

# Leveraging MSO Deferral Plans in M&A Transactions: *A Win-Win* for Buyers and Sellers

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## Introduction

Merger-and-acquisition (“M&A”) deals live and die by after-tax economics. Earn-outs, installment payments, and competing buyer-seller tax objectives often become sticking points that erode value or derail negotiations altogether. A **Management Services Organization (“MSO”) Deferral Plan** offers a unique way to turn that friction into shared upside—allowing sellers to accrue earn-out proceeds **before** taxes while giving buyers an immediate deduction that lowers the true cost of the acquisition.

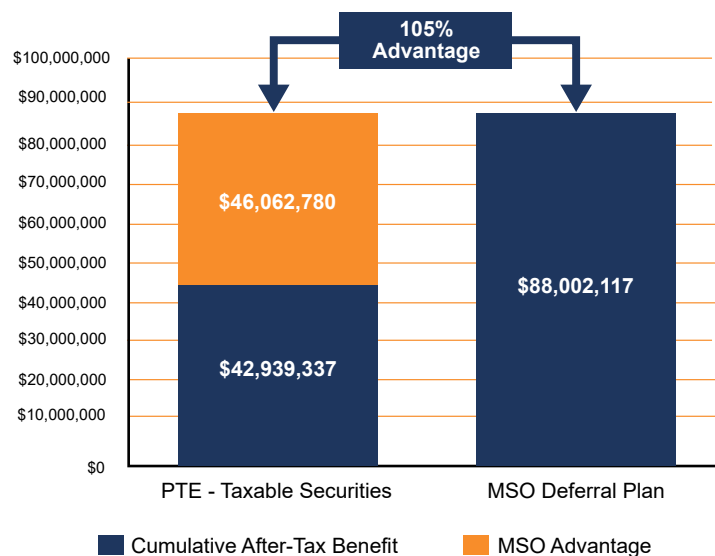
## MSO Deferral Plan—Background and Mechanics

Pass-through entity (“PTE”) owners have historically had no practical avenue to defer their own compensation: any amount “set aside” still flowed through and triggered current income tax. The solution:

1. Form an **MSO C corporation (C Corp)** to provide bona-fide management services to the operating business.
2. Have the operating company **pay a deductible management fee** to the MSO.
3. Treat a portion of that fee as **“reasonable compensation”** and **defer** it into a traditional nonqualified Deferred Compensation Plan (DCP) sponsored by the MSO.

### Tax arbitrage in action:

**Assumptions:** 37% PTE tax rate (taxable securities also incorporates 3.8% NIIT) vs. 30% C corporation (“C Corp”) rate; \$5 million deferred annually for five years at a 7% gross return; 15-year accumulation period and 10-year payout.



## Why MSO Deferral Plans Matter in M&A

Earn-outs are typically taxed at capital gains to the seller and amortized over time to the buyer. But, when the earn-out payments are sent to the seller through an MSO for ongoing services, the tax implications change for both the buyer and seller:

- Payments to the MSO are converted to **ordinary income** for the seller and are **immediately deductible** for the buyer; the sellers “reasonable compensation” amount can then be **deferred**.
- The buyer’s present-value tax savings could be shared, raising the headline purchase price without increasing the buyer’s *net* cost.
- Sellers achieve **pre-tax growth** on the deferred proceeds (i.e., the earn-out) and can better control the timing of tax recognition while accumulating wealth on a tax-favored basis.



## Benefits to the Seller

Selling a closely held business is often a once-in-a-lifetime liquidity event, and the way the proceeds are taxed can materially alter a founder’s net outcome. Routing contingent payments through an **MSO Deferral Plan** effectively place the earn-out into a tax-favored position that lets the seller decide when—and over how many years—to recognize the income as taxable. Not only does that preserve income tax bracket strategy, but it also allows the sellers’ capital to compound **pre-tax** inside the deferred compensation plan that provides access to institutionally priced investment funds.

The arrangement simultaneously provides a narrative for continued seller involvement: the MSO performs management and advisory services post-closing, buttressing the valuation that supports the earn-out. In order to effectuate this strategy, the deferred compensation plan should reside within a C Corp, the original owners of the parent S corporation (“S Corp”) or Limited Liability Company (LLC) (“the seller”) entities can elect a **tax-free S-to-C conversion**.

Most importantly, the seller can leverage every dollar of the buyer’s immediate deduction through a negotiated “gross-up,” lifting the stated purchase price without costing the buyer.

- ✓ Defers recognition of earn-out payments, allowing the seller to spread income over multiple years and potentially manage tax brackets more efficiently.
- ✓ Provides flexibility in structuring payments, as compensation for services, which can be tailored to the seller's financial and tax planning needs.
- ✓ Enables the seller to offset income taxes by investing in qualifying assets (e.g., solar, energy), potentially reducing the effective tax burden.
- ✓ May allow for the conversion of an S Corp to a C Corp, simplifying the receipt and deferral of earn-out payments.
- ✓ Seller is able to establish business purpose by utilizing an MSO to receive earn-out payments for services rendered to the buyer.
- ✓ Can increase the overall value of the transaction by negotiating a share of the buyer's tax deduction benefit.
- ✓ Offers a structured approach to manage contingent liabilities and post-sale obligations through the MSO entity.
- ✓ Provides the seller with a creative, tax-efficient strategy that will align both parties' objectives.

## Benefits to the Buyer

For buyers, an MSO Deferral Plan fundamentally **recharacterizes earn-out payments**. Instead of amortizing purchase price over 15 years—and waiting that long to enjoy the deduction—the buyer books an ordinary income expense the moment the MSO invoices for services. On a \$25 million earn-out paid evenly over five years, that acceleration alone can generate roughly **\$7.5 million in tax savings**, assuming a 30% corporate rate.

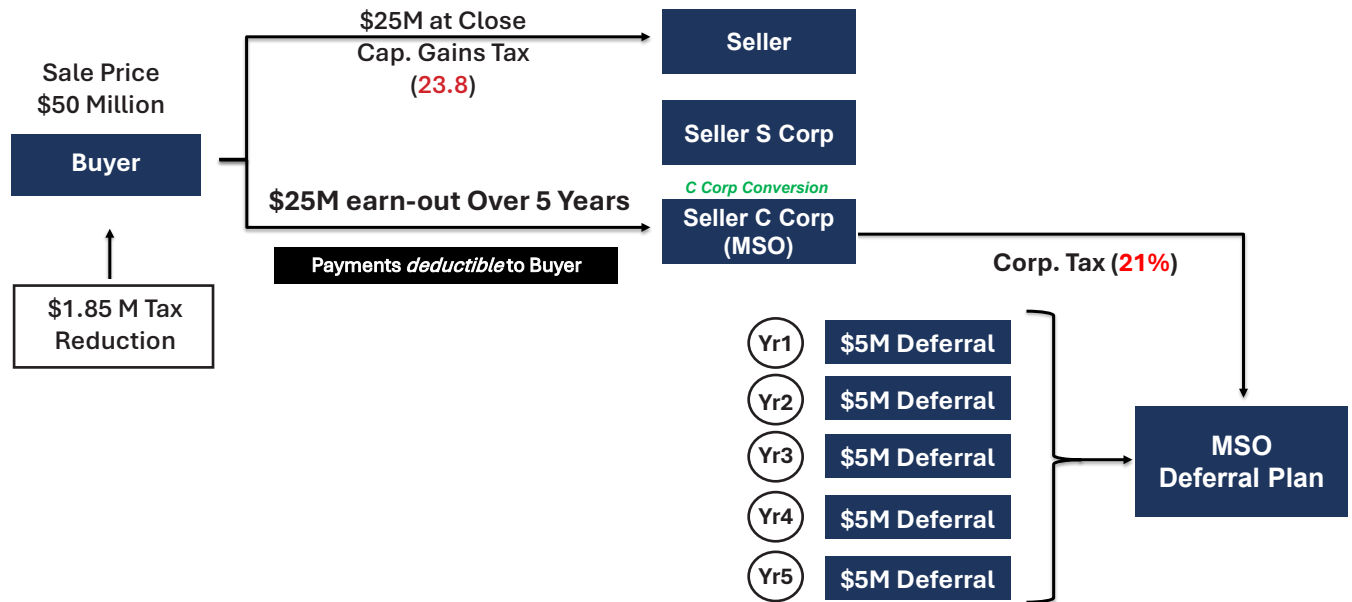
Those savings can be redeployed to fund integration costs, service acquisition debt, or **simply increase the offer price** (Note: which may be needed to consummate the deal) while leaving the buyer's net economics unchanged. Implementation is almost friction-free: the seller can establish and fund the plan without buyer approval. By letting both parties share in a newly created pool of tax alpha, the structure raises deal certainty—often a more valuable commodity than a marginal boost in valuation.

## Deal Structures—Asset Sale vs. Stock Sale

| Deal Type         | Typical Flow of Earn-Out                           | MSO Implementation                                                                 |
|-------------------|----------------------------------------------------|------------------------------------------------------------------------------------|
| <b>Asset Sale</b> | Earn-out paid to Legacy S Corp (seller).           | Convert the S Corp to a C Corp MSO that invoices the buyer for services.           |
| <b>Stock Sale</b> | Earn-out paid directly to individual shareholders. | Form a <b>new</b> MSO C Corp to provide ongoing services and receive the earn-out. |

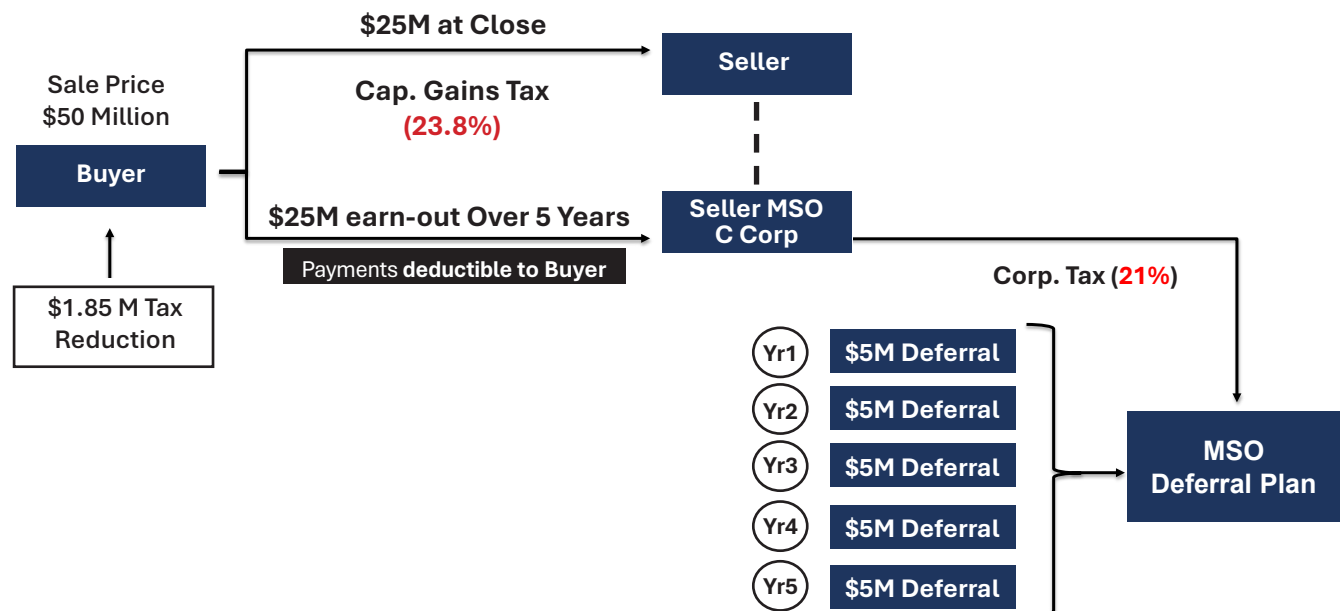
## MSO Deferral Plan - Asset Sale

*\$25 Million Earn-Out over 5 Years*



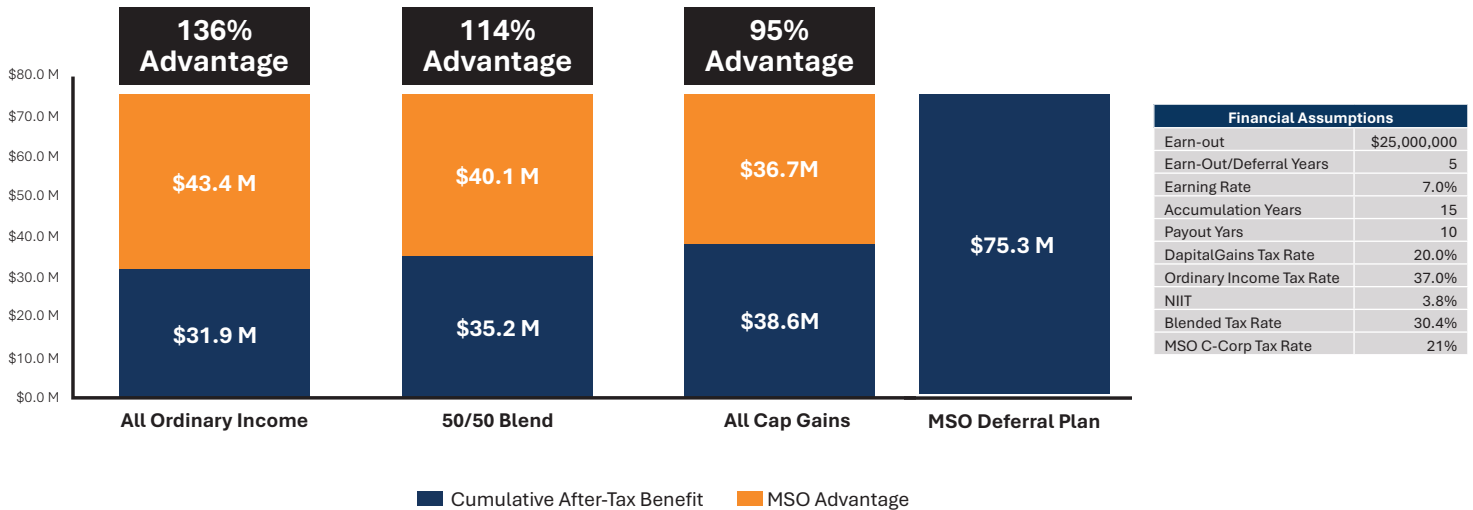
## MSO Deferral Plan - Stock Sale

*\$25 Million Earn-Out over 5 Years*



## Comparative Economics

Below are the modeled outcomes for a \$25 million earn-out paid over five years. Scenarios compare investing **after-tax** proceeds versus **deferring** through an MSO at a 7% gross return.



Note: Hypothetical example. Results may vary. Both capital gains and investment earnings on taxable securities are subject to a 3.8% Net Investment Income Tax (NIIT).

## Implementation Roadmap

Deploying an MSO Deferral Plan follows a well-defined playbook:

**Discovery and Feasibility** - We begin with a collaborative modeling session to test various deferral amounts, payout horizons, and investment credit rates. The output is a side-by-side comparison of after-tax outcomes for both buyer and seller, ensuring the economics warrant moving forward.

**Reasonable Compensation Study** - A third-party consultant independently benchmarks the management fee which includes the reasonable compensation analysis that the MSO will pay the employee(s). This step is critical given the Internal Revenue Code (IRC) Section 162 and other related Internal Revenue Service guidance.

**Entity Formation and Documentation** - Once compensation levels are set, we incorporate the MSO C Corp, draft the master services agreement between the operating company and the MSO, and adopt an IRC Section 409A-compliant deferred compensation plan. Legal opinions are secured where appropriate.

**Funding Strategy and Administration** - Corporate-Owned Life Insurance (COLI) will be acquired to fund the plan due to its tax-efficient build-up and informal funding of the liability. The assets and liabilities are then tracked in real time on a proprietary administration technology platform, mapbenefits® with access given to the seller to asset-allocate their deferred income into a variety of funds.

**Timeline** - Most transactions can progress from feasibility to first contribution within **90-120 days**, comfortably inside typical M&A closing schedules.

## Confidential Transaction Rules

Mezrah Consulting's compensation for transactions is limited to the revenue on the placement of the COLI assets (i.e., assets used to fund the deferred compensation plan). Therefore, the MSO deferral strategy does not trigger a reportable transaction. However, if there was a direct cash component which exceeded the minimum fee thresholds (\$250,000 for corporations, \$50,000 for all other taxpayers), the transaction may be reportable. Mezrah Consulting's business model does not contemplate fees at this level being charged to the client.

In summary, Mezrah Consulting's strategy in an M&A context provides the following:

1. Allows the seller to defer their income on the earn-out part of the transaction and accumulate wealth on a tax favored basis.
2. Provides for part of the transaction to be deductible to the buyer, which lowers the net costs of the purchase.
3. Provides the seller with leverage in increasing the purchase price.

## Key Takeaways

An MSO Deferral Plan is a contrarian approach and strategy for adding value to both the buyer and seller; it is a **strategic financing instrument** that reconciles competing buyer-seller objectives. By converting contingent consideration into deductible service fees, the buyer secures an immediate tax benefit that can be shared with the seller, effectively **boosting purchase price without increasing cash outlay**.

The seller, in turn, gains the ability to defer and control income recognition while enjoying pre-tax, institutionally managed investment growth. The technique works in both asset and stock sales, requires no modifications to the buyer's existing benefit programs, and brings deal certainty by aligning incentives—not pitting them against each other. In a market where multiples are compressing and diligence timelines are tightening, that alignment can be the difference between a **stalled negotiation** and a **successful closing**.



Please note the above discussion is not intended to be inclusive of all tax code sections that may apply. Mezrah Consulting and its affiliates are not tax professionals, and this document should not be considered tax advice or guidance.

## More Information

For more information, email Mezrah Consulting at [connect@mezrahconsulting.com](mailto:connect@mezrahconsulting.com) or call (813) 367-1111. Visit our website at [mezrahconsulting.com](http://mezrahconsulting.com) to learn more.

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## Who We Are

Mezrah Consulting, is a national benefits consulting firm based in Tampa, Florida, with **more than 30 years of expertise** in executive benefits consulting for over 300 companies throughout the U.S. As **subject matter experts**, we specialize in designing, funding and administering **non-qualified executive benefit plans** while uncovering value and mitigating risks. Our proprietary cloud-based fintech platform, *mapbenefits*®, provides **enterprise plan management** for plan participants and plan sponsors. Our focus is on sharing ideas that enable companies and key personnel to accumulate and preserve wealth on a tax-favored basis through innovative solutions and **protect their business strategies and financial performance**.

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