

Taxation Update

CGT changes to the treatment of 'earn-out arrangements'

ACTION REQUIRED

These proposed changes must be reviewed by:

- buyers and sellers of "in progress" transactions incorporating an earnout;
- sellers contemplating business sales but deterred by the tax treatment of earnouts;
- buyers (not sellers) under a standard earnout entered into on or after 17 October 2007.

A Federal Government 2010 Budget measure proposes a change to the CGT treatment of "earn out arrangements" used in connection with the sale and purchase of a business, or business assets. Once implemented, this measure will reinstate the "look through" approach which had been generally accepted as correct, prior to the issue of an ATO ruling in October 2007.

What is an "earn out" arrangement? (See Box 1 on Page 5)

Where the value of a business, or particular business assets cannot be valued because of uncertainty about future economic performance, it is common to structure the arrangements to include a provision for:

- additional contingent payments to be made by the buyer (standard earnout arrangement); and/or
- a reduction in the sales price received by the seller (reverse earnout arrangement).

Both earnout arrangements aim to align the sales price paid for a business, with the actual performance achieved by the business during the earnout period.

Government's proposal

The CGT law will be amended to enshrine the "look through" approach. In brief, any "earnout right" is ignored and:

- all amounts received by a seller under an earnout arrangement will be treated as capital proceeds for the business sale;
- all amounts paid by the buyer under an earnout arrangement will be treated as part of the buyer's cost base for the relevant asset.

For the seller, this will ensure access to any CGT small business concessions for all capital proceeds. The compliance obligations will be less onerous as there is no need to value an earnout right, and the policy position will align with the commercial view of the transaction.

Standard earnout arrangements

Under a standard earnout, the buyer has the contractual entitlement to receive additional amounts in future periods, provided the business meets or exceeds agreed performance hurdles.

The "cost recovery" method will be adopted. Under this approach, the seller's cost base will be reduced by sale proceeds in periods when the quantum of the proceeds become certain. A capital gain is recognised once the proceeds exceed the cost base.

Receipt of additional proceeds in future years will result in a capital gain (where the cost base has not been exceeded in a prior year) or in further capital gains (where the cost base has been previously exceeded.)

Where the sale transaction qualifies for CGT concessional treatment, each capital gain will qualify for that concessional treatment, irrespective of the year in which the gain is calculated and returned.

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Example

Seller and buyer agree a business is worth at least \$800,000, but potentially \$1 million or more if the majority of customers stay with the business. Due to the uncertainty of the customer loyalty, the parties agree to an earnout arrangement, structured on the following terms:

- buyer pays \$800,000 on settlement; and
- buyer will pay an amount for each of the next 3 financial years equal to 50% of the revenue above \$500,000, but capped at \$200,000 per year.

Revenues for the business in the following 3 years are \$700,000, \$600,000 and \$700,000. The seller receives additional payments of \$100,000, \$150,000 and \$100,000.

The seller's cost base for the business is \$1 million.

Proposed tax treatment for the seller

	Cost base	Capital proceeds	Adjusted cost base	Capital gain/loss (annual)
Year 0	\$1 million	\$800,000	\$200,000	\$0
Year 1	\$200,000	\$100,000	\$100,000	\$0
Year 2	\$100,000	\$150,000	\$0	\$50,000
Year 3	\$0	\$100,000	\$0	\$100,000
Total	\$1 million	\$1.15 million	\$0	\$150,000

Overall the seller's capital proceeds were \$1.15 million, resulting in an overall capital gain of \$150,000 realised as two separate gains of \$50,000 and \$100,000 (the capital gains in Year 2 and Year 3 are brought to account in the respective income year for Year 2 and Year 3). CGT concessions that apply to the sale transaction will apply to each capital gain, irrespective of the year in which is realised.

Proposed tax treatment of buyer

	Amount paid	Cost base
Year 0	\$800,000	\$800,000
Year 1	\$100,000	\$900,000
Year 2	\$150,000	\$1.05 million
Year 3	\$100,000	\$1.15 million

Applying the cost recovery method, the buyer's cost base of the business is \$1.15million.

A consequence of adopting the cost recovery method is that a seller who incurs an overall capital loss in the sale transaction will not recognise that loss until the end of the arrangement. This consequence balances the positive, that there is no need (in most circumstances) to amend prior period assessments.

Reverse earnout arrangements

Under a reverse earnout, the lump sum paid at settlement is set based on the business meeting agreed performance marks. If the performance falls short of those marks, the buyer is entitled to recover part of the purchase price paid.

The approach to be adopted is based on the proceeds "repaid" rules (for a seller), and the proceeds "recoupment" rules (for a buyer).

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Example

Two parties agree that a widget making business is worth at least \$1.7 million, but potentially \$2 million or more if the specialised widgets produced by the business are really popular. Due to the uncertainty, they agree to a reverse earnout arrangement, structured on the following terms:

- buyer pays a lump sum of \$2 million; and
- where the profit is less than \$250,000 the seller agrees to pay the buyer 50 percent of the difference for the next three financial years (the reverse earnout right).

The profit for the business in the following three years are \$20,000 \$40,000 and \$60,000. Therefore, the seller makes payments of \$115,000, \$105,000 and \$95,000.

The seller has a cost base of \$1.7 million.

Proposed tax treatment of seller

	Cost base	Capital proceeds	Adjusted cost base	Capital gain/loss
Year 0	\$2 million	\$2 million	\$1.7 million	\$300,000
Year 1	-\$115,000	Amend to \$1.885 million	\$1.7 million	Amends Year 0 capital gain to \$185,000
Year 2	-\$105,000	Amend to \$1.78 million	\$1.7 million	Amends Year 0 capital gain to \$80,000
Year 3	-\$95,000	Amend to \$1.685 million	\$1.7 million	Amends Year 0 \$15,000 capital loss

The seller must amend their tax assessment at the end of each income year in which they make (or become obligated to make) payments - in this example, at the end of Year 1, Year 2 and Year 3. At the end of the income year for year 3 the seller makes a final amendment to their capital proceeds, to \$1.685 million (and thus realises an overall \$15,000 capital loss on the sale.)

Proposed tax treatment of buyer

	Amount paid	Cost base
Year 0	\$2 million	\$2 million
Year 1	-\$115,000	\$1.885 million
Year 2	-\$105,000	\$1.78 million
Year 3	-\$95,000	\$1.685 million

Under the repaid method, recoupments are deducted from the cost base of the asset when they are made. Thus the cost base for the buyer is \$1.685 million.

(The examples have been taken from the Treasury consultation paper.)

Purchase price adjustments - which assets affected?

Where a purchase price is adjusted to give effect to an earnout arrangement, the adjustment will impact the asset which is the subject of the uncertainty.

In the case of a share sale transaction, the only relevant assets are the sale shares. Any adjustment will be made to the capital proceeds/ cost base of the shares.

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In the case of a sale of assets transaction, any earnout adjustment would not be prorated across all sale assets, but would be restricted to the value attributed to assets the value of which are uncertain at contract date. Thus there would be no change to the values attributed to land, plant and equipment, or trading stock (assuming fair market values have been determined at contract date). But the values of the following asset types may be uncertain in appropriate circumstances, and subject to earnout modification:

- goodwill
- intellectual property rights
- other identifiable intangible assets.

Transitional arrangements

The proposed changes have a prospective start date, but with some transitional relief. Notably, there is no transitional relief for the "anomaly" most in need of relief.

Dates	Application
Date of Royal Assent to the amending legislation.	Proposed changes will operate prospectively.
Between 12 May 2010 and date of Royal Assent.	Taxpayer election (buyer and seller) to choose either the new "look through" approach, or the "rights analysis" per TR 2007/D10.
From 17 October 2007	Only the BUYER in a STANDARD earnout arrangement will have a choice to apply the new "look through" approach. This would result in later year earnout payments being added to the buyer's cost base in the relevant asset.
Pre 17 October 2007	Seller and buyer could apply the "look through" approach.

The "biggest loser" is a taxpayer who sold an asset pursuant to an earnout in the period from 17 October 2007 to 12 May 2010. Despite the fact TR2007/D10 was only a draft ruling (and therefore of no legal effect) the Government's proposal does not extend relief to sellers during that period. They remain subject to the to-be replaced "rights analysis", and the shortcomings of that approach, noted above.

Integrity measures proposed

Integrity measures are foreshadowed, so that the proposed changes will apply to only earnout arrangements that are "genuine", and do not seek to artificially delay tax liabilities. Such measures may include a time limit on adjustments; a requirement there be a "genuine" uncertainty as to an asset's value, based on contingent performance; the transaction be at arms length; and the assets not be trading stock or revenue assets.

Treasury consultation

The Government has opened a consultation period in relation to the proposed changes. Treasury is running the consultation process, and any clients who wish to make a submission should do so by Friday 11 June 2010 (the submission closing date). We would be pleased to assist in the preparation of any submissions on the consultation issues. Please refer any questions to your regular RSM Bird Cameron contact.

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Box 1

Prior to 2007, it had been the practice in M&A transactions involving an earnout, to adopt a “look through” approach. For the seller, any consideration received in subsequent years pursuant to the earnout, was treated as additional capital proceeds arising from the sale. To account for this, it would often be necessary to amend the tax return of the business sale year. The purchaser would treat subsequent earnout payments as additional cost base.

The “look through” approach was provided for in an earlier ruling (TR93/15), but this was withdrawn on 17 October 2007. The “look through” approach is accepted by the ATO in relation to the receipt of compensation for damage to an underlying asset. In both cases, a strict “rights analysis” was not adopted; the commercial and sensible “look through” approach was preferred.

This changed when the ATO issued TR 2007/D10 on 17 October 2007. This draft ruling adopted a strict “rights analysis”. A seller of a business with an earnout provision, would receive capital proceeds of a lump sum payment (i.e. what was paid at settlement) plus a “right to future income” (the earnout right). The earnout right had to be valued, and that value was included as capital proceeds in the CGT sale calculation. As the earnout was paid out, there would be separate annual capital gains or losses, independent of the sale capital gain, and not qualifying for any CGT small business concessions. The purchaser of the business was not permitted to include the earnout payments in the cost base of the acquired business. The draft ruling also addressed “reverse earnout arrangements,” and applied a similar approach, requiring the capital proceeds paid to be valued, and allocated between the value for the business and the value for the reverse earnout right.

The draft ruling, released in October 2007, has remained a draft for over 3 1/2 years. Throughout that time, it has been heavily criticised and the ATO has refrained from finalising it, perhaps in tacit acknowledgement of the overly technical and uncommercial analysis it contains.

That position will now be reversed, with the “look through” approach previously applied in practice, to be reinstated, this time with the benefit of specific legislative provisions.

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