

Federal Tax Court rules on income recognition in case of an earn-out-clause

The Federal Tax Court has ruled on the retroactive consequences of an earn-out-clause included in an amended share purchase agreement.

In a decision published on 23 May 2012 (case reference: [IX R 32/11](#)), the Federal Tax Court (BFH) overruled a 2011 decision of the [tax court of Munich](#) (case reference: 10 K 2394/09), holding that payments made under an earn-out clause included in an amended share purchase agreement (SPA) must be taxed as capital gains of the seller of the shares in the year in which the seller receives the payment, and not as capital gains in the year in which the shares were originally sold.

The case involved a shareholder who sold some of his shares in a German GmbH in 2000. The original SPA had an earn-out clause, which was based on the future performance of the company over a five-year period. The SPA was amended in 2004 to insert a new earn-out clause based on a three-year period starting from the original date of the contract (i.e. from the year 2000). The seller received an additional payment from the buyer under the amended earn-out clause and declared that payment as a capital gain in his 2004 tax return. The German tax rules applying to capital gains on the sale had been changed in the intervening period, which resulted in more favorable tax treatment for the seller.

In the first instance, the tax court of Munich had held that any change to the original purchase price in a sale of a substantial shareholding had retroactive consequences for tax purposes. The court saw the reason for the payment in the original earn-out clause and did not consider the amendment to the SPA and the shortened monitoring period for the earn-out clause to be relevant.

The BFH, however, disagreed and overruled the decision of the tax court of Munich with respect to the retroactive consequences of the amendment to the earn-out clause. The BFH stated very generally, and in line with previous case law, that retroactive consequences will arise only if, at the time the shares are sold, no final agreement on the purchase price has been reached. Conversely, where the purchase price has been agreed and fixed and is subsequently amended, any additional payments must be taxed at the level of the seller in the year in which the additional payment is made. The BFH did not see the reason for the payment in the original earn-out clause, but only in the amended earn-out clause, so the court concluded that the additional payment should not have any retroactive consequences. As a result, the more favorable 2004 tax rules applied to the additional payment.

If you have any questions, please contact the authors of the article at gtln@deloitte.de or your regular Deloitte contact.

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