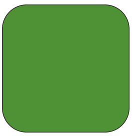

# SELLING EMPLOYEE/ SHAREHOLDER TRANSITION PERIOD PAYMENTS AFTER THE CONSTRUCTION COMPANY ACQUISITION

**This article discusses the structure of employee/shareholder seller transition period payments during a construction company acquisition.**

ROBERT F. REILLY

There has been considerable consolidation in the construction industry during the last several years. Larger companies have acquired smaller companies to take advantage of economies of scope and scale. Healthier companies have acquired financially distressed companies. Many company owners have reached retirement age and have completed an ownership transition to either management/employee buyers or to corporate acquirers.

In all of these cases, the construction company buyers want to ensure a smooth transition of all of the company sellers' business relationships. Of course, negotiations of the transaction price and structure are important to completing any construction industry acquisition. After agreeing on those transactional terms, the transaction parties typically nego-

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tiate over how long (and to what extent) the company sellers will provide transition period services to the company buyers and how the company sellers will be compensated for these services.

In the acquisition of a construction company (particularly a closely held construction company), it is common for the company buyers to request that any individual employee/shareholder seller agree to continue to work for the acquired construction company during a specified transition period. This type of employee/seller transition period employment is common in the acquisition of construction industry companies — and in related companies, such as architectural and engineering firms. The term of the post-transaction seller employment is typically a matter of negotiation between the company buyers and the company sellers. Post-transaction seller employment transition periods of one to two years are the most common. However, longer employment transition periods are not rare.

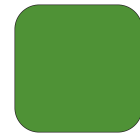
In most construction companies (again, particularly in closely held companies), the employee/shareholder sellers often have direct contact with the company's clients or customers. For example, in the case of the typical general contractor company, the clients may have a direct and personal relationship with the individual company owner/contractor. Although no longer a stockholder in the acquired company, that individual contractor may have to continue working for the construction company for a time until all clients become comfortable with the new owners. In addition, the construction company sellers may have personal relationships with all of the company's construction industry specialty subcontractors. Here again, the selling shareholders may need to continue working for the acquired company for a period of time in order to successfully transition all of the subcontractor relationships to the new owners. Finally, the construction company sellers may have personal relationships with all of the company's employees and tradespeople. The selling shareholders may have to continue working for the acquired company for a period in order to ensure the smooth transition of these employee and tradespeople relationships to the new owners.

Naturally, the employees/shareholder sellers expect to be fairly compensated for their professional services during the transition period employment. Likewise, the construction company buyers will want to fairly compensate the selling employees/shareholders in order to ensure an efficient ownership transition and a successful company acquisition. The two questions related to such post-transaction transition period payments are: (1) How much should the construction company buyers pay to the employee sellers for these transition period services? and (2) How should these transition period payments be structured?

The answer to the first question is based on the unique facts and circumstances of the individual deal. The amount of such transition period payments is typically based on direct negotiations between the construction company buyers and the selling employees/shareholders. The amount of agreed-upon transition period payments will depend on (1) the actual amount of services the sellers will provide to the buyers, (2) the buyers' perception of the risk associated with transferring the acquired business operations, and (3) the sellers' opportunity cost (i.e., how much they could earn through alternate employment opportunities). Of course, this buyer/seller negotiation should be conducted — and the transition period payment terms should be agreed to — before the company acquisition is closed.

The answer to the second question will have direct federal income tax consequences for both the construction company buyers and the employee/shareholder sellers. Related to the issue of structuring transition period payments, these two transaction parties (buyers and sellers) have opposing tax interests. Therefore, the question of the structure of the employees/sellers transition period payments is the subject of this discussion.

There are two general approaches to structuring transition period payments.



**IN THE ACQUISITION OF A CONSTRUCTION COMPANY (PARTICULARLY A CLOSELY HELD CONSTRUCTION COMPANY), IT IS COMMON FOR THE COMPANY BUYERS TO REQUEST THAT ANY INDIVIDUAL EMPLOYEE/ SHAREHOLDER SELLER AGREE TO CONTINUE TO WORK FOR THE ACQUIRED CONSTRUCTION COMPANY DURING A SPECIFIED TRANSITION PERIOD.**

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

In addition to tax and legal counsel, a valuation analyst is often involved in answering these two transaction structure questions: (1) What is a reasonable amount of compensation to pay to the selling shareholders? and (2) What is the fair price to pay for the value of the acquired construction company?

**TRANSITION PERIOD PAYMENTS CHARACTERIZED AS DEFERRED PURCHASE PRICE WILL BE SUBJECT TO THE LOWER CAPITAL GAINS TAX RATE AND WILL NOT BE SUBJECT TO PAYROLL TAX WITHHOLDING.**

## Buyer and seller considerations in structuring the transition payments

The transaction structuring issue is whether the transition period payments to the company sellers represent either (1) a contingent purchase price amount or (2) employment compensation for services provided by the sellers. In certain circumstances, the total transition period payments could be considered to include both a contingent purchase price component and an employment compensation for services component. From an income tax perspective, each of the two alternative transition period payment characterizations will benefit only one party (i.e., the buyers or the sellers). Thus, there is an inherent conflict of economic interest between these two transition period payment structures.

From the sellers' perspective, if the employee/shareholder sellers are individuals and the transition period payment is characterized as compensation (including a payment for transition services and for any covenant not to compete), then the payment will be subject to federal income tax — at a tax rate of up to 39.6 percent. In addition, these transition period compensation payments will be subject to the employee portion of the Federal Insurance Contributions Act (FICA) and to a state income tax.

On the other hand, any transition period payment that is characterized as deferred purchase price (for either the company stock or the company assets) will generally be more attractive to the sellers for income tax purposes. This is because transition period payments characterized as deferred purchase price will be subject to the lower capital gains tax rate and will not be subject to payroll tax withholding. Therefore, company sellers generally prefer the capital gains tax treatment on any transition period payments.

From the company buyers' perspective, it may be advantageous to characterize the transition period payments as employee compensation for services. The payment of employee compensation will usually generate a current income tax deduction for the acquired construction company. Nonetheless, if characterized as employee compensation, the transition period payments may also be subject to the Internal Revenue Code (IRC) Section 280G deduction limitation on golden parachute payments. Furthermore, such transition period payments would have to comply with Section 409A (i.e., income inclusion for nonqualified retirement plans), requiring the consideration of any collateral provisions.

## Factors to consider when characterizing the transition payments

Several factors should be considered by the transaction participants when the parties characterize the transition period payments as either contingent purchase price earn-out payments or employee compensation for services payments. These factors include, but are not limited to, the following considerations:

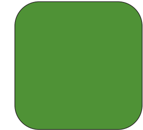
- *Transition services conditions*. Generally, if the transition period payments are conditioned on the future services that are actually provided by the employees/sellers, the payments should be characterized as employee compensation (see, for

example, the judicial decision in *Commissioner v. Duberstein*,[1]
- *Proportionality of the transition payments*. The parties should consider whether the transition period payments are proportional to the sellers' prior ownership of the company stock. If there is proportionality (i.e., if all of the sellers receive the transition period payments, but the services are provided by only some of the selling employees/shareholders), then this factor may indicate that the transition payments should be characterized by a return on capital and should receive deferred purchase price treatment.
- *Negotiations between the transaction parties*. The actual negotiations between the transaction parties play an important role in the characterization of the transition period payments. If the parties disagree on the purchase/sale price and the transition period payments are later proposed as a means of resolving that sale price disagreement, this factor may indicate that the transition period payments should be characterized as a deferred purchase price.
- *Target company price valuation.* If the amount of the transition period payments represents a component of the total reasonable value for the acquired company, this factor indicates that the transition period payments should be characterized as deferred purchase price.
- *The amount of employee/seller reasonable compensation*. If the individual selling shareholders are already being paid a reasonable level of employee compensation for their post-transaction services, this factor may indicate that any additional transition period payments should be characterized as deferred purchase price.

When the post-transaction services are tied to the transition period payments, then the payments may be characterized as compensation for services under IRC Section 1.61-2. However, if one or more of the previously mentioned structuring factors are present, then the parties should consider whether (1) there is a compensatory intent to the transition payments or (2) the transition payments represent one component of the intrinsic value of the acquired company stock or assets.

## Legal precedent for the characterization of transition period payments

From an income tax perspective, there are several judicial and administrative rulings related to the question of transition period payment characterization.



**FROM AN INCOME TAX PERSPECTIVE, THERE ARE SEVERAL JUDICIAL AND ADMINISTRATIVE RULINGS RELATED TO THE QUESTION OF TRANSITION PERIOD PAYMENT CHARACTERIZATION.**

***Arrowsmith v. Commissioner.*** In the *Arrowsmith* judicial decision, two taxpayers liquidated a corporation that they had co-owned. The two taxpayers divided the corporate liquidation proceeds equally, reporting the profits from the distributions as capital gains.[2] In a subsequent tax year, a judgment was rendered against the liquidated corporation. The two taxpayers paid the judgment, and they then reported the judgment payment as an ordinary business loss deduction.

In this judicial decision, the court held that those judgment payments — and the resulting tax deduction — should be characterized as capital in nature. The court reached this conclusion because the claim on which the judgment was rendered related to the original corporate liquidation. The court concluded that the basis of the taxation treatment related to the origin of the claim (i.e., the liquidation).

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

***Lane Processing Trust v. United States of America*.** In the *Lane Processing Trust* judicial decision, an employee-owned company sold all of its assets, and the company sale proceeds were distributed to the employee–owners.[3] In this case, both the right to the distribution and the amount of the distribution were contingent upon the employees/shareholders being em-

ployed by the company at the time of the transaction, their job classification, their length of employment, etc.

The court rejected the company's claim that the distribution payments were not employee compensation. Rather, the court held that the distribution payments were based on factors "traditionally used to determine employee compensation, specifically, the value of services performed by the employee, the length of the employee's employment, and the employee's prior wages."[4] Therefore, the court concluded that the sale proceed payments were more closely aligned to employment services than to stock ownership.

THESE CONSTRUCTION COMPANY BUYERS WANT TO ENSURE THAT THERE IS AN EFFICIENT TRANSITION OF THE SELLERS' RELATIONSHIPS WITH CUSTOMERS, CLIENTS, SUPPLIERS, SUBCONTRACTORS, AND EMPLOYEES.

***R.J. Reynolds Tobacco Co. v. the United States.*** In this case, an employer company claimed that payments made to certain employee–owners, under a profit distribution plan and proportionate to their shareholdings, were deductible compensation expenses rather than stock dividends. The court held that the payments were not compensation payments but were instead based on the employees' stock ownership. The court reached this conclusion for the following reasons:

- The payments were in proportion to each employee's stock ownership.
- The payments were in addition to each employee's existing reasonable compensation arrangements.
- In prior income tax, accounting, and litigation matters, the employer company had treated the payments as dividends rather than as compensation.[5]

**Revenue Ruling 2007-49.** In this ruling, illustrative guidance was issued for the following three situations:

- No transfer for Section 83 purposes had occurred when new services-based restrictions imposed on vested stock caused those same stock shares to become unvested.
- A transfer for Section 83 purposes did occur when an employee–shareholder exchanged substantially vested stock for unvested stock in a Section 368(a) reorganization.
- A transfer for Section 83 purposes also occurred when an employee–shareholder exchanged substantially vested stock for unvested stock in a taxable stock acquisition transaction.

In the first situation, Revenue Ruling 2007-49 suggests that an employee–shareholder can subject existing stock to services-related conditions and retain capital gains tax treatment. In the second and third situations, the employee–shareholder will maintain basis in the property and can make a Section 83(b) election at the time of the transfer in order to have any subsequent gain taxed at the capital gains tax rate.

While not directly on point with respect to the transition period payment issue, this ruling suggests that at the very least (1) the intrinsic value of the stock is capital in nature and (2) any increase in that stock value may (or may not) require a Section 83(b) election in order to subject any additional upside to capital gains tax treatment.[6]

## Summary and conclusion

Closely held construction company buyers often ask the selling employees/shareholders to continue to provide services to the company for a transition period after the company sale is completed. These construction company buyers want to ensure that there is an efficient transition of the sellers' relationships with customers, clients, suppliers, subcontractors, and employees.

The structuring (or the characterization) of these transition period payments can have a direct income tax consequence both to the construction company buyers and to the selling employees/shareholders. Such transition period payments may be categorized as compensation expenses for services provided by the selling shareholders. These payments would qualify as current-period tax deductions for the acquired construction company, but they would represent ordinary income to the selling employees/shareholders. Alternatively, these transition period payments may be categorized as contingent purchase price earn-out payments. These payments would represent capital gains to the selling employees/shareholders, but

they would only adjust the buyers' tax basis in the acquired construction company stock or assets. In other words, the acquired company would not receive an income tax deduction for these payments.

This discussion summarized the transition period payment income tax considerations to both the construction company buyers and the company sellers. It listed many of the factors that the transaction parties should consider when characterizing these payments. This discussion also presented some relevant judicial and administrative tax guidance with regard to the determination of such payments as a compensation expense versus a purchase price earn-out.

The transaction participants should consider this issue of transition period payment characterization when negotiating and structuring the company sale transaction. Both parties may consult tax and legal advisers. Additionally, both parties may consult valuation analysts to assess (1) the reasonableness of the post-transaction compensation to employees/shareholders and (2) the reasonableness of the total amount of the transaction purchase price. ■

**NOTES**

1 *Commissioner v. Duberstein*, 363 U.S. 278 (1960).

2 *Arrowsmith v. Commissioner*, 344 U.S. 6 (1952).

3 *The Lane Processing Trust v. United States*, 25 F.3d 662 (8th Cir. 1994).

4 *Ibid.*

5 *R.J. Reynolds Tobacco Company v. United States*, 149 F. Supp. 889 (Ct. Cl. 1957).

6 Internal Revenue Ruling 2007-49.