Structuring the Selling Employee/ Shareholder Transition Period Payments after a Closely Held Company Acquisition

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Corporate acquirers often acquire closely held target companies. In such acquisitions, it is common for the corporate acquirer to want to retain the services of the target company selling employee/shareholders. This discussion summarizes the many reasons why corporate acquirers would want to retain the selling employee/shareholders' services during some post-acquisition transition period. However, both the structuring and the characterization of such transition period payments have income tax consequences both (1) to the corporate acquirer and (2) to the selling employee/shareholders. This discussion explains those income tax consequences to both transaction participants.

Introduction

In the acquisition of a closely held services company, it is common for the company acquirer to request that any individual employee/shareholder sellers agree to continue to work for the acquired company during a specified transition period.

This type of employee/seller transition period employment is common in the acquisition of both:

1. professional services practices (such as accounting firms and medical practices) and
2. other services-related companies (such as construction companies and architectural and engineering firms).

The term of the post-transaction seller employment is typically a matter of negotiation between the company acquirer and the company sellers.

Post-transaction seller employment transition periods of one to two years are common. However, longer post-transaction seller employment transition periods are not uncommon.

In such services-related companies (and particularly in closely held companies), the employee/shareholder sellers often have direct contact with the company's clients or customers. For example, in the case of a construction company, the clients may have a direct and personal relationship with the individual company owner/contractor.

Although no longer a stockholder in the acquired company, that individual contractor may continue working for the construction company for a time period until all clients become comfortable with the new owner.

In addition, the illustrative construction company seller may have personal relationships with all of the company's construction industry specialty subcontractors.

Again, the selling shareholder may continue working for the acquired company for a time period in order to successfully transition all of the subcontractor relationships to the new owner.

Finally, the illustrative construction company seller may have personal relationships with all of the company's employees and tradespeople. The selling shareholder may continue working for the acquired company for a time period in order to ensure the smooth transition of these employee and tradespeople relationships to the new owner.

Of course, the employee/shareholder sellers would expect to be fairly compensated for their professional services during the transition period employment.

And, the acquirer company will want to fairly compensate the selling employee/shareholders in order to ensure an efficient ownership transition and a successful company acquisition.

Alternative Transition Period Payment Transaction Structures

The following two questions relate to such post-transaction transition period payments:

1. How much should the company buyer pay to the employee sellers for these transition period services?
2. How should these transition period payments be structured?

Of course, the answer to the first question is based on the unique facts and circumstances of each individual deal. The amount of such transition period payments is typically based on direct negotiations between the company acquirer and the selling employee/shareholders.

The amount of agreed-upon transition period payments will depend on the following:

1. The actual amount of services the sellers will provide to the buyer
2. The buyer's perception of the risk associated with transferring the acquired business operations
3. The sellers' opportunity cost (i.e., how much they could earn through alternative employment opportunities)

This buyer/seller negotiation should be conducted—and the transition period payment terms should be agreed to—before the company acquisition is closed.

The answer to the second question will have direct federal income tax consequences to both the company acquirer and to the employee/shareholder sellers. And, related to this transition period payment structuring issue, these two transaction parties (buyer versus sellers) have adverse income tax consequences to each other.

Therefore, the question of the structure of the employee/sellers transition period payments is the subject of this discussion.

Basically, the two alternative payment structures are as follows:

- The payments could be considered to be employee compensation for the transition period services provided by the former shareholders. This structure raises the question: what is a reasonable amount of employee compensation for the services rendered?
- The payments could be considered to be an earn-out provision that is part of the overall company (whether a stock deal or an asset deal) purchase price. This structure raises the question: what is the total amount of the deal purchase price that the acquirer paid for the target company business?

In addition to tax counsel and legal counsel, a valuation analyst is often involved in answering these two transaction structure questions.

This involvement is because the valuation analyst can assist in answering both questions:

1. What is the amount of reasonable compensation to pay to the selling shareholders?
2. What is the fair price to pay for the value of the acquired company?

Buyer Tax Considerations versus Seller Tax Considerations in Structuring the Transition Payments

The transaction structuring issue is whether the transition period payments to the company sellers represent either:

1. a contingent purchase price amount or
2. employment compensation for services provided by the sellers.

In certain circumstances, the total transition period payments could be considered to include components of both:

1. a contingent purchase price component and
2. employment compensation for services component.

There is an inherent conflict of economic interest between these two alternative transition period payment structures. This is because, from an income tax perspective, either transition period payment characterization will benefit only one party (i.e., the buyer or the sellers) to the acquisition transaction.

From the business sellers' perspective, if the employee/sellers are individuals and the transition period payment is characterized as compensation (including a payment for transition services and for any covenant not to compete), then the payment will be subject to federal income tax—at an income tax rate of up to 39.6 percent.

In addition, these transition period compensation payments will be subject to the employee portion of FICA and to a state income tax.

On the other hand, any transition period payment that is characterized as deferred purchase price (for either the company stock or the company assets) will generally be more attractive to the sellers for income tax purposes.

This is because transition period payments characterized as deferred franchise price will:

1. be subject to the lower capital gains tax rate and
2. not be subject to payroll tax withholding.

Therefore, the company sellers would generally prefer the capital gains tax treatment on any transition period payments.

From the business buyer's perspective, it may be advantageous to characterize the transition period payments as employee compensation for services. This is because the payment of employee compensation will usually generate a current income tax deduction for the acquired company.

Nonetheless, if characterized as employee compensation, the transition period payments may also be subject to the Internal Revenue Code Section 280G deduction limitation on golden parachute payments.

And, such transition period payments would have to comply with Section 409A (i.e., income inclusion for nonqualified retirement plans), requiring the consideration of any collateral provisions.

Factors to Consider in the Structuring of the Transition Payments

Several factors should be considered by the transaction participants when characterizing whether the transition period payments are contingent purchase price earn-out payments or employee compensation for services payments.

These factors include, but are not limited to, the following considerations:

- The transition services conditions. Generally, if the transition period payments are conditioned on the future services that are actually provided by the employee/sellers, then this factor may indicate that the payments should be characterized as employee compensation (consider, for example, the judicial decision in *Duberstein*, 363 U.S. 278 (1960)).
- The proportionality of the transition payments. The transaction parties should consider whether the transition period payments are proportional to the sellers' prior ownership of the company stock.

  That is, if there is proportionality—if all of the sellers receive the transition period payments based on the services provided but only some of the selling employee/shareholders—then this factor may indicate that the transition payments should be characterized as a return on capital and as a deferred purchase price.
- The negotiations between the transaction parties. The actual negotiations between the transaction parties play an important role in the characterization of the transition period payments.

  To the extent that the parties disagree on the purchase/sale price and the transition period payments are later proposed as a means of resolving that sale price disagreement, this factor may indicate that the transition period payments should be characterized as a deferred purchase price.
- Target company price valuation. If the amount of the transition period payments represent a component of the total reasonable value for the acquired company, this factor indicates that the transition period payments should be characterized as deferred purchase price.
- The amount of employee/seller reasonable compensation. If the individual selling shareholders are already being paid a reasonable level of employee compensation for their post-transaction services, then this reasonable compensation factor may indicate that any additional transition period payments should be characterized as deferred purchase price.

When the post-transaction services are tied to the transition period payments, then the payments may be considered as compensation for services under Regulations Section 1.61-2.

However, if one or more of the above-mentioned structuring factors are present, then the parties should consider whether:

1. there is any compensatory intent to the transition payments or
2. the transition payments represent one component of the intrinsic value of the acquired company stock or assets.

From an income tax perspective, some of the judicial and administrative guidance related to these transition period payment characterization questions includes the following:

- *Arrowsmith* (344 U.S. 6 (1952)). In the *Arrowsmith* judicial decision, two taxpayers liquidated a corporation that they had co-owned.

  The two taxpayers divided the corporate liquidation proceeds equally, reporting the profits from the distributions as capital gains. In a subsequent tax year, a judgment was rendered against the liquidated corporation.

  The two taxpayers paid the judgment, and they then reported the judgment payment as an ordinary business loss deduction.

  In this judicial decision, the court held that those judgment payments—and the resulting tax deduction—were capital in nature. The court reached this conclusion because the claim on which the judgment was rendered related to the original corporate liquidation.

  The court concluded that the basis of the taxation treatment related to the origin of the claim (i.e., the liquidation).

  Likewise, if the payment of a transition payment represents nothing more than the intrinsic value of the company stock (or assets) that the individual sellers owned before the transaction, then *Arrowsmith* suggests that the transition payments represent a payment for the acquired company shares (or assets).

- *Lane Processing Trust*, 25 F.3d 662 (8th Cir. 1994). In the *Lane Processing Trust* judicial decision, an employee-owned company sold all of its assets, Then, the company sale proceeds were distributed to the employee-owners.

  In this case, both the right to the distribution and the amount of the distribution were contingent upon the employee/shareholders being employed by the company at the time of the transaction, their job classification, their length of employment, and so forth.

  The court rejected the company's claim that the distribution payments were not employee compensation.

  Rather, the court held that the distribution payments were based on factors "traditionally used to determine employee compensation, specifically, the value of services performed by the employee, the length of the employee's employment, and the employee's prior wages."

  Therefore, the court concluded that the sale proceed payments were more closely aligned to employment services than to stock ownership.

- *R.J. Reynolds Tobacco Co.* (149 F.Supp. 889 (Ct. Cl. 1957)). In this case, an employer company claimed that payments made to certain owner-employees, under a profit distribution plan and proportionate to their shareholdings, were deductible compensation expense—rather than stock dividends.

  The court held that the payments were not compensation payments, but were instead on account of the employees' stock ownership.

  The court reached this conclusion for the following reasons:

  1. The payments were in proportion to each employee's stock ownership.
  2. The payments were in addition to each employee's existing reasonable compensation arrangements.
  3. In prior income tax, accounting, and litigation matters, the employer company had treated the payments as dividends rather than as compensation.

- Revenue Ruling 2007-49. In Revenue Ruling 2007-49, three sets of guidance were issued on the following situations:

  1. No "transfer" for Section 83 purposes had occurred when new services-based restrictions imposed on vested stock caused those same stock shares to become "unvested."

2. A transfer for Section 83 purposes did occur when an employee-shareholder exchanged substantially vested stock for unvested stock in a Section 368(a) reorganization.
3. A transfer for Section 83 purposes also occurred when an employee-shareholder exchanged substantially vested stock for unvested stock in a taxable stock acquisition transaction.

In situation (1), Revenue Ruling 2007-49 suggests that an employee shareholder can subject its existing stock to services-related conditions and retain capital gains tax treatment.

In situations (2) and (3), the employee shareholder will maintain basis in the property and can make a Section 83(b) election at the transfer in order to have any subsequent gain taxed at the capital gains tax rate.

While not directly on point with respect to the transition period payment issue, this ruling suggests that, at the very least:

1. the intrinsic value of the stock is capital in nature and
2. any increase in that stock value may (or may not) require a Section 83(b) election in order to subject any additional upside to capital gains tax treatment.

Summary and Conclusion

Closely held company acquirers often ask the selling employee/shareholders to continue to provide services to the company for a transition period after the company sale is completed.

These company acquirers want to ensure that there is an efficient transition of the sellers' relationships with customers/clients, suppliers and subcontractors, and employees.

The structuring (or the characterization) of these transition period payments can have a direct income tax consequence to both:

1. the company buyer and
2. the selling employee/shareholders.

Such transition period payments may be categorized as compensation expense for services provided by the selling shareholders. These payments would qualify as current period tax deductions for the acquired company, but they would represent ordinary income to the selling employee/shareholders.

Alternatively, these transition period payments may be categorized as contingent purchase price earn-out payments.

These payments would represent capital gains to the selling employee/shareholders, but they would only adjust the buyer's tax basis in the acquired company stock or assets.

> **"Such transition period payments . . . would qualify as current period tax deductions for the acquired company, but they would represent ordinary income to the selling employee/shareholders."**

In other words, the acquired company would not receive an income tax deduction for these payments.

This discussion summarized the transition period payment income tax considerations to both the company buyer and the company sellers. This discussion listed many of the factors that the transaction parties should consider when characterizing these payments.

And, this discussion presented some relevant judicial and administrative tax guidance with regard to the characterization of such payments as compensation expense versus a purchase price earn-out.

The transaction participants should consider this transition period payment characterization issue when negotiating and structuring the company sale transaction. Both transaction parties may consult their tax and legal advisers.

And, both transaction parties may consult a valuation analyst in order to assess:

1. the reasonableness of the post-transaction employee/sellers' compensation and
2. the reasonableness of the total amount of the transaction purchase price.

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