section 409A

A. Statutory objective: prevent employees from manipulating the timing of deferred compensation subject to Section 409A.

B. Consequence of Violation:
1. Immediate taxation of deferred amounts
2. 20% penalty tax on deferred amounts brought into income
3. Interest penalty

C. Payment Dates. The arrangement must provide, from inception, that deferred compensation may be paid only on one of six events:
1. Separation from service
2. Disability
3. Death
4. An objectively determinable, nondiscretionary date or dates on which objectively determinable amounts are to be paid
5. Change in control
6. Unforeseeable emergency

D. Subsequent Deferral Rule. Elections made after deferral to delay a scheduled payment or change the form of a payment are restricted:
1. 12-month delay of effective date
2. Subsequent election to be made at least 12-months in advance of scheduled payment
3. Original payment date must be delayed at least five years

IV. Earn-Out Problem: Earn-outs are payable according to a schedule established in the acquisition negotiations. This negotiated schedule will not qualify as one of the six sanctioned payment events selected at the time of deferral.

A. Regulatory Relief (Conventional View). Under Treas. Reg. Section 1.409A-3(i)(5)(iv)(A), an earn-out provides a good payment date if:
   1. Payout is on the same schedule and under the same conditions applicable to other shareholders and
   2. Earn-out period is not more than five years.

B. Regulatory Relief (Strict Construction). Earn-out provides a good payment date as long as payout is on the same schedule and under the same conditions applicable to shareholders. Under this view, the five-year rule only applies where the plan is later amended to provide for a new time or form of distribution.

C. Further Relief for Extension/Addition of Vesting Requirement. If payment under an existing plan would be made on a change in control, you can add a vesting requirement before the change in control, and the compensation will be outside 409A under the short-term deferral rule. Normally, you would not be able to modify vesting in this manner, and if you did it would be disregarded.
   1. This relief is conditioned on compensation being paid on the same terms and conditions as apply to other shareholders.
   2. Query extending vesting to the payment date of each earn-out installment?

D. More Vesting Relief. Under Treas. Reg. Section 1.409A-3(i)(5)(iv)(B), vesting otherwise due to occur upon a change in control can be extended without additional compensation. Existing payment schedule under which payments begin when the new vesting requirement has been met will be good if change in control is:
   1. Arm's length and
   2. Buyer is unrelated to service recipient or service provider.

   Query applicability of this provision to earn-outs, since it does not appear to allow change to the original payment schedule.

V. Transaction-Based Compensation. Relief extends to amounts that "relate to" target stock.
   A. Service recipient's purchase of its stock held by service provider/employee
   B. Compensation payable pursuant to stock right held by service provider/employee
   C. Compensation calculated by reference to the value of service recipient stock

VI. Change in Control.
   A. Change in ownership of employer (more than 50% of total fmv or total voting power)
   B. Change in the ownership of a substantial portion of employer's assets (40% gross fmv during 12-monnth period)
   C. Not acquisition of effective control (30% voting power or board majority)

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