

What is an Earn-out?

Earn-outs are a familiar feature of private equity transactions. In simple terms, an earn-out is a mechanism that allows part of the purchase price for a business to be deferred and made contingent on the future performance of the target. Typically, the buyer pays a portion of the consideration upfront and agrees to pay additional consideration if the business meets agreed performance metrics over a defined period post-completion (i.e. earnings before interest, taxes, depreciation and amortisation (EBITDA), revenue or customer retention).

Standard Terms and Commercial Rationale

Earn-outs are usually structured around:

- **A defined measuring period** – Commonly one to three years following completion.
- **Performance metrics** – Clear financial or operational targets.
- **Payment terms** – Cash, shares in the acquiring entity or a mix of both.
- **Governance protections** – Restrictions on how the buyer may operate the target during the earn-out period to avoid unfairly influencing the performance target's performance.

From a commercial perspective, earn-outs help bridge valuation gaps between buyers and sellers. They allow a buyer to mitigate the risk of overpaying, while giving the seller an opportunity to benefit from the business's future success under new ownership. In private equity transactions earn-outs are particularly attractive where the management team is rolling over equity or staying on to drive performance.

The Irish Tax Risks

While commercially useful, earn-outs carry several Irish tax risks that are often overlooked.

Loss of Capital Gains Treatment

For selling shareholders, the key expectation is that earn-out payments qualify for capital gains tax (CGT) treatment at 33%, subject to available reliefs and exemptions. However, this can be put at risk if:

- The earn-out is linked to the personal performance of the seller rather than the business. In such cases, the Irish Revenue Commissioners (Revenue) may argue that payments are not consideration for shares but instead constitute employment income subject to Pay-As-You-Earn (PAYE), Universal Social Charge (USC) and Pay Related Social Insurance (PRSI) at a rate of up to 52%.

- The earn-out is satisfied in shares rather than cash. Without careful structuring, this can trigger immediate tax liabilities on receipt of the shares, without the seller having received any cash to settle the tax liability.

As such it is important to ensure that earn-outs are objectively linked to business performance and not tied to the ongoing performance, or employment of individual sellers. Where shares are used as consideration, a seller should consider their pre-sale structuring options in order to benefit from "rollover relief" or deferral mechanisms.

Employment Tax – Risk of Reclassification

Where management shareholders remain in place, there is a risk that earn-out payments are seen as an additional reward for their work rather than a return on investment. This can result in the entire earn-out being subject to income tax at marginal rates (up to 52%) instead of CGT at 33% and employers being exposed to PAYE withholding obligations, with associated penalties and interest, if incorrectly classified.

The parties to a transaction should clearly document that the earn-out is linked to share value, not employment performance. Avoid including personal Key Performance Indicators (KPIs) or service conditions as triggers. Where management is to receive incentivisation for performance, a separate employment bonus or share option arrangement is preferable.

Valuation and Timing Issues

The tax treatment of earn-outs often depends on whether the consideration is ascertainable at completion. If not, sellers may be treated as having disposed of their shares for an "unascertainable consideration", which can complicate the timing and calculation of CGT. This may require complex valuation exercises and, in some cases, upfront tax liabilities on amounts not yet received.

Therefore, where possible, it is important to negotiate clear and objectively measurable earn-out metrics to avoid ambiguity in valuation and treatment.



Conclusion

Earn-outs remain a valuable tool in private equity transactions, offering flexibility in pricing and alignment of interests. However, from an Irish tax perspective, they carry significant tax risks, particularly the risk of reclassification as employment income. The key to managing these risks is careful structuring and clear drafting.

When used carefully, earn-outs can deliver commercial benefits without creating unexpected tax exposures. Poorly structured, they can leave both sellers and buyers facing unnecessary costs and disputes with Revenue.

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Contact

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