



TECHNICAL UPDATE

CGT TREATMENT OF EARNOUTS – EXPOSURE DRAFT LEGISLATION RELEASED

FEDERAL TREASURY HAS RELEASED THE LONG AWAITED EXPOSURE DRAFT LEGISLATION AND EXPLANATORY MATERIALS THAT PROVIDE FOR A NEW MEANS OF ADDRESSING THE CAPITAL GAINS TAX (CGT) TREATMENT OF EARNOUTS.

An 'earnout' refers to an arrangement where assets of a business are transferred for consideration comprising an upfront payment and additional payments (the 'earnout') subsequent to the sale based on the economic performance of the assets after completion of the sale.

The only guidance on the CGT treatment of earnouts under the current provisions had been a draft Taxation Ruling TR 2007/D10, which treated the earnout as a separate asset for CGT purposes. The consequences of this approach were that the value of the earnout right had to be added to the capital proceeds in respect of the disposal of the business assets, and a separate capital gain or loss arose at the time of the expiry or satisfaction of the earnout right, or as each instalment was received (depending on the circumstances). One of the main concerns with this approach was that any CGT concessions that are available for the sale of the asset may not be available for the subsequent CGT events for the earnout right.

In 2010 the previous Government announced that the income tax law would be amended to provide a more benign taxation treatment than that prescribed under TR 2007/D10. At the same time, Federal Treasury released a discussion paper that disclosed a preferred solution, whereby the value of the earnout right was disregarded in calculating the capital gain or loss on disposal of the underlying asset. Each payment of instalments under the earn-out would be treated as a separate CGT event, but one that would be related back to the disposal of the underlying asset, so that any CGT concessions applicable to the disposal of the asset would also be available on the capital gain on the earnout right.

SECTOR

Tax

CONTACT

MARCUS LEONARD

National Leader, Tax
Tel: +61 2 9240 9771
marcus.leonard@bdo.com.au

LISA PRITCHARD

Partner, Adelaide
Tel: +61 8 7421 1418
lisa.pritchard@bdo.com.au

MARK MOLESWORTH

Partner, Brisbane
Tel: +61 7 3237 5999
mark.molesworth@bdo.com.au

ERIC OLUFSON

Partner, Cairns
Tel: +61 7 4046 0000
eric.olufson@bdo.com.au

MAL SCIACCA

Partner, Darwin
Tel: +61 8 8981 7066
mal.sciacca@bdo.com.au

BRETT SKIRVING

Partner, Hobart
Tel: +61 3 6234 2499
brett.skirving@bdo.com.au

DAVID BLAKE

Partner, Melbourne
Tel: +61 3 9603 1709
david.blake@bdo.com.au

RUSSELL GARVEY

Partner, Perth
Tel: +61 8 6382 4865
russell.garvey@bdo.com.au

The new approach

The approach adopted in the exposure draft (ED) has some similarities to the approach in the 2010 discussion paper, in that the value of the earnout right is not included in the calculation of the capital gain or loss on disposal of the underlying asset, and the right to the earnout will be disregarded as a separate CGT asset. However, the rest of the treatment is markedly different to that adopted in the 2010 discussion paper. Under the ED, where the thresholds specified therein are met, in determining the capital proceeds from the disposal of the CGT asset(s) the payments under the earnout will be retrospectively added to the capital proceeds in calculating the capital gain (or loss) in respect of the disposal that occurred at the time of the relevant CGT event A1 (typically the date of the contract under which the sale occurred).

The measures make corresponding changes to the acquirer's cost base.

A necessary outcome of the approach adopted will be that the assessment of each of the disposer and acquirer for the year which the CGT event (asset/business disposal) occurred will have to be amended at the time of each payment under the earnout

Conditions for the application of the new approach

The new measures addressing 'look-through earnout rights' are restricted, such that they will only apply where:

- The right is a right to future financial benefits that are not readily ascertainable at the time the right is created
- The transaction involves a disposal of a CGT asset which is a CGT event A1
- The relevant CGT asset is an 'active asset' of the disposer
- All of the financial benefits that can be provided under the right are to be provided within four years of the CGT event (and there is no option to extend or renew the arrangement beyond such four years)
- The financial benefits supplied are contingent on the economic performance of the relevant CGT asset(s) or the business for which it is reasonably expected that each of the CGT assets will be an 'active asset' during the relevant earnout period
- The value of the financial benefits reasonably relates to such economic performance
- The parties to the arrangement deal with each other at arm's length.

Disposal of shares in a company or interests in a trust

The measures can also apply to the disposal of shares in a resident company or an interest in a resident trust estate for CGT purposes if:

- The transferor:
 - Being an individual, was a CGT concession stakeholder as defined for the purposes of the small business CGT concessions, or
 - Not being an individual, would own a sufficient share of the company or trust that they would be a CGT concession stakeholder if such transferor were an individual
- At that time the company or trust is carrying on a business and has been carrying on a business since the start of the most recent income year ending before that time
- The company or trust derived assessable income in the most recent income year of which:
 - At least 80 per cent was from carrying on one or more businesses, but
 - Excluding income derived (directly or indirectly) from assets producing specified classes of passive income.

Capital loss

If a capital loss is realised by the disposer on the disposal of the relevant CGT asset before taking into account look-through earnout rights, the loss is disregarded until the earnout rights have been exhausted.

No requirement to be a small business

Although some of the conditions above use terminology from the Small Business CGT concessions, there is no requirement for the taxpayer to meet the small business \$2 million turnover threshold or the \$6 million asset threshold.

Reverse earnouts

The provisions also apply to 'reverse earnouts' where the disposer is required to refund amounts of capital proceeds where performance hurdles are not met. In those circumstances the provisions operate to decrease the capital proceeds of the disposer with corresponding decreases in the cost base of the acquirer.

Commissioner's extended time for amendment of assessments

As a consequence of the amendments in respect of the tax treatment of earnouts under the ED, the ED provides for an extension to the period in which the Commissioner can review and amend assessments in respect of the provision of benefits under the earnout to the later of the period of review that would normally apply, and four years after the final date when financial benefits could be provided under the look-through earnout right.

Tax consolidation consequences

One of the concerns in relation to both TR 2007/D10 and the 2010 discussion paper, was that they did not appropriately deal with tax consolidation for the purchaser of the assets that were shares in a joining entity. There were concerns that not all the value paid for the shares by a purchaser that was in a tax consolidated group would be recognised in the cost base of the shares, and consequently not in step one of the allocable cost amount (ACA). The Explanatory Materials for the ED have indicated that these issues have been dealt with by the ED without any additional amendments by ensuring all the appropriate costs will be taken into account in the cost base of the asset. Therefore section 705-65(5B) of the Income Tax Assessment Act 1997 will operate as it was originally intended for earnout arrangements. However, this will require a recalculation of the ACA and cost base allocation each time an earnout instalment is received.

Application Date

These new rules will apply from 23 April 2015, the date of release of the ED. However, there are transitional rules where taxpayers have followed the proposed tax treatment outlined in the 2010 discussion paper. Provided the taxpayer prepared their tax returns reasonably anticipating the changes as outlined in the 2010 discussion paper, there will be a statutory bar on the Commissioner amending the taxpayer's assessment for the relevant year to apply the pre-23 April 2015 law (generally as outlined in TR 2007/D10).

BDO comment

The approach adopted under the ED, in tying the provision of payments under the earnout rights to the disposal of the business assets that the earnout relates to, provides a much more appropriate outcome than was the case under the application of TR 2007/D10. This is particularly the case where the earnout is in relation to assets which attract the operation of the CGT small business concessions.

It should be noted that the earnout rights addressed by the proposed measures are confined to those calculated by reference to the economic performance of those assets. The Explanatory Materials cite as an example of rights that would not be look-through earnout rights, rights to additional payment in respect of a mining tenement where additional minerals were discovered by the acquirer.

The strict four year time limit for the application of the proposed measures should also be noted. Where the earnout rights extend beyond this period, a taxpayer would be left to grapple with the possible application of the approach espoused in TR 2007/D10.

The Treasury is asking for submissions on the ED by 21 May 2015. BDO will be preparing a submission and if you have any comments in this regard, please contact your usual BDO Tax contact.

National expertise

The BDO Tax team is one of the largest and most dynamic tax practices in Australia, with 30 partners and more than 150 specialists located in each major city across the country.

MORE INFORMATION

1300 138 991
www.bdo.com.au

NEW SOUTH WALES
NORTHERN TERRITORY
QUEENSLAND
SOUTH AUSTRALIA
TASMANIA
VICTORIA
WESTERN AUSTRALIA

This publication has been carefully prepared, but it has been written in general terms and should be seen as broad guidance only. The publication cannot be relied upon to cover specific situations and you should not act, or refrain from acting, upon the information contained therein without obtaining specific professional advice. Please contact the BDO member firms in Australia to discuss these matters in the context of your particular circumstances. BDO Australia Ltd and each BDO member firm in Australia, their partners and/or directors, employees and agents do not accept or assume any liability or duty of care for any loss arising from any action taken or not taken by anyone in reliance on the information in this publication or for any decision based on it.

BDO refers to one or more of the independent member firms of BDO International Ltd, a UK company limited by guarantee. Each BDO member firm in Australia is a separate legal entity and has no liability for another entity's acts and omissions. Liability limited by a scheme approved under Professional Standards Legislation other than for the acts or omissions of financial services licensees.

BDO is the brand name for the BDO network and for each of the BDO member firms.

© 2015 BDO Australia Ltd. All rights reserved.