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AUSTRALIA + NEW ZEALAND

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Dear Angela

Discussion paper: Issues concerning earnout arrangements (excluding arrangements that create look-through earnout rights)

Chartered Accountants Australia and New Zealand (CA ANZ) welcomes the opportunity to comment on the Discussion paper*: Issues concerning earnout arrangements (excluding arrangements that create look-through earnout rights)* (the Paper) which demonstrates that despite the introduction of Subdivision 118-I of the *Income Tax Assessment Act 1997* (ITAA 1997), there is still uncertainty over the tax treatment of earnout arrangements, especially around the interactions between capital gains tax and other areas of the tax legislation.

CA ANZ understands that the Board of Taxation has completed its Post-implementation review of contingent consideration rules (earn out arrangements). Accordingly, any ATO consultation on earnout arrangements should consider the outcome of the Board's review (and stakeholders' response to the Board's recommendations) before reaching final published views on these arrangements.

We anticipate that the outcome of the consultation and the Board's review is that legislative amendments will be required to ensure the tax system provides practical business outcomes for earnout arrangements that do not qualify under Subdivision 118-I.

Our comments on the Paper consultation questions are set out in the attachment. If you wish to discuss this submission, please contact at first instance Karen Liew on (02) 8078 5483 or via email at karen.liew@charteredaccountantsanz.com.

Yours sincerely

Michael Croker
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Consultation questions

Separate asset approach

Question 1. Do you have examples of earnout arrangements where the 'separate asset' approach should not apply? If so why?

CA ANZ believes that earnout arrangements that do not comply with the requirements under Subdivision 118-I of the *Income Tax Assessment Act 1997* (ITAA 1997) should not be automatically treated under the "separate asset" approach but rather the appropriate tax treatment be determined in accordance with the facts and circumstances of the particular arrangement. For example, where an earnout arrangement is only ineligible for look-through treatment under Subdivision 118-I because its duration is for seven years, it seems inappropriate for the 'separate asset' approach to apply from a consistency point of view.

The starting point in determining the appropriate tax treatment of an earnout arrangement should be to determine what is the character and nature of the right to receive and obligation to make future payments under the sale and purchase agreement. A part of this process would be whether this right to receive or obligation to make future payments is on revenue or capital account.

Should the payment be on capital account, as previously submitted in the Professional Bodies Joint submission (dated 14 December 2007) on the withdrawn draft ruling TR 2007/D10, the look-through approach should apply and the separate asset approach be rejected.

In reality, payments made under a contract will confer upon the payee a chose in action, which will only be discharged upon the performance of event that may trigger payment. Deconstructing all the payments into separate assets will result in issues where there is a divergence between the ultimate payments and the market value of the rights at the time of the sale transaction. The problems arising with standard earnouts were provided in the Professional Bodies Joint submission.

Deductibility of earnout payments under section 8-1

Question 2. What ought to be the key distinguishing features to determine whether the payments under an earnout arrangement should be governed by the principles in Cliffs International or Colonial Mutual Life Assurance as relevant?

As discussed above, the tax treatment of payments under an earnout arrangement should depend on its own facts and circumstances and be determined based the nature of the payments themselves. Nevertheless, *Cliffs International Inc v FCT* (1979) 79 ATC 4059 (*Cliffs International*) and *Colonial Mutual Life Assurance Society Ltd v FCT* (1953) 89 CLR 428 (*Colonial Mutual Life Assurance*) provide guidance on the nature of these payments under an earnout arrangement.

The facts in *Cliffs International* resulted in the majority of the judges to find that the payments were on revenue account whereas the facts in *Colonial Mutual Life Assurance* resulted in a finding that the payments were on capital account, i.e. consideration for the acquisition of the land.

Based on the decisions of the majority in *Cliffs International*, it appears that the following factors contributed to a finding of the payments being of revenue nature:

- Barwick CJ was of the view that the payments were in the nature of royalties. As they were recurrent payments, measured in relation to the produce of mining, and was a consequence of the availability of the mining income from the consortium conducting the mining, his Honour concluded the payments were outgoings (i.e. disbursements) incurred in gaining the assessable income (i.e. the royalties paid by the consortium to Cliffs International).

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Furthermore, at the time of the sale of shares in Basic Materials Co. Pty Ltd (Basic) (this company had the right to occupy the land for the purpose of prospecting for iron ore), Cliffs International did not know whether there were iron deposits on the land in question. Thus, the Western Australian Government had not yet granted the mining tenement to mine the iron ore.

This contingency to make the deferred payments seemed to indicate to Barwick CJ that, in substance, the payments were not for the shares in the Basic but in fact were for a share in the royalties received from mining the iron ore should that activity eventuate.

It was also noted that Cliffs International did not mine the iron ore – they had assigned the right to mine the iron ore to a consortium. i.e. the right which gave rise the ability to make the payments was not with the purchaser.

- Jacob CJ said "the preponderating factors are that the payments were in respect of a depreciating asset, that they were recurrent over the life of the asset if the asset was used throughout its life and that the amount of the payments were proportioned to the use made of the asset".
- Murphy J, from a practical and business point of view, said the payments were not of a capital nature. The acquisition of the shares in Basic did not depend upon the payment of any of the "deferred payments". If any were made, it would be for the exercising the right to mine the ore in pursuance of the consortium agreement. The amount of the deferred payments was indeterminate but calculated based on the rate of 15c per ton and the amount to paid depended on the exercise of the rights to mine.

Based on the High Court in *Colonial Mutual Life*, it appears the following factors contributed to a finding of the payments being of capital nature i.e. for the acquisition of the land:

- The rent charge was for the acquisition of land which is an acquisition of property of the most permanent character and it was a condition for erecting the new building so the purchaser could carrying on the business of letting shops and office space.
- The right which gave rise the ability of to make the payments of rent was with the purchaser.

Looking at both cases together it appears the following made a difference as to whether the judges thought the future payments were of a capital nature and part of the consideration of the main asset or whether the judges thought the future payments were in substance for something else.

- Where the activity generating the payment/benefit has the possibility of never occurring - e.g. the ability to mine the iron ore may never eventuate as there could be a finding of insufficient iron ore reserves - one could interpret the nature of the future payment as participation in the share of the proceeds from that activity should it eventuate, i.e. the payments are revenue in nature.
- Where the purchaser has the ability to engage the activity which generates the payment/benefit or control the activity which generates the payment/benefit may lend weight to a finding that the future payments/benefits are capital in nature and part of the consideration for the main asset.
- Where the asset subject of the purchase is of a permanent character, i.e. not depreciating, and there is minimal upfront consideration paid, the payments are for the asset and capital in nature.
- Whether the payments are for a finite period or indefinite should not be a factor of itself which would make a difference to the nature of the payment.

Deductibility of earnout payments under section 40-880

Question 3: To the extent that they are not otherwise recognised for tax purposes, is there any basis for payments incurred by the grantor under an earnout to be deductible under section 40-880 given the exclusions in paragraphs 40-880(5)(d) and 40-880(9)(b)?

Yes there is basis for the payments incurred by the grantor under an earnout to be deductible under section 40-880 of the ITAA 1997.

Exclusion in paragraph 40-880(5)(d)

According to paragraphs 46 and 47 of TR 2011/6: *Income tax: business related capital expenditure - section 40-880 of the* Income Tax Assessment Act 1997 *core issues*, the 'rights' referred to in paragraph 40-880(5)(d) has limited practical application, i.e. it does not include all legal rights, only those similar to leases. Paragraphs 46 and 47 are extracted below.

> "**Expenditure in relation to a lease or other legal or equitable right**
>
> 46. Paragraph 40-880(5)(d) provides that the taxpayer cannot deduct expenditure they incur to the extent that it is in relation to a lease or other legal or equitable right.
>
> 47. The existence of paragraphs 40-880(5)(a) and 40-880(5)(f) and section 25-110 mean that paragraph 40-880(5)(d) has limited practical application. It applies to expenditure incurred on or after 1 July 2005 that has a sufficient and relevant connection to a lease or right held by an entity other than the taxpayer. The 'rights' in question do not include all legal rights but only those similar to leases in that they give the taxpayer a right to exploit the asset with which the right is associated. In other words, the right is carved out of an asset but falls short of full ownership of the asset. Examples of such rights include profits à prendre, easements and other rights of access to land. The rights however are not limited to rights associated with land."

Exclusion in paragraph 40-880(9)(b)

According to the Explanatory Memorandum to *Tax Laws Amendment (2006 Measures No. 1) Act 2006* which repealed the old s40-880 and replaced it with a new s40-880, subsection 40-880(9) is to deal with capital amounts which comprise of the transfer or distribution funds, repayments or other blackhole expenditures that do not give rise to any income tax consequences. See paragraphs 2.79 and 2.80 of the EM below.

> ***"Returns of capital***
>
> 2.79 Some capital amounts are not considered legitimate blackhole expenditures as they comprise the transfer or distribution of funds, repayments, or do not give rise to any income tax consequences. As such, the expenditure does not represent an economic loss to the taxpayer and is not deductible. ***[Schedule 2, item 30, subsection 40-880(9)]***
>
> 2.80 Expenditures excluded by this provision include, but are not limited to:
>
> - dividends paid by companies;
> - distributions by trustees;
> - margin calls;
> - payments made by a company to buy back its own shares; and
> - repayments of loan principal."

The payments made by the grantor are not returns on equity or repayments of loan principal and do result in an increase in cost in acquiring the asset i.e. economic loss.

Ending of the earnout right

Question 4: (a) In what circumstances could it be argued that an earnout payment does not result in CGT event C2 happening?

(b) Are there circumstances where subsection 112-30(5) might be relevant to an earnout payment?

(c) Are there other examples of where the cost base and reduced cost base of an earnout right may not be fully recognised due to the operation of section 118-20 or the indefinite nature of the earnout right?

4(a) CA ANZ are of the view that where earnout payments are of a capital nature, they form part of consideration for the sale of the business and therefore do not result in CGT event C2. That is, we are of the view the look-through approach applies. The payment to discharge the purchaser's obligation to pay should not give rise to a separate capital gain to the seller.

(b) If the separate asset approach is to be applied to the right to future payments under an earnout arrangement, we are of the view that each right to a future financial benefit should be treated as a separate asset so that when payment is made upon an trigger event, CGT event C2 happens to the whole of the relevant asset (i.e. that right) and the apportionment formula in subsection 112-30(3) has no application. With this approach, the main issue will be apportioning the market value of the main asset being sold to determine the appropriate cost base for each right to a future financial benefit.

(c) No comment.

Creating the earnout right

Question 5. (a) Do you agree that the creation of an earnout right can constitute 'borrowing money or obtaining credit' so far as the buyer is concerned? Does this at least require that the earnout right has the legal features of a debt, such as certainty that an amount will be payable (albeit contingent on information already capable of being known) or certainty as to the time of payment (even if the amount of the payment is contingent on future events)?

(b)If not, are there examples where the creation of an earnout right would not amount to 'borrowing money or obtaining credit'?

In most circumstances, CA ANZ is of the view that an earnout right would not constitute 'borrowing money or obtaining credit' so far as the buyer is concerned. Where there is certainty that a future amount is payable, it may be arguable that the buyer is obtaining credit. However, where the amount payable in the future is contingent and can result in a nil amount from the event, it would be difficult to characterise payment as a borrowing or obtaining credit.

Grant a right to income from mining

Question 6. Would ATO guidance on CGT event D3 be helpful? If yes, on what aspects of CGT event D3 do you want guidance?

No comment.

Division 40 depreciating assets

Question 7. Would ATO guidance on the Division 40 consequences of disposing or acquiring a depreciating asset in consideration for an earnout right be helpful? If yes, on what aspects of Division 40 do you want guidance?

Should the ATO continue with the separate asset approach to earnouts, ATO guidance from the seller and buyer perspectives on the Division 40 consequences of disposing or acquiring a depreciating asset would be useful.

Division 974 Equity interest

Question 8. (a) Do you think there is a relevant distinction between the terms 'borrowing money or obtaining credit' in paragraph 104-35(5)(a) (see paragraph 48) and 'financing arrangement' in section 974-130?

(b) On what basis can the grant of an earnout right constitute 'borrowing money or obtaining credit but not a financing arrangement under Division 974?

There is a distinction between 'obtaining credit' in paragraph 104-35(5)(a) and 'financing arrangement' in section 974-30 of the ITAA 1997.

Where the earnout arrangement involves a right to future payment which is certain to provide an amount, the buyer can seen as 'obtaining credit' as the buyer has an extended amount of time to pay for the asset.

Under section 974-130, broadly, a financing arrangement involves a scheme to raise finance for an entity or fund another scheme that is a financing arrangement. When a buyer grants an earnout right to the seller because there is a disagreement or uncertainty as to the market value of the asset, generally the purpose of the earnout arrangement is not for raising finance for the buyer. Generally, we would not view these earnout arrangements as financing arrangements and thus not equity interests under section 974-75.

Nevertheless, the circumstances around each earnout arrangement will be different and one would need to consider the facts and circumstances around the earnout arrangement before concluding whether there is a financing arrangement and whether there is an equity interest.

Division 230 financial arrangement

Question 9. (a) Are there examples of earnout arrangements where the contingencies would not be regarded as a reasonable measure of economic performance?

(b) Are there examples of earnout arrangements that are solely contingent on revenue or turnover? Where an earnout arrangement is solely contingent on revenue or turnover, in what circumstances would that contingency be regarded (or not regarded) as a reasonable measure of economic performance?

(c) Where an earnout is contingent on revenue or turnover, but also requires that the revenue or turnover has reached a specified level or a minimum price being charged, do you agree that the earnout payments may not be regarded as solely contingent on receipts or turnover?

Given the Commissioner expects that subsection 230-460(13) would generally operate to exclude most earnout arrangements from Division 230 (paragraph 66 of the Discussion Paper), we would anticipate that a broad interpretation would be given to the meaning of "the amounts, or the values, of those benefits are only contingent on aspects of the economic performance of the business after the sale".

(a) Some examples of earnout arrangements not regarded as a reasonable measure of economic performance:

- Payment as a result of the outcome of a litigation that a company is involved in
- Payment upon discovery of information e.g. mineral deposits
- Payment upon obtaining a consent or approval e.g. licence approval or development application consent
- Payment calculated by reference to the performance of a share market index or other industry or economic indicies.

(b) & (c) No comment.

Question 10. (a) Are there any other types of earnout arrangements (with features not referred to above) that should be covered by any additional guidance the ATO may provide? If yes, what guidance would be helpful?

(b) Are there any other issues in connection with earnout arrangements on which the Commissioner could provide advice or guidance? If yes, please set out these issues?

No comment.

Appendix A

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