Australian Government
Australian Taxation Office

Discussion Paper

Issues concerning earnout arrangements (excluding arrangements that create look-through earnout rights)

This paper is seeking submissions on possible guidance products to be developed by the Australian Taxation Office.

Purpose and status of this discussion paper

The purpose of this paper is to facilitate consultation between the Australian Taxation Office (ATO) and the community as part of the process of developing advice on the application of the tax law.

This paper is prepared solely for the purpose of obtaining comments from interested parties. All views in this paper are therefore preliminary in nature and should not be taken as representing either an ATO view or that the ATO will take a particular view.

This paper is not a publication that has been approved to allow you to rely on it for any purpose and is not intended to provide you with advice or guidance, nor does it set out the ATO's general administrative practice. Therefore, this paper does not provide protection from primary tax, penalties or interest for any taxpayer that purports to rely on any views expressed in it.

Date of issue	3 December 2018
Contact officer *(for comments or further information)*	Contact officer details have been removed as the comments period has ended.
Final date for comments	1 February 2019

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Introduction

1. The Board of Taxation is currently conducting a post-implementation review of the tax treatment of contingent consideration (including earnouts).[1] In light of the Board's review, the ATO is seeking your feedback on the need and priority for additional public advice and guidance on the income tax treatment of arrangements (commonly referred to as 'earnouts') entered into in the context of the sale of a business asset or interests in an entity carrying on a business. The arrangements usually involve the grant of a right (or multiple rights) to one or more future payments which are contingent on future events in connection with the business. The quantum of the payments may also be unascertainable at the time the right is granted.

2. On 26 February 2016, legislative amendments were enacted to allow look-through CGT treatment for qualifying earnout arrangements in the sale of business assets, with application to look-through earnout rights (as defined) created on or after 24 April 2015.[2] Broadly, these amendments in Subdivision 118-I of the *Income Tax Assessment Act 1997*[3] are intended to ensure that the CGT provisions do not present a deterrent to a specific type of transaction – the sale of a business where a genuine disagreement about the value of the business going forward is resolved by at least one of the parties agreeing to provide future financial benefits linked to the performance of the business.[4]

3. While it is expected that most standard and reverse earnout arrangements created on or after 24 April 2015 would qualify for look-through treatment under Subdivision 118-I, there are arrangements that do not satisfy the requirements of a look-through earnout right. This discussion paper focuses on such arrangements which do not qualify as look-through earnout rights under Subdivision 118-I.

4. In addition to seeking feedback, this discussion paper also seeks to highlight some of the issues which may need to be considered when you enter into such an arrangement and this may also assist you in determining whether these issues may be better understood through the provision of additional ATO public advice and guidance.

Background

5. Draft Taxation Ruling TR 2007/D10 *Income tax: capital gains: capital gains tax consequences of earnout arrangements* was concerned with the CGT consequences of standard and reverse earnout arrangements. It did not deal with tax consequences outside of Parts 3-1 and 3-3.

6. TR 2007/D10 defined a standard earnout arrangement as any transaction in which an income-earning asset (often a business asset) is sold for consideration that includes the creation of an 'earnout right' in the seller of the asset.[5] TR 2007/D10 also dealt with reverse earnout arrangements. This paper does not deal with reverse earnout arrangements specifically, but they may be considered for public advice and guidance in the future.

7. TR 2007/D10 was withdrawn with effect from 7 December 2016 because it was expected that most standard and reverse earnout arrangements created on or after 24 April 2015 would qualify for look-through treatment under Subdivision 118-I. Taxpayers can still rely on TR 2007/D10 for earnout arrangements created on or before the date of withdrawal. However, there has been no change to the ATO's view on the CGT consequences for earnout arrangements that do not satisfy the requirements for look-through treatment under Subdivision 118-I.

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[1] Refer CEO Update – July 2018: https://cdn.tspace.gov.au/uploads/sites/74/2018/07/CEO_Update_July_2018.pdf.
[2] These legislative amendments also provide protection for taxpayers that have reasonably and in good faith anticipated the changes before enactment of the law – see subsection 170B(3) and table item 14 in subsection 170B(8) of the *Income Tax Assessment Act 1936*.
[3] All legislative references in this consultation paper are to the *Income Tax Assessment Act 1997* (ITAA 1997) unless otherwise indicated.
[4] Paragraph 1.28 of the Explanatory Memorandum to the Tax and Superannuation Laws Amendment (2015 Measures No. 6) Bill 2015 (2015 EM).
[5] Paragraph 2 of TR 2007/D10.

8. For the purposes of TR 2007/D10, an 'earnout right' is a right to an amount calculated by reference to the earnings generated by the asset for a defined period following the sale (generally a period of between one and five years). It is to be distinguished from a right to sum in respect of that sale which is certain as to amount and as to receipt (such as an instalment sale).[6]

9. TR 2007/D10 did not address a number of issues, including:

- the possibility that a receipt from an earnout right with a term of one to five years may be assessable, in full or in part, as ordinary income (as it was considered that would only be the case in extreme circumstances)[7]
- the possibility that payments made to satisfy an obligation under an earnout right may be allowable as an ordinary deduction, and
- the income tax consequences of selling a depreciating asset in consideration for an earnout arrangement under Division 40.

10. This discussion paper considers a number of tax issues in relation to earnout arrangements, including the sale of a Division 40 depreciating asset where the consideration includes an earnout arrangement. However, it does not apply to look-through earnout rights as defined in Subdivision 118-I or arrangements under which such rights are created.

11. The Commissioner recognises that there may also be a need for further ATO guidance on issues in relation to Subdivision 118-I look-through earnout rights. These issues are outside the scope of this discussion paper and may be considered at a future time.

Scope and purpose

12. The purpose of this discussion paper is to guide the ATO's approach to the taxation of non-qualifying earnout arrangements by:

- identifying the need and priority for public advice and guidance on any areas which you think are unclear, or cause difficulties in understanding your obligations
- reviewing views expressed in existing ATO guidance to identify areas which need to be clarified or changed, and
- considering whether any specific compliance approach ought to be adopted to help resolve the practical challenges of valuing earnout rights.

13. The ATO is also considering the scope of non-qualifying earnout arrangements that would be covered by any guidance, including:

- whether it should be limited to arrangements that are contingent on the economic performance of an asset or business
- arrangements connected with the sale of a Division 40 depreciating asset
- earnout arrangements which are long term or of indefinite duration (such as arrangements linked to the life of a business such as a mine), and
- royalty-like earnout arrangements linked to the production of commodities.

14. The ATO seeks to engage transparently with you and invites your feedback on the ideas raised in this discussion paper. We also encourage you to raise any other relevant issues or specific concerns about the matters discussed in this paper.

[6] Paragraph 3 of TR 2007/D10.
[7] Paragraph 10 of TR 2007/D10.

Separate asset approach

15. TR 2007/D10 adopted a 'separate asset' approach in relation to standard earnout arrangements in respect of the treatment of both a seller and a buyer. The application of the CGT provisions under this approach are as follows:

The seller:

- an earnout right is 'other property … received' by the seller in respect of the disposal of the original asset. The seller's capital proceeds from CGT event A1 includes the market value of that right (worked out at the time of the CGT event)
- the earnout right is property, and a CGT asset, in the hands of the seller. Under subsection 112-30(1), the first element of cost base of the earnout right is that part (which may be all) of the market value of the original asset given by the seller in exchange for the earnout right as is reasonably attributable to its acquisition, and
- generally, the seller's ownership of an earnout right will come to an end when satisfied by the payment of an amount or amounts by the buyer, or by expiring without any amounts becoming payable. In each of these situations, CGT event C2 happens.

The buyer:

- under subsection 110-25(2), when a buyer acquires a CGT asset in exchange for the granting of an earnout right, the first element of the buyer's cost base of the asset includes the market value of the right (worked out at the time of acquisition)
- any money later paid pursuant to the earnout arrangement is not paid to acquire the original asset, but is paid to discharge the buyer's obligation under the earnout arrangement, and
- CGT event D1 does not happen as a result of the creation of an earnout right in the seller.

16. In *Zim Properties Ltd v. Proctor (Inspector of Taxes)* (1984) 129 Sol Jo 68; 58 TC 371, Warner J considered that the choice of which was the most relevant asset (from which a settlement sum was derived) depended on the 'reality of the matter'.

17. In Taxation Ruling TR 95/35 *Income tax: capital gains: treatment of compensation receipts*, the Commissioner stated that one of the principles underlying the interpretation of the CGT provisions is the 'most relevant asset approach'. The identification of the most relevant asset involves a process of analysing all the possible assets of a taxpayer to determine the asset to which the capital proceeds received (or entitled to be received) by that taxpayer most directly relates.[8]

18. The 'most relevant asset approach' taken in TR 95/35 was adopted and applied, in combination with the 'continuum of events' approach, in Taxation Ruling TR 1999/19 *Income tax: capital gains: treatment of forfeited deposits*. The 'continuum of events' approach, taken from the Full Federal Court decision in *FC of T v. Guy* 96 ATC 4520; (1996) 32 ATR 590, provides that it is only possible to relate capital proceeds to a CGT event happening to an underlying asset when they are received in the course of the same 'continuum of events' as that CGT event.

19. Having referred to all of the above principles, TR 2007/D10 concluded that, in the case of earnout arrangements, the 'reality of the matter' is that the parties have entered into a financial arrangement that is independent of the sale transaction from which it arises.[9] This represents the Commissioner's current view.

20. Prior to the issue of TR 2007/D10 on 17 October 2007, the ATO's views in relation to earnout arrangements were set out in TR 93/15 *Income tax: capital gains tax consequences of consideration comprising a lump sum plus a right to a contingent and unascertainable amount*

[8] Paragraph 3 of TR 95/35.
[9] Paragraphs 83 to 90 of TR 2007/D10.

(which was subsequently withdrawn on the date TR 2007/D10 was issued). The views expressed by the Commissioner in TR 93/15 in relation to the seller's tax treatment of the earnout right broadly reflected the views subsequently expressed in TR 2007/D10 (that is, the earnout right was a separate asset for CGT purposes and a 'look-through' approach could not be adopted). However, in relation to the *buyer's* tax treatment, the Commissioner had expressed the view[10] that in order for property to be 'given' for the purposes of former subsection 160ZH(4) of the *Income Tax Assessment Act 1936* (ITAA 1936), now section 110-25, and form part of the CGT cost base, the property must first be the property of the giver. Consequently, it was considered that a buyer did not 'give property' to the seller when granting an earnout right to the seller because the buyer had no property to dispose of and nothing could be transferred or conveyed from the buyer. However, the payment of a further amount by the buyer to satisfy the contingent obligations under the earnout arrangement was considered to be an amount of money that could be included in the CGT cost base of the asset acquired at the time of the payment (in effect the Commissioner accepted that a buyer could adopt a 'look-through' approach).

21. On 16 January 2008, the Commissioner issued Draft Taxation Ruling TR 2008/D1 *Income tax: tax consequences for a company of issuing shares for assets* dealing with the tax consequences for a company of issuing shares for assets (which was subsequently finalised on 27 August 2008 as TR 2008/5) and expressed the view that when a company issues shares as consideration for assets, the provision of shares is the provision of property given, or required to be given, in respect of acquiring the assets.[11] This was on the basis that the Commissioner considers that the more correct view is that, in the context of the CGT cost base provisions, the issuing of shares is the 'giving of property'.[12] The Commissioner confirmed that the contrary view expressed in TR 93/15 in relation to the grant of an earnout right (referred to in paragraph 20 of this discussion paper) was withdrawn.

22. The 'separate asset' approach means that payments required to be made by the buyer to the seller pursuant to the earnout right have no effect on the cost base of the underlying asset acquired. The deductibility of those payments under section 8-1 or their deductibility as business related capital expenditure under section 40-880 is discussed in paragraphs 23 to 32 of this discussion paper.

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

Deductibility of earnout payments under section 8-1

23. As noted in paragraph 9 of this discussion paper, TR 2007/D10 did not deal with the possibility that a payment made to satisfy an obligation under an earnout right may be allowable as an ordinary deduction under section 8-1. In *Cliffs International Inc v. FCT* (1979) 79 ATC 4059, the majority (three out of five judges) of the Full High Court found that the deferred payments (which were in the nature of royalty payments) were of a revenue nature and deductible. However, it can be observed that this conclusion was finely balanced.[13]

24. While the Commissioner in *Cliffs International* relied substantially on the High Court decision in *Colonial Mutual Life Assurance Society Ltd v. FCT* (1953) 89 CLR 428, it was considered that the facts in *Colonial Mutual Life Assurance* were distinguishable.[14]

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[10] Paragraph 27 inserted by erratum notice TR 93/15E.
[11] Paragraph 11 of TR 2008/5.
[12] Paragraph 81 of TR 2008/5.
[13] It is noteworthy that all judges in the lower Full Federal Court considered that the deferred payments were not deductible (*FCT v. Cliffs International Inc* 77 ATC 4564 per Bowen CJ, Franki and Brennan JJ). The primary judge had held the deferred payments were deductible (*Cliffs International Inc v. FCT* 77 ATC 4217 per Brinsden J).
[14] Barwick CJ 79 ATC 4066. However, the reasoning of Barwick CJ in *Cliffs International* was criticised by Edmonds J in the Full Federal Court decision of *SPI Powernet Pty Ltd v FC of T* [2014] FCAFC 36: "*His honour got to this conclusion by focusing on the occasion of the making of the payments rather than the nature of the liability discharged or the character of the asset/advantage obtained. Jurisprudence both before and after Cliffs International does not support that approach*".

25. Gibbs J, in his dissenting judgment in *Cliffs International*, placed significant reliance on the decision in *Colonial Mutual Life Assurance* to conclude that the advantage sought by the payments was of a capital nature. That is, whether one looks at the 'true legal character' of the expenditure or at what it was 'calculated to effect from a practical and business point of view'.[15] Although the obligation to make payments in *Colonial Mutual Life Assurance* was limited to a fixed period whereas the obligation in *Cliffs International* could continue indefinitely, Gibbs J thought the case was 'indistinguishable'.[16]

26. In *Cliffs International*, Barwick CJ emphasized that 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.[17]

27. Where a buyer is obliged to satisfy an earnout right by way of periodic payments and the payments represent working expenses that are incurred as part of an income-producing activity (such as mining), the payments *may* be deductible to the buyer under ordinary deduction principles. However, if the payments represent expenditure necessary for the acquisition of property or of rights of a permanent character the possession of which is a condition of carrying on an income-producing activity (for example, the payments are part of the purchase price), they will generally not be deductible to the buyer.

Consultation 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 (that is, the obligation being limited to a fixed period in *Colonial Mutual Life Assurance* 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.

Deductibility of earnout payments under section 40-880

28. Where *Cliffs International* should be distinguished and the earnout payments are appropriately regarded as expenditure of a capital nature, they are therefore not deductible under section 8-1. The application of the separate asset approach outlined above will also mean that the payments are not taken into account for Division 40 or CGT purposes (as they relate to the grantor's obligation under the earnout right and not the assets acquired in consideration for granting the earnout right). However, the blackhole expenditure provision in section 40-880 may permit the earnout payments to be deducted over a five-year period. To be deductible under section 40-880, an earnout payment needs to be incurred in relation to a taxpayer's business, a business that used to be carried on, or a business that is proposed to be carried on.[18]

29. Where the threshold conditions are satisfied, blackhole expenditure may still be excluded from the scope of section 40-880 where one of the various exceptions applies, including:

- paragraph 40-880(5)(d): expenditure to the extent that it is in relation to a lease or other legal or equitable right[19], or
- paragraph 40-880(9)(b): expenditure to the extent that, for another entity, it is a return on or of an equity or debt interest.[20]

[15] Gibbs J 79 ATC 4066.
[16] Gibbs J 79 ATC 4068.
[17] Barwick CJ 79 ATC 4064.
[18] Refer paragraphs 40-880(5)(a),(b) and (f).
[19] The scope of paragraph 40-880(5)(d) is considered in paragraph 47 of Taxation Ruling TR 2011/6 *Income tax: business related capital expenditure – section 40-880 of the Income Tax Assessment Act 1997 core issues*.
[20] See discussion on TOFA.

30. Paragraph 40-880(5)(d) was briefly discussed in the context of determining deductibility of expenditure for gaming machine entitlements in *Commissioner of Taxation and Sharpcan Pty Ltd* [2018] FCAFC 163. Greenwood ACJ stated in the context of paragraph 40-880(5)(d) that the statutory right conferred by the gaming machine entitlements was in the nature of a legal or equitable right.

31. An earnout right may constitute a 'legal or equitable right' under the broad interpretation of paragraph 40-880(5)(d) in the *Sharpcan* decision.

32. It should also be noted that *Sharpcan* did not have to consider whether the reference to 'other legal or equitable right' is limited to a right held by, or to be acquired, by the taxpayer incurring the expenditure. In other words, whether the exception in paragraph 40-880(5)(d) would apply to amounts paid by a buyer under an earnout arrangement where the payment of those amounts relates to an *obligation* of the buyer. However, it may be argued that the words 'in relation to' are sufficiently broad to include payments made to extinguish (wholly or partly) a contractual right.

Consultation 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)?

Ending of the earnout right

33. TR 2007/D10 confirmed that an earnout right is property, and a CGT asset, in the hands of the seller.[21] The seller's capital proceeds for the asset sold therefore includes the market value of the earnout right (worked out at the time of the CGT event A1).[22]

34. Once the seller has acquired the earnout right, TR 2007/D10 confirmed that, generally, the seller's ownership of an earnout right will come to an end when satisfied by the payment of an amount or amounts by the buyer, or by expiring without any amounts becoming payable and this will cause CGT event C2 to happen under section 104-25.[23]

35. The method for determining the CGT consequences of an earnout right being discharged differs depending on whether the totality of earnout rights under the earnout arrangement is a single CGT asset, or it is appropriate to regard each right to an instalment under the earnout right as a separate CGT asset.[24]

36. The totality of rights under a contract is generally a single CGT asset for CGT purposes. However this is ultimately a question of fact to be decided on a case by case basis.[25]

37. Where an earnout right that entitles the seller to more than one future financial benefit is a single CGT asset, CGT event C2 happens to a part of that right at the time each financial benefit is to be determined. The seller's cost base and reduced cost base for the part of the earnout right to which the CGT event happens is worked out using the formula in subsection 112-30(3). Under subsection 112-30(4), the remainder of the cost base after each payment date is attributed to the part of the asset that remains.[26]

38. Where CGT event C2 happens because part of the earnout right is discharged by the provision of financial benefits by the buyer, the seller may make a capital loss if those capital proceeds are less than the reduced cost base for that part of the earnout right. However, where CGT event C2 happens because part of the earnout right has expired without any obligation arising on the part of the buyer to provide a financial benefit, the capital proceeds are nil. Under the

[21] Paragraph 15 of TR 2007/D10.
[22] Paragraph 13 of TR 2007/D10.
[23] Paragraph 17 of TR 2007/D10.
[24] Paragraph 19 of TR 2007/D10.
[25] Taxation Determination TD 93/86 *Income tax: capital gains: are the totality of rights under a contract considered to be the one asset, or is each right considered to be a separate asset for CGT purposes.*
[26] TR 2007/D10 at paragraph 21.

formula in subsection 112-30(3), the cost base and reduced cost base for the relevant part to which the CGT event happens will also be nil.

39. Subsection 112-30(5) provides an exception to the application of the apportionment formula in subsection 112-30(3). It provides that an amount that forms part of the cost base or reduced cost base of an asset is not apportioned if, on the facts, that amount is 'wholly attributable' to the part to which the CGT event happened or to the remaining part. Depending on the facts and circumstances, it may be difficult to establish whether part of the cost base or reduced cost base of an earnout right is wholly attributable to a particular part of an earnout right which ends. For example, if the earnout right was valued on the basis of the present value of each possible payment under the earnout right, the value of a possible payment could be regarded as representing part of the cost base or reduced cost base that is wholly attributable to that part of the earnout right represented by the possible payment. In other cases, it may not be possible to determine whether part of the cost base or reduced cost base of an earnout right is wholly attributable to the part of the earnout right that has ended (and the apportionment formula in subsection 112-30(3) would apply).

40. Where each right to a future financial benefit is a separate CGT asset, CGT event C2 happens to the whole of the relevant asset at the time of the discharge or expiry of that right. The apportionment formula in subsection 112-30(3) has no application. The seller may make a capital loss in both discharge and expiry cases if those capital proceeds are less than the reduced cost base of each separate right.

41. TR 2007/D10 did not consider the possibility that a payment could be made under an earnout right without part of the right ending. However, if an earnout right has an indefinite term or is indefinite in nature it may be difficult to determine whether part of the right has ended. If a payment does not result in the whole or part of an earnout right ending, then CGT event H2 should happen under section 104-155 and the cost base and reduced cost base of the earnout right would remain the same.

42. Even where a payment does not result in the whole or part of an earnout right ending, the cost base or reduced cost base of the earnout right would only be taken into account when there is either a disposal of the earnout right or the earnout right expires.

The anti-overlap provision

43. As noted in paragraph 9 of this discussion paper, TR 2007/D10 did not deal with the possibility that payments under an earnout right may be assessable as ordinary income under section 6-5.[27] If a payment which is assessable as ordinary income also forms part of the capital proceeds for a CGT event C2 or CGT event H2, a capital gain from the event is reduced under the general anti-overlap rule in section 118-20 to the extent that the payment is included in their assessable income. However, a capital gain under CGT event C2 can only be reduced to zero and cannot result in a capital loss. In addition, because section 118-20 reduces capital gains but not capital proceeds, a capital loss under CGT event C2 cannot be created or increased where ordinary income is also included in the capital proceeds.

The valuation issue

44. The Commissioner recognises that there are compliance costs for the seller in obtaining valuation of the earnout rights in order to set the cost base of the earnout right for the purpose of calculating any subsequent gain or loss under CGT event C2.

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[27] This is possible. For example, in *Ivanac v. Deputy Federal Commissioner of Taxation* 95 ATC 4683, Lee J of the Federal Court applied *Cliffs International* and held that the receipt of a royalty payment was not part of the capital purchase price for the sale of the tenements. Further, a capital sum directed to be paid by way of a royalty would bear the character of income in the hands of the recipient. Another example is *Egerton-Warburton v. DFCT* (1934) 51 CLR 568 where it was held that payments under an annuity granted in consideration for the acquisition of capital assets were ordinary income in the hands of the recipient.

45. The Commissioner is committed to working with taxpayers to develop and implement, where possible, administrative guidance that may reduce compliance costs associated with valuation. The Commissioner is currently undertaking a scoping process alongside this discussion paper to better understand the valuation issues relevant to taxpayers.

Consultation 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?

Creating the earnout right

46. Section 104-35 provides that, in general, CGT event D1 happens if you create a contractual right or other legal or equitable right in another entity. An earnout right is a contractual right for these purposes.

47. For the grantor (that is,. the buyer), CGT event D1 may happen when the earnout arrangement is entered into as this is the time when the right is created. The buyer will make a capital gain to the extent that any money received or the market value of any property received in respect of creating the right are more than the incidental costs incurred that relate to the event.

48. TR 2007/D10 stated at paragraph 26 that CGT event D1 does not happen as a result of the creation of an earnout right by the buyer in the seller. The draft ruling stated[28] that this is because the composite phrase 'borrowing money or obtaining credit from another entity' in the exception in paragraph 104-35(5)(a) should be given a broad interpretation in the context of CGT event D1. The creator of the right comes under a reciprocal obligation to provide financial benefits if the contingency is satisfied. This will be the case notwithstanding that no financial benefit may ultimately become payable because of the failure of a contingency.[29] Paragraph 104-35(5)(a) reflects former section 160MA of the ITAA 1936, which provided that the creation of a "*debt* by borrowing money or obtaining credit from another person" is not a disposal for CGT purposes. In addition, *Marren v. Ingles* [1980] 3 All ER 95 is authority for the proposition that a contingent right (which might never be realised) to receive an unascertainable amount of money at an unknown date is not a 'debt'.[30]

49. The Commissioner is reviewing whether the above position in TR 2007/D10 remains correct or whether it can apply to a broader range of earnout arrangements than were contemplated in that draft ruling. It is contemplated that this position may not be correct in all cases, for example where the earnout arrangement is not a form of finance for the buyer.

Consultation 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'?

[28] TR 2007/D10 at paragraphs 142 to 147.
[29] See discussion on TOFA for the interaction with debt/equity analysis under Division 974.
[30] Lord Wilberforce at 98 (Lord Salmon and Viscount Dilhorne concurring) and Lord Fraser of Tullybelton at 101 (Lord Russell of Killowen concurring). See also *Strategic Finance Ltd (in rec and in liq) v. Bridgman* [2013] 3 NZLR 650 at 667.

Granting a right to income from mining

50. Section 104-45 provides that CGT event D3 happens if a taxpayer owns a prospecting or mining entitlement, or an interest in one, and grants another entity a right to receive ordinary or statutory income from operations allowed to be carried on by the entitlement.

51. Unlike CGT event D1, CGT event D3 does not contain a list of exceptions.

52. If CGT event D3 happens, it will apply in preference to CGT event D1.[31] The buyer will make a capital gain to the extent that the money received or the market value of the property received exceeds the expenditure incurred in granting the right.

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

Earnout arrangements in respect of Division 40 depreciating assets

53. As noted above, TR 2007/D10 adopted the separate asset approach in relation to earnout arrangements for CGT purposes. Similarly, TR 2008/5 adopts the separate asset approach in relation to the issue of shares for CGT and Division 40 purposes.

54. Consistent with the approach in TR 2007/D10 and TR 2008/5, it may be argued that when a Division 40 depreciating asset is sold in consideration for the grant of an earnout right, the earnout right constitutes a non-cash benefit and its market value is included in the termination value of the depreciating asset for the seller and the Division 40 cost of the depreciating asset for the buyer.

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

Taxation of financial arrangements (TOFA) and earnout arrangements

Division 974 equity interest

55. An earnout arrangement will be an equity interest if the arrangement satisfies the equity test and is not a debt interest. The equity test would be satisfied under section 974-75 where:

- the earnout arrangement constitutes a *financing arrangement* of the buyer under section 974-130[32], and
- (relevantly) the earnout right carries a right to a variable or fixed return from the company where the right itself, or the amount of the return, is in substance or effect '*contingent on aspects of the economic performance*' of the company or a part of the company's activities.[33]

56. If the grant of earnout rights is characterised as an equity interest, this will have relevance for a wide range of provisions under the *Income Tax Assessment Act 1997*. One consequence of this will be that any earnout payment would constitute an expenditure that is a return on an equity interest and denied a deduction under section 26-26 (but may be a frankable distribution[34]). As can be seen in the following, another consequence of an earnout being an equity interest is that Division 230 cannot apply to the earnout.

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[31] Section 102-25.
[32] Subsection 974-75(2).
[33] Subsection 974-75(1) table item 2. The other items in that table would generally not be relevant to an earnout right.
[34] Subsection 202-40(2).

Financing arrangement

57. Broadly, a financing arrangement is a scheme that is entered into or undertaken to raise finance for an entity or to fund dealings with a scheme to raise finance for an entity.[35]

58. Most of the earnout arrangements that the Commissioner is aware of appear to be used to manage economic exposure to the business rather than as a form of vendor finance. However, this will always depend on the specific facts and circumstances.

Consultation 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?

Contingent on aspects of the economic performance

59. For a right to a payment, or the amount of a payment, under an earnout right to be regarded as 'contingent on aspects of the economic performance', the right or amount must be linked to a reasonable measure of this performance in the context of the relevant entity or activity.[36] A clear example of a right or amount being contingent on economic performance would be where it is contingent on profits.[37]

60. In addition, it is necessary to consider whether the right or amount may be excluded from the scope of the statutory definition of 'contingent on aspects of the economic performance' on the basis that it is contingent solely on receipts or turnover. This should only have practical significance where turnover or receipts would (depending on the facts and circumstances) be regarded as a reasonable measure of economic performance. In that case, the statutory definition in subsection 974-85(1) modifies the ordinary meaning of 'contingent on economic performance'.[38]

61. The Explanatory Memorandum to the New Business Tax System (Debt and Equity) Bill 2001 (which inserted section 974-85) notes that turnover rent would be an example of a contingency based solely on receipts or turnover.[39] Where payments under an earnout right are contingent on turnover or receipts of a business, it will be necessary to closely examine the specific facts and circumstances of the earnout right to determine if turnover or receipts is the *sole* contingency.

62. For example, if an earnout is contingent on both the amount of turnover or receipts *and* something else like the level of turnover or receipts or a minimum price being charged, turnover or receipts may not be the *sole* contingency. Even if turnover or receipts is not the sole contingency, it will still be necessary to determine if the contingencies as a whole are a reasonable measure of the economic performance of the relevant entity or activity.

Division 230 financial arrangement

63. For taxpayers who are subject to Division 230 (either because of their financial value or because they have elected for Division 230 to apply to their financial arrangements), it will first be necessary to determine where an earnout right (or corresponding obligation) is a 'financial arrangement' as defined in section 230-45. This may be the case where the earnout arrangement does not include non-cash settlable rights or obligations that are more than insignificant and the

[35] Subsection 974-130(1).
[36] Refer paragraph 1.52 of the 2015 EM. Although that Bill relates to the look-through earnout right provisions in Subdivision 118-I (and is not in the context of the debt/equity rules in Division 974), the 2015 EM does provide some guidance on the ordinary meaning of 'contingent on economic performance'.
[37] Example 2.7 in the Explanatory Memorandum to the New Business Tax System (Debt and Equity) Bill 2001 (2001 EM).
[38] Paragraph 1.141 of the 2015 EM.
[39] Paragraph 2.32 of the 2001 EM. Although note that paragraph 1.53 of the 2015 EM indicates that sale or turnover of a business may be an appropriate measure of economic performance in the context of some businesses or assets.

earnout right is not an equity interest.[40] If the earnout arrangement imposes obligations on the buyer which are not cash-settlable (for example, obligations in relation to the operation of the relevant business) and that obligation is considered to be more than insignificant, the earnout arrangement would not be a 'financial arrangement' as defined in section 230-45.

64. Even if an earnout right is a section 230-45 financial arrangement, subsection 230-460(13) identifies those earnouts to which Division 230 will not apply. Division 230 will not apply where the amounts, or the values, of the financial benefits are:

- only 'contingent on aspects of the economic performance' of the business, as that term is defined in section 974-85 (if the earnout right is a look-through earnout right created on or after 24 April 2015)[41], or
- contingent only on the economic performance of the business (if the earnout right is not a look-through earnout right created on or after 24 April 2015).

65. The discussion of subsection 974-85(1) in paragraphs 55 to 62 of this discussion paper (in the context of whether an earnout right may be an equity interest) is therefore also relevant for the application of subsection 230-460(13). Although the scope of the amendment to subsection 230-460(13) is unclear[42], the amendment should only make a difference to determining the application of Division 230 to an earnout arrangement where it can be established that the right to a payment, or the amount of a payment, under an earnout right is *solely* contingent on receipts or turnover. As noted above, this will require a close examination of the terms of the arrangement. If the amendment applies to such an earnout arrangement and the earnout arrangement is a section 230-45 financial arrangement, gains and losses under the earnout arrangement may be recognised under Division 230.

66. The Commissioner expects that subsection 230-460(13) would generally operate to exclude most earnout arrangements from Division 230.

Consultation 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?

Consultation 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?

[40] If the earnout right is both a financial arrangement as defined in subsection 230-45(1) and an equity interest covered by subsection 230-50(1), it will be regarded as a financial arrangement under section 230-50 for the purposes of Division 230, which may limit the extent to which any gains or losses from the earnout right are recognised under Division 230 (see TD 2011/12 *Income tax: where an equity interest is a financial arrangement which satisfies both subsections 230-45(1) and 230-50(1) of the Income Tax Assessment Act 1997, which provision applies?*).

[41] See the application provision in section 3 and item 4 of Schedule 1 to the *Tax and Superannuation Laws Amendment (2015 Measure No. 6) Act 2016*. Notwithstanding the literal wording of the application provision, it is not clear whether the amendment was intended to be limited only to look-through earnout rights such that the former version of subsection 230-460(13) continues to apply to all other types of earnout rights.

[42] Refer to footnote 41.

References

ATOlaw topic(s)	Income tax ~~ Assessable income ~~ Ordinary income Income tax ~~ Capital allowances ~~ Business related costs Income tax ~~ Capital gains tax ~~ Capital proceeds Income tax ~~ Capital gains tax ~~ CGT assets Income tax ~~ Capital gains tax ~~ CGT events ~~ CGT events - general Income tax ~~ Capital gains tax ~~ CGT events ~~ CGT event C1 to C3 - end of a CGT asset Income tax ~~ Capital gains tax ~~ CGT events ~~ CGT event D1 to D4 - bringing into existence a CGT asset Income tax ~~ Capital gains tax ~~ CGT events ~~ CGT event H1 and H2 - special capital receipts Income tax ~~ Capital gains tax ~~ cost base and reduced cost base Income tax ~~ Capital gains tax ~~ Earnout arrangements ~~ Look-through CGT treatment - post 24 April 2015 Income tax ~~ Capital gains tax ~~ Earnout arrangements ~~ Other Income tax ~~ Capital gains tax ~~ Valuation / market value issues Income tax ~~ Debt equity rules ~~ Application of Division 974 ~~ Financing arrangement Income tax ~~ Deductions ~~ Black hole expenditure - section 40-880 Income tax ~~ Deductions ~~ General deductions - section 8-1 ~~ Capital vs revenue expenditure
Legislative references:	ITAA 1997 ITAA 1997 6-5 ITAA 1997 8-1 ITAA 1997 26-26 ITAA 1997 Div 40 ITAA 1997 40-880 ITAA 1997 40-880(5)(d) ITAA 1997 40-880(9)(b) ITAA 1997 102-25 ITAA 1997 104-25 ITAA 1997 104-35 ITAA 1997 104-35(5)(a) ITAA 1997 104-45 ITAA 1997 104-155 ITAA 1997 110-25 ITAA 1997 110-25(2) ITAA 1997 112-30(1) ITAA 1997 112-30(3) ITAA 1997 112-30(4) ITAA 1997 112-30(5) ITAA 1997 Subdiv 118-I ITAA 1997 118-20 ITAA 1997 202-40(2) ITAA 1997 Div 230 ITAA 1997 230-45 ITAA 1997 230-45(1) ITAA 1997 230-50 ITAA 1997 230-50(1) ITAA 1997 230-460(13) ITAA 1997 Div 974 ITAA 1997 974-75 ITAA 1997 974-75(1) ITAA 1997 974-85 ITAA 1997 974-85(1) ITAA 1997 974-130 ITAA 1997 974-130(1) ITAA 1936 ITAA 1936 (former) 160MA ITAA 1936 (former) 160ZH(4)

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Case references:	Cliffs International Inc v. FCT 77 ATC 4217 Cliffs International Inc v. FCT (1979) 79 ATC 4059 Colonial Mutual Life Assurance Society Ltd v. FCT (1953) 89 CLR 428 Egerton-Warburton v. DFCT (1934) 51 CLR 568 FC of T v. Guy 96 ATC 4520; (1996) 32 ATR 590 Federal Commissioner of Taxation v. Cliffs International Inc 77 ATC 4564 Ivanac v. Deputy Federal Commissioner of Taxation 95 ATC 4683 Marren v. Ingles [1980] 3 All ER 95 Sharpcan Pty Ltd and Commissioner of Taxation [2017] AATA 2948 SPI Powernet Pty Ltd v. FC of T [2014] FCAFC 36 Strategic Finance Ltd (in rec and in liq) v. Bridgman [2013] 3 NZLR 650 Zim Properties Ltd v. Proctor (Inspector of Taxes) (1984) 129 Sol Jo 68; 58 TC 371
Other references:	TR 93/15 TR 95/35 TR 1999/19 TR 2008/5 TR 2011/6 TR 2007/D10 TR 2008/D1 TD 93/86 TD 2011/12 Explanatory Memorandum to the New Business Tax System (Debt and Equity) Bill 2001 Explanatory Memorandum to the Tax and Superannuation Laws Amendment (2015 Measures No. 6) Bill 2015
ATO references:	1-FETH33G
BSL	TCN