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Using Purchase Price as Retention:

A Multijurisdictional Survey of the Tax Treatment of Holdback Arrangements

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Introduction

Buyers in an M&A transaction oftentimes intend to rely on members of the target company's management to remain post-closing and assist them with running the purchased business. One way to achieve this goal of retention is to hold back a portion of the purchase price otherwise payable to the management shareholders at closing and pay the proceeds over time based on a vesting schedule tied to continued employment with the buyer or its affiliates post-closing. From a tax perspective, holdback arrangements are ideally structured to (i) delay tax recognition until future payment is received based on applicable tax, as opposed to recognizing tax at the closing of a transaction before payment has been made and (ii) permit taxation of the payment at more favorable capital gains rates, rather than compensation income rates. Ultimately, this will involve a very fact-specific analysis and the tax treatment may vary depending on the tax law of the relevant jurisdiction.

Covering a variety of jurisdictions around the globe, the Multijurisdictional Survey of the Tax Treatment of Holdback Arrangements provides a summary of various design considerations and related tax issues that M&A buyers should consider regarding the tax treatment of holdback arrangements in a question and answer format.

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Brazil

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What is the capital gains tax rate in your jurisdiction that is applicable to individual stockholders upon a sale of a business?

- For individuals who are residents in Brazil and for non-resident companies and individuals:
  - 15% for the portion of capital gains not exceeding BRL 5 million;
  - 17.5% for the portion of capital gains between BRL 5 million and BRL 10 million;
  - 20% for the portion of capital gains between BRL 10 million and BRL 20 million; and
  - 22.5% for the portion of capital gains that exceeds BRL 30 million.

  The capital gains tax is final and definitive, and the tax treaties to avoid double taxation between Brazil and the applicable jurisdiction must prevail (which is a case-by-case analysis).

What is the compensation income tax rate in your jurisdiction that is applicable to employees, including any employer tax withholding obligations?

- The monthly compensation received by employees in Brazil in 2020 is subject to the following withholding income tax rates:
  - Income of up to BRL 1,903.98 is exempted from withholding tax;
  - Income between BRL 1,903.99 and 2,826.65 is subject to a 7.5% withholding tax rate (a deduction of BRL 142,80 of the withholding tax due is applicable);
  - Income between BRL 2,826.66 and BRL 3,751.05 is subject to a 15% withholding tax rate (a deduction of BRL 354,80 of the withholding tax due is applicable);
  - Income between BRL 3,751.06 and 4,664.68 is subject to a 22.5% withholding tax rate (a deduction of BRL 636,13 of the withholding tax due is applicable);
  - Income exceeding BRL 4,664.68 is subject to a 27.5% withholding tax rate (a deduction of BRL 869,36 of the withholding tax due is applicable).

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Brazil

- The annual compensation will be offered to taxation by the employee in April, 2021, based on the following income tax rates (the withholding tax indicated above will be offset, noting that other deductions of the income tax due may apply):
  - Income of up to BRL 22,847.76 is exempted from income tax;
  - Income between BRL 22,847.77 and BRL 33,919.80 is subject to a 7.5% rate (a deduction of BRL 1.713,58 of the income tax due is applicable);
  - Income between BRL 33,919.81 and BRL 45,012.60 is subject to a 15% rate (a deduction of BRL 4,257.57 of the income tax due is applicable);
  - Income between BRL 45,012.61 and BRL 55,976.16 is subject to a 22.5% rate (a deduction of BRL 7,633.51 of the income tax due is applicable);
  - Income exceeding BRL 55,976.16 is subject to a 27.5% rate (a deduction of BRL 10,432.32 of the income tax due is applicable).

If, upon a sale of a business, (i) the buyer withholds a portion of the cash proceeds otherwise payable at closing to shareholders, who are also managers or employees of the business, in respect of their shares, and (ii) the buyer pays such cash proceeds to the shareholder over a period of time, subject to the shareholder remaining employed by the business post-closing on the applicable payment dates (as the only condition to payment), then: would the withheld portion of the purchase price become taxable to the shareholder on the date of payment (rather than on the closing date)?

- The withheld portion of the purchase price would become taxable on the date of payment.

If, upon a sale of a business, (i) the buyer withholds a portion of the cash proceeds otherwise payable at closing to shareholders, who are also managers or employees of the business, in respect of their shares, and (ii) the buyer pays such cash proceeds to the shareholder over a period of time, subject to the shareholder remaining employed by the business post-closing on the applicable payment dates (as the only condition to payment), then: would the withheld portion of the purchase price be taxed as capital gains or as compensation income?

- Capital gains. The share sale is subject to capital gains, assuming that seller will transfer all of the shares to buyer and the individual will become an employee of the company, and thus, will no longer be a shareholder.

Does the result differ if the payment of the proceeds is accelerated upon a "good leaver" termination of employment (i.e. a termination by the company without "cause" or a resignation by the shareholder for "good reason")?

- No, assuming that the parties will be able to segregate the amounts related to the purchase price (share sale) and the ones related to payment of compensation and/or indemnification due to dismissal of the employee (former shareholder).

Does the result differ if the receipt of the proceeds is conditioned on satisfaction of certain performance criteria for the business (e.g., an "earn-out"), in addition to the continued employment condition?

- No, the payment date is maintained because the taxpayer is an individual.

Brazil

Do the tax consequences differ if the withheld portion of the proceeds is payable in the form of buyer stock (rather than cash)?

- This is not usual in Brazil and the answer to this question will depend on the specifics of each case. However, in general terms, assuming that the payment in the form of buyer stock (of target) does not mean that the initial transaction was cancelled and that the stock is being returned to the seller (former shareholder), the selling shareholder will be subject to capital gains as if he or she had received cash. Note that the capital gains tax upon a sale of shares held by an individual in Brazil should be calculated on the sales date and, in the case of installments, should be paid upon its receipt. Therefore, conservatively, the fact that the purchase price is paid with buyer stock does not change the taxation of the initial transaction. The difference in this case is that from a buyer perspective (who will be the selling shareholder now) the transfer will be an additional transaction, also subject to capital gains.

Does the result differ if other non-employee shareholders are receiving cash proceeds only?

- No, provided that the agreements and the transaction documents make it clear that the payment is resulting from the share sale and not from the employment relationship.

What impact, if any, does the valuation of the stock at the time of payment have on the tax treatment, when the number of shares of buyer stock issued is determined based on the stock price of buyer at the time of closing?

- Assuming a fair market value transaction with third parties, if the purchase price was established at the sales date (at closing) and it is subject to adjustments based on the market value of the target, the amount of the capital gains tax due by the former shareholder (now employee) may be subject to changes upon payment (increase or decrease depending on the case).

What impact, if any, does the valuation of the stock at the time of payment have on the tax treatment, when the number of shares of buyer stock issued is determined based on the stock price of buyer at the time of payment?

- This answer depends on a case-by-case analysis. However, in general terms, if the transaction agreement provides that the effectiveness of the share sale depends on the satisfaction of the employee performance criteria (for instance), it is possible to show support that the payment upon closing was subject to a future and uncertain event and should be subject to capital gains tax only when and if the condition is satisfied.

Alternatively, does the analysis above differ if the proceeds, whether in the form of cash or buyer stock, are paid up front at closing, but are subject to a clawback provision (i.e., relinquishment or buy-back of stock, or repayment of cash) if the continued employment condition (or performance criteria) is not satisfied?

- This answer depends on a case-by-case analysis. However, in general terms, if the transaction agreement provides that the effectiveness of the share sale depends on the satisfaction of the employee performance criteria (for instance), it is possible to show support that the payment upon closing was subject to a future and uncertain event and should be subject to capital gains tax only when and if the condition is satisfied.

If the proceeds are reported as capital gains and later, upon audit, determined to be compensation income, what are the risks / penalties / consequences for the shareholder? What are the risks / penalties / consequences for the buyer?

- The risks of the proceeds related to the purchase and sale transaction being treated as compensation in Brazil are very low, assuming that the employee will cease to be a shareholder and that the parties have the documentation to prove that this part of the income of the individual does not derive from the rendering of services. In the case of an assessment by the authorities, the shareholder would be subject to pay the difference in taxes (the difference between the tax paid over capital gains and the tax that would apply to compensation income), plus interest and a 75% fine. The buyer could be subject to a fine for lack of withholding of 75% over the amount of income tax that should have been withheld in the case of compensation income.

Canada

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What is the capital gains tax rate in your jurisdiction that is applicable to individual stockholders upon a sale of a business?

- Canadian personal income tax rates are graduated and vary by province/territory of residence. The highest 2020 capital gains tax rate for individuals is 27% (Nova Scotia).

What is the compensation income tax rate in your jurisdiction that is applicable to employees, including any employer tax withholding obligations?

- Canadian personal income tax rates are graduated and vary by province/territory of residence. The highest 2020 employment income tax rate for individuals is 54% (Nova Scotia). Social contributions (Canada Pension Plan/Quebec Pension Plan and Employment Insurance/Quebec Parental Insurance Plan) may also apply, up to the relevant contribution ceiling. Employers are required to withhold income tax from remuneration paid to employees, and may also be required to deduct/remit employee/employer social contributions (Canada Pension Plan/Quebec Pension Plan and Employment Insurance/Quebec Parental Insurance Plan), up to the relevant contribution ceiling. Some provinces/territories impose additional payroll taxes (e.g., employer health taxes).

If, upon a sale of a business, (i) the buyer withholds a portion of the cash proceeds otherwise payable at closing to shareholders, who are also managers or employees of the business, in respect of their shares, and (ii) the buyer pays such cash proceeds to the shareholder over a period of time, subject to the shareholder remaining employed by the business post-closing on the applicable payment dates (as the only condition to payment), then: would the withheld portion of the purchase price become taxable to the shareholder on the date of payment (rather than on the closing date)?

- The timing of taxation will depend on the nature of the holdback (part of the proceeds for the shares or employment income. If the holdback is considered to be proceeds for the shares and is subject to capital gains tax, it will generally be taxable at the time of the sale, however, a capital gains reserve may be available in respect of a portion of the holdback to the extent it is payable after the end of the year (the maximum period over which a reserve can be claimed is generally 5 years). If the holdback is considered to be employment income, it will generally be taxable on receipt (subject to constructive receipt or the application of the salary deferral arrangement rules).

Canada

If, upon a sale of a business, (i) the buyer withholds a portion of the cash proceeds otherwise payable at closing to shareholders, who are also managers or employees of the business, in respect of their shares, and (ii) the buyer pays such cash proceeds to the shareholder over a period of time, subject to the shareholder remaining employed by the business post-closing on the applicable payment dates (as the only condition to payment), then: would the withheld portion of the purchase price be taxed as capital gains or as compensation income?

- The tax treatment will depend on whether the withheld portion is considered to be received by the individual in his or her capacity as either a shareholder or an employee. This will depend on all of the facts, including whether the payment of the holdback results in a price per share that is consistent with the price per share paid to non-employee shareholders.
- Even if the holdback is considered to be received by the individual in his or her capacity as a shareholder, the holdback may be subject to tax as regular income, and not as a capital gain, if contingent on the use of, or production from, property. Where certain conditions are met (including that it is reasonable to assume that the holdback relates to underlying goodwill, the value of which cannot reasonably be expected to be agreed upon at the time of the sale, and that the holdback will be paid within 5 years), the Canada Revenue Agency's administrative position is to permit a cost recovery method, effectively taxing the holdback as a capital gain. The holdback may also be subject to tax as regular income if it is considered to be in respect of a restrictive covenant (e.g., a non-compete) and no exception is available.
- Note that cross-border holdbacks/earn-outs may have Canadian withholding tax implications.
- Note also that special rules apply to payments in respect of stock options.

Does the result differ if the payment of the proceeds is accelerated upon a "good leaver" termination of employment (i.e. a termination by the company without "cause" or a resignation by the shareholder for "good reason")?

- This factor may be relevant to the characterization of the holdback (part of the proceeds as payment for the shares or employment income); that is, depending on the other facts, this may suggest the holdback is not for employment services.

Does the result differ if the receipt of the proceeds is conditioned on satisfaction of certain performance criteria for the business (e.g., an "earn-out"), in addition to the continued employment condition?

- This factor may be relevant to the characterization of the holdback (part of the proceeds as payment for the shares or employment income); that is, depending on the other facts, this may suggest the holdback is for employment services.

Do the tax consequences differ if the withheld portion of the proceeds is payable in the form of buyer stock (rather than cash)?

- If a portion of the proceeds is paid in shares, a tax rollover may be available where certain conditions are met (this may require the parties to file an election).
- If the buyer grants an individual stock options in the individual's capacity as an employee of the buyer or a non-arm's length (i.e., related) corporation, the employee stock option rules may apply (deferring the timing of taxation until the shares are acquired and potentially providing for a 50% deduction if certain conditions are met, including that the exercise price is at least equal to the fair market value of the shares at grant).

Does the result differ if other non-employee shareholders are receiving cash proceeds only?

- This factor may be relevant to the characterization of the holdback (part of the proceeds as payment for the shares or employment income); that is, depending on the other facts, this may suggest the holdback is for employment services.

Canada

What impact, if any, does the valuation of the stock at the time of payment have on the tax treatment, when the number of shares of buyer stock issued is determined based on the stock price of buyer at the time of closing?

- This factor may be relevant to the characterization of the holdback (part of the proceeds as payment for the shares or employment income); that is, depending on the other facts, this may suggest the holdback is for employment services (i.e., because the individual will share in the upside/downside).

What impact, if any, does the valuation of the stock at the time of payment have on the tax treatment, when the number of shares of buyer stock issued is determined based on the stock price of buyer at the time of payment?

- It is unclear whether this factor, on its own, may be relevant to the characterization of the holdback (as part of the proceeds for the sale of shares or employment income).

Alternatively, does the analysis above differ if the proceeds, whether in the form of cash or buyer stock, are paid up front at closing, but are subject to a clawback provision (i.e., relinquishment or buy-back of stock, or repayment of cash) if the continued employment condition (or performance criteria) is not satisfied?

- If considered as part of the proceeds for the sale of shares, a reverse earn-out should reduce the risk of the proceeds being treated as regular income; however, a capital gains reserve would generally not be available (so that the full amount would generally be taxable at the time of the sale). An amount later determined not to be payable should generally result in a capital loss at that time. The capital loss may be used to reduce capital gains (potentially including a capital gain on the sale), subject to the loss carryover and limitation rules (note that capital losses can only be carried back 3 tax years).
- If considered employment income, the holdback will generally be taxable on receipt, even if subject to forfeiture.

If the proceeds are reported as capital gains and later, upon audit, determined to be compensation income, what are the risks / penalties / consequences for the shareholder? What are the risks / penalties / consequences for the buyer?

- The individual would generally be required to pay the additional tax with interest compounded daily at the prescribed rate (currently 6%).
- The buyer would generally be subject to a 10% penalty of income tax and social contributions not remitted; required to pay the employee and employer portions of social contributions not remitted with interest compounded daily at the prescribed rate (currently 6%); and subject to interest compounded daily at the prescribed rate (currently 6%) on income tax not withheld (generally ending on the personal income tax filing due date, provided the individual is a resident of Canada for the purposes of the Income Tax Act (Canada)). If the individual is a non-resident of Canada for purposes of the Income Tax Act (Canada), the buyer may also be required to pay income tax not remitted. Additional consequences may apply in respect of underpaying other provincial/territorial payroll taxes (e.g., employer health taxes).
- Additional penalties may apply in the case of misconduct (e.g., gross negligence, tax evasion, etc.).

China

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What is the capital gains tax rate in your jurisdiction that is applicable to individual stockholders upon a sale of a business?

- The capital gains tax rate in China for an individual stockholder upon a sale of business is 20%.

What is the compensation income tax rate in your jurisdiction that is applicable to employees, including any employer tax withholding obligations?

- The compensation income rate in China for employees is a 7-level progressive rate ranging from 3% to 45%.

If, upon a sale of a business, (i) the buyer withholds a portion of the cash proceeds otherwise payable at closing to shareholders, who are also managers or employees of the business, in respect of their shares, and (ii) the buyer pays such cash proceeds to the shareholder over a period of time, subject to the shareholder remaining employed by the business post-closing on the applicable payment dates (as the only condition to payment), then: would the withheld portion of the purchase price become taxable to the shareholder on the date of payment (rather than on the closing date)?

- This is unclear under existing rules. On the one hand, the taxpayer has not derived income upon the closing date on the portion of the deferred payment. On the other hand, there is a specific rule regarding individual income tax on share transfers which stipulates that taxpayers need to pay tax on share transfers on the closing date, without addressing a deferred payment situation. Therefore, it is possible to have different outcomes depending on the interpretation of the local tax bureau.

If, upon a sale of a business, (i) the buyer withholds a portion of the cash proceeds otherwise payable at closing to shareholders, who are also managers or employees of the business, in respect of their shares, and (ii) the buyer pays such cash proceeds to the shareholder over a period of time, subject to the shareholder remaining employed by the business post-closing on the applicable payment dates (as the only condition to payment), then: would the withheld portion of the purchase price be taxed as capital gains or as compensation income?

- Generally, the characterization of income would depend on the terms of the underlying agreement. If the payment is treated as part of the purchase price in the share sale agreement, even if the payment is subject to the shareholder remaining employed by the business post-closing, this should not change the characterization into compensation income, unless the agreement indicates that the payment is compensation.

China

Does the result differ if the payment of the proceeds is accelerated upon a "good leaver" termination of employment (i.e. a termination by the company without "cause" or a resignation by the shareholder for "good reason")?

- Likely no, but the answer would also depend on the specific circumstances of the payment arrangements with the shareholder/employee. For example, in the case where the shareholder/employee's employment compensation is separately paid, it may further support that the deferred payment is part of purchase price.

Does the result differ if the receipt of the proceeds is conditioned on satisfaction of certain performance criteria for the business (e.g., an "earn-out"), in addition to the continued employment condition?

- Likely no.

Do the tax consequences differ if the withheld portion of the proceeds is payable in the form of buyer stock (rather than cash)?

- Likely no.

Does the result differ if other non-employee shareholders are receiving cash proceeds only?

- Likely no.

What impact, if any, does the valuation of the stock at the time of payment have on the tax treatment, when the number of shares of buyer stock issued is determined based on the stock price of buyer at the time of closing?

- Likely no.

What impact, if any, does the valuation of the stock at the time of payment have on the tax treatment, when the number of shares of buyer stock issued is determined based on the stock price of buyer at the time of payment?

- Like no, if the only condition on the deferred payment with buyer stock is that the number of shares of buyer stock is determined based on the stock price of buyer at the time of payment.

Alternatively, does the analysis above differ if the proceeds, whether in the form of cash or buyer stock, are paid up front at closing, but are subject to a clawback provision (i.e., relinquishment or buy-back of stock, or repayment of cash) if the continued employment condition (or performance criteria) is not satisfied?

- Likely no, although as a separate issue, it may be practically difficult to claim a refund of the clawed back amount.

China

If the proceeds are reported as capital gains and later, upon audit, determined to be compensation income, what are the risks / penalties / consequences for the shareholder? What are the risks / penalties / consequences for the buyer?

- The tax authority may require the shareholder as the taxpayer to back-file the underpaid tax and be subject to a levy of late payment surcharges at 0.05% per day (around 18.25% annual rate) within 3 years, or 5 years where the underpaid tax amount exceeds RMB 100,000. In the case of tax evasion, there is no time limit for tax authorities to collect the unpaid/underpaid tax and levy late payment surcharges. In practice, the tax authority will pursue the underpaid tax and late payment surcharges from the withholding agent (i.e., the buyer). In addition to the underpaid tax and late payment surcharges, the tax authority may also impose a penalty on the buyer as the withholding agent at 0.5 to 3 times of the under-withheld tax (or 0.5 to 5 times of the under-withheld tax in case of tax evasion).

France

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What is the capital gains tax rate in your jurisdiction that is applicable to individual stockholders upon a sale of a business?

- The capital gains tax rate applicable to individual stockholders upon a sale of business is 30%.

What is the compensation income tax rate in your jurisdiction that is applicable to employees, including any employer tax withholding obligations?

- Gross remuneration income is subject to an employee social security tax (up to 23%) and income tax withholding (up to 45%).

If, upon a sale of a business, (i) the buyer withholds a portion of the cash proceeds otherwise payable at closing to shareholders, who are also managers or employees of the business, in respect of their shares, and (ii) the buyer pays such cash proceeds to the shareholder over a period of time, subject to the shareholder remaining employed by the business post-closing on the applicable payment dates (as the only condition to payment), then: would the withheld portion of the purchase price become taxable to the shareholder on the date of payment (rather than on the closing date)?

- The withheld portion of the purchase price may be taxable on the date of payment, subject to meeting specific conditions.

If, upon a sale of a business, (i) the buyer withholds a portion of the cash proceeds otherwise payable at closing to shareholders, who are also managers or employees of the business, in respect of their shares, and (ii) the buyer pays such cash proceeds to the shareholder over a period of time, subject to the shareholder remaining employed by the business post-closing on the applicable payment dates (as the only condition to payment), then: would the withheld portion of the purchase price be taxed as capital gains or as compensation income?

- In principle, the payment is taxed as capital gain, but there is a significant risk of requalification of the payment as employment remuneration.

Does the result differ if the payment of the proceeds is accelerated upon a "good leaver" termination of employment (i.e. a termination by the company without "cause" or a resignation by the shareholder for "good reason")?

- Yes, this increases the risk of requalification as employment remuneration.

France

Does the result differ if the receipt of the proceeds is conditioned on satisfaction of certain performance criteria for the business (e.g., an "earn-out"), in addition to the continued employment condition?

- Yes, this increases the risk of requalification as employment remuneration.

Do the tax consequences differ if the withheld portion of the proceeds is payable in the form of buyer stock (rather than cash)?

- No.

Does the result differ if other non-employee shareholders are receiving cash proceeds only?

- No

What impact, if any, does the valuation of the stock at the time of payment have on the tax treatment, when the number of shares of buyer stock issued is determined based on the stock price of buyer at the time of closing?

- Mitigate the risk of requalification as employment remuneration.

What impact, if any, does the valuation of the stock at the time of payment have on the tax treatment, when the number of shares of buyer stock issued is determined based on the stock price of buyer at the time of payment?

- This increases the risk of requalification as employment remuneration.

Alternatively, does the analysis above differ if the proceeds, whether in the form of cash or buyer stock, are paid up front at closing, but are subject to a clawback provision (i.e., relinquishment or buy-back of stock, or repayment of cash) if the continued employment condition (or performance criteria) is not satisfied?

- This mitigates the risk of requalification as employment remuneration.

If the proceeds are reported as capital gains and later, upon audit, determined to be compensation income, what are the risks / penalties / consequences for the shareholder? What are the risks / penalties / consequences for the buyer?

- Remuneration income is subject to employer up to 45% social security contributions and employee up to 23% withholding + income tax up to 45%. Capital gains are subject to a 30% flat tax rate. The following late penalties may apply : - social security : 5% + 0.2% monthly interest- income tax : 10% + 0.4 monthly interest

Germany

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What is the capital gains tax rate in your jurisdiction that is applicable to individual stockholders upon a sale of a business?

- Provided that (i) the individual stockholder does not hold, and has not held in the last five years, 1% or more of the company's stated capital and (ii) the shares are not held as business assets by the individual stockholder, the capital gains realized will be subject to income tax at a flat rate of 25% (plus solidarity surcharge and church tax, if applicable, on the income tax amount due). If the flat rate exceeds the personal income tax rate of the stockholder, the stockholder may elect a personal assessment to apply his/her personal income tax rate. Capital gains realized from the sale of shares are subject to an annual lump sum allowance of EUR 801 for individuals and EUR 1,602 for couples filing jointly applicable to all types of investment income (including dividend income) for the relevant tax year. However, flat rate taxation does not apply and the capital gain will be subject to taxation according to the partial income procedure if: (x) the individual stockholder holds, or has held in the last five years, 1% or more of the company's stated capital or (ii) the shares are held as business assets by the individual stockholder. Under the partial income tax procedure, 40% of realized capital gains will be income tax exempt and the remaining 60% subject to the progressive income tax rate of up to 45% (plus solidarity surcharge and church tax, if applicable, on income tax amount due). If shares were acquired prior to January 1, 2009, capital gains realized upon sale will likely be exempt from income tax as the shares were held for more than one year.

What is the compensation income tax rate in your jurisdiction that is applicable to employees, including any employer tax withholding obligations?

- The regular progressive income tax rate, which also applies to income from employment, ranges from 14% to 45% (plus solidarity surcharge and church tax, if applicable, on the income tax amount due). The employer has to withhold the income tax due and to remit it to the responsible tax authority. With respect to income from employment up to respectively applicable contribution ceilings (in 2020 up to a maximum of EUR 82,800), the employer must generally withhold social security contributions and pay employer's social security contributions. The aggregated rates for the employee and for the employer amount respectively is up to 19.325% (or to 19.575% for employees without children and above 23 years old; to be paid by the employee only) in total (including the portion attributed to health, care, pension and unemployment insurance). However, different contribution ceilings apply.

If, upon a sale of a business, (i) the buyer withholds a portion of the cash proceeds otherwise payable at closing to shareholders, who are also managers or employees of the business, in respect of their shares, and (ii) the buyer pays such cash proceeds to the shareholder over a period of time, subject to the shareholder remaining employed by the business post-closing on the applicable payment dates (as the only condition to payment), then: would the withheld portion of the purchase price become taxable to the shareholder on the date of payment (rather than on the closing date)?

- Generally, the purchase price is subject to income taxation at the date of receipt (i.e. the date of payment).

Germany

If, upon a sale of a business, (i) the buyer withholds a portion of the cash proceeds otherwise payable at closing to shareholders, who are also managers or employees of the business, in respect of their shares, and (ii) the buyer pays such cash proceeds to the shareholder over a period of time, subject to the shareholder remaining employed by the business post-closing on the applicable payment dates (as the only condition to payment), then: would the withheld portion of the purchase price be taxed as capital gains or as compensation income?

- Generally, an instalment payment of the residual purchase price from the sale of shares should be treated as capital gains for income tax purposes. However, if the residual purchase price is subject to the shareholder remaining employed by the business post-closing on the applicable payment dates, it is likely that German tax authorities will treat the payment as income from employment.

Does the result differ if the payment of the proceeds is accelerated upon a "good leaver" termination of employment (i.e. a termination by the company without "cause" or a resignation by the shareholder for "good reason")?

- No. According to the case law of Federal Tax Court with respect to qualification of income realized from equity awards, a "good leaver/ bad leaver" clause is rather an indication of the income to be qualified as income from employment.

Does the result differ if the receipt of the proceeds is conditioned on satisfaction of certain performance criteria for the business (e.g., an "earn-out"), in addition to the continued employment condition?

- No. While the inclusion of certain performance criteria for the business (e.g., an "earn-out") only should not result in the treatment of residual purchase price as income from employment, the inclusion of the continued employment condition should rather result in the income being qualified as income from employment.

Do the tax consequences differ if the withheld portion of the proceeds is payable in the form of buyer stock (rather than cash)?

- The form of the payment (cash or stock) should not make a difference.

Does the result differ if other non-employee shareholders are receiving cash proceeds only?

- No. The form of the payment towards other recipients should not make a difference if the grant of buyer stock to employees is subject to a continued employment condition.

What impact, if any, does the valuation of the stock at the time of payment have on the tax treatment, when the number of shares of buyer stock issued is determined based on the stock price of buyer at the time of closing?

- Generally, the fair market value of the shares at the time when they are issued to the employee, i.e. the employee becomes the beneficial owner of the shares, is decisive.

What impact, if any, does the valuation of the stock at the time of payment have on the tax treatment, when the number of shares of buyer stock issued is determined based on the stock price of buyer at the time of payment?

- Generally, the fair market value of the shares at the time of issuance to the employee (i.e. when the employee becomes the beneficial owner of the shares) is decisive.

Alternatively, does the analysis above differ if the proceeds, whether in the form of cash or buyer stock, are paid up front at closing, but are subject to a clawback provision (i.e., relinquishment or buy-back of stock, or repayment of cash) if the continued employment condition (or performance criteria) is not satisfied?

- No. The proportion of the payment (whether in the form of cash or buyer stock) which is subject to a continued employment condition will likely be treated as income from employment.

If the proceeds are reported as capital gains and later, upon audit, determined to be compensation income, what are the risks / penalties / consequences for the shareholder? What are the risks / penalties / consequences for the buyer?

- From the wage tax perspective, the employer (buyer) will be made liable for underpaid wage tax. Furthermore, the employer will have to recover the wage tax paid from the employee which might result in an additional administrative effort for the employer. If the employer assumes the wage tax liability and does not recover the wage tax paid from the employee, this will be treated as an additional benefit in kind provided to the employee subject to wage tax withholding. Furthermore, failure to withhold wage tax due might result in criminal liability for the employer (imprisonment of up to five years or a monetary penalty). From a social security perspective, failure to pay the required social security contributions may lead to late payment interest payments as well as criminal liability (imprisonment of up to five years or a monetary penalty) and blacklisting. To commit the criminal offence, the employer must merely be aware that contributions are not paid timely, irrespective of malice or an intention to enrich. Please also note an employer can only deduct the employee's estimated social insurance contribution from the payable salary. If for one month no social insurance contribution has been withheld for the employee's social security contributions, the employer may only withhold this sum from the employee's salary within the following three payrolls. After this period of time, the employer will have to bear the underpaid employee's social security contributions.

Israel

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What is the capital gains tax rate in your jurisdiction that is applicable to individual stockholders upon a sale of a business?

- With respect to equity which was granted under an employee equity plan and which is subject to tax pursuant to Section 102 of the Israeli Income Tax Ordinance ("Section 102 equity"), subject to compliance with the requirements of Section 102 of the Israeli Income Tax Ordinance, such equity granted under the trustee capital gains route of Section 102 will be taxed upon sale at a rate of 25% + 3% surplus tax which applies to income above 651,601 NIS (from any source).
- With respect to other equity such as founder shares or equity held in investor capacity ("regular equity"), the capital gains tax rate applicable to individuals is generally 25%, which rate is increased to 30% in the case of a sale of shares by a "significant shareholder", plus, in each case, a 3% surtax applicable to individuals with annual chargeable income over a certain threshold (roughly USD 185,500). A "significant shareholder" refers to a shareholder who directly or indirectly, alone or together with another, holds at least 10% of one or more of the means of control of the company. "Means of control" generally includes the right to vote, receive profits, nominate a director or general manager of the company, receive assets upon liquidation or instruct someone who holds any of the aforesaid rights regarding the manner in which he or she is to exercise such right(s), all regardless of the source of such right.

What is the compensation income tax rate in your jurisdiction that is applicable to employees, including any employer tax withholding obligations?

- With respect to Section 102 equity, progressive tax rates (depending on the employee's income) up to a 47% marginal tax rate plus a 3% surtax on income above 651,601 NIS. The employer is subject to withholding tax obligations based on such rates.
- With respect to regular equity, progressive tax rates (depending on the employee's income) up to a 47% marginal tax rate plus a 3% surtax. The employer is subject to withholding tax obligations based on such rates.

If, upon a sale of a business, (i) the buyer withholds a portion of the cash proceeds otherwise payable at closing to shareholders, who are also managers or employees of the business, in respect of their shares, and (ii) the buyer pays such cash proceeds to the shareholder over a period of time, subject to the shareholder remaining employed by the business post-closing on the applicable payment dates (as the only condition to payment), then: would the withheld portion of the purchase price become taxable to the shareholder on the date of payment (rather than on the closing date)?

- With respect to Section 102 equity, the withheld portion of the purchase price may be taxable on the date of payment, subject to the receipt of a tax ruling from the Israel Tax Authority (the "ITA").
- With respect to regular equity, generally, the shareholder is required to report the transaction and the capital gain to the ITA and pay the applicable tax within 30 days, unless the ITA allows deferral of the payment date in writing, in which case, an interest charge and the Consumer Price Index ("CPI") adjustments will generally apply.

Israel

If, upon a sale of a business, (i) the buyer withholds a portion of the cash proceeds otherwise payable at closing to shareholders, who are also managers or employees of the business, in respect of their shares, and (ii) the buyer pays such cash proceeds to the shareholder over a period of time, subject to the shareholder remaining employed by the business post-closing on the applicable payment dates (as the only condition to payment), then: would the withheld portion of the purchase price be taxed as capital gains or as compensation income?

- With respect to Section 102 equity, the withheld portion of the purchase price may be taxable on the date of payment, subject to the receipt of a tax ruling from the ITA, and, provided that the value of the company or purchaser is equal to or higher than the purchase price. If the value has decreased, then upon the payment date the tax will be calculated as follows: the portion of the payment equal to the percentage of decrease in share value will be subject to ordinary income tax and only the remainder of the payment will be subject to capital gains tax. For example if the value decreased by 10%, 10% of the payment will be taxed as ordinary income and 90% would be subject to capital gains tax. In addition, the payment will not be able to be released to the employee prior to the lapse of the holding period required under Section 102 which is 24 months from the date of grant. During such time the net cash will be held by the trustee nominated by the company pursuant to the trustee capital gains route. This assumes the receipt of a tax ruling in the form currently being issued by the tax authorities. The tax authorities may at any time change their position regarding the taxation of these arrangements, in which case, the applicable tax may be determined pursuant to ITA Circular 5/2017 (the "Circular") (as described below).

  With respect to regular equity, and pursuant to ITA Circular 5/2017 (the "Circular"), there are several conditions that need to be met in order for the withheld portion of the purchase to be treated as capital gains, as follows:

  - The shares held by the selling shareholders are (i) ordinary shares, (ii) classified as equity and (iii) confer upon such holders rights that are identical to those granted to all other ordinary shares of the same class, and the gain from the sale of which, but for the holdback mechanism, would be classified as a capital gain.
  - The selling shareholders have held the shares for at least twelve months prior to the signing of the sale transaction agreement.
  - The shares held by the selling shareholders are sold as part of a transaction in which all of the rights in the company are sold.
  - The percentage of the selling shareholders' rights in the company that are subject to the holdback mechanism is not more than 50% of all of the rights held by such selling shareholders in the company.
  - The holdback amount does not constitute additional consideration, and the price per share paid to the individual selling shareholders is identical to that paid to all holders of ordinary shares. For this purpose, the Circular provides that this condition will be presumed met if, upon the sale of the company's shares, shareholders who are not subject to a holdback mechanism hold at least one third of the means of control of the company.
  - The individual selling shareholders enter into new employment agreements that are effective (at the latest) on the date the transaction closes, or continue to work under their existing employment agreements, or amended agreements, whereby their compensation is not lower than their compensation prior to the transaction.
  - In its tax filings, the acquiring company records the holdback amount as consideration for the acquisition of shares in the transaction, and does not take an Israeli tax deduction for such holdback amount.
  - The individual selling shareholders report the sale of their shares to the ITA and are generally required to make an advance payment of the full tax liability amount in connection with the total consideration received (including any amount in escrow or the holdback amount, disregarding that these remain unpaid). If a selling shareholder does not eventually receive the total holdback amount, he/she will be entitled to amend his/her tax return to obtain a tax refund plus interest and CPI adjustments. The acquiring company must not be a related party, as defined in section 88 of the Income Tax Ordinance (New Version) of 1961 (the "Ordinance"), of the acquired company or its shareholders (including the individual shareholders).
  - The holders of the majority of the issued capital of the acquired company (including the individual selling shareholders subject to the holdback mechanism) are not related parties under section 88 of the Ordinance.

  The Circular notes that it does not apply where the acquired company was, at any point since its incorporation, a transparent entity for tax purposes.

Does the result differ if the payment of the proceeds is accelerated upon a "good leaver" termination of employment (i.e. a termination by the company without "cause" or a resignation by the shareholder for "good reason")?

- No.

Israel

Does the result differ if the receipt of the proceeds is conditioned on satisfaction of certain performance criteria for the business (e.g., an "earn-out"), in addition to the continued employment condition?

- No.

Do the tax consequences differ if the withheld portion of the proceeds is payable in the form of buyer stock (rather than cash)?

- With respect to Section 102 equity, yes. Subject to the receipt of a tax ruling and the issuance of the buyer stock as an equity grant pursuant to an employee equity plan which is filed for approval under the trustee capital gains route of Section 102, the roll-over will be tax exempt and tax will be due upon the sale of the stock. The tax status of the award will be retained, and therefore, if the award was subject to the beneficial tax arrangement of the trustee capital gains route, the buyer stock will continue to be subject to the same tax consequences.
- With respect to regular equity, generally, no. Where the deal consideration is paid, wholly or partially, in shares or other rights of the acquiring company, various tax deferral mechanisms applicable under the Ordinance may be available.

Does the result differ if other non-employee shareholders are receiving cash proceeds only?

- No.

What impact, if any, does the valuation of the stock at the time of payment have on the tax treatment, when the number of shares of buyer stock issued is determined based on the stock price of buyer at the time of closing?

- With respect to Section 102 equity, general considerations regarding tax exemption and tax continuity would apply provided a tax ruling is granted.
- With respect to regular equity, this is not entirely clear. Based on the provisions of the Circular, the holdback amount that is paid to shareholders (up to the price per share payable to the remaining sellers of shares of similar class), will be taxable as a capital gain upon meeting the said conditions, and any excess will be taxable as ordinary employment income. As such, it would seem that the number of shares of buyer stock issued to the shareholder should be based on the stock price of the buyer stock at closing to match the price-per-share received by other shareholders.

What impact, if any, does the valuation of the stock at the time of payment have on the tax treatment, when the number of shares of buyer stock issued is determined based on the stock price of buyer at the time of payment?

- It is unclear how the tax authorities would address this issue with respect to Section 102 equity.
- With respect to regular equity, this is not entirely clear. Based on the provisions of the Circular, the holdback amount that is paid to shareholders (up to the price per share payable to the remaining sellers of shares of similar class), will be taxable as a capital gain upon meeting the said conditions, and any excess will be taxable as ordinary employment income. As such, it would seem that the number of shares of buyer stock issued to the shareholder should be based on the stock price of the buyer stock at closing to match the price-per-share received by other shareholders.

Israel

Alternatively, does the analysis above differ if the proceeds, whether in the form of cash or buyer stock, are paid up front at closing, but are subject to a clawback provision (i.e., relinquishment or buy-back of stock, or repayment of cash) if the continued employment condition (or performance criteria) is not satisfied?

- With respect to Section 102 equity, yes, in this case cash payments will be subject to immediate tax withholding and in case of a clawback the employee will need to claim a loss and attempt to reclaim the taxes paid. The chances are not high. In the case of stock consideration, subject to the receipt of a tax ruling and the issuance of the stock as an equity grant pursuant to an employee equity plan, which is filed for approval under the trustee capital gains route of Section 102, the roll-over will be tax exempt, and tax will be due in accordance with the beneficial tax arrangement of the trustee capital gains route, upon sale of the stock. In such case, forfeiture of stock will not trigger a taxable event, but if the stock was sold and a clawback applies to the cash consideration, the clawback of the cash will be the same as noted above regarding the cash proceeds.
- With respect to regular equity, no. There may be non-tax implications, however, that need to be taken into consideration (e.g., employment law considerations/restrictions that may apply).

If the proceeds are reported as capital gains and later, upon audit, determined to be compensation income, what are the risks / penalties / consequences for the shareholder? What are the risks / penalties / consequences for the buyer?

- With respect to Section 102 equity, since the withholding is pursuant to a tax ruling issued by the Israel Tax Authority there is no chance of audit, unless there was misrepresentation of facts in the tax ruling.
- With respect to regular equity, for the shareholder, higher tax rates are applicable, thus creating a higher tax bill based on said ordinary tax rates, plus interest (4%), CPI adjustments and potentially a penalty of 15% of the late tax payment. In addition, social security taxes applicable to compensation income would apply. The buyer/employer would essentially be subject to higher withholding rates based on the re-characterization and thus it, too, would be subject to a higher withholding tax bill, interest, CPI adjustments and penalties, as noted above, as well as withholding obligations toward the National Security Institute for withholding of social security fees applicable to compensation income. The substantive tax liability is of the shareholder/employee. The ITA can collect from the employer (for under-withholding) or from the employee, but not twice.

Italy

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What is the capital gains tax rate in your jurisdiction that is applicable to individual stockholders upon a sale of a business?

- Capital gains upon sale of shares are subject to a 26% substitute tax.

What is the compensation income tax rate in your jurisdiction that is applicable to employees, including any employer tax withholding obligations?

- Employment income is subject to income taxation at progressive rates ranging from 26% to 43%, plus regional and municipal surcharges. The employer is required to apply withholding tax at the time of payment of the stock awards. This withholding tax is a prepayment of individual income tax and the rates applied tend to prospectively coincide to the final tax burden of the employee which will be finally calculated at year-end.

If, upon a sale of a business, (i) the buyer withholds a portion of the cash proceeds otherwise payable at closing to shareholders, who are also managers or employees of the business, in respect of their shares, and (ii) the buyer pays such cash proceeds to the shareholder over a period of time, subject to the shareholder remaining employed by the business post-closing on the applicable payment dates (as the only condition to payment), then: would the withheld portion of the purchase price become taxable to the shareholder on the date of payment (rather than on the closing date)?

- Yes, the portion of the purchase price would be taxable on the date of payment.

If, upon a sale of a business, (i) the buyer withholds a portion of the cash proceeds otherwise payable at closing to shareholders, who are also managers or employees of the business, in respect of their shares, and (ii) the buyer pays such cash proceeds to the shareholder over a period of time, subject to the shareholder remaining employed by the business post-closing on the applicable payment dates (as the only condition to payment), then: would the withheld portion of the purchase price be taxed as capital gains or as compensation income?

- The purchase price paid to the selling shareholder would generally be taxed as a capital gain. However, depending on the circumstances and due to the resolutive condition of remaining employed and/or a possible surplus-value embedded in the purchase price paid to the employee/manager, a portion of the purchase price may be taxed as compensation income. The risk increases if the value of the proceeds is higher than the fair market value of the shares sold (e.g., because the employee/shareholder receives a price higher than that would have been awarded to non-employee minority shareholder). While there is no precedent in this matter, it would be iniquitous to tax the entire purchase price as employment income; only the possible differential price should be so regarded.

Italy

Does the result differ if the payment of the proceeds is accelerated upon a "good leaver" termination of employment (i.e. a termination by the company without "cause" or a resignation by the shareholder for "good reason")?

- No, the tax treatment would not differ. The withheld portion paid upon termination of the employment relationship should not change its nature and the relative tax treatment.

Does the result differ if the receipt of the proceeds is conditioned on satisfaction of certain performance criteria for the business (e.g., an "earn-out"), in addition to the continued employment condition?

- The proceed conditioned on satisfaction of performance criteria (such as "performance earn-out clauses") would constitute a component of the price linked to an uncertain and future event, a variable payment representing consideration for the purchase of the shareholding.
- In this regard, such a portion of the purchase price should be treated as a capital gain for tax purposes. However, since such condition for the payment of the proceeds represents an additional link to the employment of the employee shareholder and the related performance, it increases the risk of re-characterization of the proceeds as employment income.

Do the tax consequences differ if the withheld portion of the proceeds is payable in the form of buyer stock (rather than cash)?

- No, the in-kind payment of the price does not affect the tax treatment for the seller.

Does the result differ if other non-employee shareholders are receiving cash proceeds only?

- No, the result does not differ.

What impact, if any, does the valuation of the stock at the time of payment have on the tax treatment, when the number of shares of buyer stock issued is determined based on the stock price of buyer at the time of closing?

- Generally, the risk of re-characterization of proceeds as compensation is higher if its value is higher than the fair market value of the shareholding (e.g., because the employee/shareholder receives a price higher than that would have been awarded to non-employee minority shareholder). In this scenario, the link between earnings finally achieved and employment relationship is stronger and the risks of characterization as employment income are further increased.

What impact, if any, does the valuation of the stock at the time of payment have on the tax treatment, when the number of shares of buyer stock issued is determined based on the stock price of buyer at the time of payment?

- Generally, the risk of re-characterization of proceeds as compensation is higher if its value is higher than the fair market value of the shareholding (e.g., because the employee/shareholder receives a price higher than that would have been awarded to non-employee minority shareholder).

Alternatively, does the analysis above differ if the proceeds, whether in the form of cash or buyer stock, are paid up front at closing, but are subject to a clawback provision (i.e., relinquishment or buy-back of stock, or repayment of cash) if the continued employment condition (or performance criteria) is not satisfied?

- A clawback provision in the share sale agreement would be a resolutive clause that does not affect the tax treatment of the sale of a shareholding as a capital gain. However, a potential risk of re-characterization as employment income remains.

Italy

If the proceeds are reported as capital gains and later, upon audit, determined to be compensation income, what are the risks / penalties / consequences for the shareholder? What are the risks / penalties / consequences for the buyer?

- Capital gains upon sale of shares are subject to a 26% substitute tax. Income subject to substitute tax should not be reported on the tax return because it has already been taxed.
- If the tax authorities believe that the proceeds have been misclassified they may claim the payment of the additional taxes due by the employee (i.e. the regional and municipal and the difference between the employment income tax calculated according to the progressive rates and the fixed 26% capital gain tax already paid by the employee). The applicable penalties for unfaithful personal income tax return range from 90% to 180% of the higher taxes due.

Japan

For further information or assistance with tax treatment of holdback arrangements, please reach out to any of the contacts listed below or your usual Baker McKenzie contact.

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What is the capital gains tax rate in your jurisdiction that is applicable to individual stockholders upon a sale of a business?

- Capital gains derived from an alienation of shares is subject to individual income tax at the flat rate of 20.315%.

What is the compensation income tax rate in your jurisdiction that is applicable to employees, including any employer tax withholding obligations?

- Compensation income (or Kyuyo Shotoku) is subject to a progressive individual income tax rate at 5% - 45% (+ surcharge at 2.1% of individual income tax) plus a local inhabitant tax at 10% (the total marginal tax rate is 55.945%).As for stock incentive plans, income upon exercise (e.g., of a stock option) and income upon vesting (e.g., of restricted stock) is categorized as compensation income, even if it is received from the offshore parent company (as opposed to from a local subsidiary which is the direct employer of the local employees).In the case of compensation income from an offshore parent/affiliate, no Japanese withholding obligations are imposed on the local subsidiary or the offshore parent/affiliate. On the other hand, a local employer must file From 9(3) to report the employee's offshore income. However, for compensation income paid locally in Japan, the local employer must withhold taxes in accordance with the statutory withholding table.

If, upon a sale of a business, (i) the buyer withholds a portion of the cash proceeds otherwise payable at closing to shareholders, who are also managers or employees of the business, in respect of their shares, and (ii) the buyer pays such cash proceeds to the shareholder over a period of time, subject to the shareholder remaining employed by the business post-closing on the applicable payment dates (as the only condition to payment), then: would the withheld portion of the purchase price become taxable to the shareholder on the date of payment (rather than on the closing date)?

- The answer depends on the terms and conditions under the relevant agreement. Generally, for Japanese income tax purposes, income must be recognized as taxable when an enforceable right to receive payment arises, even if the actual payment is delayed (and thus no arbitrary income deferral is possible). This rule applies to the sale of shares under which the transfer transaction should be recognized when the transfer contract becomes effective such as on the closing date. On the other hand, if the holdback portion can be characterized as forfeitable in the future due to non-satisfaction of a condition precedent, if any, then it may be possible to treat the holdback portion as taxable only when the payment becomes definitive such as upon actual cash payment. Namely, if there is a case in which the withheld portion may not be paid, such withheld portion should not be taxed at the time of the closing date (conversely, if the withheld portion will be paid in any case without forfeiture, it should be taxed at the time of the closing date).

Japan

If, upon a sale of a business, (i) the buyer withholds a portion of the cash proceeds otherwise payable at closing to shareholders, who are also managers or employees of the business, in respect of their shares, and (ii) the buyer pays such cash proceeds to the shareholder over a period of time, subject to the shareholder remaining employed by the business post-closing on the applicable payment dates (as the only condition to payment), then: would the withheld portion of the purchase price be taxed as capital gains or as compensation income?

- Generally, the withheld portion of the purchase price should be treated as compensation income because the payment upon a sale of a business is made based on status as both a shareholder and a manager/employee, and the payment is characterized as being in relation to the manager/employee relationship (if such a relationship exists, the compensation income category applies as a rule). However, the income category issue should further be confirmed in light of the terms and conditions of the relevant agreement. Further, if the agreement states that the post-closing payment is an adjustment of consideration for the share transfer, the holdback portion should be categorized as capital gains.

Does the result differ if the payment of the proceeds is accelerated upon a "good leaver" termination of employment (i.e. a termination by the company without "cause" or a resignation by the shareholder for "good reason")?

- If the payment is triggered by a termination of employment, generally the payment may be treated as retirement income (or Taishoku Shotoku) and certain deductions and a lower tax rate may apply. However, in the case where the payment upon the sale of a business is also paid to existing managers/employees, if conditions are met, the payment is characterized as ordinary compensation income, because a bonus paid upon retirement is categorized as compensation income for Japanese tax purposes and the payment in question resembles such a retirement bonus.

Does the result differ if the receipt of the proceeds is conditioned on satisfaction of certain performance criteria for the business (e.g., an "earn-out"), in addition to the continued employment condition?

- Generally, it should be treated as compensation income because the payment upon a sale of a business is made based on status as both a shareholder and a manager/employee, and the payment is characterized as being in relation to the manager/employee relationship (if such a relationship exists, the compensation income category applies as a rule). However, the income category issue should further be confirmed in light of the terms and conditions of the relevant agreement. Further, if the agreement states that the post-closing payment is an adjustment of consideration for the share transfer, the holdback portion should be categorized as capital gains.

Do the tax consequences differ if the withheld portion of the proceeds is payable in the form of buyer stock (rather than cash)?

- Payment in the form of buyer stock would be characterized as an in-kind exchange transaction for Japanese tax purposes which is a taxable transaction per se. Accordingly, assuming that the exchanged buyer stock is common stock with full rights as a shareholder, the tax consequences should not differ from that applicable to cash consideration (in both cases, the inflow of income with enforceable rights occurs). If the withheld buyer stock is payable in the form of restricted stock units etc., the taxable event may be deferred until the restriction lapses or terminates, but the answer depends on the fact pattern and is subject to further analysis.

Does the result differ if other non-employee shareholders are receiving cash proceeds only?

- In such a case, the income category may differ. If the payment due to a sale of a business is made to non-employee shareholders, the income should be categorized as miscellaneous income (or Zatsu Shotoku) which is also subject to progressive tax rate taxation up to 55.945%. However, if the payment is for the transfer of shares, capital gain treatment will apply also to non-employee shareholders

What impact, if any, does the valuation of the stock at the time of payment have on the tax treatment, when the number of shares of buyer stock issued is determined based on the stock price of buyer at the time of closing?

- Taxable gain should be measured based on the fair value of the stock at the time of the taxable event (i.e., the number of shares and their fair value affects the tax calculation, but how the number of shares is determined is not relevant). In this scenario, the link between earnings finally achieved and employment relationship is stronger and the risks of characterization as employment income are further increased.

Japan

What impact, if any, does the valuation of the stock at the time of payment have on the tax treatment, when the number of shares of buyer stock issued is determined based on the stock price of buyer at the time of payment?

- Taxable gain should be measured based on the fair value of the stock at the time of the taxable event (i.e., the number of shares and their fair value affects the tax calculation, but how the number of shares is determined is not relevant).

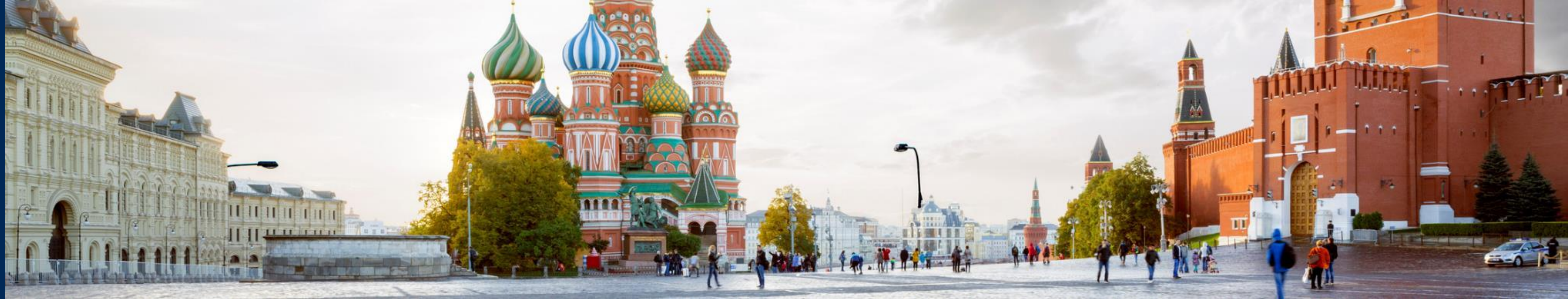
Alternatively, does the analysis above differ if the proceeds, whether in the form of cash or buyer stock, are paid up front at closing, but are subject to a clawback provision (i.e., relinquishment or buy-back of stock, or repayment of cash) if the continued employment condition (or performance criteria) is not satisfied?

- Payment in the form of buyer stock would be characterized as an in-kind exchange transaction for Japanese tax purposes which is a taxable transaction per se. Accordingly, assuming that the exchanged buyer stock is common stock with full rights as a shareholder, the tax consequences should not differ from that applicable to cash consideration (in both cases, the inflow of income with enforceable rights occurs). If the withheld buyer stock is payable in the form of restricted stock units etc., the taxable event may be deferred until the restriction lapses or terminates, but the answer depends on the fact pattern and is subject to further analysis.

If the proceeds are reported as capital gains and later, upon audit, determined to be compensation income, what are the risks / penalties / consequences for the shareholder? What are the risks / penalties / consequences for the buyer?

- Generally, assuming that the compensation income and/or capital gain categories apply for the payment, it should be fully taxed (including the portion which may be subject to clawback) at the time of payment (as the payment is the taxable event for compensation income and the closing is the taxable event for capital gain as a rule, and no exceptional deferral provision exists for such income under the exiting Japanese tax law). That said, the tax treatment at the time of a clawback may be vary depending on the fact pattern and terms and conditions of the relevant agreement.

Russia



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What is the capital gains tax rate in your jurisdiction that is applicable to individual stockholders upon a sale of a business?

- There is no special regulation regarding the individual income tax rate on capital gains received by an individual as compared to compensation received from the employer. The net income (capital gain) of the individual stockholders upon a sale of shares is subject to the individual income tax at the flat 13% rate (as ordinary income, in particular, employment compensation) in case such stockholders are Russian tax residents, i.e. they have stayed in Russia for not less than 183 calendar days during twelve consecutive months.

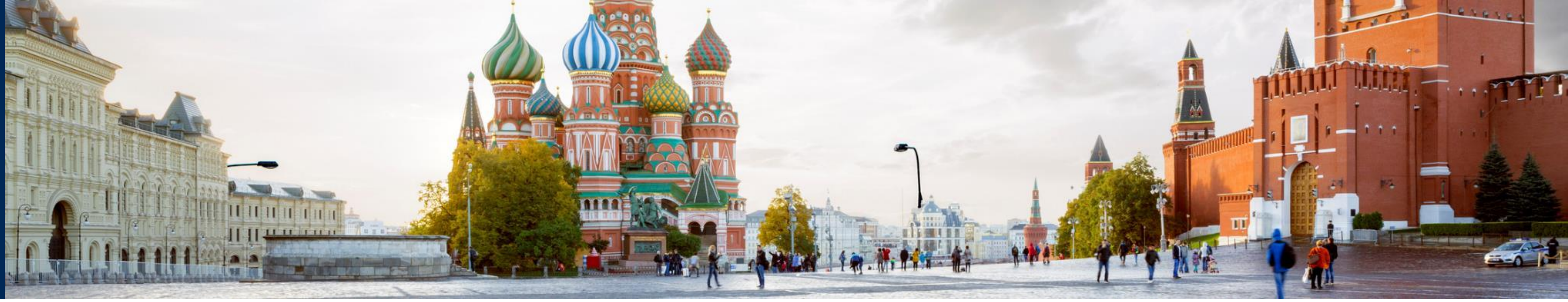
What is the compensation income tax rate in your jurisdiction that is applicable to employees, including any employer tax withholding obligations?

- There is no special regulation regarding the individual income tax rate on employee compensation compared to capital gains or other ordinary income. The employee income received from the employer as compensation for services is subject to individual income tax at the flat 13% rate for employees who are Russian tax residents. The employer, as the tax agent, is required to withhold the 13% individual income tax from payments to employees and remit it to the Russian state budget.

If, upon a sale of a business, (i) the buyer withholds a portion of the cash proceeds otherwise payable at closing to shareholders, who are also managers or employees of the business, in respect of their shares, and (ii) the buyer pays such cash proceeds to the shareholder over a period of time, subject to the shareholder remaining employed by the business post-closing on the applicable payment dates (as the only condition to payment), then: would the withheld portion of the purchase price become taxable to the shareholder on the date of payment (rather than on the closing date)?

- Payments made to employees in respect of their shares become taxable to the shareholder on the date of each payment receipt.
- Because such payments are treated as proceeds from the sale of shares (capital gains), the date of payment receipt is the date of actual payment, including the date of income payment to the bank account of the employee. This applies both when payments are made by the foreign buyer or the Russian employer.
- If an employee's income is nominated in foreign currency, it must be converted into Russian Rubles at the official exchange rate of the Central Bank of the Russian Federation on the date of income receipt (i.e. date of the actual payment).
- If payments are re-characterized as employee compensation, the date of payment receipt is either the date of actual payment or the last day of the month for which the compensation was accrued. This could apply if the Russian subsidiary fails to prove that the payments constitute capital gains rather than employee compensation.

Russia



If, upon a sale of a business, (i) the buyer withholds a portion of the cash proceeds otherwise payable at closing to shareholders, who are also managers or employees of the business, in respect of their shares, and (ii) the buyer pays such cash proceeds to the shareholder over a period of time, subject to the shareholder remaining employed by the business post-closing on the applicable payment dates (as the only condition to payment), then: would the withheld portion of the purchase price be taxed as capital gains or as compensation income?

- Capital gains or compensation received by an individual are taxed as ordinary income at the same flat rate of 13%.
- Generally, such payments should be treated as proceeds from the sale of shares (capital gains).
- If the payments are made by the Russian employer and the Russian employer fails to prove that the payments constitute capital gains, there is a risk that they might be re-characterized by the Russian tax authorities as employee compensation

Does the result differ if the payment of the proceeds is accelerated upon a "good leaver" termination of employment (i.e. a termination by the company without "cause" or a resignation by the shareholder for "good reason")?

- No, acceleration of payment upon a "good leaver" termination of employment does not change the tax consequences. Payments made to the employees become taxable on the date of payment receipt.

Does the result differ if the receipt of the proceeds is conditioned on satisfaction of certain performance criteria for the business (e.g., an "earn-out"), in addition to the continued employment condition?

- No, satisfaction or non-satisfaction of certain performance criteria for the business does not affect the tax consequences. Payments made to employees are subject to tax at the date of payment receipt.
- It should be noted that in case the payment of proceeds that are conditioned on satisfaction of certain performance criteria for the business, it might serve as additional evidence for the Russian tax authorities that such payment constitutes employees' compensation rather than capital gains.

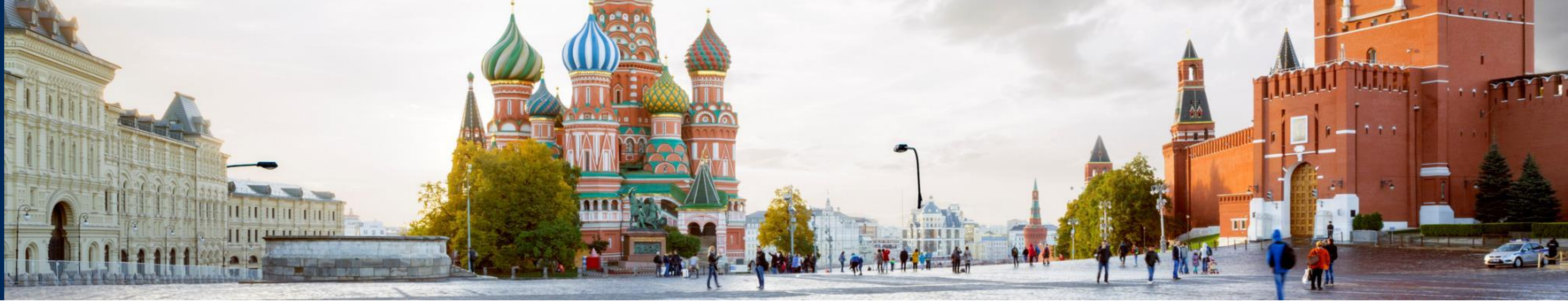
Do the tax consequences differ if the withheld portion of the proceeds is payable in the form of buyer stock (rather than cash)?

- Under the circumstances of the transaction, when payments for shares are made to the individual shareholders of the target company in the form of buyer stock, such transaction could be structured as a conversion (or exchange) of shares.
- If the transaction terms provide for a conversion (or exchange) of the shares of the target company into buyer stock and the individual shareholders receive income in the form of buyer stock, the statutory tax exemption applies to such income.

Does the result differ if other non-employee shareholders are receiving cash proceeds only?

- No, the relationships with non-employee shareholders would not affect the tax consequences for the payments to the employees (whether in the form of buyer stock or cash) as long as such different treatment is properly documented.

Russia



What impact, if any, does the valuation of the stock at the time of payment have on the tax treatment, when the number of shares of buyer stock issued is determined based on the stock price of buyer at the time of closing?

- For tax purposes, as long as the employee applies the tax exemption in case of shares conversion (exchange), there is no difference in tax consequences whether the number of buyer shares issued is determined based on the stock price of buyer at the time of closing or at the time of payment.
- If for any reason the statutory tax exemption based on conversion of shares would not apply, the number of buyer shares issued should be determined based on the stock price of buyer at the time of closing. It would be necessary since the taxable income would be calculated as the difference between the fair market value of buyer shares on the date of closing (i.e. at the time of conclusion of the agreement) and the amount of actual expenses of the employee for acquisition of buyer shares (i.e. the price of the target company shares owed to the employee under the target company acquisition agreement).

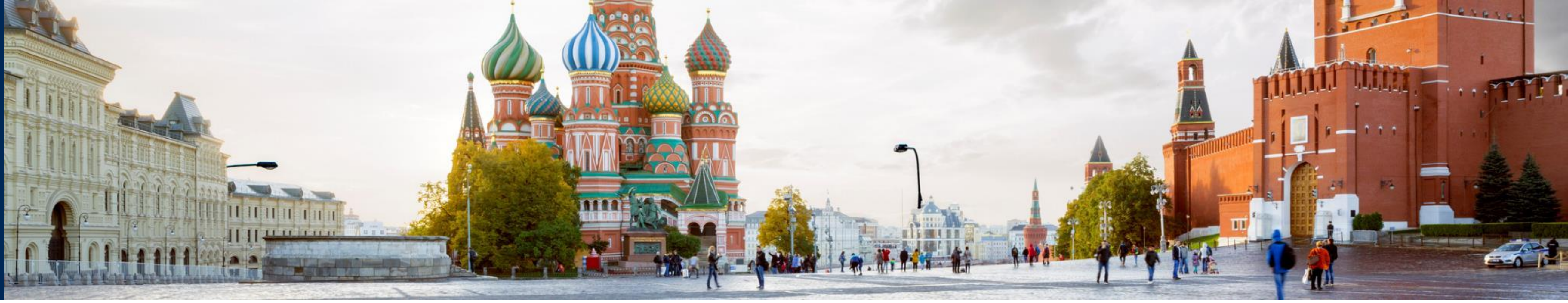
What impact, if any, does the valuation of the stock at the time of payment have on the tax treatment, when the number of shares of buyer stock issued is determined based on the stock price of buyer at the time of payment?

- For tax purposes, as long as the employee applies the tax exemption in the case of a share conversion (or exchange), there is no difference in the tax consequences for whether the number of buyer shares issued is determined based on the stock price of buyer at the time of closing or at the time of payment.
- If for any reason the statutory tax exemption based on conversion of shares would not apply, the number of buyer shares issued should be determined based on the stock price of buyer at the time of closing. This would be necessary because the taxable income would be calculated as the difference between the fair market value of buyer shares on the date of closing (i.e. at the time of conclusion of the agreement) and the amount of actual expenses of the employee for acquisition of the buyer shares (i.e. the price of the target company shares owed to the employee under the target company acquisition agreement).

Alternatively, does the analysis above differ if the proceeds, whether in the form of cash or buyer stock, are paid up front at closing, but are subject to a clawback provision (i.e., relinquishment or buy-back of stock, or repayment of cash) if the continued employment condition (or performance criteria) is not satisfied?

- If the continued employment condition (or performance criteria) is not satisfied, and payment for the shares has already been made to the employee shareholder, then the share purchase contract will be terminated in full or in part.
- The payment received by an individual who is the seller of assets (e.g. shares) and actually returned in full amount to the buyer as result of the termination of the agreement, generally does not constitute income and is not subject to individual income tax. There could also be no grounds for submitting a tax return, depending on the timing of the repayment of cash or relinquishment of buyer stock.
- In this case, the following two situations may take place:
  - If payments in the form of cash or buyer stock are made up front at closing, and the actual clawback (actual repayment of cash or return of shares) takes place in the same tax period, no individual income tax would be reported and paid since the employee did not receive any income in this tax period.
  - If payments in the form of cash or buyer stock are made up front at closing, and the actual clawback (actual repayment of cash or return of shares) takes place in a different tax period (next or later), the individual income tax would be reported and paid in the tax period when the employee received payments.
- Then, in the tax period when the actual clawback took place, the amount of tax effectively overpaid by the employee on the date of payment receipt could be set off against forthcoming payments for individual income tax or other taxes, arrears of taxes, penalties and fines, or could be refunded to the employee from the Russian budget.
- If excess tax was withheld by the Russian employer as the tax agent from the employee's income at the time of payment, the tax agent must refund it based on a written application of the employee in the tax period when the actual clawback took place.
- If the cash payments made by the Russian employer were re-characterized as compensation, in practice, the claw-back provision would not be enforceable.

Russia



If the proceeds are reported as capital gains and later, upon audit, determined to be compensation income, what are the risks / penalties / consequences for the shareholder? What are the risks / penalties / consequences for the buyer?

- The selling shareholder's income may be re-characterized as compensation if payments are made by the Russian employer and there is failure to prove with proper documentation that the payments constitute capital gains. In this case, no direct tax risks arise for the foreign buyer. However, the Russian employer would be required to withhold and pay the individual income tax from the gross amount of the employees' income, without deducting employees' expenses (but would be entitled to recognize payments to the employees as labor costs in order to reduce its corporate profits tax base). The Russian employer would also have to pay the social insurance contributions (which are not withheld or deducted from payments to the employees). In 2020, the Russian employing entity would pay: i. to the Russian Pension Fund, at the rate of 22% on the year-to-date salary and other payments not exceeding the threshold of RUB 1,292,000 (USD 17,500) plus 10% on the year-to-date salary and other payments exceeding that threshold, without a cap; ii. to the Social Security Fund, at the rate of 2.9% on the year-to-date salary and other payments not exceeding the threshold of RUB 912,000 (USD 12,300) and no additional contributions on the amounts exceeding that threshold; iii. to the Mandatory Medical Insurance Fund, at the rate of 5.1% on the total year-to-date salary and other payments, without a threshold; and iv. to the Social Security Fund covering occupational accidents and disease, at the applicable minimum rate of 0.2% for desk employees on the total year-to-date salary and other payments, without a threshold. The Russian tax authorities would also assess against the Russian employer the 20% tax penalty and late payment interest both for the under-withheld individual income tax and the social insurance contributions. The late payment interest is charged at 1/300th of the Russian Central Bank refinancing rate (currently it is equal to the ley rate at 5.50% per annum) for each day of delay in tax payment for the first 30 days of delay, plus 1/150th of the refinancing rate for each day of delay in tax payment beginning from day 31 of delay, and currently it is capped by the amount of the underpaid tax deficiency.

Singapore

For further information or assistance with tax treatment of holdback arrangements, please reach out to any of the contacts listed below or your usual Baker McKenzie contact.

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What is the capital gains tax rate in your jurisdiction that is applicable to individual stockholders upon a sale of a business?

- Singapore does not impose tax on capital gains. Any gains arising from the disposal of shares should not be subject to Singapore taxes if the gain is capital in nature.

What is the compensation income tax rate in your jurisdiction that is applicable to employees, including any employer tax withholding obligations?

- Gains or profits from any employment (including gains from equity awards such as stock options) sourced in Singapore are subject to Singapore income tax, unless specific an exemption or administrative concession applies. Income arising from employment in Singapore is deemed to be sourced in Singapore.
- Singapore tax resident employees are subject to tax on their Singapore employment income (net of available deductions / relief) at income tax rates ranging from 0% to 22%. Non-Singapore tax resident employees are taxed at the flat rate of 15% or the resident rates, whichever results in a higher tax amount on their Singapore employment income.
- Non-Singapore tax resident employees who are employed in Singapore for 60 days or less in a calendar year are exempt from tax any income in respect of gains / profits from any employment in Singapore. This exemption does not apply to emoluments received by a director of a company (among others).
- An employer's tax obligations for Singapore withholding tax does not apply to an employee's remuneration, unless a tax clearance event is triggered. Tax clearance reporting is required where a foreign employee or a Singapore permanent resident employee (i) ceases employment, (ii) departs from Singapore for more than 3 months, or (iii) is posted overseas (the "Tax Clearance Events"). In such circumstances, the employer will be required to seek tax clearance from the Inland Revenue Authority of Singapore ("IRAS") at least one month before the Tax Clearance Event occurs. The employer will need to report the employee's employment income (including the deemed gains from equity awards) to IRAS, and withhold all monies due to the employee until tax clearance is given or 30 days after the tax clearance is submitted to IRAS, whichever is earlier.

If, upon a sale of a business, (i) the buyer withholds a portion of the cash proceeds otherwise payable at closing to shareholders, who are also managers or employees of the business, in respect of their shares, and (ii) the buyer pays such cash proceeds to the shareholder over a period of time, subject to the shareholder remaining employed by the business post-closing on the applicable payment dates (as the only condition to payment), then: would the withheld portion of the purchase price become taxable to the shareholder on the date of payment (rather than on the closing date)?

- A taxable event will be triggered when the individual shareholder is legally entitled, and has an irrevocable right, to the sales proceeds (and hence the gain or profit on his or her sale of shares).

Singapore

If, upon a sale of a business, (i) the buyer withholds a portion of the cash proceeds otherwise payable at closing to shareholders, who are also managers or employees of the business, in respect of their shares, and (ii) the buyer pays such cash proceeds to the shareholder over a period of time, subject to the shareholder remaining employed by the business post-closing on the applicable payment dates (as the only condition to payment), then: would the withheld portion of the purchase price be taxed as capital gains or as compensation income?

- Capital gains are not taxable in Singapore. Whether the withheld portion of the purchase price will be regarded as employment income of the individual shareholders will depend on the specific terms and conditions under the sales and purchase agreement. Where the withheld portion is characterized as the individual shareholder's salary / employment income, and its payment / release is conditional upon the employee's continued employment in Singapore, there is a risk that the withheld portion of the purchase price may be regarded as employment income for Singapore income tax purposes. Whether a receipt is characterized as employment income is a question of fact and therefore requires a case by case analysis of the terms and conditions under the sales and purchase agreement. There are no definitive rules or specific factors that would determine the characterization of the receipt. In general, the more factors that indicate that the receipt is made to the recipient as a reward for or in return for acting as or for being an employee, the more likely a position would be taken that the receipt is a gain or profit from employment. The following non-exhaustive factors (which are not on their own conclusive and may carry varying levels of weight) may suggest the withheld amount is to be characterized as employment income:
  1. where the release of the withheld amount is conditional upon remaining employed by the business or where any outstanding withheld amount is forfeited if the employee leaves the company;
  2. whether the amount paid out from the withheld portion is calculated based on key performance indicators tied to the individual's performance as an employee (e.g., the amount that is paid out from the withheld sum each year depends on the individual employee's sales performance);
  3. whether the amount withheld (or duration withheld) depends on how long the employee has been employed in the company; and
  4. how the payment of the withheld sum is characterized by the company from an accounting point of view (e.g., as salary expenditure).]

Does the result differ if the payment of the proceeds is accelerated upon a "good leaver" termination of employment (i.e. a termination by the company without "cause" or a resignation by the shareholder for "good reason")?

- Capital gains are not taxable in Singapore. Whether the withheld portion of the purchase price will be regarded as employment income of the individual shareholders will depend on the specific terms and conditions under the sales and purchase agreement. Where the withheld portion is characterized as the individual shareholder's salary / employment income and its payment / release is conditional upon the employee's continued employment in Singapore, there is a risk that the withheld portion of the purchase price may be regarded as employment income for Singapore income tax purposes.

Does the result differ if the receipt of the proceeds is conditioned on satisfaction of certain performance criteria for the business (e.g., an "earn-out"), in addition to the continued employment condition?

- Capital gains are not taxable in Singapore. Whether the withheld portion of the purchase price will be regarded as an employment income of the individual shareholders will depend on the specific terms and conditions under the sales and purchase agreement. Where the withheld portion is characterized as the individual shareholder's salary / employment income and its payment / release is conditional upon the employee's continued employment in Singapore, there is a risk that the withheld portion of the purchase price may be regarded as employment income for Singapore income tax purposes.

Do the tax consequences differ if the withheld portion of the proceeds is payable in the form of buyer stock (rather than cash)?

- The fact that the non-employees shareholders receive the entire sales proceeds in cash, but the employee shareholders receive a portion of the sales proceeds in the form of buyer stock should not affect the analysis. The tax authorities may question the reason / rationale for the difference in treatment if they are aware of the arrangement.
- This assumes that "buyer stock" does not include / refer to employees' stock-based / equity awards, and the buyer stock issued to the employee shareholders is not subject to a selling restriction or moratorium. Otherwise, these factors may indicate or increase the risk that the withheld portion of the purchase price may be regarded as employment income for Singapore income tax purposes.

Singapore

Does the result differ if other non-employee shareholders are receiving cash proceeds only?

- The fact that the non-employee shareholders receive the entire sales proceeds in cash but the employee shareholders receive a portion of the sales proceeds in the form of buyer stock should not affect the analysis. The tax authorities may question the reason / rationale for the difference in treatment if they are aware of the arrangement.
- This assumes that "buyer stock" does not include / refer to employees' stock-based / equity awards, and the buyer stock issued to the employee shareholders is not subject to a selling restriction or moratorium. Otherwise, these factors may indicate or increase the risk that the withheld portion of the purchase price may be regarded as employment income for Singapore income tax purposes.

What impact, if any, does the valuation of the stock at the time of payment have on the tax treatment, when the number of shares of buyer stock issued is determined based on the stock price of buyer at the time of closing?

- This should not change the analysis.

What impact, if any, does the valuation of the stock at the time of payment have on the tax treatment, when the number of shares of buyer stock issued is determined based on the stock price of buyer at the time of payment?

- This should not change the analysis.

Alternatively, does the analysis above differ if the proceeds, whether in the form of cash or buyer stock, are paid up front at closing, but are subject to a clawback provision (i.e., relinquishment or buy-back of stock, or repayment of cash) if the continued employment condition (or performance criteria) is not satisfied?

- This should not change the analysis.

If the proceeds are reported as capital gains and later, upon audit, determined to be compensation income, what are the risks / penalties / consequences for the shareholder? What are the risks / penalties / consequences for the buyer?

- The employer has the obligation to file the return of the employee's employment income (including share and / or stock option gains) to IRAS annually. The employees have the obligation to report all employment gains as well as any other income / gain in their personal income tax returns and are responsible for paying their personal income tax.
- In the event that the proceeds are reported as capital gains and later, upon audit, determined to be employment income, the potential penalties that may be imposed on the buyer (i.e., employer) and the individual shareholder (i.e., employee) are as follows:
  1. a penalty of up to two times the tax undercharged imposed on the employer and the employee; and
  2. a fine not exceeding SGD5,000 or imprisonment for a term not exceeding 3 years or to both the employer and the employee.

  More serious penalties will apply if there was tax evasion.

South Korea

For further information or assistance with tax treatment of holdback arrangements, please reach out to any of the contacts listed below or your usual Baker McKenzie contact.

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What is the capital gains tax rate in your jurisdiction that is applicable to individual stockholders upon a sale of a business?

- Assuming that individual stock holders are Korean residents, the capital gain tax rates for share transfer are as follows:
  - Shares of majority shareholders: 22-33 % including local surtax; and
  - Other than the above : 11%-22% including local surtax.

  Note that listed shares of non-majority shareholders in the stock market are not subject to capital gain tax.

What is the compensation income tax rate in your jurisdiction that is applicable to employees, including any employer tax withholding obligations?

- The compensation tax rate is 6.6% to 46.2% (over KRW 500 million) including local surtax. Employers are responsible for withholding tax when they pay wage income to employees based on a simplified tax rate table which has a similar tax rate to general tax rates of 22-33 % including local surtax for shares of majority shareholders and 11%-22% including local surtax.

If, upon a sale of a business, (i) the buyer withholds a portion of the cash proceeds otherwise payable at closing to shareholders, who are also managers or employees of the business, in respect of their shares, and (ii) the buyer pays such cash proceeds to the shareholder over a period of time, subject to the shareholder remaining employed by the business post-closing on the applicable payment dates (as the only condition to payment), then: would the withheld portion of the purchase price become taxable to the shareholder on the date of payment (rather than on the closing date)?

- This remains an area of uncertainty as the terms and conditions of a relevant contract for a specific transaction would need to be reviewed. Assuming that the title of shares is transferred on the closing date and there remains an unpaid purchase price of a fixed purchase price on the closing date, which would not change under a certain condition, such unpaid purchase price would be taxable on the closing date. However, if a remaining unpaid purchase price could be viewed as an adjustment to the purchase price on the closing date, subject to change under a certain condition, then such unpaid purchase price would be adjusted to the already paid purchase price on the date of payment and become taxable on the date of payment.

South Korea

If, upon a sale of a business, (i) the buyer withholds a portion of the cash proceeds otherwise payable at closing to shareholders, who are also managers or employees of the business, in respect of their shares, and (ii) the buyer pays such cash proceeds to the shareholder over a period of time, subject to the shareholder remaining employed by the business post-closing on the applicable payment dates (as the only condition to payment), then: would the withheld portion of the purchase price be taxed as capital gains or as compensation income?

- There is no precedent or ruling which directly deals with this case. Based on the court ruling which treats gains from sales of shares by employees with a put option granted by the parent company as compensation income, the withheld portion of the purchase price could be viewed as compensation income depending on the relevant conditions. However, it could be treated as other income (which is subject to income tax at a rate of 6.6~46.2%) or capital gains by the tax authority.

Does the result differ if the payment of the proceeds is accelerated upon a "good leaver" termination of employment (i.e. a termination by the company without "cause" or a resignation by the shareholder for "good reason")?

- No. It appears that the characteristics of income are more related to the condition of when payment is fully made (i.e., whether the payment could be viewed as being made for the compensation of the employee's performance, etc.).

Does the result differ if the receipt of the proceeds is conditioned on satisfaction of certain performance criteria for the business (e.g., an "earn-out"), in addition to the continued employment condition?

- Yes. It appears that the characteristics of income are more related to the condition of when payment is fully made (i.e., whether the payment could be viewed as being made for the compensation of the employee's performance, etc.).

Do the tax consequences differ if the withheld portion of the proceeds is payable in the form of buyer stock (rather than cash)?

- No. It appears that the characteristics of income are more related to the condition of when payment is fully made (i.e., whether the payment could be viewed as being made for the compensation of the employee's performance, etc.).

Does the result differ if other non-employee shareholders are receiving cash proceeds only?

- No. It appears that the characteristics of income are more related to the condition of when payment is fully made (i.e., whether the payment could be viewed as being made for the compensation of the employee's performance, etc.).

What impact, if any, does the valuation of the stock at the time of payment have on the tax treatment, when the number of shares of buyer stock issued is determined based on the stock price of buyer at the time of closing?

- No. It appears that the characteristics of income are more related to the condition of when payment is fully made (i.e., whether the payment could be viewed as being made for the compensation of the employee's performance, etc.).

South Korea

What impact, if any, does the valuation of the stock at the time of payment have on the tax treatment, when the number of shares of buyer stock issued is determined based on the stock price of buyer at the time of payment?

- No. It appears that the characteristics of income are more related to the condition of when payment is fully made (i.e., whether the payment could be viewed as being made for the compensation of the employee's performance, etc.).

Alternatively, does the analysis above differ if the proceeds, whether in the form of cash or buyer stock, are paid up front at closing, but are subject to a clawback provision (i.e., relinquishment or buy-back of stock, or repayment of cash) if the continued employment condition (or performance criteria) is not satisfied?

- The analysis does not differ in substance as it appears that the characteristics of income are more related to the condition of when payment is fully made (i.e., whether the payment could be viewed as being made for the compensation of the employee's performance, etc.). However, a better argument may be made that the clawback portion represents a purchase price adjustment in this case as compared to the case of withholding purchase price proceeds that are payable over a period of time.

If the proceeds are reported as capital gains and later, upon audit, determined to be compensation income, what are the risks / penalties / consequences for the shareholder? What are the risks / penalties / consequences for the buyer?

- The risks / penalties / consequences are as follows:
  1. Shareholders:- Additional tax from the tax rate difference between capital gains tax and compensation tax rate;- Penalties for underreporting of tax: 10% of underreporting tax; and- Penalties for underpayment: underpaid tax times 25/100,000 times days of underpayment.
  2. Buyers:- Withholding tax for compensation tax based on the simplified tax rate table (which could be reimbursed by shareholders pursuant to terms and conditions of a contract);- Penalties for failure to withhold taxes: 3% of underpaid taxes plus underpaid tax times 25/100,000 times days of underpayment (up to 10% of underpaid taxes); and- Penalty for non-filing of payment statement: 1% of payment.

Spain

For further information or assistance with tax treatment of holdback arrangements, please reach out to any of the contacts listed below or your usual Baker McKenzie contact.

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What is the capital gains tax rate in your jurisdiction that is applicable to individual stockholders upon a sale of a business?

- Capital gains tax rates depend on the total savings income amount (19%, 21% and 23%). If the total annual savings income tax base (interests, dividends and capital gains per calendar year) exceeds €50.000, such income is taxed at a 23% rate. (Note that a 27% maximum flat tax rate for savings income is expected to be implemented in the near future).

What is the compensation income tax rate in your jurisdiction that is applicable to employees, including any employer tax withholding obligations?

- The compensation tax rate is progressive and depends on the total taxable compensation income. Generally, a maximum 45% withholding rate applies for taxable compensation income exceeding €60,000, though the maximum final tax rate depends on the region in which the individual resides (currently ranging from 43.5%-52%, though an increase is expected in the near future).

If, upon a sale of a business, (i) the buyer withholds a portion of the cash proceeds otherwise payable at closing to shareholders, who are also managers or employees of the business, in respect of their shares, and (ii) the buyer pays such cash proceeds to the shareholder over a period of time, subject to the shareholder remaining employed by the business post-closing on the applicable payment dates (as the only condition to payment), then: would the withheld portion of the purchase price become taxable to the shareholder on the date of payment (rather than on the closing date)?

- The answer varies depending on the characterization of the withheld portion either as employment income or as capital gain, which would mainly depend on the relevant circumstances of the case. The withheld amount might be deposited in an escrow account as a guarantee for either the buyer or the seller. The seller may generally be taxed on the entire purchase price on the closing date, and, if there is a difference in the final purchase price that the seller receives, then he/she should amend his/her tax return accordingly. It could also happen that the transaction results in a capital gain that is allocated as installments, in which case, even though the capital gain is calculated on the closing date, it might be allocated for tax purposes when payments are made, assuming that more than 1 year elapses between payments.

If, upon a sale of a business, (i) the buyer withholds a portion of the cash proceeds otherwise payable at closing to shareholders, who are also managers or employees of the business, in respect of their shares, and (ii) the buyer pays such cash proceeds to the shareholder over a period of time, subject to the shareholder remaining employed by the business post-closing on the applicable payment dates (as the only condition to payment), then: would the withheld portion of the purchase price be taxed as capital gains or as compensation income?

- If the payment of such withheld amounts is linked to the selling shareholders continuing to render services at the company (and such is the only condition to pay such withheld amount), the Spanish Tax Authorities might find that this amount is deemed compensation income for those employees, and thus re-characterize such payment from capital gain to compensation (employment) income, subject to tax withholding and social security contributions (if not capped).

Spain

Does the result differ if the payment of the proceeds is accelerated upon a "good leaver" termination of employment (i.e. a termination by the company without "cause" or a resignation by the shareholder for "good reason")?

- Yes, the risk of requalification by the Spanish Tax Authorities increases as such clause is linked to an employment contract.

Does the result differ if the receipt of the proceeds is conditioned on satisfaction of certain performance criteria for the business (e.g., an "earn-out"), in addition to the continued employment condition?

- It appears that if the proceeds are paid depending on the satisfaction of performance criteria (such as EBITDA, sales development or client retaining ratios), in addition to the continued employment condition, the risk of requalification would still remain as the Spanish Tax Authorities might link the development of such ratios with the condition of employment of the seller and shareholder.

Do the tax consequences differ if the withheld portion of the proceeds is payable in the form of buyer stock (rather than cash)?

- The risk of requalification remains irrespective of whether the payment is in the form of cash or buyer stock if the incentive derives from an employment relationship between the shareholder and the company. Note that an exchange of shares may qualify as a tax neutral transaction.

Does the result differ if other non-employee shareholders are receiving cash proceeds only?

- If other non-employee shareholders receive cash proceeds only, while employee shareholders receive buyer stock, such difference might be seen as a consequence from the employment condition. This triggers the risk of re-characterization as employment income by the Spanish Tax Authorities.

What impact, if any, does the valuation of the stock at the time of payment have on the tax treatment, when the number of shares of buyer stock issued is determined based on the stock price of buyer at the time of closing?

- If the number of shares issued is determined based on the closing price, and the proceeds (in form of shares) are paid on a later date, this might reduce the risk of re characterization as income since the subsequent rendering of services of the employee has not direct impact on the valuation of the shares.

What impact, if any, does the valuation of the stock at the time of payment have on the tax treatment, when the number of shares of buyer stock issued is determined based on the stock price of buyer at the time of payment?

- If the number of shares issued is calculated at the time of the payment, the Spanish Tax Authorities may have an additional argument to re characterize the withheld portion as compensation income given that the relevant amount is dependent on the development of the employee activities.

Alternatively, does the analysis above differ if the proceeds, whether in the form of cash or buyer stock, are paid up front at closing, but are subject to a clawback provision (i.e., relinquishment or buy-back of stock, or repayment of cash) if the continued employment condition (or performance criteria) is not satisfied?

- Generally, the analysis should not differ because if the employment contract link still remains, whether the amount is paid up-front or in the future by the buyer, this might still be seen as evidence for the Spanish Tax Authorities to reclassify such income as compensation income, subject to progressive tax rates and withholdings and social security contributions for the payer.

Spain

If the proceeds are reported as capital gains and later, upon audit, determined to be compensation income, what are the risks / penalties / consequences for the shareholder? What are the risks / penalties / consequences for the buyer?

- Shareholder: Payment of the tax due and not paid (difference between 23% tax rate of capital gains and 43,5%-52% maximum rate on compensation income), plus penalties (75%-150% though certain reductions might apply) and default interests. If the tax due and not paid exceeds €120,000 per tax and year, a criminal offence might have been committed.
- Buyer: Payment of withholding taxes and social security contributions not paid if any. Withholdings could be claimed back from the shareholder as they are the shareholder's Personal Income Tax liability. Penalties and default interests should in any case be borne by the employer, in its condition as the withholding agent.

United Kingdom

For further information or assistance with tax treatment of holdback arrangements, please reach out to any of the contacts listed below or your usual Baker McKenzie contact.

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What is the capital gains tax rate in your jurisdiction that is applicable to individual stockholders upon a sale of a business?

- 20% unless they benefit from Entrepreneurs' relief, in which case it is 10%.

What is the compensation income tax rate in your jurisdiction that is applicable to employees, including any employer tax withholding obligations?

- Variable income tax rates up to 45% and employee social security contributions of 2% (on income above £50,000 p.a.). Employer social security contributions are 13.8% and uncapped. Employers with wage bills over £3m also pay the apprenticeship levy at 0.5%.

If, upon a sale of a business, (i) the buyer withholds a portion of the cash proceeds otherwise payable at closing to shareholders, who are also managers or employees of the business, in respect of their shares, and (ii) the buyer pays such cash proceeds to the shareholder over a period of time, subject to the shareholder remaining employed by the business post-closing on the applicable payment dates (as the only condition to payment), then: would the withheld portion of the purchase price become taxable to the shareholder on the date of payment (rather than on the closing date)?

- The answer depends on whether the withheld portion is ascertainable or unascertainable. If the amount is ascertainable, it will be taxed in full upon closing with the ability for a shareholder to adjust his or her return if the withheld portion is not eventually paid out. If the amount is unascertainable, the right to receive the withheld amount will be taxed upon the closing date based on its net present value, i.e. a discount for uncertainty and delay. The withheld portion is treated as a separate asset that is disposed of upon the date of payment, which could lead to a second taxable event (or a taxable loss).

United Kingdom

If, upon a sale of a business, (i) the buyer withholds a portion of the cash proceeds otherwise payable at closing to shareholders, who are also managers or employees of the business, in respect of their shares, and (ii) the buyer pays such cash proceeds to the shareholder over a period of time, subject to the shareholder remaining employed by the business post-closing on the applicable payment dates (as the only condition to payment), then: would the withheld portion of the purchase price be taxed as capital gains or as compensation income?

- The withheld portion of the purchase price will be taxed as capital gains provided that the conditions below are met:

1. The withheld portion is part of the valuable consideration given for the shares,
2. The value received from the withheld portion reflects the value of the shares sold,
3. The withheld portion is not compensation for the manager/employee not being fully remunerated for continuing employment,
4. The withheld portion is not conditional on future employment beyond a reasonable requirement to stay to protect the value of the business being sold - it would be hard to justify a period of more than 2 years,
5. The withheld portion is not conditional upon personal performance targets - these should be limited to company performance targets (if any),
6. Non-employees or former employees receive the withheld portion on the same terms as employees.

The important point is a valuation one, namely that employee sellers and non-employee sellers receive the same value of consideration upon the closing date, whether that is in the form of upfront consideration or withheld portion. This means that the net present value of the withheld portion needs to be considered. The above considerations are all factors to consider and so the position as a whole will need to be reviewed as well as individual provisions. Note that with respect to options and restricted stock units (RSUs) that are settled in shares, if unexercised options and unvested RSUs pay out as part of the transaction and have a portion of the cash purchase price withheld, they could still be subject to income tax and social security on the full value of the option/RSU holder consideration (both upfront and withheld) on completion.

Does the result differ if the payment of the proceeds is accelerated upon a "good leaver" termination of employment (i.e. a termination by the company without "cause" or a resignation by the shareholder for "good reason")?

- This is not determinative but would be considered in light of the factors below.
  - The withheld portion of the purchase price will be taxed as capital gains provided that the conditions below are met:
    1. The withheld portion is part of the valuable consideration given for the shares,
    2. The value received from the withheld portion reflects the value of the shares sold,
    3. The withheld portion is not compensation for the manager/employee not being fully remunerated for continuing employment,
    4. The withheld portion is not conditional on future employment beyond a reasonable requirement to stay to protect the value of the business being sold - it would be hard to justify a period of more than 2 years,
    5. The withheld portion is not conditional upon personal performance targets - these should be limited to company performance targets (if any),6. Non-employees or former employees receive the withheld portion on the same terms as employees..

Does the result differ if the receipt of the proceeds is conditioned on satisfaction of certain performance criteria for the business (e.g., an "earn-out"), in addition to the continued employment condition?

- Performance conditions for the business are permitted. Personal performance conditions would mean that the payment is employment income instead of capital gains. Any business performance conditions should ideally also apply to any non-employee sellers.

United Kingdom

Do the tax consequences differ if the withheld portion of the proceeds is payable in the form of buyer stock (rather than cash)?

- Payment in the form of buyer stock can impact the timing of the capital gains treatment and may result in a deferral of taxation until disposal of the shares. If the amount is ascertainable, it will be taxed in full upon closing with the ability for a shareholder to adjust his or her return if the withheld portion is not eventually paid out. If the amount is unascertainable, the right to receive the withheld amount will be taxed upon the closing date based on its net present value, i.e. a discount for uncertainty and delay. The withheld portion is treated as a separate asset that is disposed of upon the date of payment, which could lead to a second taxable event (or a taxable loss).

Does the result differ if other non-employee shareholders are receiving cash proceeds only?

- This will be a factor to consider, but the important point is that all sellers receive the same net present value at closing.

What impact, if any, does the valuation of the stock at the time of payment have on the tax treatment, when the number of shares of buyer stock issued is determined based on the stock price of buyer at the time of closing?

- None - stock will be taxable when sold based on the sale proceeds less the base cost.

What impact, if any, does the valuation of the stock at the time of payment have on the tax treatment, when the number of shares of buyer stock issued is determined based on the stock price of buyer at the time of payment?

- None.

Alternatively, does the analysis above differ if the proceeds, whether in the form of cash or buyer stock, are paid up front at closing, but are subject to a clawback provision (i.e., relinquishment or buy-back of stock, or repayment of cash) if the continued employment condition (or performance criteria) is not satisfied?

- The proceeds will be taxed at completion as capital gain. If being paid via stock, the company and the individuals may need to consider entering into 431 elections to exclude the application of the restricted securities regime from an income tax perspective after completion. Please note that it is currently unlikely that employees will be able to claim any rebate on any income tax paid on acquisition of the shares if they are later subject to clawback. Any clawback can give rise to a loss for capital gains tax purposes.

If the proceeds are reported as capital gains and later, upon audit, determined to be compensation income, what are the risks / penalties / consequences for the shareholder? What are the risks / penalties / consequences for the buyer?

- As there will be a withholding obligation, the employing entity could be liable for income tax, employee and employer social security contributions. In such case, the employing company may recover income tax and employee social security contributions (and to the extent permitted employer social security contributions) from the employee. The employing company would also owe interest and could have penalties of up 100% of the amount due. The employee would face a claim for payment (most likely from the employer) and would need to amend his or her self-assessment return to avoid paying income tax and capital gains tax on the same amount.

USA

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What is the capital gains tax rate in your jurisdiction that is applicable to individual stockholders upon a sale of a business?

- Short-term capital gains for assets held for one year or less are taxed at federal ordinary income rates of up to 37% (with the actual rate being a progressive rate determined based on the individual's taxable income). Long-term capital gains for assets held more than one year are taxed at a maximum rate of 20% (with the actual rate determined being a progressive rate determined based on the individual's taxable income) for federal income tax purposes. An additional 3.8% surcharge applies to certain investment income of individuals. Additional taxes may apply for state and local income tax purposes.

What is the compensation income tax rate in your jurisdiction that is applicable to employees, including any employer tax withholding obligations?

- Compensation income is taxed at federal ordinary income rates of up to 37% (with the actual rate being a progressive rate determined based on the individual's taxable income). Additional taxes may apply for state and local income tax purposes.
- Employers are required to withhold from compensation paid to employees for federal income tax, Social Security tax and Medicare tax.
- The amount required to be withheld for federal income tax generally depends on the employee's wages, filing status and number of withholding exemptions. The required withholding amount for Social Security tax is 6.2% of the first USD 137,700 (for 2020) of wages paid, and for Medicare tax is 1.45% on the first USD 200,000 of wages plus an additional 0.9% for wages above USD 200,000.
- Additional withholding tax obligations may apply for state and local income tax purposes.

If, upon a sale of a business, (i) the buyer withholds a portion of the cash proceeds otherwise payable at closing to shareholders, who are also managers or employees of the business, in respect of their shares, and (ii) the buyer pays such cash proceeds to the shareholder over a period of time, subject to the shareholder remaining employed by the business post-closing on the applicable payment dates (as the only condition to payment), then: would the withheld portion of the purchase price become taxable to the shareholder on the date of payment (rather than on the closing date)?

- If the holdback is treated as purchase price consideration and eligible for capital gains treatment (as described above), then the payments will generally be taxable upon receipt under the installment sale method of reporting, subject to exceptions for consideration payable in exchange for certain types of assets (e.g., inventory, publicly-traded stock).
- If the holdback is treated as compensation income (as described above), then the payments will generally be taxable upon receipt, subject to compliance with, or an exemption available under, the deferred compensation rules of U.S. Internal Revenue Code Section 409A.

USA

If, upon a sale of a business, (i) the buyer withholds a portion of the cash proceeds otherwise payable at closing to shareholders, who are also managers or employees of the business, in respect of their shares, and (ii) the buyer pays such cash proceeds to the shareholder over a period of time, subject to the shareholder remaining employed by the business post-closing on the applicable payment dates (as the only condition to payment), then: would the withheld portion of the purchase price be taxed as capital gains or as compensation income?

- Generally, the withheld portion of the purchase price may be treated as purchase price consideration (taxed at capital gains rates provided the asset being transferred is a capital asset), unless it is determined that the payments are being made to the management-shareholder in connection with the performance of services for the buyer or its affiliates, in which case, the payments should be treated as compensation income (taxed at ordinary income rates). This determination ultimately depends on the facts and circumstances of the particular transaction, with no single factor being determinative. A requirement for the management shareholder to remain employed through certain post-closing dates as a condition to the receipt of payment is generally indicative of treatment as compensation income. However, other factors to consider in support for treating the withheld portion as purchase price consideration may include the following: (i) the total payments made to all selling shareholders represent a reasonable value of the price paid to acquire the company, (ii) the value of the withheld portion reflects (and does not exceed) the proportionate value of the consideration that actually becomes payable to other selling shareholders holding shares of the same type, (iii) the payment period for the withheld portion is reasonable, (iv) the management-shareholder is separately entitled to reasonable compensation for the performance of post-closing services with the buyer or its affiliates, (iv) the amount of the holdback payable to the management shareholders does not vary based on the location of employment, length of employment, job classification or other factors traditionally used to determine employee compensation, and (v) the definitive agreement underlying the sale of the company and related ancillary documents are appropriately drafted to reflect the intended tax treatment of the withheld portion as purchase price consideration. In addition, it is important to consider the sources of the withheld portion of the purchase price consideration which may include proceeds payable with respect to equity incentive awards, in addition to shares held directly by the management-shareholder, in which case, the payments may be subject to the deferred compensation rules of Code Section 409A and would need to be structured to be exempt from, or compliant with, Code Section 409A.

Does the result differ if the payment of the proceeds is accelerated upon a "good leaver" termination of employment (i.e. a termination by the company without "cause" or a resignation by the shareholder for "good reason")?

- This factor is not determinative, but should be considered as part of the facts and circumstances analysis of whether the purchase price be taxed as capital gains or as compensation income. In particular, providing for payment of the proceeds upon a "good leaver" termination of employment increases the likelihood that the purchase price consideration will be paid to the management-shareholder.

Does the result differ if the receipt of the proceeds is conditioned on satisfaction of certain performance criteria for the business (e.g., an "earn-out"), in addition to the continued employment condition?

- This factor is not determinative, but should be considered as part of the facts and circumstances analysis of whether the purchase price be taxed as capital gains or as compensation income. For example, if the earn-out is based on the satisfaction of financial or other business performance conditions (as opposed to individual performance conditions) and/or the earn-out is payable on the same terms and conditions to non-employee shareholders, this would provide support for treating the withheld portion as purchase price consideration.

Do the tax consequences differ if the withheld portion of the proceeds is payable in the form of buyer stock (rather than cash)?

- This does not change the facts and circumstances analysis as to whether the withheld portion of the purchase price will be treated as purchase price consideration or compensation income, but paying in the form of buyer stock, rather than cash, raises other tax issues.
- If the buyer stock is treated as purchase price consideration and the installment sale method of reporting applies, then the shares of buyer stock will generally become taxable to the management-shareholder at the time each installment payment is received (i.e., not taxable at closing), with the taxable amount generally determined in proportion to the gain realized from the difference between the value of the shares of buyer stock received and the basis in the shares of target stock previously held by the management-shareholder.

- If the buyer stock is treated as compensation income, then the tax rules of U.S. Internal Revenue Code Section 83 apply. Under Section 83, the value of buyer stock received would be taxed as compensation income (at ordinary income tax rates) at the time that the shares of buyer stock are no longer subject to a substantial risk of forfeiture (i.e., at the time the shares are earned and vested) and (y) any subsequent appreciation in value of buyer stock would be taxed at capital gains rates at the time of disposition of buyer stock. However, if the management-shareholder makes a timely election under Section 83(b) to be taxed on the value of buyer stock received, then (i) the management-shareholder should not recognize any compensation income at closing, assuming that the value of buyer stock received is equal to the amount paid by the management-shareholder to acquire buyer stock (i.e., the value of the proceeds that would otherwise be payable at closing in respect of the target equity held by the management-shareholder) and (ii) the management-shareholder should receive capital gains treatment on the subsequent disposition of buyer stock.

Does the result differ if other non-employee shareholders are receiving cash proceeds only?

- This factor is not determinative, but should be considered as part of the facts and circumstances analysis when considering whether tax consequences differ if the withheld portion of the proceeds is payable in stock rather than cash.

What impact, if any, does the valuation of the stock at the time of payment have on the tax treatment, when the number of shares of buyer stock issued is determined based on the stock price of buyer at the time of closing?

- If the number of shares of buyer stock issued is determined based on the stock price of buyer at the time of closing, then the value of the shares delivered to the management-shareholder should correspond proportionately to the value of the purchase price consideration received by other selling shareholders at closing, which would provide support for treating the withheld portion as purchase price consideration. While this factor is not determinative, it should be considered as part of the facts and circumstances analysis when considering whether tax consequences differ if the withheld portion of the proceeds is payable in stock rather than cash.

What impact, if any, does the valuation of the stock at the time of payment have on the tax treatment, when the number of shares of buyer stock issued is determined based on the stock price of buyer at the time of payment?

- If the number of shares of buyer stock issued is determined based on the stock price of buyer at the time of payment, then the value of the shares delivered to the management-shareholder would reflect any increase or decrease in the stock price of buyer between the date of closing and the date of payment. The characterization of this incremental value is likely to follow the treatment of the shares as purchase price consideration or compensation income. An alternative approach may be to bifurcate the treatment between purchase price consideration and compensation income. While this factor is not determinative, it should be considered as part of the facts and circumstances analysis when considering whether tax consequences differ if the withheld portion of the proceeds is payable in stock rather than cash.

Alternatively, does the analysis above differ if the proceeds, whether in the form of cash or buyer stock, are paid up front at closing, but are subject to a clawback provision (i.e., relinquishment or buy-back of stock, or repayment of cash) if the continued employment condition (or performance criteria) is not satisfied?

- The tax treatment applicable to determination of whether tax consequences differ if the withheld portion of the proceeds is payable in stock rather than cash generally applies. The clawback amount is typically payable by the management-shareholder on an after-tax basis and the parties may additionally seek to claim a refund, offset or loss associated with any taxes previously paid on amounts returned to the buyer. There may also be employment law issues to consider regarding enforceability of the clawback.

USA

If the proceeds are reported as capital gains and later, upon audit, determined to be compensation income, what are the risks / penalties / consequences for the shareholder? What are the risks / penalties / consequences for the buyer?

- The shareholder would be subject to tax on the difference resulting from characterizing the amount at issue as compensation income, plus a late payment penalty (equal to 0.5% of the amount of tax owed for each month that remains unpaid from the due date, up to a maximum of 25%) and interest (equal to the federal short-term interest rate plus 3%). Additional penalties and interest may apply for federal, state and local income tax purposes.
- The buyer would be responsible for employer tax reporting and withholding penalties, including a penalty for failure to make required deposits (ranging from 2% to 15% of the late deposit), a penalty for failure to file a timely return (equal to 5% per month of the tax due on the return, up to a maximum of 25%) and a late payment penalty (equal to 0.5% of the amount of tax owed for each month that remains unpaid from the due date, up to a maximum of 25%), and interest (equal to the federal short-term interest rate plus 3%). Additional penalties and interest may apply for federal, state and local income tax reporting and withholding purposes.
- Additional penalties may apply in cases of negligence, intentional disregard of rules or regulations, fraud or tax evasion.

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