THE TAX INSTITUTE

THE MARK OF EXPERTISE

25 May 2015

Mr Tom Reid
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By email: taxlawdesign@treasury.gov.au

Dear Mr Reid,

Providing 'look-through' CGT treatment to earnout arrangements

The Tax Institute welcomes the opportunity to make a submission to the Treasury in relation to the *Tax and Superannuation Laws Amendment (2015 Measures No. 4) Bill 2015: CGT treatment of earnout rights* Exposure Draft (**Exposure Draft**).

Extensive confidential consultation took place in relation to the development of the Exposure Draft in which The Tax Institute participated. We are disappointed that Treasury seems to have rejected many of our measured and considered views on the many issues we raised. As such, we reiterate our concerns below.

We query why the Exposure Draft imposes a four year limit on qualifying earnout arrangements, rather than the period of five years referred to in the original proposals paper.[1]

Summary

Our submission below addresses our main concerns in relation to the Exposure Draft, in particular:

- The inclusion of unnecessary additional elements in the Exposure Draft that appear to have been included for the purpose of trying to prevent taxpayers from falling within the rules; and
- Treasury's reliance on the Commissioner's views in Taxation Ruling TR 2007/D10 about which industry has expressed significant concerns.

[1] Treasury Proposals Paper *Capital gains tax treatment of earn-out arrangements* issued in May 2010 at part 3.3 (**Proposals Paper**).

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Preliminary comments

The release of the Exposure Draft is an acknowledgement that a problem exists with the current state of the capital gains tax (**CGT**) laws and their interpretation.

The Exposure Draft contains a proposed solution to the problem, but only for narrowly defined arrangements. The restriction of the solution to 'look-through earnout rights' as defined seems intended to allow the problem to continue to exist in every other relevant circumstance.

Paragraph 1.23 of the Explanatory Memorandum (**EM**) to the Exposure Draft implies that the problem is to be allowed to continue to exist in those other circumstances, so as to preclude 'the deferral of the payments of income tax …' in relation to the relevant money or property. No mention is made in that paragraph, nor elsewhere in the EM in relation to the apparent policy, that the deferral will be compensated for by the levying of general interest charge in any event. Conversely, paragraph 1.15 expresses the view that certain costs genuinely incurred by the entity obliged to provide financial benefits '… are generally not recognised under the capital gains tax system …'.

That is, the apparent policy behind restricting the solution to narrowly defined 'look-through earnout rights' is to:

(a) create artificial complexity and unnecessary compliance costs required to ascertain whether an arrangement is a 'look-through earnout right';
(b) consequently deny some taxpayers recognition in the tax system for genuinely incurred expenditure;
(c) for no stated reason other than the supposed 'deferral' of tax receipts which would in any case be compensated for by general interest charge.

The Tax Institute has previously submitted that the solution ought to be applied universally across the CGT system, wherever the relevant problem exists. For example, the underlying problem could be resolved more broadly by a rule that a promise to provide capital proceeds is not, in itself, capital proceeds (nor in itself the relevant element of cost base), no doubt with some consequential and ancillary rules being required.

It is clear that this proposal has been rejected. Accordingly, our submission below focuses on the Exposure Draft as a means of implementing the apparent policy decision. The making of the submission does not imply any change in The Tax Institute's view that the underlying decision not to solve the problem in its entirety is very poor tax policy.

Accordingly, we consider that the Exposure Draft and EM are a good attempt (in a design sense) to solve the issues arising from the ATO position adopted in TR 2007/D10. The linking of the payments under the 'look through earn-out arrangement' to the existing cost base and capital proceeds rules reduces complexity. The need to amend (on a repetitive basis) the Income Tax Return for the year of the gain is unfortunate, but the trade-off is acceptable.

Specific comments

1. *Legislation*

Overall, we observe there appear to be some unnecessary additional elements in the Exposure Draft that simply appear to have been included for the purpose of trying to prevent taxpayers from qualifying for the rules. In detail:

- Section 118-565(1)(c) – we do not agree that this should be limited to CGT Event A1. However, if that limit is to be retained, some of our concerns could be alleviated by including some commentary in the EM which confirms that CGT Event A1 ‘happens’, even if another, more specific, CGT event (such as B1 or K6) also ‘happens’ and is the event under which the CGT consequences are calculated (see sections 102-23 and 102-25).

- Section 118-565(1)(e) – the four years from the date of the CGT event for payment to be received will, in practice, limit the earnout period to consideration of three year ends after the CGT event date. We understand the desire to limit the period in some way.

  We note the earlier Proposals Paper contemplated a five year limitation period (which would in effect be a four year period based on the reasoning above) and strongly suggest Treasury adopt this longer timeframe. Allowing for the payment to be made by the end of the fourth tax year after the year in which the gain was made would perhaps be more realistic without giving away too much to those whom it is (apparently) thought may be seeking to arbitrage the system.

  We note that in the case of a standard sale of a CGT asset with a deferred settlement, the gain does not ‘happen’ until settlement, albeit that the gain has to be reported in the year of contract. Section 170 of the *Income Tax Assessment Act 1936* (Cth) expressly allows for amendments out of time to accommodate this – even if the deferral is 20 years long. While in the case of an earnout beneficial ownership of the asset has been transferred, there are some similarities between the circumstances.

- Section 118-565(1)(f) - this section is very narrow, particularly when considering the EM, and there will be many arrangements that fail that test (for no obvious policy rationale). The original 1993 ruling[2] was about contingent payments. We query why the nature of the contingency matters for the purposes of the proposed provisions so long as there is a contingency.

[2] TR 93/15 which was withdrawn on 17 October 2007

- Section 118-565(2) – we understand the rationale for the provision, but are unclear as to the type of clause that will trigger the application of the provision. On occasion, contracting parties may enter an agreement to vary certain terms of the original contract. We query whether such a general agreement would be enough to cut the taxpayer out of these provisions.

  Further, a discretion for the Commissioner to extend time where the parties, for good commercial reasons unrelated to the tax law want to extend the earnout period, would be in accordance with the balance of the CGT provisions where the Commissioner is generally given a relieving discretion in relation to time limits. We suggest such a discretion be specifically provided for.

- Section 118-570 – we welcome the extension as being sensible to avoid the valuation issues that are inherent in the current approach. However, section 118-570(1)(c)(ii) requires a minimum 20% interest holding in order for the provision to apply. Such a minimum holding requirement does not apply if the asset can be proven to be 'active' on the basis of the Division 152 test. If the mischief is with respect to widely held shares, then we suggest perhaps excluding widely held companies and trusts (as defined elsewhere in the *Income Tax Assessment Act 1997* (Cth), such as Division 166 or Division 152).

  However, we note that if, in respect of a particular shareholder, it can be demonstrated that the company in which the shares are held has more than 80% active assets, then section 118-565 will apply (as the shares will be active). In these circumstances, it appears inequitable to impose a minimum holding percentage on the alternative test. What may be needed is either an exclusion of interests in widely held entities where there is a liquid market for those interests such that the market value of the interests are able to be easily ascertained.

  The minimum 20% interest holding requirement, as currently drafted, will create considerable problems, particularly for a buyer. In many closely held companies, there will likely be multiple shareholders with interests exceeding 20%, but other senior employees with material shareholdings that are below 20%. The way the provisions are currently drafted, a buyer of 100% of the shares in the company would have to apply the new rules to the acquisition of the majority shareholders' interests, but would be left in the current problematic situation for the purchase of the minority shareholders' interests. There should be a 'drag along' rule, by which, as long as one accepting vendor qualifies under the 'look-through earnout right' rules, then all other accepting vendors under the relevant arrangement are also treated as having a 'look-through earnout right'.

- Section 118-570 avoids valuation issues for the application of the earnout rules, but there is nothing in the Exposure Draft which purports to solve this for the $6 million maximum net asset value test in Division 152. Consider the following example:

- the taxpayer (not a Small Business Entity) has a business worth somewhere between $4.5 million and $5.5 million, and other assets worth $1 million;
- the taxpayer strikes a deal to sell the business for an upfront payment of $4.5 million, with a second payment of up to $500,000 after 1 year, and a third payment of up to $500,000 after two years (with the obligation to make the second and third payments, and the amount of those payments, contingent upon the performance of the business in the meantime.

The issue is whether the taxpayer should claim CGT Small Business Relief (**SBR**) in respect of the year of disposal. In making that decision, it will have to value the earnout rights, so as to determine whether it passes the $6 million Maximum Net Asset Value Test. That valuation is inherently difficult, but also crucial:

- if the taxpayer values the earnout rights at only $400,000 (based on the view that this is the amount it reasonably expects to receive), then it would presumably claim SBR (as $1 million + $4.5 million + $400,000 = $5.9 million). However, if it ends up receiving earnout payments which exceed $500,000, then it is likely that the Commissioner will query the initial valuation, and argue that SBR should not have been claimed. This would appear to have potentially disastrous consequences (refer to paragraphs 1.86, 1.96 and 1.97 of the EM), particularly if a superannuation fund is involved.

  However, if the taxpayer is worried about that prospect, it may adopt a more conservative approach, only claiming SBR once it becomes clear that it will not receive anything more than $500,000. This of course means that the taxpayer has paid a large amount of (unnecessary) tax in the meantime, for which it will now have to claim a refund.

  We query whether a better way can be found. As a minimum, relief should be provided from penalties, and adverse superannuation consequences, if the taxpayer can demonstrate that it acted reasonably. Additionally, we suggest consideration should be given to providing a 'rule of thumb' valuation method that should be applied in such cases.

  There would also appear to be a technical deficiency with the extension rule in section 116-20(2), in that it only applies where a financial benefit is actually 'provided or received'. If (on the facts of the above example) the taxpayer receives the second payment (Year 1), but no third payment (Year 2), section 116-20(2)(b) would only appear to extend the time for the choice to Year 1(as there is nothing received at Year 2). However, this problem could be addressed early, by amending section 116-120(2)(b) so that it refers to the year in which a financial benefit 'may' or 'could' be received under the look-through earnout right.

We understand this problem is not limited to cases only involving a 'look-through earnout right' and therefore suggest the issue could be resolved for all relevant cases as set out above.

- Section 118-580 – could Treasury confirm that when the loss becomes 'regarded' again, that the original return is amended and therefore the loss can pick up gains realised in the intervening years? Inclusion of a note in the EM confirming this would be useful.

- The proposed amendments to Subdivision 152-D (the small business retirement exemption) contained at Items 13, 14 and 15 of the Exposure Draft seem to operate appropriately in the context of a standard earnout arrangement, but it is difficult to see how they will operate in the context of a 'reverse earnout'. We suggest Treasury consider whether there needs to be an additional amendment that says something along the lines of our comments on section 118-580 (about certainty of future payments) in this context.

- We consider that there may be a more general problem with the way that the proposed provisions deal with reverse earn-out arrangements. Proposed section 116-120 seems to say that, for example, if a taxpayer receives $500 at settlement, but may have to pay back $100, then the taxpayer must return the whole of the $500, and then amend their return later to reduce it. We query whether this is workable as it could potentially complicate a number of CGT concession claims and introduce a number of other compliance issues[3].

  We suggest Treasury consider inclusion of a general rule that monies payable under a reverse earn-out arrangement are only treated as received to the extent that they become certain. The concessions should then work the same way as they do for a standard earn-out arrangement.

2. *Transitional Rules*

The amendments apply to CGT events happening on or after 23 April 2015. As the Exposure Draft and EM were released at approximately 6pm AEST on that day, consideration should be given to making the application date 24 April 2015.

In addition, it would be useful if the schedule to section 170B of the *Income Tax Assessment Act 1936* (Cth) could be amended to include reference to the relevant announcement rather than requiring taxpayers to rely on the amending Act itself to confirm that the protection offered under section 170B is available up to and including 23 April 2015.

[3] We refer, for example, to the claiming of a superannuation concession as mentioned in paragraph 1.91 of the EM.

3. *Other*

a) Depreciating assets

It is disappointing that the provisions do not apply to depreciating assets. This can inequitably affect:

i) mining tenements that can be either taxed under the CGT provisions or Division 40 depending upon factors not relevant to the policy – this will lead to taxpayers in broadly similar circumstances being treated differently; and
ii) businesses with large IP values depending upon whether the IP is depreciating (copyright, patent, registered design, plant breeders right) or not (trademark, confidential information etc).

While a possible solution to this is to 'sell the company', this may not always be possible or appropriate and so cannot be relied on to remove the issue. A similar approach to the cost and terminating value provisions of Division 40 as has been taken to the cost base and capital proceeds provisions in the exposure draft would fairly simply solve this issue.

b) Scrip-for-scrip rollovers

Under the current scrip-for-scrip arrangements in Subdivision 124-M of the *Income Tax Assessment Act 1997* (Cth), an earnout right would generally be taken to be 'ineligible proceeds' and therefore the vendor can only obtain partial rollover for the sale of shares, even if the earnout right is a right to additional (replacement) shares. Assuming that the earnout right is a right to additional (replacement) shares if certain performance targets are met, those shares should satisfy the definition of financial benefit (section 974-160). Also assuming the arrangement satisfies the proposed rules for look-through earn-out rights, it is unclear whether proposed section 116-20 overrides the rules around partial rollover in Subdivision 124-M (specifically section 124-790).

We understand the policy intent of the look-through earnout arrangements is or was to include earnout arrangements. We therefore recommend that a consequential amendment is made to Division 124-M to make it clear that a right issued as part of a qualifying earnout is not 'ineligible proceeds'.

4. *Explanatory Memorandum*

In detail:

- Example 1.1 at paragraph 1.35: second bullet point in paragraph 4 – this is a minor point, though we note the spouse of a 20% holder can be a 'CGT concession stakeholder' in a company if they have a non-zero interest. This should be considered with respect to the example.

- Example 1.2 at paragraph 1.43 - in some cases litigation could easily have an effect on overall goodwill value and future economic performance of that goodwill. Consider for example if the litigation in the context of this example were for passing off, food poisoning or health regulation breaches.

  We query whether all warranties and warranty claims are not subject to the 'separate asset' approach that the ATO advocates. More specifically, we refer to paragraph 1.46 in the EM and the operation of proposed section 118-565(1)(e). If the warranties extend beyond the four year time limit in this provision, does this mean that payments can still be made under the "arrangement" outside four years? Parties will be required to have to carefully define the term "arrangement" for the purpose of their earn-out agreement.

- Paragraphs 1.91 and 1.92 of the EM both refer to an extension of two years after the potential final financial benefit is received. Items 8 and 13 of the Exposure Draft indicate that this period may instead be six months.

5. Relevance of TR 2007/D10

Overall, there is an assumption running through the EM that the Commissioner's views in TR 2007/D10 are correct, though industry has expressed significant concerns over the content of the draft ruling[4]. For example, reference is made to the draft ruling in paragraphs 1.11. The content of the ensuing paragraphs also only contain the Commissioner's view, though this is not made clear.

Section 118-575 appears to adopt the Commissioner's views in TR 2007/D10 that CGT Event C2 can occur and requires a taxpayer to disregard a capital gain or loss made from CGT Event C2 occurring. This presupposes that a capital gain or loss can arise in the first place – arguably this cannot occur as the payments received under the earn-out arrangement are properly attributable to the original CGT event, not the disposal of the earn-out right.

We have no problem with section 118-575 being added, because it does protect some taxpayers if the Commissioner's views are actually correct. However, that would clearly leave taxpayers who fall outside the look-through earnout rules, even in fairly comparable circumstances, unprotected.

On the other hand, we note that the Commissioner takes the view in the draft ruling that CGT Event D1 does not happen when an earn-out right is created[5], though many advisers have doubted the correctness of this view. In this regard, we see some inconsistency between the proposed rules and the current view the Commissioner

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[4] See for example the Joint Bodies submission to the ATO in relation to TR 2007/D10. A copy of the submission is available on The Tax Institute's website (http://www.taxinstitute.com.au/submissions/joint-professional-body-submission-in-relation-to-tr-2007/d10).

[5] See paragraphs 26, 28, 147 and 157 of TR 2007/D10.

holds in the draft ruling that will continue to apply to taxpayers who do not fall under the new provisions.

Again, we have no problem with section 118-575 protecting some taxpayers, but submit that similar protection ought to be afforded to other taxpayers. This would be relevant if, for example, the Commissioner changed his mind about the applicability of CGT Event D1 in circumstances comparable to (but not falling within) the look-through earnout right rules. Otherwise, this may create inequitable treatment between taxpayers whose earnout arrangements are subject to the proposed rules and those who are not.

We suggest that Treasury and the ATO should work closely together and consult widely in relation to the appropriate replacement for TR 2007/D10 in the light of the narrow application of the proposed legislation.

If you would like to discuss any of the above, please contact either me or Tax Counsel, Stephanie Caredes, on 02 8223 0059.

Yours sincerely

Stephen Healey
President