Earn-outs (Ireland)

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A Practice Note considering the use of earn-outs in share purchase transactions in Ireland, where all or part of the purchase price is calculated by reference to the future financial performance of the target company. It highlights some of the advantages and disadvantages of earn-out arrangements, the key issues to consider when structuring an earn-out, and the tax treatment of earn-out payments.

An earn-out is a mechanism commonly used on the sale and purchase of a company, which involves calculating at least part of the purchase price by reference to the post-completion performance of the target company.

Earn-out arrangements can vary widely, but under a typical structure, the buyer makes an initial payment on completion, followed by one or more deferred payments contingent on the target company's financial performance during an agreed period following completion. While this is essentially a straightforward concept, there are several difficult underlying issues which can give rise to complex and challenging negotiations between buyers and sellers.

This Note considers some of the advantages and disadvantages of earn-out arrangements, and provides guidance on the key drafting and negotiating issues that the buyer and seller should consider when structuring an earn-out, including:

- Agreeing and defining the relevant performance indicator against which the earn-out consideration is calculated.
- The timing and structure of the earn-out payments.
- The mechanics for measuring the target company's performance during the earn-out period and the process for resolving any disputes.
- The seller's continuing rights and obligations (if any) in relation to the management of the target company during the earn-out period, and whether there are any restrictions on the target company's activities during the earn-out period that could have a negative impact on the earn-out.

The Note also summarises the principal Irish tax issues the parties to a corporate transaction should take into account when they are considering adopting an earn-out structure.

In this Note, it is assumed that there is more than one seller unless otherwise stated. It is also assumed that the transaction is structured as the purchase of the entire issued share capital of a company (the target). For a general overview of other common approaches to calculating and paying the price in a corporate transaction, see *Practice note, Structuring the Purchase Price: Acquisitions (Ireland)*.

In this note some UK resources are referred to as they are very useful in an Irish content. For more on the relationship between Irish and English law see, *Practice note, The relationship between Irish and English law*.

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For more detailed information on the common accounts-related issues and concerns when drafting and negotiating an earn-out arrangement, see *Practice Note, Price adjustment mechanisms in corporate acquisitions: accounting issues* (UK). This note is also relevant in an Irish content where accounting standards are similar.

What is an Earn-out?

An *earn-out* is a general expression covering any mechanism where, on the sale and purchase of a company's shares, the purchase price is wholly or (more usually) partially determined by reference to, or is contingent on, the post-completion performance of the target company.

The standard earn-out is calculated by reference to the target company's profits over, for example, the two or three financial periods after completion. It is also possible, but perhaps less typical, to link the earn-out to other financial or operational benchmarks, such as turnover, net assets, or number of products sold or new customers gained during the agreed earn-out period (for further information, see *Benchmarks for Calculating the Earn-out*).

The basis for calculating earn-out consideration can vary widely from transaction to transaction. In some instances, it is a specified percentage of profits or other revenue or earnings generated by the target company during the earn-out period. It is also common to structure an earn-out as one or more contingent payments that are payable only if certain performance targets are met. On this approach, if the earn-out targets are not achieved, the buyer is not obliged to make the earn-out payments (although in some cases, it pays a lower amount).

Reasons to Use an Earn-out

Earn-out arrangements are most commonly used when:

- The buyer and seller cannot agree on the value of the target company. The parties may have different views on the target company's value because the seller may be more optimistic about the target company's prospects than the buyer. For example, this might happen where the target company:
    - has little operating history but significant growth potential;
    - has a new product or technology that may increase its profitability or value;
    - has experienced a fall in earnings that may be temporary; or
    - is operating in a volatile economy or industry that can adversely affect the target company's profitability or cause its value to fluctuate widely.
- The buyer has limited access to funds. This can be an issue when debt financing is not readily available. In that case, the buyer may have to structure its deal with deferred payments of at least part of the purchase price to avoid relying on third-party financing.

Even though using an earn-out can help progress a deal in the situations mentioned above, it also creates the potential for disputes and may not be appropriate in all circumstances. For example, an earn-out is difficult to structure and measure if the buyer intends to integrate the target company with its other businesses immediately after completion. The parties must carefully consider the relative advantages and disadvantages of an earn-out before incorporating one into their transaction.

Benefits of an Earn-out

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An earn-out can have advantages for both the buyer and the sellers.

From the sellers' perspective, an earn-out may:

- Provide a mechanism whereby the sellers can reap the full benefit of selling a profitable business. Without an earn-out, the buyer's doubts concerning the actual profitability or value of the target company may discount the price it is prepared to pay.
- Give the sellers an opportunity to benefit from the synergistic advantages of being part of a larger corporate group. The synergies may unlock value that would not have been realised otherwise, causing the target company to perform better than it would have on its own and enable the sellers to achieve the earn-out targets and secure a greater pay out. However, this can be an issue for the buyer, as it may be unwilling to pay an increased earn-out if the post-acquisition performance of the business is solely underpinned by post-completion synergies (for more on this issue, see *Synergistic Benefits*).

From the buyer's perspective, an earn-out can:

- Ensure a more accurate valuation of the target company and protect the buyer from overpaying. An earn-out structure values the target based on actual future performance, rather than basing the purchase price on past performance or predictions of future performance. This can remove a significant element of uncertainty for the buyer.
- Deliver cash flow benefits by deferring payment of at least part of the purchase price for a period after completion. Deferring part of the purchase price can also reduce the buyer's dependence on third-party financing because less capital is required upfront and, in some instances, the buyer may be able to use the target company's earnings during the earn-out period to fund the earn-out payments. This can be particularly helpful for private equity buyers when credit markets are tight and the availability of debt financing is limited.
- Apportion risk by ensuring that the potential risks and rewards of the target company's future performance are shared by the buyer and the sellers.
- If some or all of the sellers are key to the target company's success, motivate those sellers to stay on and maximise the profitability and performance of the business following completion (see *Continued Involvement of Sellers*).

Disadvantages of an Earn-out

Despite the potential advantages, an earn-out structure is not without potential drawbacks. For example:

- Earn-outs prevent the parties from achieving a "clean break" on completion. Adopting an earn-out structure means that the sellers retain a significant interest and, in many cases, a day-to-day involvement in the target business going forward. The buyer is usually significantly constrained as to what it can and cannot do with the target business during the earn-out period (see further *Post-Completion Operation of the Target Company*).
- While generally, the parties' interests are aligned in maximising the target company's profitability and performance during the earn-out period, earn-outs often lead to post-completion disputes between the buyer and the sellers. Most disputes arise when the earn-out involves financial targets and the parties disagree on how to measure the target company's performance against those targets.

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- Factors unrelated to the target company's performance or intrinsic value can cause fluctuations in profitability in the post-completion period, and it can be difficult to exclude these fluctuations from the earn-out calculation. This may work to the advantage or disadvantage of either party, depending on the circumstances. For example:
  - the buyer may make other acquisitions or changes to its business plan after completion, which improves the target company's profitability and causes it to achieve an earn-out target it may not otherwise have achieved; or
  - a general downturn in the economy might cause the target company to be less profitable and fail to achieve an earn-out target it would have achieved in a better economic climate.
- Negotiating and drafting earn-out provisions can prove difficult and time consuming. The process often requires complex accounting and financial statement analysis, which relies heavily on the involvement of the parties' accountants and financial officers. These factors can have a negative impact on the transaction timetable and often lead to increased transactions costs.
- Earn-outs require post-completion monitoring and measuring of the target company's performance. The time spent on this can be an unwelcome and costly distraction for the buyer and the target company's management.
- Earn-outs can encourage short-termism and damage the target company's prospects in the long term. If the sellers are managing the target company during the earn-out period, they may attempt to manage the business solely to achieve the earn-out targets (such as maximising the short-term profits by cutting costs). Although this would increase the target company's profits during the earn-out period, the approach may have an adverse effect on its long-term performance.
- An earn-out may be inefficient for tax purposes if the seller is a company and the disposal falls within the participation exemption under section *626B TCA* (PE). This is because the PE only exempts from corporation tax any gains arising on the disposal of **shares or certain assets related to shares**. Consideration received in connection with an earn-out is taxed in respect of the disposal of a *chose in action* (which is neither a share nor an asset related to shares) where the earn-out is unascertainable. Any gain arising on the disposal of such a right is therefore subject to corporation tax on capital gains. While earn-outs are more usually found when sellers are individuals, the availability PE may mean that corporate shareholders are unlikely to accept an earn-out arrangement where the earn-out is unascertainable if they can benefit from the PE. They may alternatively seek to crystallise the full gain on the disposal of the shares to avoid any negative implications arising from the earn-out. .
- If the sellers are individuals who potentially qualify for revised entrepreneurs' relief in respect of the disposal of their shares, that relief is unlikely to be available on disposal of the earn-out right where the earn-out is unascertainable at the date of the disposal of the shares. Additionally, care is required as a claim for relief at the earlier date on which the target shares are exchanged for the earn-out right is likely to mean that capital gains tax (CGT) is payable before the proceeds of the earn-out right are received.
- There can be adverse tax consequences for individual sellers if the earn-out payments are re-characterised by the *Revenue Commissioners* as some sort of bonus payment relating to employment, rather than consideration for the shares (see *Income Tax*).

The parties can reduce or eliminate some of the potential disadvantages of an earn-out by carefully considering the various issues and problems that may arise and drafting the share purchase agreement (SPA) to address them. However, in some instances, the disadvantages may make it impractical or inadvisable to use an earn-out.

Alternatives to an Earn-out

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Given the potential drawbacks of an earn-out structure, it is worth briefly mentioning other ways of linking consideration for a share purchase to performance. Possible alternatives include:

- The sellers continuing as employees of the target and receiving bonuses calculated by reference to the target company's post-completion performance. However, bonus arrangements of this type can give rise to as much contentious debate as a full-blown earn-out. Additionally, they are likely to be tax inefficient on the basis that they result in:
  - the target having to account for income tax and Universal Social Charge (USC) and Pay Related Social Insurance (PRSI) on the bonus payments; and
  - the employee receiving an income payment rather than a capital payment and therefore being taxed less favourably.
- Buying only part of the target company's share capital and linking the buyer's acquisition of the remainder (and the applicable price) to performance via a *put option* or a *call option*. However, a structure of this type further complicates negotiations because (subject to the size of the retained holding) the sellers will want to be in a position to fetter the operations of the target company far more than if the buyer was acquiring 100% of the target.

Structuring and Negotiating an Earn-out

The terms governing an earn-out arrangement are usually set out in a separate schedule to the SPA for the transaction (for example, see *Standard Clause, Earn-out: share purchases: Schedule 1 (Earn-out Payments)*(UK).

While the parties must always tailor the earn-out provisions in an SPA to reflect the circumstances of the transaction and the parties' expectations, they should address the following common issues in all earn-out scenarios:

- Determining and defining the relevant performance indicator against which the earn-out is measured and calculated.
- The length of the earn-out period.
- The timing and structure of the earn-out payments.
- The mechanics for measuring the target company's performance during the earn-out period and the process for resolving any disputes.
- The sellers' continuing rights and obligations (if any) in relation to the management of the target company during the earn-out period.
- Whether there are any restrictions on the target company's activities during the earn-out period that could have a negative impact on the earn-out.

For a Checklist of the key corporate and commercial matters to consider when drafting and negotiating earn-out provisions in an SPA, see *Checklist, Drafting an earn-out: share purchases* (UK). This Checklist also works from an Irish perspective save that in the dispute resolution procedure an Irish chartered accountant should be used.

Benchmarks for Calculating the Earn-out

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The parties can base the earn-out on a variety of financial or operational metrics or targets. Most earn-outs involve financial metrics, such as the target company's pre- or post-tax profits, *EBITDA*, revenue, or earnings per share during the earn-out period.

When making a choice between the different types of financial metric, the parties often have different preferences. The sellers generally prefer revenue-based metrics because they are less affected by costs and expenses and there is less scope for the buyer to manipulate the results. However, the buyer often resists revenue-based metrics, especially if the sellers continue to operate the target company following completion, because they do not motivate the sellers to control costs and expenses. Most buyers believe net income (which factors in costs and expenses) is a better indicator of the target company's performance.

Despite their prevalence, in some transactions, it may not make sense to use financial metrics to underpin the earn-out. For example, it may be difficult to use a financial metric for new or developing businesses, or target companies with new technologies, where there is a lack of historical information on which to base the earn-out targets.

In these circumstances, it may be preferable to identify operational targets, such as a minimum number of product sales or new customers. Operational targets can also have the added advantages of placing the focus on improving the operational effectiveness of the target company and being harder to manipulate by altering accounting practices.

Whatever performance benchmark the parties decide to apply, they should ensure that the earn-out metrics or targets are:

- Clearly defined.
- Objective and easy to measure.
- Compatible with the nature of the target company's operations.

The parties must also try to identify and account for the various contingencies that may affect the target company's ability to achieve the earn-out targets. They can address these contingencies by including or excluding them (or their effects) from the calculations of the target company's performance (see *Defining Financial Targets*).

Additionally, if the buyer is relying on the sellers to run the target company during the earn-out period (see *Continued Involvement of Sellers*), it should ensure the earn-out targets are set at realistically achievable levels, because the sellers may not be motivated if they believe the targets are unattainable.

Defining Financial Targets

When an earn-out arrangement is based on a financial metric or target, the earn-out provisions in the SPA must:

- Be as clear as possible in defining the relevant financial metric that drives the earn-out.
- Set out how the parties will assess the target company's performance against that metric.

This can often involve complex accounting issues, and it is usually necessary for the parties to ensure their accounting advisers are closely involved in this aspect of the earn-out provisions (see further general guidance, see *Practice Note, Price adjustment mechanisms in corporate acquisitions: accounting issues: Defining the relevant financial components*). This note is also relevant in an Irish content where accounting standards are similar.

Definition of Profit

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In relation to a profit-based earn-out, the definition of profit, and clear provisions on how the profit figure is calculated, are critical. The normal starting point is to employ the accounting practices and principles used in preparing the target company's audited accounts for the accounting period immediately before completion.

However, the parties will inevitably discuss specific further adjustments which should be made. Some of the adjustments may be necessary to reflect the specifically agreed treatment of a particular item, for example, bad debt provisions. Further adjustment may also be necessary to give effect to various seller protection clauses (see *Post-Completion Operation of the Target Company*). The SPA must also state whether the profit is net or gross.

For more detailed information on defining profit in the context of an earn-out, see generally *Practice Note, Price adjustment mechanisms in corporate acquisitions: accounting issues: Defining "profit"*(UK). This note is also relevant in an Irish content where accounting standards are similar.

Treatment of Extraordinary Items

The parties usually agree in an earn-out to exclude gains or losses outside the target company's normal profits, for example, if they:

- Are one-off items.
- Are not part of the core business of the company.
- Arise from changes in values outside the target's control.

However, the parties may need to reach specific agreement regarding the treatment of any extraordinary items that the parties know about, such as relocation or redundancy costs arising from the transaction. They may also need to agree regarding any windfall profits the target company may make in the future.

For more detailed information on this issue, see *Practice Note, Price adjustment mechanisms in corporate acquisitions: accounting issues: Treatment of extraordinary, unusual or exceptional items* (UK). This note is also relevant in an Irish content where accounting standards are similar.

Synergistic Benefits

A difficult area in earn-out negotiations is determining the treatment of synergistic benefits which the target may derive because of the acquisition, such as:

- Reduced headcount.
- Lower property costs.
- The benefit of the greater purchasing power of a larger group, resulting in lower costs for certain items, such as insurance.
- Cheaper borrowing.
- Generally being able to drive preferential terms with suppliers and customers.

The starting point for a buyer is usually that these benefits should be excluded in determining the profit figure for the purposes of the earn-out, as it will want to avoid paying an increased earn-out where the target's performance is solely underpinned by post-completion synergies. However, in practice, it may be difficult to quantify these benefits precisely.

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The sellers are generally reluctant to allow any upfront costs required to achieve anticipated synergies (such as relocation or redundancy payments) to prejudice their ability to achieve the earn-out).

For further information on this issue, see *Practice Note, Price adjustment mechanisms in corporate acquisitions: accounting issues: Synergistic benefits* (UK). This note is also relevant in an Irish content where accounting standards are similar.

Group Resources

When the target company is joining a larger corporate group, in some situations, the buyer may want to utilise the target's workforce or other resources to support and develop the business of the wider group. The sellers may be concerned if the target's resources are used by the buyer's group to such an extent that they can no longer support the acquired business properly, or if their use results in higher expenditure within the business, as this could decrease any earn-out payments.

Depending on the circumstances, the buyer may be willing to agree that if it uses the resources of the acquired business in this way, the acquired business is paid (or credited) for the services provided on an arm's length basis.

Sale of All or Part of the Target

The buyer may well decide, at some point after completion, that it makes commercial sense to sell all or part of the target group. If that sale is to take place during the earn-out period, this obviously raises an issue in relation to the calculation of the earn-out. A buyer usually has to accept that, by agreeing to an earn-out, it is restricted in a number of ways in what it can and cannot do in relation to the acquired business (see *Post-Completion Operation of the Target Company*). However, a buyer is unlikely to accept a blanket veto on a subsequent sale of all or part of the business without the sellers' consent. Indeed, to agree to that right of veto raises problematic issues regarding directors' duties and corporate governance, particularly if the buyer is a quoted company.

As the buyer will rarely accept a veto on a subsequent sale, instead, the debate usually centres on the effect on the earn-out if that sale takes place. There are many ways of resolving this issue, ranging from:

- A provision giving the sellers a right of first refusal on any subsequent proposed sale.
- Agreeing specific earn-out payments which are triggered by the consideration for the sale (normally calculated by reference to a formula).
- Providing to accelerate the earn-out payments if all or a substantial part of the target business is sold during the earn-out period.

Post-Completion Acquisitions

A related issue is the impact on the earn-out of acquisitions made by the target after completion. The buyer will often properly seek to maintain their freedom to make acquisitions after completion if they believe it is in their commercial interests to do so. In terms of the effect on the earn-out, this is an issue if the target, or an existing subsidiary of the target, either buys the business and assets of a third party or acquires a new subsidiary during the earn-out period (the earn-out being calculated by reference to the target group).

The simplest way of dealing with acquisitions of this nature is to provide that they are ignored completely for the purposes of calculating the earn-out, although that approach may give rise to practical difficulties, particularly in the case of an asset purchase.

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Where an acquisition gives rise to significant costs for the target (such as professional fees or costs of integrating the new company), the parties also need to consider these costs in the context of the earn-out. If the buyer is contemplating a specific post-completion acquisition, it may be advisable to agree the effect on the earn-out upfront.

Earn-out Period

Earn-outs typically last between one and three years but they can be longer or shorter depending on the circumstances. A variety of factors can influence whether the parties opt for a shorter or longer earn-out period, such as:

- The type of performance metric underpinning the earn-out calculation.
- The business plan used to model the earn-out.
- Whether the earn-out is contingent on the target company meeting specific targets.
- How long the sellers need to be involved in the target company's business following completion.

The sellers often prefer a shorter earn-out period which ensures they receive their earn-out payments sooner, therefore minimising the amount of time they are exposed to the buyer's credit risk and to other economic or general market risks. However, in cases where the sellers stay on to manage the target company's business after completion, and payment of the earn-out is contingent on the company meeting certain financial targets, the sellers may prefer a longer earn-out period which gives them more time to achieve the relevant targets.

The buyer generally prefers shorter earn-out periods, especially if their ability to operate the target company is subject to contractual restrictions and undertakings during the earn-out. However, if the buyer is subject to no (or minimal) post-completion restrictions, it may prefer a longer earn-out period because, for example:

- It may reduce the risk of non-recurring, exceptional, or short-term factors distorting the earn-out payments.
- It can assist cash flow by allowing the buyer more time to make (and raise funding for) the earn-out payments.
- In cases where the sellers stay on to manage the target company or its business, a longer earn-out period may reduce the risk of the sellers taking actions in the short term to achieve the earn-out at the expense of the long-term success of the business.

Earn-out Payments

Number of Earn-out Payments

If the earn-out period is particularly short (for example, 12 months or less), there is usually just one earn-out payment at the end of the earn-out period. Earn-outs that span several financial years typically involve multiple earn-out payments which are made at agreed intervals during the earn-out period.

Amount of the Earn-out Payments

The parties can take a variety of different approaches to determining the amount of each earn-out payment, including:

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- Specifying fixed earn-out payments that are payable only if specified targets are achieved. If there are multiple earn-out payments, the amount payable can be increased, decreased, or remain constant throughout the earn-out period.
- Providing for variable earn-out payments that are:
  - calculated by applying a specified multiple or percentage to the amount by which the relevant performance targets are exceeded;
  - a specified percentage of the earn-out target (for example, a percentage of the target's profit or EBITDA in a given period); or
  - calculated in accordance with another agreed formula.

If the earn-out payments are calculated in accordance with a formula, the buyer may want to cap the amount payable, while the sellers may try to negotiate a minimum payment under the earn-out. However, agreeing a maximum or minimum earn-out payment could have stamp duty implications under the contingency principle. For more information on this issue, see *Taxation of the Buyer*.

If there are multiple earn-out payments that are contingent on meeting certain targets, the parties must determine what happens if the target company fails to achieve the earn-out target in one period but makes up for it in a subsequent period. For example, whether the sellers either:

- Lose the earn-out payment for the period in which they fail to achieve the target.
- Make up the deficiency in the following period.

The buyer should also consider its entitlements in the inverse situation, where the target company achieves the earn-out target in an earlier period but fails to achieve it in later periods. In this scenario, should the buyer be entitled to claw back some of the earn-out payments it has already made? This can be a particular issue where the earn-out payments are front-loaded.

Cash or Non-Cash Consideration?

Earn-out payments are usually made in cash, but they can also be satisfied (in whole or in part) by issuing shares or loan notes in the buyer to the sellers.

For further information on using non-cash consideration in a corporate transaction, see *Practice Note, Structuring the Purchase Price: Acquisitions (Ireland): Non-Cash Consideration*.

Security for Earn-out Payments

The sellers must consider the question of security for the buyer's obligations to make the earn-out payments. In the absence of any security, all the sellers have is an unsecured contractual obligation, which they must enforce through the courts if necessary. This is a particular concern if the buyer is based overseas or its financial covenant is in any way questionable. The various types of security to consider include:

- **Cash escrow.** The sellers may require the buyer to deposit cash in an escrow account to ensure funds are available if the earn-out targets are met. While it is unlikely that the buyer will be prepared to put the maximum amount of the earn-out in escrow, it may be possible to secure at least part of the potential payment obligation in this way.

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- **Bank guarantee.** This buyer is likely to find this option extremely unattractive on the basis that any bank guarantees given for a lengthy period are expensive and may need to be cash backed.
- **Charge over assets.** The sellers may require the buyer to grant a security interest over their assets (or, subject to possible financial assistance issues, the target company) to secure the buyer's obligations. For further information, see *Practice note, Structuring the Purchase Price: Acquisitions (Ireland): Security over Assets*
- **Parent guarantee.** If the buyer is a subsidiary of a larger company, the sellers may require their parent to guarantee the buyer's obligation to make the earn-out payments. This is particularly important if the buyer is a shell company created specifically for the acquisition.
- **Charge over all or some of the shares being sold.** The buyer may offer a charge over the shares in the target company.

A related point is that the sellers may seek to make specific provision to cover a change of control of the buyer. The buyer will usually resist this on the basis that a takeover should make no difference to its ability to comply with its obligations under the earn-out. If the buyer is a public company, it may also be concerned that the provisions are a *poison pill* or (if a bid is imminent) constitute "frustrating action" contrary to the rules of the *Irish Takeover Rules*).

Mechanics of Earn-out and Dispute Resolution

The parties must agree and document in the SPA the mechanics for calculating the earn-out consideration and the procedure for resolving any disputes.

Earn-out Accounts

If the earn-out is based on a financial metric or target, it needs to rely on accounts of some form. In a classic earn-out calculated by reference to the target's profits over, for example, the two or three financial periods following completion, it is common practice to use the target group's audited accounts for this purpose.

However, in some situations the parties may "need to draw up special purpose accounts for the sole purpose of operating the earn-out. For instance, this may be necessary where the measurement periods during the earn-out period do not coincide with the target company's financial year, or the parties have agreed to apply specific accounting standards or policies when calculating the earn-out, which may differ from those used in the target's annual accounts.

For further information on the choice of accounts underpinning an earn-out arrangement, see generally *Practice Note, Price adjustment mechanisms in corporate acquisitions: accounting issues: Accounts used in an earn-out* (UK). This note is also relevant in an Irish content where accounting standards are similar.

The parties must also consider, and the SPA must specify, the accounting framework and policies that should be applied when drawing up the earn-out accounts. This is particularly important if special purpose accounts need to be prepared for calculating the earn-out, as there are no overarching rules that govern the preparation of these accounts.

Even if the target company's annual accounts underpin the earn-out calculation, the accounting framework and policies used to draw up the accounts are still an important issue for the parties to consider, as a change in accounting approach during the earn-out period could impact the amount the buyer is required to pay under the earn-out. For more detailed information on this issue, see *Practice Note, Price adjustment mechanisms in corporate acquisitions: accounting issues: Particular issues for earn-out accounts: basis of preparation* (UK). This note is also relevant in an Irish content where accounting standards are similar.

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Process for Determining the Earn-out

The process for agreeing the amount of the earn-out varies depending on whether the earn-out calculation is based on the target company's annual accounts, or whether special purpose accounts are prepared. If special purpose accounts are required, the SPA must set out the procedure, timing, and responsibility for drawing up those accounts.

If the earn-out calculation is based on the target company's audited annual accounts, it is common to agree that once the accounts are finalised, the buyer's auditors prepare a draft certificate stating what the earn-out payment is for a particular period based on those accounts. The buyer often accepts a contractual obligation to procure that the draft earn-out certificate is sent to the sellers within a specified number of days after the end of the relevant accounting period.

The party preparing the draft certificate must ensure that it complies with the substantive requirements of the SPA. A failure to do so could be fatal to the validity of the certificate and may mean the preparing party is in breach of its obligation to prepare and serve the certificate by the date specified in the SPA. For example, in the English (persuasive in an Irish context) case of *Treatt plc v Barratt and others [2015] EWCA Civ 116*, the English Court of Appeal found that the buyer's notice of its calculation of the earn-out consideration was invalid in circumstances where the SPA provided for the consideration to be calculated based on the audited accounts, but it was apparent from the buyer's notice that it had based its calculation (at least in part) on management accounts. For further information on this decision, see *Legal Update, SPA: validity of earn-out notice (Court of Appeal)*.

Once the buyer (or its auditor) has prepared and served a draft certificate setting out its calculation of the earn-out, the sellers and their advisers are usually given the opportunity to comment on the draft. It is also common to provide that a failure to comment within a specified period constitutes deemed acceptance by the sellers of the calculation set out in the draft certificate. The sellers would normally expect rights of access to all relevant information and also may seek sight of the auditors' working papers. Auditors are likely to require indemnities before granting that access.

If the parties fail to agree the amount of the earn-out, most SPAs provide for the dispute to be referred for expert determination by an independent accountant selected by the parties (or, in the absence of agreement, nominated by a specified appointing authority, such as the President of the Institute of Chartered Accountants in Ireland). Where this type of dispute resolution procedure is adopted, the SPA should also address:

- The scope of the independent accountant's remit.
- The procedure the independent accountant must follow in making their determination (for example, whether the parties have the right to make submissions) and the timeframe for delivering it.
- The status of the independent accountant's determination and any basis on which the parties can challenge it.
- The allocation of the independent accountant's fees between the parties.

For more detailed information on the key considerations when structuring an expert determination procedure, see generally *Practice Note, Expert determination*(UK). This note is also very relevant in an Irish context as similar principles apply.

Post-Completion Operation of the Target Company

As the sellers' right to receive any earn-out payments depends on the target company's performance after completion, they are vulnerable to any post-completion actions the buyer may take that could have an adverse effect on the earn-out. To address this issue, the sellers usually seek to negotiate contractual protections for the duration of the earn-out period which:

- Oblige the buyer to carry on the target company's business in the ordinary course and prevent it from making any material changes to the business.

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- Require the buyer to provide a specified level of support to the target company during the earn-out period to facilitate the achievement of the earn-out targets, or to otherwise maximise the amount of the earn-out payments.

If the sellers are not employees of the business following completion, the contractual protections they negotiate regarding the buyer's conduct of the business during the earn-out period is of particular importance to them. However, the buyer usually wants to limit the scope of its contractual or other obligations to the sellers during the earn-out period and reserve the right to take whatever steps it considers necessary to protect its investment. The tension between the parties' opposing positions on this issue can make this aspect of an earn-out arrangement one of the most difficult to structure and negotiate.

Types of contractual protections that sellers commonly seek include:

- Undertakings from the buyer to carry on the business of the target company in the ordinary course, not to make any material changes to the business without the sellers' consent, and to ensure the business is conducted on arm's length commercial terms.
- A general undertaking that the buyer will not do anything with the intention of reducing or distorting the amount of the earn-out. A broad undertaking of this type is usually important to the sellers, as it is very difficult to foresee every type of action that the buyer could take with a view to manipulating the earn-out and to cater for each scenario through a specific restriction. As a matter of principle, the buyer is likely to find it difficult to object to a provision aimed at policing deliberate anti-avoidance of the earn-out consideration.
- An undertaking not to divert business that would ordinarily have gone through the target company to another company in the buyer's group. Again, this is difficult for a buyer to resist. However, there may be tricky areas of interpretation where:
  - there is a crossover between the target's business and that of other parts of the buyer's group; or
  - opportunities to develop new business arise after completion.

  The sellers also often seek an obligation on the buyer to procure that no buyer group company competes with the target during the earn-out period.
- Restrictions on management fees and other intra-group charges and interest payments on intra-group borrowings. This is clearly an area where a buyer could manipulate the profits of the target business without diverting cash out of the buyer's group. The parties must discuss each transaction regarding what sort of charges and interest payments are reasonable in the particular circumstances.
- An undertaking to use all reasonable endeavours to maximise the target company's profits and make available sufficient resources (on an agreed basis) to ensure that the target can operate effectively.
- An undertaking to maintain the target company as a separate business unit.
- A restriction on the target company's capital expenditure during the earn-out period. The sellers do not usually want the business to incur significant capex or research and development (R&D) costs if the full benefit of the expenditure is only felt towards the end of, or even after, the earn-out period. However, the buyer may be reluctant to accept restrictions on the business's R&D budget or capex because it may undermine its long-term growth. While there are no easy answers to this tension, a possible solution is to agree that any capex or R&D expenditure made during the earn-out period above an agreed level is added back into the calculation of profits for the purposes of the earn-out.

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Additionally, the sellers often seek to broaden the scope of the buyer's post-completion undertakings to include the type of protection normally required by investees in a business, such as private equity investors or minority shareholders. For example, the sellers may insist on veto rights for major decisions affecting the target company, such as:

- Changing the target's constitution.
- Winding up the target.
- Changing the target's accounting reference date or materially altering accounting practices or policies.
- Incurring debt.
- Paying dividends or making any other distributions.
- Hiring and firing key employees.

These issues go to the heart of the debate about the extent of the sellers' ability to restrict the buyer's freedom to operate the target business and are usually resisted strongly by a buyer. In some instances, it may assist to agree a detailed operating strategy or business plan for the earn-out period upfront.

Where the sellers are individuals, the debate surrounding the extent of their influence or control over the post-completion operation of the target company's business is also heavily influenced by whether they will manage the target company following completion. If the sellers will continue to be employed in senior management positions, and they are satisfied that the buyer will give them a reasonable degree of autonomy in continuing to run the target, they may be less concerned with negotiating a long list of restrictions on what the buyer can and cannot do, and more interested in ensuring that their employment continues throughout the earn-out period and addressing the effect on the earn-out if they are removed (see *Continued Involvement of Sellers*).

If the sellers continue to have effective operational control of the target company's business during the earn-out period, the buyer may also seek "reverse" protections to ensure that it can prevent the sellers from acting in a short-term or opportunistic manner with a view to maximising the earn-out at the expense of the long-term prospects of the business.

Continued Involvement of Sellers

Where the sellers are and continue to be employees of the target company, an earn-out can assist in retaining and motivating them to maximise the target's success following completion. Securing the sellers' post-completion involvement in the business can be a particularly important consideration in a "people" business, where a significant part of the target company's value is linked to its employees' skills.

As a result, it is very common for some or all of the sellers to continue as employees of the target company during (and often after) the earn-out period. These arrangements, however, give rise to further issues to negotiate between the buyer and the sellers.

From the buyer's perspective, its main interest is usually to ensure that seller employees:

- Are tied in for a sufficient period.
- Have an agreed benefits package.
- Are restricted from competing for a period after ceasing to be an employee of the target.

It is common for the parties to negotiate new employment agreements which are then put in place at completion. However, post-termination covenants are often more effectively addressed through the SPA, as the courts are more likely to uphold those

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covenants (for further information, see generally *Practice Note, Restraint of trade in commercial and corporate contracts*) (UK)(similar common law principles are applied in Ireland).

Ensuring that a seller-employee stays with the business throughout the earn-out period can be a difficult issue for the buyer. While the buyer can address this to some extent by the length of the notice period in the seller's employment contract, this is a double-edged sword for an employer (unless the employer can give shorter notice than the employee, which the employee is unlikely to accept). In any event, the practical reality is that an employee who has decided to leave will not perform effectively. A buyer often addresses this issue by linking earn-out payments to the continued involvement of the sellers and, in particular, by defining circumstances where departure results in a reduced earn-out (that is, where a seller is a *bad leaver*). The parties are then likely to debate what constitutes a bad leaver.

The following bad leaver scenarios are normally considered non-contentious:

- Dismissal for dishonesty.
- Dismissal for material breach.

However, there are obviously a number of other circumstances in which employees can leave, such as:

- Death.
- Incapacity.
- Alleged constructive dismissal.
- Redundancy.
- Perhaps most commonly, the employer ending the employment relationship by notice (that is, the employee is not guilty of serious misconduct or any other behaviour justifying summary dismissal, but for commercial reasons, the employer wants the individual to leave).

The parties should consider all the circumstances in which the sellers could leave their employment with the target company and agree how each one impacts the earn-out.

The parties must also carefully consider from a tax perspective any linkage between the earn-out payments and the sellers' continued employment in the target business, as the parties usually want to avoid the earn-out payment being treated as employment income. For further information on this issue, see *Income Tax*.

A seller who is a *good leaver* during the earn-out period may seek the right to an acceleration of the earn-out or something similar. The buyer is likely to resist this. The debate on this issue is further complicated if there are multiple sellers.

Interrelationship with Claims Under the Sale Documentation

The buyer is likely to seek an express right to set off any claims it may have against the sellers under the SPA against any payments that fall due under the earn-out. These claims might arise under:

- The sellers' warranties.
- The tax covenant.

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- Any specific indemnities that the sellers may have given.

In these circumstances, the buyer may argue that it should not have to make all or part of the earn-out payment, at least until its claim against the sellers is resolved.

Although a general right of set-off in relation to finally determined or settled claims may not be contentious, the sellers usually require protection against the buyer coming up with arguably spurious claims with the principal purpose of delaying or avoiding the earn-out payments. A common compromise is to agree that before the buyer can exercise a right of set-off in relation to an unresolved claim, it must obtain an opinion from counsel confirming that the relevant claim has a reasonable prospect of success. The sellers may also insist that the amount of the proposed set-off is paid by the buyer into an escrow account pending final determination or resolution of the claim. For further information on this issue, see *Practice note, Structuring the Purchase Price: Acquisitions (Ireland): Buyer Set-off Rights*

Taxation of the Earn-out

From a taxation perspective, there are several pitfalls to be aware of when evaluating and advising on an earn-out structure. In the first instance, where an individual is disposing of their shares in a company, it is usually preferable to seek CGT treatment respect of any earn-out payments. This allows for a lower rate of tax (currently 33%) than if those payments fall under income tax provisions instead (and an effective rate of up to 52% once USC and PRSI are accounted for), and also may allow the payments to qualify for some of the tax reliefs available in respect of CGT (revised entrepreneur relief, retirement relief).

Where CGT treatment applies to the earn-out, the seller must exercise caution in calculating the overall gain accruing, particularly where part of the consideration is unascertainable at the time that the sale occurs.

While it is unusual for a corporate seller to enter into earn-out provisions when making a disposal of shares, where it does occur, the principles for calculating CGT for an individual as outlined in *Calculating CGT for an Earn-out* apply. Certain reliefs available to corporates, most notably the Participation Exemption, may result in a different approach being taken than would be taken with individuals. In particular, where the Participation Exemption applies, it will be advantageous for the corporate seller to recognise the full value of the earn-out as part of the consideration for the disposal of the shares held by the corporate seller. This is because the Participation Exemption is claimed on the disposal of shares or certain assets relating to shares and will not apply where the disposal is of a chose in action (which the right to the earn-out may be). This contrasts with the position generally for individuals who will wish to link the tax crystallisation event (generally the disposal of the shares) with the payment of the consideration and perhaps not recognise a disposal early.

The following is a summary of the tax issues that the parties to a transaction should consider when they are considering adopting an earn-out arrangement.

Taxation of the Sellers

Capital Gains Tax

For CGT treatment to apply in respect of any earn-out, the receipt must be specifically linked to the sale of shares and the SPA should ideally include wording to that effect.

The facts around the disposal and the details of the documentation are of particular importance. Where arrangements or payments are entered into and these do not specifically link to the sale of shares, there is a risk that these payments would be regarded instead as emoluments by Revenue and subject to income tax under Schedule E to the *Taxes Consolidation Act 1997 (TCA*

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1997). This risk is heightened where the individual disposing of the shares continues in their post at the company and receives additional payments which may be construed as connected to their employment.

One mechanism for reducing this risk is to have the same earn-out entitlements provided to any sellers who are not continuing as employees of the company post-completion. Having a separate, distinctive employment pay package, unconnected with the deferred amounts, is also indicative that the payment is not in respect of the employment.

Where the facts surrounding the disposal and the wording contained in the documentation provide comfort that the payment(s) qualify for CGT treatment, the next issue is determining the relevant dates by which both any CGT payments are due and when the sellers must file the CGT return.

Where a disposal occurs between 1 January and 30 November, the Sellers must pay by 15 December of the same year. However, if the disposal takes place between 1 December and 31 December, the CGT is payable by 31 January the following year. As such, it is necessary to have regard to legislation governing the time of disposal in the case of earn-outs because, if the legislation requires the disposal before the earn-out payment is made, there is a divergence between the date on which tax is payable and the date on which the payment (from which the tax might be made) is received under the earn-out.

The seller is required to file a CGT return no later than 31 October in the year following the date of disposal. This is the case even where there is no tax payable by virtue of reliefs or allowable losses.

Calculating CGT for an Earn-out

In calculating the point at which tax arises in connection with an earn-out, the initial question is whether the consideration payable on the earn-out is ascertainable or unascertainable at the date of disposal.

Ascertainable Consideration

Ascertainable consideration is the more straightforward instance, which typically occurs where a portion of the consideration (the total amount of which is defined) is deferred for several months or years and is only paid where the company reaches certain targets in terms of its performance. Where this "maximum cap" is in place, CGT is calculated based on this maximum amount, even where the methodology for calculating the actual deferred payment makes clear that the quantum is based on performance of the target company following the initial purchase. This is based on the Revenue view in Ireland which may contrast with the view of HMRC in the UK. In the UK, HMRC do not regard the existence of a maximum cap as involving ascertainable consideration where the calculation methodology is based on post-completion events.

In terms of the technical basis for calculating CGT upfront on ascertainable consideration, when calculating a chargeable gain arising on a disposal, the consideration for that calculation should not take into account:

- Any discount for the postponement of the right to receive any part of the consideration or any risk it might not be paid (*section 563, TCA 1997*).
- Discounts for any risk that part of the consideration may prove irrecoverable.

Therefore, where the amount payable to the disponer is ascertainable (including where there is a maximum payment), the CGT computation must include the full amount of the consideration ignoring:

- Any discount for postponing receipt of the proceeds.

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- The fact that part of the consideration may be irrecoverable or contingent on the occurrence of some future event.

(*Section 563, TCA 1997*.)

Where a portion of the proceeds prove irrecoverable in the future, the tax computation made at the time of the disposal may be adjusted later under section 563.

Where any part of the consideration taken into account is shown to be irrecoverable to the satisfaction of the Inspector, an adjustment either by way of repayment or otherwise is made (*section 563(1)(b), TCA 1997*).

In determining whether an amount is irrecoverable, the UK First-Tier Tribunal decision in *Atherly v HMRC [2018] UKFTT 0408 (TC)* may be instructive. In holding that a loan from an individual to his company was irrecoverable, the tribunal had regard to the current and previous performance of the company, and had particular regard to the fact that there was a only a "hope but no realistic possibility" of a change in the company's fortunes to the extent that would allow it to repay the loan. While past performance is often said to not be a good indicator of future performance, the tribunal here regarded the company's track record as persuasive evidence that the amount was irrecoverable.

The obvious disadvantage arising here is that the disponer is required to account for the full amount of CGT "upfront" at the time of disposal, despite not receiving the full amount of the consideration to which they may be entitled until a future date. This may result in cash flow difficulties for the seller in the short term. Where the disponer does not receive the maximum amount, they may recover this amount of overpaid tax.

However, for a corporate seller which qualifies for the Participation Exemption, this recognition of the full consideration upfront at the time of disposal of shares may be preferred.

Unascertainable Consideration

This usually arises where the earn-out provides for an amount of consideration that is certain, such as EUR2 million, and goes on to state that there is an additional unascertainable amount, say EUR2 million plus an amount determined by the profits of the company in the following three years. As there is no "maximum cap" present here, and the earn-out is not ascertainable, section 563 of the TCA 1997 does not apply.

The issue of what to do in such a situation has been considered in the UK under similar legislation. The decision in the UK case of *Marren v Ingles [1980] 1 WLR 983* outlined that where the consideration is not only contingent on the happening of a future event but is unascertainable in amount, then the sellers should pay the consideration recognised for CGT purposes on the initial disposal based on the then current value of the right to the future payment.

This issue has not been tested in the Irish courts, but in practice the Revenue Commissioners follow the *Marren v Ingles* decision.

Therefore, where the earn-out is unascertainable (and does not fall to be treated under the terms of section 563 of the TCA 1997), the value of the earn-out (that is, the value of the right to the future consideration) falls to be determined by an independent valuer at completion. This valuation must be included in the proceeds of sale in calculating the gain on the initial sale.

A separate asset (that is, the right to the future contingent proceeds) are then deemed to exist having a base cost or deductible cost equal to the value determined for the earn-out at the time of the disposal of the shares. Each subsequent receipt under the earn-out is deemed a part disposal of the separate asset. Where more than one earn-out payment is made, this ordinarily requires a further independent valuation of the remaining earn-out at the time of each receipt for the purposes of allocating the base cost of the separate asset in calculating any gain or loss on the part disposal.

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The treatment of a separate asset as existing from the initial sale means that that asset is not the same asset the subject of the initial sale (such as shares). it is in effect a chose in action. This can of course mean that any reliefs that might apply to gains on shares do not apply to any gains on this separate asset.

For the purposes of the CGT calculation for the initial completion, the parties must estimate the total proceeds(these being the upfront consideration and the value of the unascertainable earn-out) and the sellers must pay tax on that basis. The parties must undertake a valuation as to the likely future value of the right to the earn-out consideration. However, if it transpires that the proceeds eventually received are different, then that additional profit or loss is treated as arising on disposal of a separate asset, namely the right to receive a contingent sum.

If additional profit is achieved, the sellers must submit a separate return at that time for a notional separate asset. A person making this disposal has the risk that the rate of CGT is greater than 33% if the rate has increased before proceeds are received. If a loss arises, it can only be brought forward against future gains so the person ends up having paid excess CGT with no relief available immediately. This is a different treatment to where section 563 of TCA 1997 applies in that, where section 563 applies, any consideration not received gives rise to an ability to seek a tax refund.

Earn-outs and Share-for-Share Transactions

In some transactions, an earn-out may be provided in the form of shares in the acquiring company, such that section 586 of the TCA 1997 might apply to offer "paper-for-paper" relief were the shares issued.

Where part of the consideration for a takeover consists of shares to be issued at a future date if a contingency is satisfied, the earn-out element is treated as shares, and the sellers may be due relief under section 586 of the TCA 1997 (Company amalgamations by exchange of shares). This is a concessionary practice.

It should be noted that if the shares to be issued in satisfaction of the earn-out are in a different entity to the acquiring company, then the paper for paper relief may not apply. This should be carefully reviewed.

Tax Planning Points

Where the earn-out element of the sales proceeds is significant, it may in the case of an individual seller be worth structuring the sale such that shares are disposed of in tranches rather than in one upfront sale to avoid the need to pay tax on proceeds that will not have been received, thereby minimising a cashflow impact. However, care is needed to ensure that the transaction does not inadvertently:

Fall within the charge to income tax.

Fall foul of provisions relating to sale at over value.

Result in reliefs (which might depend on levels of shareholding being held at the time of disposal – e.g. revised entrepreneur relief/ retirement relief) not applying.

Income Tax

Income tax is charged under Schedule E where an individual has or exercises an office or employment in respect of "all salaries, fees, wages, perquisites or profits" from the office or employment (*section 112, TCA 1997*). Therefore, in a situation where the vendor disposes of their shares, but continues in the employ or within a role for the company, the subsequent payments may well be treated as emoluments.

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Lawyers and their clients need to be aware of the anti-avoidance provisions contained in section 135 of the TCA 1997. Originally drafted to prevent companies from making distributions which would be treated as capital as opposed to income by the individual receiving them, the sweeping application of section 135(3A) TCA conceivably requires certain consideration from the sale of shares to be treated under income tax provisions as opposed to CGT to the extent that sale is funded by the assets or other resources of the company being sold (which may be desirable for a buyer in many commercial situations). In the context of earn-outs, where payments follow the buyer taking shareholding control, care is required to ensure the provisions of section 135(3A) TCA do not have application.

Revenue guidance on the topic provides some comfort that bona fide financing arrangements entered into by a buyer to fund the earn-out element of the consideration are outside the scope of the provisions (*Irish Revenue: Tax and Duty Manual: Tax and Duty Manual: Section 135 TCA – Anti-avoidance: Part 06-02-05*). However, those financing arrangements should be considered on a case-by-case basis to ensure they do not fall foul of the provision, particularly as this is based on guidance and the legislation is more restrictive.

Taxation of the Buyer

Stamp Duty

The general position in Irish law is that any liability to stamp duty is determined at the date that the instrument making the disposal is executed. The buyer or transferee is liable to both make the stamp duty return and pay any associated liability (*section 2, Stamp Duties Consolidation Act 1999* (SDCA 1999)). Events which occur after the execution of an instrument do not generally give rise to a stamp duty liability or affect the amount of duty on a prior instrument. Understandably, these concepts give rise to practical issues where there is no definite amount of consideration which is ascertainable when the instrument is executed, as is the case in an earn-out scenario. To provide a degree of certainty on this, the Revenue Commissioners developed the "contingency principle."

As with CGT, the principle as developed by the courts is concerned with whether there is an amount payable which is either specified in the instrument or can be ascertained at the time the instrument is executed. The principle has several aspects:

- Where there is a fixed maximum sum or cap on the amount payable, then stamp duty is calculated on this maximum sum or amount of a cap.
- Where there is a fixed minimum sum (but no maximum), then stamp duty is calculated on this minimum sum.
- If there are both maximum and minimum sums provided for in the instrument, the Revenue Commissioners expect stamp duty to be levied on the maximum sum.
- Where there is an amount specified but it is subject to variation upwards or downwards, then stamp duty is calculated on the specified amount.
- Where there is neither a minimum nor maximum sum or no specified figure that is subject to variation, then there is no amount on which *ad valorem* duty can be assessed and therefore no liability to duty.

Legislative intervention has, to a large extent, superseded the application of the contingency principle. In relation to instruments chargeable under the conveyance on sale head of charge where the consideration is not ascertainable, stamp duty now falls to be charged by reference to the market value of the property conveyed. As such, the default position in Irish law is that the buyer must pay stamp duty on the market value of any unascertainable consideration.

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Stamp duty is chargeable at the time the instrument is first executed and therefore any future adjustments should not be taken into consideration in determining the amount of stamp duty payable. As such, where there are adjustments to be made outside the stamp duty payment requirements (that is, 44 days from the date of execution), then it is advisable that stamp duty is levied on the amount paid rather than making estimates or deferring payments (interest and penalties apply).

From a technical standpoint, where the consideration for a sale cannot be ascertained at the date of execution of a conveyance, then the duty is charged on the amount or value of the consideration that could be obtained from a buyer paying full consideration for that sale (that is, the market value of the assets passing) (*section 44(1), SDCA 1999*).

The Revenue Commissioners have previously confirmed that where an earn-out results in the consideration paid being unascertainable, as opposed to unascertained, the market value approach should be used. Where consideration is ascertainable but is not ascertained on closing, the "wait-and-see" approach can be used. This results in stamp duty becoming payable once the ascertainable but previously unascertained amount is clarified.

In an earn-out or deferred consideration scenario, the market value principle should be applied (*section 44, SDCA 1999*). Revenue have been known to seek to stamp the maximum cap where one is provided but the legislative provisions should take precedence, so that market value is the stampable amount.

Therefore, in circumstances where the total consideration payable is unascertainable, it is necessary to determine the market value of the shares being transferred by way of a valuation exercise.

Example of Calculation of Earn-out Right: Satisfied in Cash

James sells his company for **EUR2.5 million** cash plus an earn-out linked to earnings arising annually for three years based on the company's performance.

The value of the earn-out right is discounted for uncertainty and budgeted performance to **EUR300,000**. The cash earn-out ultimately paid to James is **EUR550,000**.

On sale:	Total sale proceeds (EUR2.5 million cash + EUR300,000 earn-out) = EUR2.8 million (assuming no base cost)
Tax on sale:	EUR694,000 (EUR1 million x 10% and EUR1.8 million x 33%) (assuming revised entrepreneurs' relief applies)
Earn-out:	Earn-out gain = EUR250,000 (EUR550,000 - EUR300,000)
Tax on earn-out:	EUR82,500 (EUR250,000 x 33%)

Effective overall tax rate (EUR776,500 / EUR3.05 million) is 25.46%.

Additional Tax Considerations

An adviser advising on the suitability of an earn-out structure should ensure their client carefully considers the following:

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- While the initial payment may qualify for a particular tax relief under Irish legislation (such as revised entrepreneur relief/retirement relief for individuals or the Participation Exemption in the case of a corporate buyer), these same reliefs may not be available to the vendor where a subsequent gain is realised on any additional payments.
- The above reliefs are tied to the disponer holding a certain percentage shareholding at the time the consideration is received; this is not the case where the shares have been disposed of several months or years before the payment of the earn-out consideration. Without a relief available, the prevailing rate of CGT applies on any gain received.
- The CGT rate at the time of the initial payment is a "known" quantity and can be taken into account when calculating any gain on this payment. However, as additional payments are made in the months or years ahead, this rate may have changed in the interim. While the vendor would welcome a lower rate, the rate may increase, leading to a greater overall tax liability.
- The adviser ought to provide worked examples on any future gain arising where the CGT rate has either increased or decreased to assist their client with the decision-making process at the time the mechanism of any earn-out is calculated.
- If, subsequent to the initial payment, the seller becomes non-Irish tax resident, any additional proceeds may fall outside the Irish tax net.

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