Clough Limited v Commissioner of Taxation -

Decision impact statement

Clough Limited v Commissioner of Taxation

Court citation(s):	[2021] FCAFC 197
Venue:	Federal Court of Australia
Venue reference no:	WAD 60 of 2021
Judge:	Kenny, Davies and Thawley JJ
Judgment date:	12 November 2021
Appeals on foot:	No
Decision outcome:	Favourable to the Commissioner

Impacted advice

This decision has no impact on any related advice or guidance.

Précis

This Decision impact statement outlines the ATO's response to this case which concerns whether the payments made for cancellation of certain options and performance rights held by employees in the context of a corporate takeover by a major shareholder were deductible under section 8-1 of the *Income Tax Assessment Act 1997*.

All legislative references in this Decision impact statement are to the *Income Tax Assessment Act 1997*.

Brief summary of facts

Clough Limited (Clough) is in the business of providing engineering and construction services to the mining, energy and infrastructure industries in Australia and Papua New Guinea. Clough had an entitlement and retention policy to incentivise its employees under an employee option plan and employee incentive scheme.

Prior to its takeover, Clough was listed on the Australian Securities Exchange (ASX). It was 61.6%-owned by Murray & Roberts Limited (M&R), a wholly-owned subsidiary of South African-listed company Murray & Roberts Holdings, being the head company of the Murray & Roberts Group.

In August 2013, the two entities in the Murray & Roberts Group and Clough entered into a Scheme Implementation Arrangement (SIA) under which M&R would acquire the remaining shares in Clough. As a condition precedent to the SIA, Clough made offers to buy out the various unvested options and performance rights held by its employees. The offers were conditional on the SIA becoming effective. If this had not occurred, under the plan rules, the change of control provisions would have applied. The unvested rights would have vested and M&R would likely have had to acquire shares from the employees. While those rights could have been ‘cashed out’ at Clough’s election, this required specific additional steps, and these were not done.

Importantly, the offers made to the employees to cancel their unvested options were not made in compliance with the terms of the employee remuneration plans. Unlike

under the plan, it was not a requirement of the cancellation payment that the employee remain employed by Clough post-acquisition by M&R.

The SIA was implemented on 11 December 2013 and Clough made payments to employees for cancellation of their respective options and performance rights on the same day. Clough was subsequently delisted from the ASX on 12 December 2013.

Clough's deemed assessment in respect of the 2013–2014 income year treated the payments as non-deductible. Clough objected to the deemed assessment on the basis that it was entitled to deduct the payments made for the cancellation of options and rights issued under option and incentive schemes, totalling $15,050,487. The Commissioner disallowed the objection. Clough subsequently appealed.

The primary judge, Colvin J, dismissed the appeal, concluding that on the evidence before him the amounts were not paid with a view to Clough gaining or producing assessable income but to satisfy a requirement of a takeover bid. On appeal, the Full Federal Court agreed that Colvin J had not been in error in so holding, and also that the amounts were in any event on capital account.

Issues decided by the Court

The judgment of the Federal Court at first instance

At first instance[1], Colvin J held at [112–113] that the payments were made to facilitate the takeover of Clough by M&R, not in gaining or producing income nor necessarily incurred in the course of carrying on a business carried on for that purpose. In concluding that the payments did not fall within the positive limbs of section 8-1, Colvin J did not reach a view about whether the payments would have been excluded as being outgoings of capital by reason of paragraph 8-1(2)(a).

The judgment of the Full Federal Court on appeal

On appeal[2], the Court unanimously held at [18] that although:

> … the payments were made both to facilitate a change in control and … to honour legal or commercial obligations [owed to employees]… in a practical business sense, the payments are better characterised as payments made pursuant to an agreement to secure a change in control rather than as meeting employee entitlements on a change of control.

That is:

> … The payments were made to effect a reorganisation of the capital structure of Clough, through a takeover by Murray & Roberts and the delisting of Clough from the ASX.

This dual nature is recognised at [74]. However, the proper character of the payments '…were not incurred in gaining or producing assessable income on the basis that the occasion of them lay in the takeover and not in gaining or producing assessable income', as was said at [85]. In addition, [86] states that the payments were not in the nature of a working expense in the carrying on of Clough's business and were not payments by way of reward to the employees, but were part of the activity required to acquire the minority shareholding under the SIA as a necessary step to secure 100% control and the delisting of Clough.

As a result, the payments did not satisfy either positive limb. In addition, the Court also found that as a whole, the payments were on capital account. The Court held

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[1] *Clough Limited v Commissioner of Taxation* [2021] FCA 108.
[2] *Clough Limited v Commissioner of Taxation* [2021] FCAFC 197.

that the payments were made for an enduring change and they were not in the nature of an ordinary working expense.

This same rationale, to complete the takeover of any minority interests, was also the basis on which the payments were on capital account under subsection 8-1(2) at [91–93], and were predominantly connected with facilitating a change in the underlying shareholding of the company – see [123].

Importantly, at [69] the Court noted that:

> Characterising expenditure from a practical and business perspective, having regard to the legal nature of the various rights created, used or brought to an end by that expenditure, requires regard to be had to the whole commercial context.

In addition, at [70] the Court noted that:

> The question of characterisation must be approached from the perspective of the person incurring the outgoing. An inquiry into the character of the receipt of the outgoing in the hands of the recipient at best distracts attention from the critical task of characterisation.

ATO view of decision

The decision is an application of well-settled principles to the facts before the Court. It is consistent with the reasoning of the Commissioner in Taxation Ruling IT 2656 *Income tax: deductibility of takeover defence costs*.

The Commissioner observes that whether a payment for the cancellation of employee entitlements in the context of a merger or acquisition event is deductible under section 8-1 is fact and circumstance-specific. Nonetheless, the decision in Clough provides authority for the characterisation of the outgoings in similar arrangements.

Note: Prior to the Federal Court hearing, the Commissioner had conceded that section 40-880 applied to the amounts made by Clough; the orders of the Court merely give effect to this concession. The operation of section 40-880 was not considered by the Court. The Commissioner's view of the nexus requirement of section 40-880 may be found in Taxation Ruling TR 2011/6 *Income tax: business related capital expenditure – section 40-880 of the Income Tax Assessment Act 1997 core issues*, namely that it is broader than that found in section 8-1. The Commissioner's view is that this concession, made after consideration of additional facts received after the objection decision was made, showed that the nexus requirement was satisfied in accordance with TR 2011/6.

Comments

We invite you to advise us if you feel this decision has consequences we have not identified. Please forward your comments to the contact officer.

Date issued:	10 March 2022
Due date:	8 April 2022
Contact officer:	Contact officer details have been removed as the comments period has expired.

Amendment history

Date	Part	Comment
15 March 2022	Note in 'ATO view of decision'	Third sentence of the note updated to reference the nexus requirement of section 40-880.

Legislative references

ITAA 1997 8-1
ITAA 1997 8-1(2)
ITAA 1997 8-1(2)(a)
ITAA 1997 40-880
ITAA 1997 40-880(2)(a)

Case references

Clough Limited v Commissioner of Taxation [2021] FCA 108; 2021 ATC 20-779; (2021) 112 ATR 752

Other references

IT 2656
TR 2011/6