

Earn-outs: How to avoid pitfalls and protect value

Grant Thornton Sale and Purchase Agreement Advisory

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Foreword

This report is based on the Grant Thornton Sale and Purchase Agreement Advisory team's experience, and input from M&A practitioners including corporate lawyers, private equity houses, corporate finance advisors and corporate directors.

Whilst the report provides buyers, sellers and advisers with general guidance on the nature and complexities of earn-outs, it is not intended to serve as legal, accounting, financial or tax advice. Even though many earn-out transactions share certain characteristics, each transaction is unique and this report is not a substitute for obtaining professional advice.

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Introduction

Earn-outs are a common feature of M&A transactions. Respondents to our 2017 International Sale and Purchase Agreement (SPA) survey reported that around 40% of deals used some form of earn-out.

% of deals in which earn-outs used

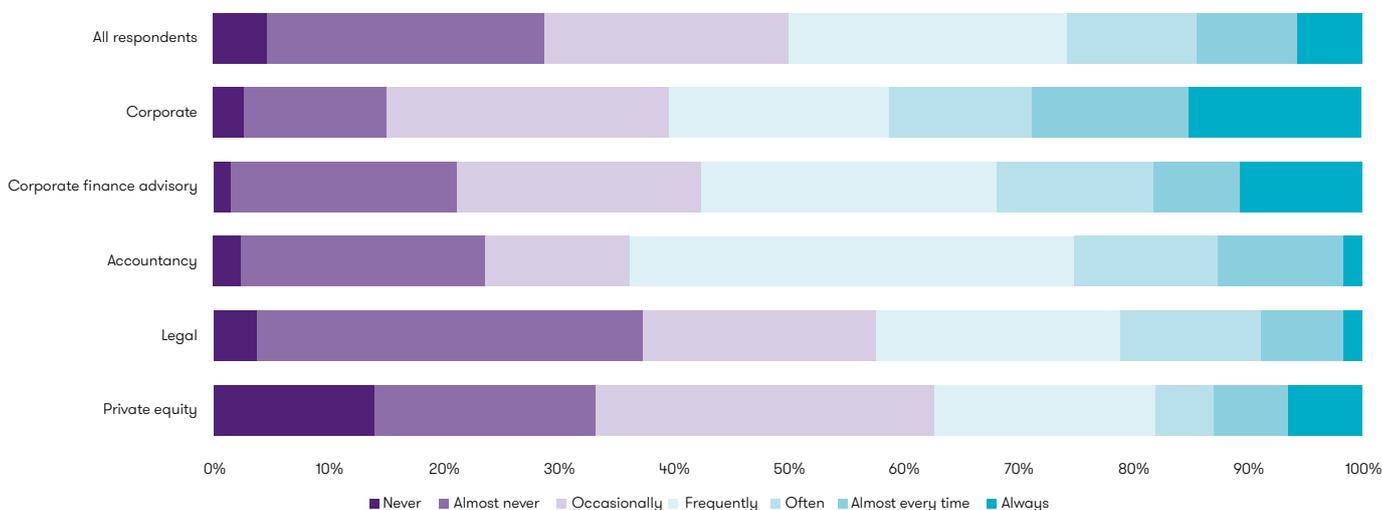
Mean averages

Overall	42%
Corporate	55%
Corporate Finance	46%
Accountancy	45%
Legal	36%
Private Equity	36%
APAC	46%
Europe	42%
N. America	29%

When used properly, earn-outs can provide the parties with an additional opportunity post-deal to true-up and validate the headline price. Earn-outs can also incentivise vendor management, who are often remaining with the business for a transitional period, to deliver further growth or profits to the benefit of both themselves and the buyer.

When not given appropriate focus and attention, or poorly-drafted in the SPA, earn-outs can damage the business and can create significant contentious post-deal disputes. Indeed, our survey respondents reported that earn-out clauses were one of the most disputed areas of SPAs post-deal. The objectives of this report are to set out the core principles of earn-outs and the pitfalls to avoid, to make an earn-out successful.

How often do you see earn-outs being used?



(Grant Thornton 'A smarter way to get deals done: International survey' 2017)



What are earn-outs?

Consideration for an acquired business may be split over time, with an amount due on completion (often subject to the deal completion mechanism adjustments as addressed in the ICAEW's "Best Practice Guideline: Completion Mechanisms" authored by Grant Thornton) and further amount(s) deferred to a later date.

The deferred element of consideration is commonly contingent on certain conditions being met. Where those contingencies relate to the business reaching certain performance targets in the post-acquisition period, the deferred consideration is commonly termed an 'earn-out'.

What are the main reasons for including earn-outs in a deal?

Earn-outs are particularly useful when:

- the buyer is acquiring a business in a new market or industry where future performance is less predictable;
- the target business is expected to experience significant growth in the near future and the seller wishes this to be factored into the price;
- it is beneficial to retain the expertise of and to incentivise existing management to ensure the future success of the business; or
- bridging a value perception gap between the parties, resulting from different expectations of future performance.

In these circumstances an earn-out can reduce the risk to the buyer of overpaying based on growth assumptions that do not transpire and it provides the opportunity for the seller to benefit from a strong post-transaction performance.

General considerations

Sellers that stay in the business may no longer have the authority internally to direct the business in the way they would like to post-deal, and its performance may be more affected by the buyer's influence than the seller's. This can become a source of dissatisfaction and possibly lead to a dispute if targets are not met.

It is worth spending the extra time thinking through the implications of the earn-out mechanism and clauses in the SPA at an early stage of drafting. Parties are more likely to take a reasonable and objective approach to any earn-out during the Heads of Terms phase, rather than as a last ditch value-bridge attempt late in any negotiation process.

Parties should ask themselves, are the conditions attached to any earn-out clauses clearly described, objectively measurable and fair? If targets are unreasonable, or are not within the seller's influence, this may damage a future working relationship with the seller and could be a demotivating factor with a detrimental impact on post-deal results. Usually, it will be in both parties' interests that the business meets its targets and the earn-out is achievable.

When it comes to the drafting of an earn-out schedule in the SPA, it is rarely the case that 'too many cooks spoil the broth'. The timely input and insights from the principals and all advisers on both the buy- and sell-side can ensure the earn-out is realistic, achievable, appropriate, practical and that the legal drafting of the schedule accurately reflects the intentions of the parties.

Given the value of an appropriately considered earn-out schedule and the risk of dispute caused by a poorly drafted schedule, we encourage parties to proactively consider the schedule early in the deal process, perhaps even before exclusivity is granted, to ensure that parties are reasonably and fairly considering the terms.

Challenges with earn-outs

Our International SPA Survey shows that earn-out clauses are frequently given the most attention in the SPA - and with good reason. It is often difficult to predict all the changes a business will undergo following a deal and the factors impacting its performance. Buyers may expect the acquired business to benefit from synergies and their plans to improve the target business. It can sometimes be difficult to fairly attribute any performance improvements between the pre-existing business and the buyer's initiatives. If earn-out targets and associated clauses in the SPA are not drafted carefully, this can increase the risk of disputes. Perhaps worse, inappropriate earn-out targets could encourage decisions by seller management that boost their chances of meeting the earn-out target, but are contrary to the long-term success of the business.

If the financial results of the business during the earn-out period are close to the upper or lower thresholds within which an earn-out amount is payable, particularly if a multiple is to be applied in arriving at the price adjustment, this is likely to lead to close scrutiny of the earn-out accounts and potentially a dispute (see SPA adjustments for comparison with target later in this report). This is because a small increment in performance could have a disproportionate impact on the amount payable by the buyer. Such disputes can be costly, and could lead to a relationship breakdown between the buyer and the seller, who may still be in the business.

Typically, earn-outs are contingent on financial performance and therefore earn-out accounts must be produced in such a way that the financial results of the business can be compared with the agreed financial targets. The basis of preparation of the earn-out accounts is subject to similar considerations as completion accounts ie trying to set out a clear preparation basis and process that will minimise the chance of disputes arising.

Earn-out provisions in SPAs should be sufficiently detailed, avoid ambiguity and take account of known and anticipated changes to the business during the earn-out period. Integration post-deal with other businesses or entities in the buyer's group, or changes to systems and personnel, can make comparable performance more difficult to measure. Careful thought should be given to ensuring actual performance can be compared with the targets on a like-for-like basis.

Hierarchy of bases of preparation

A hierarchy of bases of preparation is usually prescribed in the SPA to set out the basis of preparation of the earn-out accounts. This includes:

- agreeing and setting out specific accounting policies which take priority;
- followed by reference to historical accounts to provide a reference point for consistent treatment of items not covered by specific accounting policies;
- Where no specific accounting policies have been prescribed and no precedent treatment for a particular item exists in the reference historical accounts, the relevant local GAAP or IFRS to be applied should be agreed as a final step in the hierarchy.

Similar to completion accounts, the basis of preparation, format for earn-out accounts and the formula and mechanics for any calculations should be agreed pre-completion. It is usually advisable to attach a pro-forma and/or worked examples to the SPA to minimise the scope for post-deal disputes.



Earn-out structures

Measurement bases for earn-outs

A variety of profit measures and other performance measures can be used for earn-outs, including for example:

Example financial measures	Example non-financial measures
Turnover/revenue	Sales volumes (subject to pricing parameters)
GP% (gross profit percentage)	Number of new customers/wins
EBITDA (see below for more commentary)	Number of active customer accounts
EBIT (earnings before interest and tax)	Customer satisfaction ratings
PBT (profit before tax)	Customer churn
PAT (profit after tax)	

Key considerations when using adjusted EBITDA as a measurement basis

Starting point for EBITDA

The most common measure of earn-outs is earnings before interest, tax, depreciation and amortisation (EBITDA). EBITDA is a familiar metric for deal-practitioners, as the headline price or 'enterprise value' is commonly calculated based on an industry-specific multiple applied to EBITDA.

One essential requirement of the SPA is to define EBITDA clearly, as it is not defined in accounting standards and may not be presented in the reference historical accounts. The components to be included and excluded within EBITDA are essential to define, in particular 'earnings', as this is often the source of dispute between the parties. Parties risk a potentially extensive dispute process if they allow ambiguous drafting of this definition.

Parties will need to consider how each component of EBITDA is to be calculated. For example, the amount of revenue to recognise in the earn-out period on large contracts would have a range of judgments that could be regarded as reasonable under GAAP. Parties are therefore likely to adopt a different view if significant earn-out consideration depends on it. Parties could reduce this risk by agreeing a specific accounting policy for recognition, such as agreeing specified contract milestones to trigger recognition of a set proportion of revenue and profit. Alternatively, they may prefer to adopt a more objective measure, such as the total revenue in new contracts entered into during the earn-out period, which may be both less easy to manipulate and more beneficial for the business in the long-term.

EBITDA may be the most common measurement basis for an earn-out, but it is rare that EBITDA is the buyer's only focus post-deal. Parties should consider what is driving performance eg sales volumes, prices and revenues.

SPA adjustments for comparison with target

The EBITDA figure as drawn from the earn-out accounts will often be adjusted for certain items that are specific to the deal. This might include adjustments for:

- certain exceptional or one-off items;
- agreed amounts for directors' remuneration/bonuses;
- provisions for non-trading items or releases of prior year provisions;
- planned buyer expenditure or cost savings post-completion; or
- synergies arising from integration with the buyer's business.

To suitably benchmark EBITDA and then calculate it post-completion, the parties will need to carefully consider both historical and prospective performance in assessing prior and planned expenditure, and any adjustments that may be required in deriving both target and actual EBITDA.

If exceptional one-off items are to be adjusted, the parties will need to work together in setting the benchmark on their anticipated forecasts for EBITDA, and consider what exceptional items there might be. These can be reflected in the target and the earn-out provisions as necessary. A vague (or non-existent) definition of 'exceptional' or 'non-recurring' items may result in disputes post-deal, as parties take differing views on what should be included in such categories.

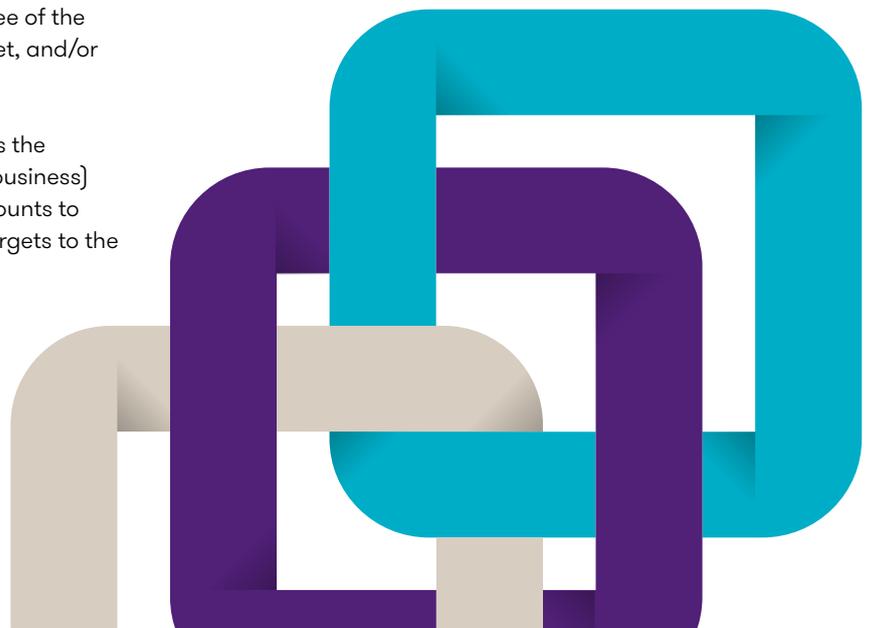
Alternative metrics

Earn-outs can be tied to more than one metric, which may include a combination of financial and non-financial measures. For example, the earn-out could be payable if the target company satisfied one or two out of three of the following: a certain level of EBITDA, a revenue target, and/or retained X% of customers.

By linking to multiple financial metrics, this reduces the opportunity for a buyer (who gains control of the business) to manipulate the preparation of the earn-out accounts to seemingly underperform and miss any earn-out targets to the detriment of the seller.

Conversely, if sellers are motivated primarily to meet revenue targets, they may cause the company to enter low margin or even loss-making contracts to boost the top line. If profits are the primary driver, the seller management may avoid incurring development expenditure and cut corners, resulting in poor quality products or services, which could damage customer relationships and be harmful to the business in the longer term. Assessing non-financial metrics as well may reduce the risk of poor practice. Non-financial metrics of performance, such as the number of retained customers, may do more to encourage seller management to operate the business in way that promotes longer-term success.

In all cases, we recommend the parties think carefully about whether the selected measures and metrics will incentivise and motivate the right behaviours, or if there is a risk of damage to the business. The purpose of the metrics should be to encourage management to meet the goals of the buyer. Parties risk focusing so much on the earn-out that they forget to focus on the importance of the long term performance of the business, post-acquisition.



Measuring the performance of the target post integration

There may be significant challenges in measuring the individual performance of the acquired business post-completion when it is immediately integrated into the acquiring company. The accounting books and records that were maintained pre-signing may be amalgamated for consolidation into the accounting records of a broader business, so that it is no longer possible to identify the target company's individual performance. In such circumstances for earn-out purposes, this would require the buyer to either keep a separate ledger for the target business or instigate procedures and processes that enable 'like for like' earn-out accounts to be produced.

Where there is going to be a heavy integration post-deal, such as sharing of customers, IP, systems and significant people changes, parties could be more ambitious and select positive integration metrics, and combined financial metrics for the entire group post-completion, agreeing how the proportion attributable to the seller should be calculated. Parties can be proactive in planning and then subsequently implementing the planned synergies within the group.

Where there are synergies to be gained parties should ask themselves "is this earn-out likely to preclude us from integration or promote segregation during the earn-out period?" Where the answer is yes, a re-evaluation of the earn-out metrics, or avoiding an earn-out mechanism altogether, may be required.

When to start the earn-out period

In our experience, typically the most common times to commence the earn-out period are at the completion date or from the start of the financial year prior to completion. In cases where the earn-out period does not start immediately post completion, this can allow the buyer a period to adjust to the new business, perhaps incurring exceptional or non-recurring costs in relation to the integration of the target into their wider business, without negatively affecting the earn-out period results. Parties should ensure the start date of the earn-out period avoids any potential manipulation of results by either the seller pre-completion, or the buyer post-completion.

In all instances, we would recommend consideration of the practicalities of preparation, including factors such as:

- whether the earn-out accounts are concurrent and aligned with the management/statutory accounts reporting period ends;
- availability of staff/professional advisers to prepare and review earn-out accounts; or
- capacity of staff simultaneously to prepare earn-out accounts alongside regular roles.

Parties may prefer to base the earn-out calculations on figures in audited financial statements, but should bear in mind it is unlikely that audited accounts will be available quickly after the end of the earn-out period, and this could cause delay in agreeing the deferred consideration.

Duration of the earn-out period

The duration of any earn-out period is typically one to two years, but occasionally up to three to five years post-completion. The longer the period, the more it becomes debatable whether the performance of the business is still a legacy of the seller's stewardship, and the less predictable it is.

The period may be much shorter in more volatile markets, or where business performance of the target is heavily affected by factors outside of the owner's control.

However, an earn-out period should be long enough to iron out the impact of any acquisition-related disruption, and should also take into account seasonality and normal fluctuations in performance that may occur within a shorter period. It is possible that performance in the first few months may be adversely affected by post-completion activities to the extent it appears worse than pre-completion, and the seller may be unfairly penalised if initial performance is not representative of the post-acquisition norm.

The duration and timing of the earn-out should also consider integration post-completion, buyers that are keen on progressing with integration quickly may well favour a shorter earn-out period.

Post-deal disputes

Frequent causes of disputes

The collective view of the respondents to our 2017 International SPA Survey is that earn-out clauses do not only take the longest to negotiate (60% of lawyers are of this view), but alongside completion accounts, earn-outs are the most disputed area of SPA after the transaction.

In general, disputes in relation to earn-outs tend to arise from:

- a lack of common understanding and interpretation of the appropriate basis of preparation of the relevant metrics per the SPA; and/or
- allegations of manipulation by one party or the other, either in accounting terms, or indeed allegations of operating the business in a way that breaches the earn-out protection provisions in the SPA.

In relation to the basis of preparation, particularly in terms of financial measures, differences of opinion typically stem from a lack of clarity in the drafting of the relevant parts of the SPA. This includes:

- **which elements are to be included/excluded** – eg whether particular costs are ‘above or below the EBITDA line’, or how to treat particular one-off, exceptional or ‘non-recurring’ revenues or costs, where their treatment has not been specified in the SPA;
- **the appropriate method of calculating included items** – typically this is expected (absent a specific agreed upon treatment set out in the SPA) to be consistent with the pre-deal methodologies of the target, but this can become difficult to calculate if the target has been transitioned to the buyer’s policies for internal and/or external reporting, and there may be no precedent treatment in pre-deal accounts;
- **how to treat structural changes** – eg the replacement of the target’s IT, HR or accounting functions and their costs with ‘equivalent’ buyer-provided services and recharged costs.

In relation to manipulation, or accusations thereof, examples include:

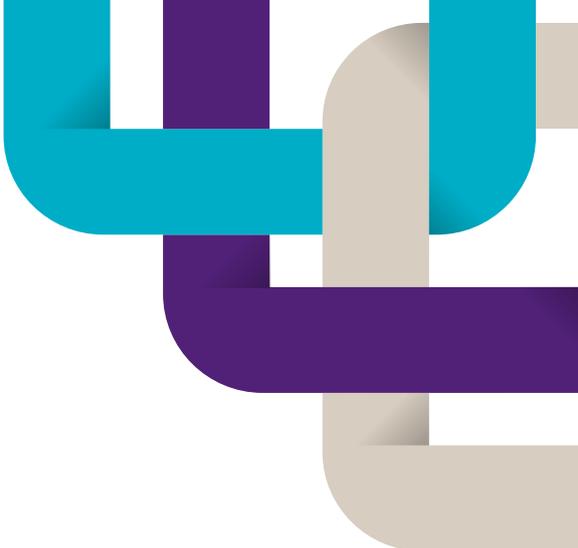
- a buyer considers that the previous management have deliberately underspent in discretionary areas, eg training, marketing, advertising, accelerated the recognition of revenues, or been ‘more optimistic’ in subjective assessments such as provisions for liabilities. Such actions would have the short term impact of boosting results within the earn-out period, but may have an adverse effect longer term; or
- a seller no longer involved in the operational control of the business considers that the buyer has deliberately overspent on discretionary areas and/or deferred the recognition of revenues within the earn-out period, or taken a more pessimistic approach to provisioning. Such actions will have the effect of depressing results in the short term.

How to avoid disputes

Given that future performance is unknown at signing, and it is subject to a myriad of factors with varying degrees of control and predictability by the parties, it is unrealistic to mitigate all risk of disputes arising from an earn-out. However, a great many could be avoided by ensuring as far as possible that the earn-out provisions in the SPA are clear and unambiguous. Clarity can be improved by having:

- clear definitions for what should be included/excluded, preferably illustrated by way of a pro-forma earn-out schedule calculation;
- clear accounting policies dealing with judgemental areas open to interpretation and manipulation;
- a clear reference point for measuring earn-out results consistently with prior results and the target, eg by reference to an historical set of audited accounts or diligence management accounts.

The parties should ensure that they are familiar with the details of the agreed basis of preparation and the implications for expected future results, in terms of how certain key components will be treated.



Specific accounting policies should be added for items that may be covered in the reference historical accounts but where i) consistency with reference accounts is being diverged from; or ii) specific policies are required to explain in more detail how the reference accounts were prepared. The parties should discuss each constituent element or metric of the earn-out calculations, to ensure that they share a common understanding, and document that understanding clearly.

Key terms should be defined, such as “adjusted EBITDA” and documented in such a way that its meaning would still be clear and unambiguous to a third party, many months or years after the negotiation of the SPA. Again, pro-forma schedules, ideally populated with illustrative data with which the parties are familiar, can add clarity. Another commonly used, but highly ambiguous, term that can lead to disputes is ‘non-recurring’, if not clearly defined.

As a fall-back position, where neither a specific accounting policy nor consistency with past treatment deals with an item (eg in the event of a new class of income or costs), then the SPA should prescribe calculation in accordance with the relevant local GAAP or IFRS. Parties often agree that consistency with GAAP should be an overriding requirement for any item not covered by a specific accounting policy, in case of any undiscovered non-GAAP compliant treatment in the reference accounts, so as not to perpetuate the same errors in the earn-out accounts.

Measurement of the performance of the acquired entity would be significantly hindered if the buyer did not maintain separate records of the acquired entity from the buyer’s group (both financially and operationally) for the duration of the earn-out period. If this is not possible or desirable for commercial and operational reasons, the parties should re-consider whether an earn-out is suitable for the deal; or whether some other form of deferred consideration arrangement should be used, such as a retention based on conditions not pinned to financial results of the entity, for example key people staying in the business or a staged equity purchase.

In circumstances where an earn-out mechanism is used and there will be operational or structural changes to the target following the acquisition, then issues should be anticipated and dealt with by specific policies in the SPA. For example, a target may have an in-house HR team which will be replaced by support from the buyer’s existing HR team with corresponding service charges. Such costs may be higher or lower than the equivalent pre-deal costs.

From its inception, the earn-out mechanism should be designed in such a way that it meets the combined aims of the seller and buyer (ie that it is fair, and all parties are incentivised to make it work). Whatever the metrics are, it is advisable to undertake some scenario modelling before the SPA is signed to ensure that the mechanics of the calculation work fairly and do not result in gaps, overlaps or double-counting, all of which can lead to disputed outcomes.

Ongoing communication between the parties during the earn-out period, can help to address issues as they arise, when the parties’ attitude to the appropriate treatment will likely be tempered by the need for continued co-operation. It will also prevent disputed matters from coming to a head all at the same time, when positions may become more entrenched once the full impact on the consideration is clear.

In order to reduce the prospect of manipulation of the metrics, appropriate protections for the benefit of the at-risk party should be included in the SPA. At a minimum, there should be clauses to the effect that the parties must act in good faith and not undertake anything that has the effect of distorting the relevant metrics. Such protections at least give the injured party some recourse for making a claim if they consider there has been a breach. However, such protections should not be a replacement for setting specific accounting policies around key areas subject to operational discretion, such as explicit minimum or maximum parameters for marketing and remuneration expenses (either in absolute or percentage terms).

Resolving disputes

Although with careful and well thought through drafting the likelihood of disputes can be reduced, the risk cannot be eliminated completely. As such, it is important to include in the SPA directions as to the process by which disputes can be effectively and efficiently resolved if they arise. In essence, the procedures should be the same as those we would recommend for disputes in relation to completion accounts:

- the preparing party (typically the buyer) should provide a draft in an agreed format within an agreed timeframe after the end of the earn-out period;
- the reviewing party (typically the seller) should have an agreed length of time either to: i) submit a notice of dispute (setting out in reasonable detail the reasons for its objections and the adjustments it proposes); or ii) to accept the draft earn-out accounts as final and binding;
- in the case of a notice of dispute being served, the parties have an agreed timeframe to seek in good faith to resolve the matters between them;
- failing a resolution of all matters within that timeframe, any remaining matters in dispute are referred to an independent accountant for expert determination.

As earn-out accounts are likely to be “special purpose” accounts rather than management or statutory accounts, their basis of preparation is governed by the specific requirements of the SPA, rather than just UK GAAP or IFRS. It is advisable for the parties to seek specialist input during the process of preparing and reviewing (as the case may be) the draft earn-out accounts and, if necessary, disputing them and if still not agreed, in making submissions to an independent expert as part of a determination. Well-structured and appropriately worded dispute notices, interparty correspondence and submissions can be a key factor in preserving value.



Completion mechanism and earn-outs

The locked box mechanism allows parties to agree the balance sheet price-adjustment treatment items, fix the equity price at completion and avoid the need for completion accounts, which in turn reduces the incidence of disputes post-deal. These benefits of the locked box mechanism may seem contradictory with the use of an earn-out mechanism, which yields a variable equity price post-completion but the two are sometimes used together.

The choice between a locked box mechanism and completion accounts should not be determined by whether or not parties want to include an earn-out mechanism (or vice versa). An effective earn-out structure can work alongside either a locked box mechanism or completion accounts. Combining a locked box mechanism with an earn-out will however require discussion of any potential interaction between the earn-out mechanism and provisions relating to leakage and the value accrual for the locked box period.

The choice whether or not to include an earn-out is typically linked to the specific purpose of the deal, be it integration, profit maximisation, supply chain optimisation, or any other deal goal. The choice between completion mechanisms is typically based on different factors, such as the quality of financial information, the requirement of parties for clarity on the working capital and net debt price-adjusters pre-deal, and the appetite for the preparation and review of completion accounts. The latter may have a bearing on whether an earn-out mechanism is feasible, as parties averse to completion accounts may have similar difficulties with earn-out accounts. Although this can be managed if properly planned, eg through basing the earn-out accounts and measurement basis on statutory accounts, so minimising the requirement for additional accounts preparation.



Tax considerations of earn-out structures

The comments below are not intended as a comprehensive or technical description of earn-out taxation, which is an extensive topic. The purpose of the discussion below is to highlight points of particular relevance to the SPA negotiations. Any tax comments relate to UK taxation as at the date of this report. It does not attempt to address any earn-out tax matters in other countries. All references to tax rates are generic and indicative, and assume that any seller entitled to an earn-out is an individual paying tax at the maximum prevailing rate.

Introduction

It is well known that earn-outs are sensitive from a tax perspective. The existence of an earn-out can result in deal discussions being more protracted as compared with a deal with no earn-out, in part due to tax issues and often due to requests for an earn-out designed to minimise adverse impacts for sellers. In particular, the adoption of non-standard earn-out terms can involve extra tax complexity and costs.

Earn-out consideration is potentially at risk of being treated as employment income in the hands of sellers. This results in an additional tax of up to 37%¹ of the consideration at current rates² plus Employers' NICs, as compared with the lowest capital gains rate. This is relevant only in the case of individuals who are present, past or future directors or employees, it is not relevant to corporate vendors or non-employee individual shareholders.

In terms of SPA negotiations this is key, as the employing company in the target group typically has the responsibility to account for the PAYE and Employer and Employee National Insurance.

Accordingly, buyers will be keen to ensure any earn-outs are appropriately structured to minimise the risk of tax liabilities being inherited by the target companies post-acquisition. At the same time, buyers will typically seek indemnity protection from the risk of earn-outs being treated as employment income, and so the onus of minimising the risk is often shifted back to the sellers³.

To the extent employment tax treatment does not apply, sellers will typically be subjected to Capital Gains Tax (CGT). The amount and timing of the CGT may be affected by the structure and horizons of the earn-out. Many of these points are led by the desire of sellers to pay CGT at Entrepreneurs Relief tax rates (10%) to the extent possible instead of the mainstream 20% rate of CGT.

Also, there is a stamp duty aspect to earn-outs and further, persons drafting and negotiating the SPA need to be alert to the interaction of the earn-out with the tax indemnities and warranties.

1. Being the difference between the 47% of additional rate income tax and Employee National Insurance rate, and the 10% Entrepreneurs' Relief rate of capital gains tax

2. Inclusive of Employees' National Insurance Contributions

3. There is a statutory restriction on the provision of an indemnity in respect of Employers' National Insurance contributions. Legal advisers will have their own view as to whether this applies to a particular SPA and earn-out structure. The parties may consider dealing with all the related tax costs instead through the price adjustment mechanism

4. Noting that recent changes in Budget 2018 with effect from 29 October 2018 make this relief more challenging to obtain in many situations.



Risks of earn-out being treated as employment income

The earn-out element of the consideration may be viewed as received by reason of employment and not as part of the consideration for the sale shares, and as a consequence is treated as employment income instead of a capital gain. HMRC take the view that earn-out consideration is received by reason of employment unless it can be shown that the earn-out is further consideration for the sale of shares, or the underlying business in the case of an asset sale. HMRC's official guidance provides indicators of when earn-out consideration represents consideration for sale. If taxed as employment income, whether the earn-out is received in the form of cash or shares, it may be taxed at 47% (current personal rate); plus there is also Employers' NICs, instead of CGT rates of 20% or potentially 10% where Entrepreneurs' Relief is available.

There is no clear rule as to when an earn-out will be taxed as employment income. None of the indicators set out by HMRC are determinative. Furthermore, the factors stated by HMRC themselves are somewhat subjective and require a level of judgement to apply. Some tax advisers have developed rules of thumb in this area, eg around conditions relating to the length of time the seller must remain an employee post sale, however a proper conclusion can be reached only on the basis of a holistic assessment of all the factors outlined by HMRC.

That said, where the earn-out is receivable on equal terms by a significant grouping of sellers, where some are non-employees (eg third party investors) and/or individuals who are employees but cease to be employees following the transaction, in many cases a significant degree of comfort can be taken from this that HMRC will not treat it as employment income for the employees among the group.

We do not summarise here all the factors set out by HMRC. The key question for parties in an SPA context is their respective stance in addressing the risk in the absence of a 'bright line' test.

One means of addressing the risk is for the sellers to apply to HMRC for a 'Non-Statutory Clearance'. However there are disadvantages. For HMRC to be bound to reply, there needs to be a "genuine point of uncertainty". In some cases this standard may not be reached and HMRC may refuse to clear. Also, there is no statutory deadline for HMRC to respond, however they do endeavour to respond within 28 days.

Our experience is that applying for clearance is not the only course of action and sometimes (for example where the parties do not wish to leave the position in HMRC's hands or the timetable is tight) reliance is instead placed on advice from recognised tax advisers. However given the unclear multi-factorial nature of the guidance it is unlikely that an adviser would give an unqualified view.

Where the risk of employment income treatment exists, a buyer will usually seek protection within the SPA in several ways:

- to outline a process for determining the status of the earn-out, including the requirement to seek a non-statutory clearance application;
- to provide a dispute resolution process in the event the buyer and seller do not agree;
- to establish which party will bear the cost of Employers' National Insurance and/or increased Apprenticeship Levy, and where this is borne by the seller to provide for an adjustment of the earn-out payment to enable effective recovery under any indemnity; or
- to establish which party will benefit from any corporation tax deduction that will accrue to the buyer as a result of the earn-out payment being taxable as employment income, and where possible under the SPA mechanics, provide for this in the price adjustment mechanism.

An alternative approach is to adopt an entirely different structure for delivery of the earn-out, which may involve a materially lower tax risk. In these circumstances the maximum sale consideration is provided upfront but subject to later downward adjustment if the returns due under any consideration securities diminish. This typically is only workable with the simplest financial structures, and needs to be carefully analysed for any knock-on implications.

5. In some circumstances, relief against UK corporation tax may be obtained as a result of the earn-out being taxed as employment income, such relief extending to the employee and employer National Insurance Contributions where borne by the employer

Gains taxation

This is relevant to the extent the earn-out is not otherwise taxed as employment income. CGT on earn-outs is an involved area and of reduced relevance to the SPA negotiations, having no impact on the earn-out target itself. As such, only a few high level points are made here.

The relevance to the SPA is mainly in the form of requests that the sellers may make for changes in the earn-out structure to accommodate their tax requirements.

There are various forms of deferred consideration, each of which has a specific CGT treatment. For a typical earn-out where the consideration is “unascertainable” at completion the applicable tax treatment is that the sellers would be required to value the deferred consideration entitlement and report this amount as taxable at the time of the sale, in their first tax return following the transaction. This tax is payable in this first tax return irrespective of the timing the deferred consideration is actually due.

Then, on actual receipt of the earn-out the individual will either be taxed on any additional receipt beyond that which was assumed in the initial tax filing or crystallise a capital loss.

Other earn-out styles may comprise a maximum amount that is “ascertainable” at the time of completion, eg a fixed sum payable dependent on a particular future event. In this instance CGT is payable upfront on the maximum amount of consideration.

Depending on the structure the seller may have to pay tax on proceeds that have yet to be received and may never be received (although there is a facility for adjusting the consideration, or carry back of losses in some cases). As such, sometimes sellers will want an earn-out structure that defers payments to horizons significantly in the future to reduce the upfront valuation. Against that others may wish for the maximum valuation to increase the element that may be entitled to the lower Entrepreneurs’ Relief rate of CGT – this is typically only available on the completion payments.

To address the issue of unfunded CGT charges in general, sellers will ask for the earn-out to be satisfied in the form of an entitlement to securities instead of cash. Some or all of the earn-out gain may then be “rolled over” into the securities and thus the gain deferred for CGT purposes. There are various alternatives as to how this is structured and potential tax elections for those who prefer early tax charges, but at a lower rate.

Stamp duty

In general, the earn-out should be assumed to form part of the consideration for the shares chargeable to stamp duty. However, the basis on which the 0.5% stamp duty charge is payable on the earn-out element of a share acquisition will depend upon the precise terms of the earn-out.

The financial structure of the earn-out including any caps on the payment and any wholly variable amounts may affect the extent of earn-out consideration which may be chargeable to stamp duty.

Earn-out arrangements: Accounting impact

A transaction will impact the buyer's statutory accounts, post-completion and in future periods, and so it is important to consider this as part of the pre-signing activities.

What are the applicable financial reporting frameworks?

Companies incorporated in the United Kingdom generally apply International Financial Reporting Standards (IFRS) or Financial Reporting Standards applicable in the UK and Republic of Ireland (UK GAAP). Similar accounting requirements apply to earn-out arrangements under both frameworks.

What is the relevant accounting position under the different reporting frameworks?

Earn-outs represent payment arrangements whereby the additional purchase consideration on acquisition is contingent on the future financial performance of the target company. Companies need to identify who is making the payment (the buyer) and who is receiving the payment (the seller).

If the transaction is between the buyer and seller only, the accounting is governed by IFRS 3 'Business Combinations' and Section 19 'Business Combinations and Goodwill' in FRS 102. The classification of such contingent consideration is then determined by reference to the requirements of IAS 32 'Financial Instruments' and Section 22 'Liabilities and Equity' in FRS 102.

Not all earn-out arrangements will be treated as contingent consideration. Different accounting standards can apply depending on the parties involved:

- If the structure involves the shareholders of the target entity, IFRS 2 'Share-based Payment' and Section 26 'Share-based Payments' in FRS 102 may apply.
- If the buyer is paying the employees of the target entity, IAS 19 'Employee Benefits' and Section 28 'Employee Benefits' in FRS 102 may apply.

How should the contingent consideration be classified?

In the accounts of the buyer, contingent consideration is classified as either a financial liability or equity.

The buyer needs to consider whether (a) a contractual obligation exists and (b) how the obligation will be settled (eg in cash, or in the buyer's own equity instruments).

What are the rules for initial and subsequent accounting measurement after classification and why does it matter?

IFRS and UK GAAP require the amount of contingent consideration to be initially recognised at fair value on the date of acquisition. Subsequent measurement depends on the classification:

- a financial liability should be re-measured at each reporting period to its fair value;
- an equity instrument is not re-measured following its initial recognition.



Our take-aways

Earn-outs are becoming an increasingly prominent component of transactions, for sound commercial and operational reasons.

The length of the earn-out and principles to be applied in each deal is of vital importance to both buyer and seller.

The need to have clear, unambiguous drafting in an SPA in respect of the earn-out is vital and is fundamental to a successful deal.

Earn-outs can be used in combination with either locked box or completion account mechanisms.

The appetite for an earn-out will be strengthened by the nature and purpose of the deal and the nature of the parties to the transaction.

In the event of an earn-out dispute, it is important that a suitable dispute resolution process has been indicated in the SPA, typically involving expert determination by an independent accountant.

About Grant Thornton's UK SPA advisory team

Our team combines pre-deal price adjustment mechanism specialists and post-dispute resolution specialists to help principals and advisers to reach an agreement that optimises the equity value and protects our client, whilst reducing the risk of disputes. Grant Thornton UK LLP offers our clients the specialised expertise, for both domestic and cross-border transactions across a full range of sectors.

The team brings insights and experience to support clients on the full range of issues that can arise during the deal process, from negotiating locked box or completion mechanisms and accounting warranties, to finalising completion accounts, earn-outs, negotiating disputes and undertaking expert determinations.

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