Earn-Outs in Cross Border Acquisitions: Managing Code Sec. 956 Exposure

By Scott A. Harty and Steven Richman

Earn-outs serve a useful purpose in acquisition transactions where the value of a business is a sticking point in the negotiations and buyers require a higher degree of security concerning their purchase. While earn-outs can help buyers and sellers bridge a valuation gap, they also provide sellers with the potential for an enhanced return on the sale (assuming the business exceeds certain predefined financial targets). In other words, an earn-out can be a win-win for both parties.

However, earn-outs also add a layer of complexity as well as the potential for disputes when subsequent earn-out payments are calculated. This complexity is often heightened in cross-border transactions. In such acquisitions, buyers should be wary of potentially adverse tax implications of an earn-out, particularly where foreign companies secure the earn-out payments. Specifically, when a controlled foreign corporation (CFC)[1] either guarantees an earn-out payment or uses its stock to secure future earn-out payments, Subpart F implications may arise, often to the detriment of the buyer.

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All earn-outs are conceptually similar regardless of the terms. To frame the issue in the cross-border context, suppose a U.S. buyer purchases a foreign company, or a group of companies that includes a foreign company, from a seller. The buyer may be hesitant about the future earnings of the business and so the parties decide to structure the purchase with an earn-out. In addition to the cash payment, the earn-out would require the buyer to make additional payments to the seller only if the business exceeds certain earnings or income thresholds (subject to review and certification by an accounting firm). As part of the negotiations, the seller requires that the earn-out payments be guaranteed or otherwise secured by the business. As a result, one or more of the target CFCs serve as collateral or provide a guarantee to secure the earn-out payments of the U.S. buyer.[2] The issue for the U.S. buyer is whether a taxable event under Subpart F occurs when the CFC provides security for the earn-out payments.

I. The Basics of Code Sec. 956

Code Sec. 956 falls within the Subpart F rules[3] that govern the taxation of CFCs. Generally, Subpart F is designed to prevent deferral of U.S. tax on specific types of income earned by CFCs. Code Sec. 956, specifically, treats certain investments by CFCs in U.S. property as a deemed distribution of the CFC's earnings and profits (E & P) to its U.S. shareholders.[4] The deemed dividend results in current taxation,[5] even though no actual distribution is made. Essentially, Code Sec. 956 prevents CFCs from investing its foreign earnings in U.S. property without the U.S. shareholders first paying tax on those earnings.

The term "United States Property" (U.S. Property) is defined to include, subject to certain exceptions, (a) tangible property located in the United States, (b) stock of a domestic corporation, (c) an obligation of a U.S. person or (d) the right to exploit certain intellectual property in the United States.[6]

An "obligation of a U.S. person" is broadly defined to include any bond, note, debenture, certificate, bill receivable, account receivable, note receivable, open account or other indebtedness of a U.S. person.[7] Additionally, even if a CFC does not directly hold a U.S. obligation, taxpayers can run afoul of Code Sec. 956 by indirectly using a CFC to support a U.S. obligation. Consequently, Code Sec. 956 also encompasses U.S. obligations that are secured by a CFC as a pledger or guarantor.[8] In other words, a CFC may generally not loan funds directly (in whatever form) to U.S. persons nor may a CFC secure a loan made to U.S. persons, whether though a guarantee or a pledge of assets.[9]Thus, even if a CFC's assets indirectly secure an obligation of a U.S. person, a deemed repatriation under Code Sec. 956 will have occurred.[10]

Pledges by CFCs to collateralize debt often take the form of a stock pledge rather than an asset pledge. While asset pledges clearly result in deemed repatriations, the stock pledge rules are more lenient. According to the Treasury regulations, a stock pledge will be treated as an indirect pledge of the CFC's assets (and thus taxable) if at least two-thirds of the CFC's voting stock is pledged and the pledge is accompanied by one or more negative covenants or similar restrictions effectively limiting the corporation's discretion with respect to the disposition of assets or incurrence of liabilities (other than in the ordinary course of business).[11] As a result, it is not uncommon for companies to pledge less than two-thirds of a CFC's voting stock in order to avoid Code Sec. 956 exposure while also providing some degree of security to a creditor.

If a CFC is the pledger or guarantor of a U.S. obligation, the amount taken into account as a deemed dividend with respect to the pledge or guarantee is the *unpaid principal amount on the applicable determination date* of the underlying obligation with respect to which the CFC is the pledger or guarantor.[12] The "applicable determination date" generally means the end of each quarter of the CFC during which it has guaranteed an obligation.[13] The "unpaid principal amount," on the other hand, is not defined in the statute, the regulations or administrative guidance. The ordinary meaning of this phrase should generally refer to the outstanding principal balance on an obligation of a U.S. person.[14]

II. Earn-Outs and Code Sec. 956

Earn-outs by their very nature are contingent obligations with no outstanding principal balance until certain metrics are achieved. The reason for including an earn-out in a transaction is because the parties cannot agree on the purchase price and thus it is unclear, at the time of closing, whether the buyer should pay additional consideration.

A. Is an Earn-Out an "Obligation"?

The first consideration for taxpayers is whether an earn-out constitutes an obligation under Code Sec. 956. As stated above, a U.S. obligation is broadly defined under the regulations[15] to include a series of common debt instruments as well as "other indebtedness." Although "other indebtedness" is not defined, it is likely that earn-outs would qualify as an obligation (albeit contingent) since the terms of most purchase agreements would create a debtor-creditor relationship with the buyer obligated to pay an amount, as yet undetermined, to the seller.

Assuming the earn-out is an obligation and the buyer is ultimately obligated to pay the seller additional consideration at some point, the issue may not be *whether* an earn-out is an obligation but *when* does the earn-out trigger an income inclusion.

B. The Unpaid Principal Amount of an Earn-Out

As stated above, if a CFC is the pledger or guarantor of a U.S. obligation, the amount taken into account by the U.S. shareholder is the *unpaid principal amount* of the underlying obligation.[16] In a typical acquisition structured as a cash purchase with the possibility for subsequent earn-out payments, at closing the buyer is under no obligation to pay the seller any principal amount. Accordingly, there should be no unpaid principal amount to include under Code Sec. 956 because it is not possible to determine whether any amount will ultimately be due and payable by the buyer.

A typical earn-out payment is not determinable until (i) predefined financial targets are achieved and (ii) there has been an opportunity to audit the financial statements and calculate the amount of the earn-out payment. Consequently, for most earn-outs, a valid obligation to pay a fixed sum arises only after certain financial conditions are satisfied and verified.

Under these circumstances, the earn-out should ripen into an obligation and thereby trigger a Code Sec. 956 inclusion only when the payment becomes due under the terms of the purchase agreement. At that point, there is an enforceable obligation to pay a fixed or determinable sum and an "unpaid principal balance" has been established.

1. Potential Counterargument—Unpaid Principal Amount Accrues During Fiscal Year

It could also be argued that the obligation for an earn-out payment accrues during the fiscal year as the financial targets are achieved (or as soon as the financial targets are achieved) rather than upon a final determination after the close of the fiscal year. This argument, however, would not be consistent with the terms of most earn-out arrangements or existing IRS guidance.

In CCA 201436047, the IRS addressed the question of whether accrued but unpaid interest on U.S. obligations is treated as U.S. Property. The IRS ruled that accrued but unpaid interest on a note constitutes an obligation because it falls within the meaning of "other indebtedness" in Reg. §1.956-2T(d)(2)(i). According to the IRS, the accrued interest represents a "valid obligation to pay a fixed or determinable sum of money" and, therefore, constitutes an obligation under Code Sec. 956.

The reasoning of CCA 201436047, however, would not necessarily apply to earn-out payments guaranteed or otherwise secured by a CFC. As mentioned above, under the terms of most earn-out arrangements a valid obligation does not arise until the buyer has verified the prior year results. Unlike interest that accrues on a note and is clearly fixed or determinable on any given day, most earn-outs are not determinable until after the close of a fiscal year. To the parties, it may be apparent that some payment will be due as a result of the company's performance but it is indeterminable what the amount is. To argue that an earn-out accrues during the fiscal year would not only be inconsistent with the terms of most purchase agreements but would also fail to take into account the possibility that subsequent market fluctuations during the year may reduce or eliminate the accrual.

2. Analogous Authorities

While not directly on point, certain case law and related IRS guidance support the conclusion that an income inclusion for a contingent obligation such as an earn-out cannot arise until a fixed amount has been determined.

In *Corporacion de Ventas, Etc.*,[17] a corporation purchased its own bonds at a discount creating potential cancellation of indebtedness income. While the bonds carried a face amount, they were payable only out of the future profits of the corporation. The IRS determined that the difference between the face amount and the discounted purchase price was cancellation of indebtedness income to the taxpayer. The Tax Court affirmed the deficiency but the Second Circuit Court of Appeals reversed the ruling and held that it was impossible to determine who received the better end of the bargain. The court reasoned as follows:

> If the cancellation of indebtedness results in income on the theory that thereby assets are freed for the debtor's general use, it appears self-evident that *the obligation to be retired must be one which unconditionally subjects the obligor's assets to liability for the payment of a fixed amount*. If A covenants under seal to pay B half of next year's business profits and later pays B $1,000 for release of the covenant, it is obviously impossible to tell immediately whether the transaction was profitable or the reverse. If next year's profits should be less than $2,000, A will have lost money by his purchase of the release; on the other hand, should the profits be large he will have gained, but how much cannot be known until next year's business has been concluded, although it might be possible to make an approximate estimate in advance based on past experience. Moreover, the release of A's covenant could not possibly free capital assets from a preexisting liability (as in the Kirby case) for the covenant created no charge upon his capital assets. Likewise is this true in the case at bar, since the debentures were payable only out of a certain percentage of profits, if earned.[18]

Accordingly, the taxpayer did not realize cancellation of indebtedness income because it could not be determined whether the taxpayer had been relieved of a debt. In LTR 201027035,[19] the IRS agreed with the holding in *Corporacion* and concluded that the prepayment of certain contingent payment obligations did not give rise to cancellation of indebtedness income because the payment obligation was contingent on the taxpayer's future earnings. The IRS reasoned that contrary to the *Kirby Lumber Co.*[20] case where the taxpayer's repurchase of its bonds at a discount relieved the taxpayer of a definite liability and freed assets that were otherwise committed, contingent obligations make it impossible to determine whether the transaction is profitable or not for the taxpayer.

Similar to the *Corporacion de Ventas* case and LTR 201027035, earn-outs by their nature have no fixed amounts, and, therefore, the assets of the CFC are not unconditionally subject to liability for the payment of a fixed amount. Requiring a Code Sec. 956 inclusion prior to the point at which a fixed obligation arises (*i.e.*, an "unpaid principal amount") under the terms of the earn-out would be, to borrow a phrase from the court in *Corporacion*, "pure speculation."

C. Mitigating Code Sec. 956 Inclusions for Earn-Outs

When a U.S. obligation with an unpaid principal amount arises under an earn-out arrangement, taxpayers have several methods to possibly eliminate or mitigate a Code Sec. 956 inclusion.

1. Managing Quarterly Averaging

Most earn-out arrangements will require payment soon after the calculations have been independently verified by an accounting firm. As a result, it is possible that the earn-out payment could be satisfied before the end of the fiscal quarter in which it arises (*i.e.*, the applicable determination date). If the obligation is not outstanding at the end of a fiscal quarter then there should be no Code Sec. 956 amount to include in income because no U.S. obligation would be outstanding on an applicable determination date.[21]

If, however, the obligation to make an earn-out payment and the actual payment date straddle a fiscal quarter then the analysis is more difficult. One argument to possibly exclude the obligation from Code Sec. 956 is for the U.S. buyer to satisfy its obligation within 30 days. In Notice 88-108[22] (the "Notice"), the IRS announced that for purposes of Code Sec. 956 an obligation that otherwise would constitute an investment in U.S. Property if held at the end of a CFC's tax year does not include an obligation that is collected within 30 days from the date it is incurred, provided that the CFC does not hold obligations which, absent the 30 rule, would constitute U.S. Property for an aggregate of 60 days[23] during the tax year.[24] In other words, the CFC can take advantage of the 30-day exception more than once in a given tax year but is limited to only an aggregate of 60 days during the tax year.[25]

The Notice and subsequent guidance in CCA 201516064, however, involve loans made by a CFC to its U.S. parent company. It is not clear how the guidance would apply to a pledge of CFC stock or a guarantee by a CFC but presumably the same rules would be applicable because both a pledge and a guarantee constitute U.S. obligations. In either event, if the U.S. person repays the obligation within 30 days from the date it is incurred then arguably the obligation should be excluded pursuant to the Notice with respect to the pledge or guarantee as well.

Notwithstanding the foregoing, though, the IRS may see a distinction between the two because a CFC loan is outstanding for a specific and finite period of time whereas the pledge or guarantee may be outstanding for a much longer period of time but only be relevant for Code Sec. 956 purposes once a fixed amount is determinable.

Ideally, taxpayers would structure repayments to be made prior to the end of the fiscal quarter in which the obligation is incurred so as to avoid a Code Sec. 956 income inclusion. If that is not possible, then there is a possibility that relief under the Notice could be available, however, taxpayers must be careful to monitor any other obligations that may be outstanding for more than 60 days which could render the Notice inapplicable.

Taxpayers who do not carefully monitor these rules and the terms of their respective payment obligations do so at their own peril and could easily (if not inadvertently) run afoul of Code Sec. 956 and trigger significant income inclusions.

2. Earn-Outs and Code Sec. 959 Previously Taxed Income

The previously taxed income (PTI) rules under Code Sec. 959 are straightforward conceptually but have been described as one of those provisions that "make the head spin until it aches from the effort to understand." Therefore, a robust discussion of these rules is beyond the scope of this article. However, the rules may provide relief to a buyer in the event a Code Sec. 956 inclusion is required with respect to an earn-out arrangement.

In summary, Code Sec. 959 establishes pools of previously taxed earnings which are increased by income inclusions under Subpart F and decreased when the CFC makes distributions to its shareholders. The pools are found in Code Sec. 959(c) and are ordered as follows: (c)(1) refers to Code Sec. 956 inclusions, (c)(2) refers to Subpart F inclusions (including Code Sec. 1248 inclusions) and (c)(3) refers to nontaxed E & P of the CFC.

In general, a current year dividend is not taxable to the extent of current and prior year undistributed Subpart F income.[26] Moreover, a current year Code Sec. 956 inclusion is not taxable to the extent of prior year (not current) Subpart F inclusions, which are found in the Code Sec. 959(c)(2) account.[27] Therefore, actual distributions are applied sequentially to the various accounts starting with the (c)(1) account, and Code Sec. 956 inclusions are applied first to the (c)(2) account (Subpart F inclusions) and then to the (c)(3) account (untaxed E & P). If an actual distribution occurs in the same year as a Code Sec. 956 inclusion, then the actual distribution is taken into account before the Code Sec. 956 inclusion.[28]

In the context of acquisitions involving CFCs, it is possible that the relevant CFC may already have PTI or that the sale itself generates PTI through Code Sec. 1248. Code Sec. 1248 recharacterizes all or a portion of the seller's gain on the sale of stock in a CFC as a dividend from the CFC to the extent of untaxed E & P.[29] Any inclusion of income under Code Sec. 1248 is treated as an inclusion under Subpart F and will increase the Code Sec. 959(c)(2) PTI account.

To the extent the CFC has sufficient PTI, then an inclusion under Code Sec. 956 with respect to a pledge or guarantee of an earn-out may merely shift PTI from the (c)(2) account to the (c)(1) account resulting in no current income inclusion for the U.S. shareholder. Of course, there are a myriad of considerations to take into account (*e.g.*, current dividend distributions or other Code Sec. 956 inclusions) that may impact this basic example but taxpayers should be careful to monitor their PTI pools, the timing of actual distributions and the ability to reduce or eliminate Code Sec. 956 inclusions prior to the end of fiscal quarters.

III. Conclusion

Earn-outs are quite common in acquisition transactions but when an earn-out is secured by a CFC stock pledge or guarantee, complexities will arise under Subpart F that can be difficult to navigate. While the discussion above highlights some of these complexities in the context of earn-outs, the principles also apply where a CFC stock pledge or guarantee is used to secure other contingent obligations of a U.S. person. It is critical for taxpayers to understand the implications of these rules in the context of contingent payment obligations in order to minimize or avoid income inclusions under Subpart F.

ENDNOTES

1 A foreign corporation is a CFC if more than 50 percent of (a) the total combined voting power of all classes of its stock or (b) the total value of corporation's stock is owned (directly or indirectly) by U.S. shareholders. Code Sec. 957(a). This article assumes a general working knowledge of Subpart F and the CFC rules.

2 For purposes of the article, it is assumed that a pledge of less than two-third of the CFC stock is insufficient security for the seller.

3 All section references are to the Internal Revenue Code of 1986, as amended (the "Code"). Subpart F is found in Sections 951–965 of the Code.

4 A U.S. shareholder is any U.S. person who owns, in the aggregate (and directly or indirectly) 10 percent or more of the corporation's total voting stock. Code Sec. 951(b).

5 The U.S. shareholders are subject to tax on their proportionate share of the CFC's E & P that is invested in U.S. Property and which has not been previously taxed. Code Sec. 959(a).

6 *See generally* Code Sec. 956(c).

7 Reg. §1.956-2T(d)(2)(i) (the regulations contain certain exceptions which are not applicable to this article).

8 Code Sec. 956(d).

9 Certain exceptions apply to loans made to certain unrelated parties. Code Sec. 956(c)(2)(F).

10 Reg. §1.956-2(c)(2).

11 *Id.*

12 Reg. §1.956-1(e)(2).

13 Code Sec. 956(a)(1)(A).

14 FSA 200216022 (Jan. 8, 2002); CCA 201436047 (Sept. 8, 2014) (stating that "the definition of indebtedness that is uniformly applied throughout the Code is, in general, a restatement of the common law definition applied to debts which arise from a debtor-creditor relationship based upon a valid obligation to pay a fixed or determinable sum of money").

15 Reg. §1.956-2T(d)(2)(i).

16 Reg. §1.956-1(e)(2).

17 *Corporacion de Ventas, Etc.,* CA-2, 29 AFTR 1074 (1942).

18 *Id.*, at 1076 (emphasis added).

19 LTR 201027035 (Mar. 31, 2010).

20 *Kirby Lumber Co.,* SCt, 2 USTC ¶814, 284 US 1, 52 SCt 4 (1931).

21 Code Sec. 956(a)(1)(A).

22 Notice 88-108, 1988-2 CB 445.

23 In 2008, in response to liquidity needs of U.S. companies, the IRS issued Notice 2008-91 extending the 30/60-day rule to a 60/180-day rule. In 2009, the IRS extended the 60/180-day rule for an additional year. The notice was effective (for companies on a calendar year) for tax years 2008 and 2009. *See* Notice 2008-91, 2008-2 CB 1001 (Oct. 06, 2008) and Notice 2010-12, 2010-4 IRB, 326 (Dec. 28, 2009).

24 The Notice was issued under a prior version of Code Sec. 956, which provided that the U.S. shareholder's *pro rata* share of U.S. Property was to be determined on an end-of-year "determination date." This end-of-year determination was subsequently replaced in 1993 by quarterly averaging found in Code Sec. 956 today. Though it is not entirely clear how the 30/60-day rule applies under the quarterly averaging method, legislative history from 1993 notes that the revised statute was not intended to change the application of the 30/60-day rule under Notice 88-108. *See* H.R. Rept. No, 103-111 (1993), at 701.

25 Of related interest, the IRS recently clarified in CCA that the 30/60-day rule is a "cliff test" (*i.e.*, if the CFC holds any obligations that violate the 30/60-day rule, all of the CFC's obligations, even those that satisfy the 30/60-day rule, would constitute U.S. Property for purposes of Code Sec. 956). *See* CCA 201516064 (Dec. 22, 2014).

26 Code Sec. 959(a).

27 Code Sec. 959(f)(1).

28 Code Sec. 959(f)(2).

29 Code Sec. 1248(a).