THE TAX INSTITUTE

1 November 2018

Ms Angela Zhang
Australian Taxation Office
GPO Box 9977
SYDNEY NSW 2001

By email: FeedbackATOearnout@ato.gov.au

Dear Ms Zhang,

Discussion paper on issues concerning earnout arrangements (excluding arrangements that create look-through earnout rights)

The Tax Institute welcomes the opportunity to make a submission to the Australian Taxation Office (**ATO**) in relation to the *Discussion paper on issues concerning earnout arrangements (excluding arrangements that create look-through earnout rights)* (**Discussion Paper**).

Summary

The Tax Institute is concerned with the approach the ATO is taking to earnout arrangements and interpreting earnout rights as if they create a 'separate asset' and, in particular, that this would create differing tax outcomes in respect of earnout arrangements. The Tax Institute does not agree with this position. Our submission below addresses the questions in the Discussion Paper with this in mind.

Discussion

1. Overview

The issues the ATO is trying to address in the Discussion Paper arise as a result of the ATO's interpretation of treating the earnout rights as if they are a separate asset being received by the seller as well as the buyer in respect of the disposal of the original asset (the 'separate asset' approach). These issues were first identified at the time *Taxation Ruling TR 2010/D7W - Income Tax: Capital Gains: Capital Gains Tax consequences of earnout arrangements* (**TR 2007/D10W**) (now withdrawn) was issued[1].

[1] Refer to the Joint Bodies submissions in relation to TR 2007/D10W available on The Tax Institute's website (https://www.taxinstitute.com.au/submissions/joint-professional-body-submission-in-relation-

The Tax Institute does not agree with this approach and considers the preferred characterisation is that no separate asset is created in the seller and the buyer as a result of an earnout arrangement. Rather, one should look to the underlying assets or business being sold or the ownership interest in the assets/business.

We also do not agree with the statement in the Discussion Paper which suggests that earnout arrangements are only entered into because there is a 'genuine disagreement' about the value of the business being sold going forward (paragraph 2). Ordinarily earnout arrangements are entered into because part of the sale price is comprised of a component of future sales or profits (ie future performance of the business), for example, which are unknown at the time the sale is entered into.

In this regard, the earnout arrangement relates wholly to the original asset being disposed. The 'separate asset' approach and the ATO's understanding of why an earnout arrangement is entered into does not reflect the commercial and economic characterisation of the transaction.

Where differing administrative treatment is adopted between qualifying and non-qualifying earnouts, this will create an opportunity for arbitrage to occur – this is not a suitable outcome. The Tax Institute considers that qualifying and non-qualifying earnouts should be treated as consistently as possible. We do not support an inconsistent administrative approach that will allow arbitrage to occur. While there may be circumstances where an arrangement cannot be treated as an earnout, if the arrangement has the characteristics of an earnout, there should be consistency in how it is treated for tax purposes.

On the basis that the ATO chooses to continue applying the separate asset approach for non-qualifying earnouts, we would encourage the ATO to apply as consistent an administrative treatment as possible. Any amendments to *Taxation Ruling TR 95/35 Income Tax: capital gains tax treatment of compensation receipts* (**TR 95/35**) should reflect this rather than encourage inconsistent treatment between qualifying and non-qualifying earnouts. A legislative amendment may also be required to support the ATO's interpretation.

2. Consultation questions

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

The Tax Institute considers that the 'separate asset' approach is not the correct approach. An example of where the 'separate asset' approach should not apply is where the ATO is trying to manage the potential double deduction scenario (for a

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to-tr-2007/d10 and https://www.taxinstitute.com.au/submissions/supplementary-joint-professional-body-submission-in-relation-to-tr-2007/d10)

purchaser) by taking an interpretation which potentially results in double taxation (for a vendor). This is an inappropriate outcome.

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?*

For example, is there a distinction between payments made over a fixed period vs an indefinite period? In this respect, Gibbs J observed in Cliffs International *that the difference in circumstance (i.e. the obligation being limited to a fixed period in* Colonial Mutual *as opposed to the obligation continuing indefinitely in* Cliffs International*) did not seem material, since in each case the expenditure was the consideration paid for a capital advantage*

We consider the two cases in turn below.

***Colonial Mutual Life Assurance Society Ltd v FCT* (1953) 89 CLR 428**

Colonial Mutual concerned the acquisition of real property, with a "rental charge" of 90% of the rent received by the taxpayer for 50 years forming part of the purchase price of certain real property. This is clear from the decision.

Fullagar J (Kitto and Taylor JJ concurring) at paragraphs 4 and 5 stated:

> But the whole essence and substance of the contract is, as I have said, that the company is to acquire the land of Just Brothers in consideration of a series of payments to Just Brothers extending over a period of fifty years.
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> …
>
> This [rent charge] document recites (what is, I think, clearly correct) that Just Brothers have agreed to transfer their land to the company in consideration of the payment by the company to them of a sum equal to ninety per cent of the whole amount of the rents received by the company during the period of fifty years in respect of the three shops and the basement.

It is not clear from the facts of the case what the market value of the property acquired was.

What is clear as a finding of fact is that payments for the acquisition of a capital asset are on capital rather than revenue account. The essence of the decision is found at paragraph 9 per Fullagar J:

> For it is incontestable here that the moneys are paid in order to acquire a capital asset. The documents make it quite clear that these payments constitute the price payable on a purchase of land, and that appears to me to be the end of the matter. It does not matter how they are calculated, or how they are payable, or when they are payable, or

> whether they may for a period cease to be payable. If they are paid as parts of the purchase price of an asset forming part of the fixed capital of the company, they are outgoings of capital or of a capital nature.

While rental could abate due to damage to the premises, there was an obligation on the taxpayer to repair the premises in such case. The point of the document package was to make certain and secure the obligation, subject only to the vagaries of market forces.

***Cliffs International Inc v FCT* (1979) 79 ATC 4059**

Cliffs International remains valid law at the present time.

Barwick CJ found that:

> **14. The appellant's business thus involved it in the receipt of the royalties** from the consortium which, though I do not think it matters, accrued on a slightly different basis to that applicable to the computation of the payments to Howmet and Mt. Enid under the option agreement. As the operations of the consortium involved the mining and transport of iron ore from the area of the temporary reserves and thus attracted the obligation under the option agreement to make the "deferred payments", the appellant paid to Howmet and Mt. Enid from time to time sums equal to 15 cents per ton of iron ore mined and transported by the consortium.
>
> …
>
> **18. The proper conclusion in each case in this particular area of the law is peculiarly dependent upon the particular facts and circumstances of that case.** [Emphasis added]

In considering these matters, the contingent nature of the payments was relevant – there was no obligation to mine iron ore, but if ore was mined, the obligation crystallised. The transfer was complete upon the payment of the 'fixed' purchase price (in contrast to the elaborate security arrangements in *Colonial Mutual*).

Barwick CJ concluded:

> 31. … that, whilst the promise to make them in the events which occurred formed part of the consideration for the transfer of the shares of Howmet and the Agnew Co. in Basic, the payments themselves when made were outgoings incurred in gaining the appellant's assessable income consisting of royalties paid by the consortium and that they were not of a capital nature.

It appears that, for Barwick CJ, the contingent nature of the payments, combined with the business carried on by the taxpayer being a dealing in 'royalty' amounts, was sufficient to allow the taxpayer to deduct the amounts against the gross payments to it.

Jacobs J's view of the matter was that:

> 11. … To the question for what purpose is the expenditure made, the answer in the case of a pre-existing obligation could always be that the expenditure was made for the purpose of performing that obligation. The answer is but a conclusion of law. But that leaves no room for the "practical and business point of view" to which Dixon J. referred in Hallstroms' Case (1946) 72 CLR, at p 648 nor does it enable a solution of the problem to be found, not in "any rigid test or description" but from "many aspects of the whole set of circumstances," to use the phrases appearing in the B.P. Case (1965) 112 CLR, at p 397; (1966) AC, at p 264 . In order to solve the problem in a practical way it is necessary to look at the payments at the time each is made and to ask - what is that payment calculated to effect? Is it merely payment for the capital asset, the shares, already wholly acquired, and which are to be paid for over a period? Or is the purpose of the payment from the practical and business point of view to pay for the current mining operations?

He went on:

> 20. Each case depends on its own facts and circumstances but it may be stated that when the consideration for a depreciating asset right or advantage of limited life is a series of regular recurrent payments related to the life of the asset right or advantage then it is very likely that the recurrent payments will be found to be outgoings on revenue account. Particularly is this so when the amount of the payments is related to the use made of the asset right or advantage (at p175).
>
> 21. When a lump sum is outlayed at the outset it can properly be regarded as the cost of acquisition of the rights under the agreement then made. When there are recurrent payments it may not appear that this is so from a practical or business point of view. Thus in the Colonial Mutual Case the recurrent payments could hardly be regarded otherwise than as part of the cost of acquisition of the freehold. It was no more than a method adopted in payment for that freehold. To say that the payments were for rights of use and occupation would make no difference because those rights were rights springing from the ownership of the freehold (at p175).
>
> 22. In the present case the question can be asked of a particular payment - was it calculated to effect a discharge of the obligation to pay for the shares (or the shares together with the existing rights over the reserves) or was it calculated to effect payment for the exercise of the right to mine the ore in respect of which the payment is made? The fact that the parties to the option agreement described the payments as "deferred payments" is entitled to some weight but in the light of Mr. Dohnal's evidence of the course of negotiations it cannot be regarded as a factor of great consequence. The fact that there was an absolute transfer of the shares is also entitled to some weight but, for reasons I have stated, this factor cannot in the circumstances be regarded as of great weight. **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.** These factors in my opinion clearly

> outweigh the other factors which might support a contrary view (at p175). [Emphasis added]

The relevant factors appear to be whether the payments were contingent, which includes consideration of whether the transfer of the asset was complete without the payments (as opposed to the entry into the obligation to make the payments) being made. The character of the asset as a depreciating mining lease was also relevant. It should be noted that in all cases under consideration, the payments were recurrent and that indeed earnouts are usually of this basis.

Murphy J also found that the payments were on revenue account, simply based on Dixon J in Hallstroms 'practical hard matter of fact'.

Gibbs and Stephen J dissented - quoting Fullagar J's 'end of the matter' in *Colonial Mutual* - but it is noteworthy that Stephen J nonetheless noted:

> 14. It may be that money paid by a purchaser as part of the purchase price of a capital asset which he buys will not, for that reason alone, necessarily always bear the character of an outgoing of capital.

Turning to the question, in our view, the scope for deductibility of payments made under earnout rights could properly be limited to payments which are purely contingent in nature, or made by a person who is a 'dealer' or trader in earnout or similar rights. However, in such a case the alternative view should be stated that, based on *Cliffs International*, a wider scope for deductibility could be argued, but that the ATO does not accept that view as any more than arguable.

We do not think that the distinction turns on whether there is a fixed or variable period, but rather on the contingent nature of payments.

Rather than cite Gibbs J in dissent, the decision of Stephen J (also in dissent) at paragraphs 20-22 seems to be a better summary of the basis on which the distinctions can be drawn. Ultimately though it remains an exercise in the capital/revenue distinction based on the particular facts in issue, although it is admitted that this of itself gives little certainty to taxpayers.

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 right to be deductible under section 40-880 given the exclusions in paragraphs 40-880(5)(d) and 40-880(9)(b)?

Yes, there is, consistent with the Commissioner's position in *Taxation Ruling TR 2011/6 Income tax: business related capital expenditure - section 40-880 of the Income*

Tax Assessment Act 1997 core issues (**TR 2011/6**) that the scope of section 40-880(5)(d) is of limited application:

> 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.

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):

In the context of unpaid present entitlements to distributions from trusts, the Commissioner has expressed the view in several private rulings that it is appropriate to look through the legal rights incidentally created pursuant to the unpaid present entitlement (**UPE**) and either discharged or satisfied when the rights are facilitating what is the 'real' transaction, being the distribution from a trust to a beneficiary.[2] The Commissioner finds support for this view in the Full Federal Court decision of *FCT v Dulux Holdings Pty Ltd & Orica Ltd* [2001] FCA 1344 (**Dulux**).

In the same circumstances, it could be argued that the earnout rights are facilitating the real transaction – the sale of the asset that created the earnout right – and so consistent with the Commissioner's view on Dulux, those rights should be looked through such that there is no CGT event C2 happening.

4(b):

If an earnout right is not treated as set out in 4(a) above, then if a transaction includes more than one earnout payment, it may be appropriate to treat the right to each

[2] See, for example PBR 1012648073225 and PBR 1012571177732

payment as a separate right. This is because where each payment is contingent on meeting a certain milestone, the satisfaction of that milestone will result in the payment and the right to that payment ending. For example, if under a contract the earnouts are:

i) $1,000,000, if a threshold is greater than $20,000,000 in the 2019 income year;
ii) $1,000,000, if a threshold is greater than $25,000,000 in the 2020 income year; and
iii) $1,000,000, if a threshold is greater than $30,000,000 in the 2021 income year,

then it is appropriate that each be a separate right as achieving, or not achieving, a milestone does not affect the ability of achieving the next milestone such that subsection 112-30(5) applies.

4(c) – no response provided.

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 our view, this consultation question begins from an incorrect starting point – that the position in TR 2007/D10W was correct and appropriate. The issues with this starting point were extensively outlined in paragraphs 72 and 73 of the Joint Bodies' submission dated 14 December 2007[3].

The best that can be said in answer to Question 5(a) about the legal features of debt is that, if the ATO is determined to continue to advance the 'separate asset' approach, then a purposive basis of interpretation should be adopted in relation to the taxation of the grantor of an earnout right (ie the seller). The purpose of the legislation can hardly to have been to tax the buyer of an asset on its creation of an obligation to pay part of the purchase price. To then require that this right have the features of legal form debt (particularly in a legislative environment that now advances substance ahead of form in the determination of debt interests) appears misguided.

[3] https://www.taxinstitute.com.au/submissions/joint-professional-body-submission-in-relation-to-tr-2007/d10

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

The Tax Institute considers no further guidance on CGT event D3 is required at this time. Members note that the application of CGT event D3 will depend on the particular facts and circumstances of the earn-out arrangement and that CGT event D3 would not apply in all circumstances (eg where the grantor of the right to receive income to another entity does not own a mining or prospecting entitlement at the time of the grant of that right).

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, what aspects of Division 40 do you want guidance on?

While The Tax Institute does not agree with the 'separate asset' approach being the appropriate basis upon which earnout arrangements should be considered, in the event the ATO continues with taking the 'separate asset' approach, the guidance should be expanded to cover depreciating assets as well.

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 are good reasons to consider that the grant of an earnout right is not the creation of a financing arrangement as defined in section 974-130 of the *Income Tax Assessment Act 1997* (Cth) (**1997 Act**). In particular, the exclusion by way of example of derivatives solely for the management of financial risk in subsection 974-130(3) appears relevant. An earnout right is a way for the parties to manage the risk that a business or asset is not worth what the parties argue it to be worth. Its value is derived from the value of the business, and the arrangement (assuming it should be seen as a separate scheme at all) is used to manage the financial risk to the parties of variations in the value of the business. Given there is no such exclusion in section 104-35, then there is scope for an earnout right to be covered by section 104-35 but not section 974-130.

However, assuming for the sake of argument only that the earnout right is a financing arrangement, entered into to raise finance for the entity (because otherwise they would raise funds to be placed in escrow), the conclusion that the arrangement is an equity

interest does not necessarily follow automatically. In particular, it would be necessary to consider:

- Whether the earn out right and the purchase agreement were related schemes and, in combination, a financing arrangement; and
- The value of financial benefits given under the earnout right (or the notional scheme if they are related); and
- What financial benefits there is for an effectively non-contingent obligation to receive under the right (or notional scheme).

While each circumstance will be unique, it is our view that one could not say with certainty that all (or even a majority) of the earnout rights would constitute an equity interest.

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?

It is unclear on what basis the 'Commissioner expects that subsection 230-460(13) would generally operate to exclude most earnout arrangements from Division 230[4].' There are several earnout arrangements commonly adopted in the Energy and Resources sector, by way of example, where the exclusion will not apply.

It should be noted that subsection 230-460(13) of the 1997 Act was amended by the *Tax and Superannuation Laws Amendment (2015 Measures No.6) Act* (2016) (Cth). The suggestion that this amendment only applies to look through earnout rights cannot be correct.

In particular:

i) Section 2 clearly notes that the amendment to subsection 230-460(13) commences on the day after Royal Assent – ie 26 February 2016;
ii) Read in context, the statement in the Application provision in section 38 that 'the amendments made by Parts 1 to 3 apply in relation to look-through earnout rights created on or after 24 April 2015' can be read as meaning no more than that the provisions will apply from an earlier date in relation to look-through

[4] Paragraph 66 of the Discussion Paper

earnout rights. However, it does not prevent subsection 230-460(13) having been amended from the date following Royal Assent.

9(a):

We submit that the following types of earnout arrangements involve contingencies that would not be regarded as a reasonable measure of economic performance of the business sold:

i) A payment that is contingent on a milestone such as the preparation of a bankable feasibility study, the making of a decision to mine or the making of a final investment decision;
ii) A royalty based on a fixed price per tonne or volume of commodity produced;
iii) A royalty based on sale price only;
iv) A royalty based on sale price minus transport costs or certain agreed costs (that do not provide an accurate measure of profitability).

This is because in all these cases the contingency says nothing about the actual performance of the business. For instance, in all these cases, the company could be making a loss or a profit from conducting the business, at the time of the payment, but the payments will still be made.

For completeness, it is noted that subsection 230-460(13) only applies where there has been a sale of a business (or a company or trust carrying on a business) and a payment is only contingent on aspects of the economic performance of the **business**.

9(b):

The royalty at (iii) above is an example of an earnout arrangement that is solely based on turnover. As noted above, it is not a measure of economic performance.

9(c):

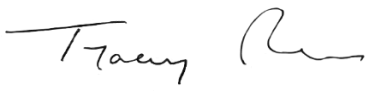
Where an earnout is contingent on revenue or turnover but also requires that the revenue or turnover has reached a specified level or a minimum price being charged, then it is still contingent solely on receipts or turnover. The minimum price is just the method for calculating the earnout. The only contingency is the level of turnover.

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?

As noted above, should the ATO choose to continue with the 'separate asset' approach, we consider that the relevant tax legislation will need to be amended to reflect this. We do not consider that an administrative approach is enough to support the ATO's view as this view currently cannot be sourced in the legislation.

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

Yours faithfully,



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