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AUSTRALIAN TAX ALERT

EXPOSURE DRAFT ON TAX TREATMENT OF EARNOUTS

THE GOVERNMENT HAS RELEASED THE LONG AWAITED EXPOSURE DRAFT WITH CHANGES TO THE TAX TREATMENT OF EARNOUT ARRANGEMENTS. IT IS COMMON FOR THE BUYERS AND SELLERS OF A BUSINESS TO INCLUDE PROVISIONS WHICH EITHER INCREASE OR DECREASE THE SALE PRICE OF A BUSINESS DEPENDING ON THAT BUSINESS' PERFORMANCE FOLLOWING THE TRANSACTION. THESE POST-TRANSACTION PAYMENTS ARE CALLED EARNOUTS AND SEEK TO SOMEWHAT DE-RISK THE TRANSACTION FROM A PURCHASER'S POINT OF VIEW.

Background

Prior to 2007, the Australian Taxation Office (**ATO**) had accepted a "look-through" treatment of earnout arrangements.

Since 2007, when the ATO issued a draft public ruling, the treatment of earnouts by both buyers and sellers of businesses has remained uncertain and problematic. In that draft ruling, the ATO stated that the buyer and seller must value the "rights" arising from the earnout and include them in the capital proceeds or cost base of the assets acquired.

Under this approach, any payments under the earnout are then made in respect of the "rights" which themselves are a CGT asset, rather than relating to the original sale.

Depending on the actual payments made under the earnout, this can lead to:

- Complexity in identifying and valuing the earnout rights (including whether single or multiple earnout rights exist);
- Increased tax payable on a sale (due to the immediate inclusion of the value of the earnout right);
- Cost base in assets not being fully recognised (due to payment for the assets not relating to the assets, from a purchaser's perspective);
- Non-application of small business concessions to the earnout payments, even if they applied to the original sale.

In 2010, the Government announced that the law would be amended to provide for look-through treatment for qualifying earnout arrangements. At this time the ATO provided administrative guidance allowing taxpayers to choose to follow the draft ruling, or adopt the look through treatment based on the government's press release.

Nearly 5 years later the exposure draft giving effect to this announcement has been released.

What is look-through treatment?

The policy underlying the look-through treatment is that an earnout is a contingent payment that reflects the uncertainty in the value of the business and therefore any payment under the earnout relates to the ascertaining of that value after the transaction.

The look-through approach allows the buyer and seller to treat payments made under a qualifying earnout as part of the original sale transaction. For sellers this will increase/decrease the capital proceeds on sale and for buyers this will increase/decrease cost base of the assets acquired.

When determining the capital proceeds at the time of a sale, under the look-through approach, the value of any contingent earnout right is not included.

Applying the look-through treatment results in tax on an amount only being payable once the deferred consideration is payable. Compared to the approach in the ATO's draft ruling this mitigates the risk that the seller is paying tax on an amount they may not ultimately receive.

Qualifying earnout rights

The exposure draft introduces the concept of a "look-through earnout right" which is a right which meets the following conditions:

- It includes future financial benefits that are not reasonably ascertainable at the time the right is created;
- It involves the disposal of a CGT asset which causes CGT event A1 to happen;
- Just before the CGT event, the CGT asset was an active asset of the entity who disposed of the asset (e.g. shares in a company that runs an active business - see below);
- All of the financial benefits that can be provided under the earnout are to be provided within 4 years of the CGT event;
- Those financial benefits are contingent on the economic performance of:
  - the CGT asset; or
  - a business for which it is reasonably expected that the CGT asset will be an active asset for the period to which those financial benefits relate;
- The value of those financial benefits reasonably relates to that economic performance; and
- The parties to the arrangement deal with each other at arm’s length.

As a result there are some important exclusions from the scope of the new measures, including:

- The sale of depreciating assets;
- Earnouts that extend past 4 years;
- The sale of assets that are not active - this will exclude businesses that derive predominantly annuity, interest, rent, royalties income; and
- Earnouts that are contingent on turnover or other non-profit based measures may be excluded.

Seller's perspective

The main benefits from the look-through approach are from the seller's side of a transaction. The application of the look-through approach will:

- Remove the need to value the contingent earnout right received;
- Defer tax until the payment under an earnout is known; and
- Allow access to discount capital gains and small business concessions on the earnout if these applied to the transaction (as the deferred receipts are treated as if they relate to the original CGT asset, not to separate assets created as a result of a transaction).

If the seller triggers a capital gain at the time of the transaction, all further receipts of earnout payments will increase their capital gain.

If the seller receives total capital proceeds which are less than their reduced cost base, a capital loss will be triggered (however, see below in relation to the timing rules for such a loss).

Buyer's perspective

The look through approach should result in a buyer recognising the full value of what is paid for an asset as the asset's tax base, but only once all payments are made under the earnout.

However, where earnout payments span a number of income years, the purchaser will have had to have lodged tax returns on the basis of the asset's cost base before the earnout payments are made. This may give rise to administrative difficulties. For example, if the assets are shares in a company that joins a tax consolidated group, this will lead to the allocable cost amount and tax cost setting process needing to be revisited each time there is a payment under an earnout. Given the complexity that can arise through this consolidation cost setting process, this may result in an onerous compliance task for the Buyer.

Administration of the rules

There are a number of consequential changes to deal with the administration of the new rules, including:

- Capital losses on a sale will be quarantined while an earnout right exists (i.e. until all amounts are paid or cease being payable);
- Amendment periods will be extended to 4 years from the expiry of an earnout right (to enable taxpayers to amend their returns);
- Interest will not be payable in under or overpayments of tax as a result of the amendments to assessments to include later earnout payments.

Transitional rules

The new look-through rules will apply to earnout right created on or after 23 April 2015. Taxpayers who relied upon the previous Government announcement in preparing their tax returns will be protected under the "announced but unenacted measures" provisions. These provisions prevent the Commissioner from amending a tax return where the taxpayer has prepared it in reasonable anticipation of the announced law change.

Action required

If transactions are currently being negotiated that include an earnout right, these amendments should be taken into consideration by both the buyer and seller of the business.

For transactions that occurred before 23 April 2015, taxpayers should review their treatment of any earnouts to determine whether their treatment falls within the "announced but unenacted measures" protection or if any prior year amendments are required.

Comments on the exposure draft are due by 21 May 2015.

MORE INFORMATION

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