Tax Court of Canada: maximum price not sufficient to create reverse earn-out

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On September 7, 2022, the Tax Court of Canada (TCC) released its decision in *4332002 Canada Inc. v Her Majesty the Queen,*[1] dismissing a taxpayer's appeal against assessments by the Canada Revenue Agency (CRA). The TCC found that certain payments arising from an agreement to purchase software assets constituted business income under paragraph 12(1)(g) of the *Income Tax Act* (Canada) (the Tax Act), as opposed to being governed by the then-existing eligible capital property rules, which would have effectively treated them as capital gains.[2] Most notably, the TCC ruled that even though the purchase price was subject to an overall maximum amount, this was not sufficient to constitute a reverse earn-out necessary to prevent the application of paragraph 12(1)(g).

What you need to know

- Sale price payments that vary in amount based on production from or use of property - known as an "**earn-out**" - are generally taxed as regular income under paragraph 12(1)(g), unless structured to come within an exception, which is known as a "**reverse earn-out** ".
- If parties wish to use a reverse earn-out, the purchase agreement should clearly structure the sale price as a discrete maximum amount that is subject to reductions if certain conditions do or do not arise, rather than increasing payments toward a maximum.
- Although the eligible capital property rules have been repealed, properly structuring a reverse earn-out in an asset sale can mean the difference between characterizing a vendor's receipts as capital gains (only 50 per cent of which is taxed) or business income.

Overview of earn-outs and reverse earn-outs

Earn-out and reverse earn-out clauses are typically used in purchase agreements where the parties cannot agree on or determine the value of property being sold. These clauses serve as a mechanism to bridge a valuation gap.

In an earn-out, the purchaser agrees to make post-closing payments for a period of time contingent on the performance of the business or specific property according to certain thresholds. These thresholds are commonly based on financial metrics, such as gross revenue or net profit over a period of time.

Reverse earn-outs can also bridge a valuation gap, but in this case, the purchaser generally agrees to pay a maximum amount subject to reduction if thresholds are not met.

4332002 Canada Inc. v Her Majesty the Queen

- Jean-Christophe Huet (Mr. Huet) developed a software program, which he held through a holding company (Holdco).
- In 2009, Holdco sold its rights in the software to MITT Australia Pty Ltd (MITT).
- The purchase agreement provided for a combination of lump sum and earn-out payments (up to a cap of $8 million) to Holdco.
- The earn-out payments were calculated based on a percentage of software sales over a three-year period post-close.
- Holdco and MITT amended their agreement when Mr. Huet did not fulfill his employment obligation to MITT under the original agreement.

As part of the amended agreement, MITT prepaid an earn-out payment without requirement for repayment in the event of insufficient sales and certain earn-out payment targets were adjusted to account for the employment termination settlement. The CRA took the position that two earn-out payments and the settlement payment were to be included in Holdco's income under paragraph 12(1)(g) as payments from the use of or production from property rather than according to the eligible capital property rules (which would have effectively treated them as capital gains). Mr. Huet argued that the agreements included "reverse earn-out" clauses rather than "earn-out" clauses, such that paragraph 12(1)(g) should not apply.

TCC decision

The TCC held that the payments in question were earn-out rather than reverse earn-out payments because the terms of the relevant agreements did not provide a mechanism by which a maximum purchase price could be reduced if certain financial targets were not fulfilled. Instead, the relevant clauses described incremental payments based on software sales, and merely stated that the total of all payments made under the agreement could not exceed a maximum. Without additional evidence regarding how payments were calculated, the Court found that the earn-out payments clearly came within paragraph 12(1)(g) and had not been structured as a reverse earn-out, with the result that paragraph 12(1)(g) applied to include these amounts as business income to Holdco.

Takeaways

Given the facts, the TCC's decision is expected. It did not modify the application of the Tax Act to earn-outs and reverse earn-outs. Instead, it reaffirmed the importance of clear contract drafting. Simply setting a cap on the total purchase price is not sufficient to establish a reverse earn-out, and rather, the purchase price must be phrased specifically as a maximum, subject to reduction under various circumstances. While this may seem like a distinction without a substantive commercial difference, the tax consequences are dramatically different and highlight the importance of obtaining tax advice whenever earn-outs are involved. This is particularly the case where the sellers include non-residents of Canada, potentially creating a withholding tax obligation on the purchaser.

This decision can be differentiated from many reverse earn-outs seen in the marketplace because the agreements in this case explicitly outlined incremental payments based on a percentage of software sales. The only hallmark of a reverse earn-out in this case was setting a maximum price, but the agreements notably lacked the downward adjustment from this maximum.

Because the eligible capital property have been repealed, vendors incorporating earn-outs in their purchase agreements will be concerned about whether earn-out payments are relevant to calculating a capital gain or if they will be recast as business income under paragraph 12(1)(g). Improper drafting of these terms can result in doubling a vendor's tax liability over the term of the earn-out. As always, it is prudent to check in with a tax advisor early on when structuring this type of agreement.

[1] *4332002 Canada Inc v Her Majesty the Queen,* 2022 CCI 101.

[2] Section 14 of the Tax Act was repealed in 2017 but applied to the taxation years in question in this case.

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